

Sida's Experience in Microfinance



MAKING FINANCIAL MARKETS WORK FOR THE POOR



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Summary

This is the report of a review of Sida's Microfinance/Rural finance (MF/RF) contributions in light of the "best practice" principles arrived at as part of the Sida/INEC MF Policy Project.

During the last few years, donor policies (but less so donor practice) on MF/RF have converged in support of what are often referred to as the "best practice" principles strongly promoted by the Consultative Group to Assist the Poorest (CGAP). Concerns about sustainability outreach (number of clients reached) and client benefits underpin these principles. These concerns can be addressed by building commercially viable MF/RF institutions that provide a range of demand-driven services and operate without subsidies, which is a prerequisite for sustainability. Commercial viability is generally also a precondition for access to commercial capital and savings deposits. This in turn is a precondition for a scale of operation that makes a difference. Efficiency will increase client benefits. It is not uncommon that the lending of one dollar by an inefficient MF/RF institution costs as much or more.

Sida's MF/RF interventions in light of "best practice" offer a diverse picture. While there has been a clear move towards "best practice" since the employment of the MF advisor, its application has been ad hoc and circumstantial. The "best practice" approach is reflected in more of a (financial) systems perspective and in the increase in support for building viable MF/RF institutions. The application of "best practice" principles is less evident in projects where credit is a component.

Support for MF/RF development raises unresolved distributive problems. The programmes of support entail a transfer of funds, either in the form of a loan or, more generally, a grant. The funds can be very substantial (> 50 MSEK in housing projects). The issue is *who will become the owners of such funds and who will control them*. In the housing projects, trusts have been established and made owners of the funds. A (substantial) trust of this type is clearly exposed to the risk of intrusion by powerful groups, particularly in contexts of corruption and weak law enforcement. Another favoured approach hitherto has been to provide support for NGOs to enable them to become viable MF/RF institutions. Few questions seem to have been raised about whom these NGOs represent and to whom their management is accountable. Furthermore, the transformation of a MF/RF NGO into a regulated MFI (private profit-seeking busi-

ness) leads to windfall gains for private investors and implies a risk for mission drift.

Another related policy issue is whether it is the *role of Sida* to develop commercial enterprises (e.g. in the field of MF/RF) apart from providing support to strengthen an enabling environment.

“Best practice” promoters (e.g. CGAP) tend to emphasise that donors should see themselves as investors in MF/RF business development. This may not be a fully appropriate argument; if MF/RF were a business proposition, it would not need substantial subsidies, which suggests that rate of return expectations cannot be set in business terms. However, other considerations *cannot* be relaxed when a business investment is made. The reason is that the objective is to develop a business enterprise and *that requires a businesslike approach by someone supporting the process in order that it succeeds*. There is a need for a business partner, not a development partner. This is more important when the organisation in receipt of support does not have business experience and a business culture.

Questions prompted by this line of argument include whether Sida can take on the role of business partner, whether it is likely that Sida can acquire adequate in-house capacity and capability to fulfil this role or whether the task should be outsourced (to SWEDFUND, SCC or another institution).

More than half of Sida’s MF/RF portfolio (in monetary terms) comprises projects in which finance (credit) is a *component* (RD and housing projects). The rationale for the component is that it will increase the number of people who will benefit in terms of the focus of the project (e.g. improved housing). The review suggests that it is normally difficult to find commercially viable MF/RF institutions interested in providing this service (implementing a credit component). All component projects reviewed operate through non-viable (financially unsustainable) institutions. None of the projects has the objective of making these institutions viable. The consequences of operating through such institutions are:

- 1) that client benefits are reduced;
- 2) that a continuous subsidy will be required to compensate for inflation and coverage of operational costs not covered by revenue if the loan capital is not to be eroded and eventually lost;
- 3) that the service (providing credit) is unlikely to be sustainable within the framework of a time-bound project;
- 4) that subsidies and provision of capital for lending tend to become disincentives for performance improvements, and
- 5) that subsidising inefficient MF/RF institutions can distort the market and make the development of viable institutions more difficult.

These consequences can be seen as costs and these costs will be higher the less efficient the MF/RF institution in question is. The costs are likely to be particularly high in remote and low potential areas.

In summary, the analysis poses the following questions of a policy nature:

- Are the “best practice” principles the preferred approach to MF/RF development?

- Is it agreed that the distributive implications of support to MF/RF are an important issue, and if so, what are the implications for Sida?
- Is it the role of Sida to support the development of commercial business entities (other than providing support to an enabling environment)?
- If the answer is no, what aspects of MF/RF development could Sida support?
- If the answer is yes, can Sida engage/provide the technical skills and capacity to implement a “best practice” approach?
- Under what assumptions is a “credit component” approach acceptable?

Options and pros and cons related to these questions are identified and discussed in the main text.

The bottom-line question is whether Sida should involve itself in MF/RF development at all.

1 Introduction

1.1 This review as part of the MF/RF policy project

The review of Sida's experience of Microfinance/Rural finance (MF/RF) interventions and the issues that this experience raises that are presented in this report is part of Sida/INEC's MF Policy Project.

The objective of this project is to *improve the quality of Sida's support to the development and expansion of sustainable micro and rural finance services to the poor.*

Other components of the project include an inventory that provides basic facts on Sida's MF/RF portfolio, in-depth studies of rural finance and housing finance, the development of training modules and training material, as well as a "tool-box" for MF/RF operations. As the project has evolved, reasons to consider a deeper analysis of the relevance and impact of MF/RF interventions have emerged. Furthermore, as a consequence of the outcome of the policy formulation process there may be reasons to define a strategy on how to restructure the MF/RF portfolio to be more in line with the adopted policy.

Note should also be taken of the CGAP Peer Review of Sida's organisation and operational approach to MF/RF undertaken in May (2002). Whereas that review was not originally planned as part of the Policy Project, it will serve as an important input in the policy discussions. A summary of the CGAP Peer Review recommendations is provided in annex 2.

This report is expected to be the main document on which discussions on a MF/RF policy framework for Sida will be based. This has influenced the presentation. As policy formulation should be the task of stakeholders in Sida, I have avoided making single point recommendations. I try rather to identify important issues, problematise them and suggest different ways of looking at them as a basis for discussion.

1.2 The purpose of the review and methodology

In the ToR, the purpose of this review focuses on Sida's approach to RF/MF in light of the current understanding of "sound donor practice" as reflected in the so-called Pink Book, published by CGAP and CGAP's work in general. In this sense the focus is strategic and principled in nature but it has also an element of operational aspects. (See excerpts of the ToR in annex 1).

In the course of the work on the review, it soon became clear that a number of underlying issues with direct and operational implications for Sida's work in the field of MF/RF demanded attention. In discussions with the MF Policy Project Team it was agreed to widen the scope of the analysis to include such issues, and, in fact, the main part of this report is devoted to a discussion of them.

The widening of the scope of the analysis reflects a recognition that MF/RF as a development topic is more complex and has wider implications than anyone of us foresaw at the outset. The distributive implication of supporting MF/RF development and the role and capacity of Sida in providing such support are fields in which important issues emerged.

The review centred on 15 MF/RF projects chosen (by the MF Policy Project Team) to represent Sida's MF/RF portfolio. (A list of the projects is given in appendix 3). In addition, non-project specific information on Sida's support to MF/RF was to be gathered through discussions with staff, including management staff. (A list of persons interviewed is given in appendix 4).

I have gone through project documents/business plans, "appraisal" reports (not always made), assessment memos, specific agreements, and evaluation reports (made only for a few projects) for the different projects. Interviews were made with desk officers in charge of the projects, including desk officers overseas (telephone interviews) and consultants and project staff (telephone interviews and e-mail). Interviews were also made with management staff at INEC and NATUR.

It should be noted that the review is not an evaluation of the projects but was to serve as a source for discussing how Sida is – and should be – operating in the field of MF/RF.

1.3 The structure of the report

The report is divided into four parts. **chapter 1** contains the standard introductory sections on background, methodology, etc.

Chapter 2 attempts to provide a wider context for a Sida MF/RF policy discussion. The concepts MF and RF are defined and the relevance of MF/RF for poverty alleviation is discussed. Finally, the global experience of MF/RF, including the change in development paradigm for MF/RF, and the "best practice" principles embedded in this change are reviewed.

In **chapter 3** of the report, Sida's interventions in the field of MF/RF are summarised.

Chapter 4 is the central piece of the report. Here a number of what seem to be key policy issues arising from the experience of supporting MF/RF development and arising from Sida's general policy framework are identified and problematised. Pros and cons of alternative positions on these policy issues are given as a basis for discussion.

The report contains a number of annexes most of which are the standard ones (ToR, etc.). In addition one annex summarises the (global) evolution of interest in MF and one annex presents the "best practice" principles in some detail.

2 Setting the context

2.1 Policy formulation by other donors

Several donors have attempted to formulate policies or strategies for MF/RF development. A review of such documents for the Asian Development Bank, the Inter-American Bank, the African Development Bank, IFAD and DFID (DFID does not have a fully-fledged policy or strategy) suggests the following.

There is a convergence towards the “best practice” principles advocated by CGAP. In brief these principles emphasise the formation of commercially viable MF/RF institutions, which is claimed to be a pre-condition for sustainability, significant outreach and lower cost of service provision.¹ All documents prescribe support to the policy and regulatory framework for MF/RF and emphasise support to institution building of service providers.

However, the documents are notably vague when it comes to suggest what such broad policy directions may imply. Several of the difficult issues, which will be discussed in this review, do not appear in any of the above-mentioned documents. Among these issues are the distributive implications of support to operations that are intended to become commercial, how projects in which MF/RF is a component are to be reconciled with “best practice” principles, and capacity and capability demands on the agencies providing support.

Should Sida make progress on these issues in formulating a MF/RF policy, it would seem to be a matter of breaking new ground.

2.2 What is micro finance and what is rural finance?

It is interesting that something that is talked about so much as MF hardly has one agreed meaning. In a mini-workshop arranged by the Peer Review Team at Sida (May 2002), the meaning of MF was phrased in almost as many ways as there were participants when they were asked to give their understanding of the concept. Such a broad interpretation is indeed not confined to Sida.

In the (MF/RF) Policy Project document, MF is defined as *financial services to all those who do not have access to basic financial services such as saving and credit in the formal financial system*. Implicitly, MF has a poverty focus and it is a matter of providing not one financial service (credit) but a wider

range of services. Historically, MF has a strong urban focus but has sprung from attempts to improve rural finance schemes in contexts where they have been most successful such as Bangladesh and Indonesia.

Likewise, rural finance (RF) is also given divergent meanings. Some would think narrowly of services to farmers, whereas others would include financial services for (large-scale) agro-business, post-harvest trading, rural infrastructure, etc.

For Sida the former understanding of RF seems more relevant. As a working definition in this report RF will be understood to mean *financial services for on-farm and off-farm activities as well as for small rural entrepreneurs having limited or no access to the formal financial system*.

One does not need to be an observant reader to see that the two definitions overlap. From a basic definition it seems to be a matter of identifying different target groups or market segments with different service needs. In the following the acronym MF/RF will be used to embrace the two.

2.3 The relevance of MF/RS as a development instrument for poverty alleviation

An assessment of the relevance of MF/RF as a development instrument for poverty alleviation can be made at different levels. One macro-level argument in support of financial services is that such services will contribute to more efficient resource allocation, which in turn will contribute to growth, and overall growth will generally contribute to poverty alleviation (even if pro-poor growth will contribute more).

At the micro level it is generally argued that MF/RF will

- make it possible to capture investment and market opportunities;
- permit income smoothing (through savings) thereby reducing vulnerability;
- reduce dependence upon exploitative and/or unreliable financial service providers (money lenders, input suppliers, market agents, etc);
- empower individuals, including women;
- increase competition and push down interest rates on the informal market.

The strength of these arguments needs to be seen in light of the fact that the demand for financial services is by nature a *derived demand*. This means that the services themselves are of no value. It is what can be achieved with the services that matters. No one borrows money for the fun of it, but for using the money for something (that may be fun).

This is to say that the effects of financial services are always *conditional*.

Credit or savings for investment will only improve the livelihood of poor people if there are profitable investment opportunities generating surpluses (deducting costs for the services). Particularly in rural areas this is often *not* the case. The causes may be many (including a poor macro-policy framework, inaccessible markets, low market prices, inappropriate production technologies, limited tenure security, limited know-how and entrepreneurial skills, etc. etc.). In other words, capital may not be the binding constraint. Other constraints may be more important and should then be addressed first, or at least at the same time.

Capital may not be a binding constraint for other reasons as well. The investor/consumer may have access to other sources of financial services that are acceptable to him/her. The poor rely almost exclusively on the informal finance sector, which is generally described as exploitative and often said to consist of unscrupulous, merciless actors who lure poor people into indebtedness, robbing them of their property, bonding their labour and depriving them of their dignity. As often is the case, reality is less black and white than that. There are indeed situations when the informal sector has these characteristics. However, as often it is not the case. To start with, some 50% of the informal finance sector for credit typically consists of relatives and friends who generally do not demand any interest. Furthermore, interest rates charged by sustainable MFIs are not necessarily dramatically lower than the rates charged by informal actors simply reflecting the fact that covering transaction costs and risk is expensive.

It is less often discussed that the informal sector generally cannot offer deposit services and time finance demanded by poor people. The interest shown in deposit services by poor people, once offered, suggests that there is an unmet demand. Provision of such services would permit (better, safer) income smoothing and reduce vulnerability.

To the extent that poor people are exploited in the informal finance sector and tied to a particular actor, the provision of an MF/RF-service may reduce dependence and empower people. As women engage in financial markets, it may also provide new opportunities for them to influence and take decisions on consumption and investments. One of the more impressive achievements of the Grameen Bank relates to these aspects, for instance.

So far there is little evidence that the mushrooming of organisations providing MF services has reduced interest rates on the informal finance markets. One guess would be that their market share simply is too small to make much of a difference.

So, where do all these arguments lead us?

Well, firstly it seems safe to conclude that we generally need to take a thorough and broad view on the development context and the existing (informal) finance sector for the poor *before* we can conclude whether an (MF/RF) intervention in a particular context is relevant or not.

Secondly, it may be possible to assess the relevance of MF/RF services from two perspectives.

From the first perspective it can be argued that all poor people save and borrow irrespective of the prospects for a lasting improvement of their livelihoods. They make use of (informal) financial service providers and they are often prepared to pay even a very high price for these services. So, those making use of the services apparently seem to consider them relevant.

Secondly, relevance can be discussed with a different perspective focusing on a development intervention as a means to contribute to a reduction of vulnerability and a removal of constraints and creation of opportunities for poor people to prosper. Implied in “prosper” is the ambition to improve livelihoods in a sustainable manner. The task is then to identify the interventions through which this process can best be promoted. It is not a matter of finding an optimal selection and sequencing

but a credible one. Assessing not only the financial service constraint but also *other constraints* without a pre-determined preference for any of them could then be a way of assessing the relevance of MF/RF-interventions.

The discussion so far has excluded any consideration of cost-effectiveness of MF/RF interventions and possible opportunity costs involved. We will return to the relevance issue later, when these additional aspects are discussed.

2.4 Present global experience, focus and direction of MF/RF in brief

In 1995 the international donor community adopted a set of principles on micro and small enterprise finance developed jointly by the Donors' Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. Sida was party to these developments. The principles were published in a booklet with a pink cover, which has since been referred to as the Pink Book. Since its formation in 1997, the Consultative Group to Assist the Poorest (CGAP) has been the key promoter of these principles. **The principles in the "Pink Book" are often referred to as the foundation of "best international practice"**. A more detailed presentation of the principles is given in appendix 5.

2.4.1 A change in paradigm for MF/RF development

It is fair to say that the principles in the "Pink Book" manifest a definite shift of paradigm for the development of MF/RF as can be seen from the following comparison.

Best practice principles	Conventional approach
Demand driven	Supply driven
Provide services	Provide an input
A range of financial services	Generally credit only
Non-targeted on purpose and geographically	Targeted on purpose and geographically
Prime focus on institution building	Prime focus on credit delivery
Sustainability on market terms	Continuous subsidies required

While reflecting a (financial) systems approach, the development of service providers is subject to specific attention in the "best practice" debate. Therefore, the key principles in "best practice" centre on the development of regulated financially sustainable MFIs (Microfinance Institutions) that provide a range of financial services, including savings, to poor clients. From these basic principles follow a number of requirements related to pricing policies, portfolio quality, managerial efficiency, capital structure, etc. *Together these requirements demand an operation that is run on commercial terms.* This means that MF/RF is to be seen as a business proposition. Subsidies are acceptable but only in a build up phase until break-even has been reached. Subsidies should decrease over time.

There are three inter-related considerations, which seems to justify this shift of paradigm, namely:

- **Sustainability** can only be achieved if an MFI/RFI operates on commercial terms.²
- **Outreach** and scale of MF/RF operations will be insignificant *unless* MF/RF institutions can access commercial capital and capital through savings deposits. This is generally not possible *unless* such an institution is commercially viable (financially self-sustainable).
- The **efficiency** required from an MF/RF institution operating on commercial terms would reduce the cost of services and increase the benefits to clients.

We will briefly look at the three arguments.

Sustainability

Generally a distinction is made between two levels of sustainability for an MFI/RFI. At a lower level of ambition, an MFI/RFI can reach the level of *operational sustainability*. At this level the MFI/RFI can generate revenue to cover its operating expenses. At a higher level of ambition, an MFI/RFI reaches *financial sustainability* at which point its revenue covers operating expenses, loan losses, cost of capital adjusted for inflation and concessional terms on capital received as grants or subsidised loans. An MFI/RFI is commercially viable when it has achieved financial sustainability but not at the level of operational sustainability.

The basic assumption underlying “best practice” is that *financially sustainable* MFIs/RFIs are to be developed and that *operational self-sustainability* only is a milestone on the road to commercial viability.

Scale and outreach (number of clients reached)

When an MFI/RFI reaches financial sustainability, something important can be achieved. In many countries the MFI/RFI can be recognised as a formal finance institution once it reaches financial sustainability. This will make it possible to access commercial capital and permit capital mobilisation through savings deposits. Therefore, financial sustainability is generally a precondition for growth in outreach of any significance. There may also be other constraints to growth in outreach (number of clients served). However, whereas many constraints such as poor management are relative (the management can be changed), a capital constraint is absolute. Therefore there are reasons to look at the capital constraint in particular.

Consider a financially self-sufficient MFI/RFI, which is recognised as a formal finance institution. It has equity capital of 20 MSEK. This MFI/RFI should be able to raise at least 50–100 MSEK in commercial (loan) capital³. Furthermore, savings deposits can be a major source of capital mobilisation. It is only exceptionally conceivable that donor funding of that magnitude would be provided. Furthermore, consider if donors should finance five or ten MFIs/RFIs in one country at that level! And then in several countries!

So, unless MFIs/RFIs can get access to commercial capital and mobilise savings deposits they will remain small and rather insignificant.

Inflation may make things worse. Unless a subsidy is given to compensate for inflation to an MFI/RFI operating at the level of operational self-sufficiency only, the capital of the institution will be eroded. If the rate of inflation is 20 %, the lending capacity of such an MFI/RFI in real terms will be reduced to less than half in five years.

Cost of services and client benefits

The level of efficiency (and the level of sustainability) has a decisive impact on the level of benefits clients will reap: the more subsidies, the less benefits.

A hypothetical example will demonstrate what is involved. Assume that the cost of lending by an MFI/RFI is 75% of the average outstanding portfolio (a level not unusual in Africa). Furthermore, assume that it operates in a rural area where the average client can hope for a return of 30% on an investment. To leave the client with any benefit, the cost of borrowing must be set below 30%, say at 10%.⁴

This means that a net cost of 65 (75 in gross cost and 10 in revenue) has been incurred to provide the client with 20 in benefits. In this example the subsidy (65) will be three times the benefit to the client. Yes, the figures in the example could have been made more favourable but they could also have been made worse with reference to specific projects, including projects supported by Sida.

Taken together the three factors (sustainability, outreach and client benefits) would seem to offer a strong rationale for the promotion of the “best practice” principles.

At the same time the “best practice” concept implies that MF/RF is a commercial, business proposition. While there would be a role for a government to provide a legal framework etc for MF/RF development, *should MF/RF development not be left to (existing and new) private actors on the market?* Why should a government or a donor intervene at the level of service provision (wholesale and retail)? The main argument offered is that of market failure.

The rationale for intervention – market failure

The main argument for government/donor intervention in the provision of financial services (at different levels) is a *market failure argument*.

The argument is that the private sector (the market) does not produce MF/RF services (a private good) to the extent that is socially desirable (socially is here used referring to society). Many would argue that this is the outcome of an immature market. Over time, as more effective lending technologies and tools for risk management develop, competition will lead commercial actors to move into the MF/RF market segments, it is argued. Others agree but argue that the process is too slow. Still others argue that for very poor people this is unlikely to happen at all. Hence, there is a market failure.

Within the framework of “best practice” the prime approach to address the market failure has been to provide support (subsidies) to organisations, notably NGOs, to become commercially viable MF/RF service providers.

Here the “best practice” framework becomes somewhat problematic. On the one hand, MF/RF is advanced as a commercial, business proposition. On the other hand, it is implicitly accepted (generally) *not* to be a viable business proposition therefore requiring subsidies. Then the intervention (subsidy) must be justified by the social benefits of speeding up the process of service provision. It would perhaps be more appropriate to talk of a *development intervention* with the view of creating a (viable) business proposition. Claiming that such a development intervention is an *investment in a business venture* is both inappropriate and misleading. If emerging MFIs/RFIs were to be regarded as (business) investment opportunities, few sensible investors would make investments in the sector! Furthermore, the emphasis of “business” and “investment” tends to result in performance demands never placed on other types of development interventions.

This, however, does not mean that costs for the interventions are irrelevant. Therefore, in assessing whether interventions in support of developing MF/RF institutions can be justified, some consideration of

- the cost of developing sustainable MFIs/RFIs (operating on commercial terms) *and*
- the benefits from accelerating the process of MF/RF service provision by commercial agents

is indeed reasonable. So what do we know about costs of establishment of sustainable MFIs/RFIs, the scale of efforts and the (incremental) benefits from providing MF/RF services by new actors? Before attempting to answer these questions, we will take note of the favoured approach to implement “best practice” principles.

The approach to intervention

As a result of the frustrating experience with government-run financial institutions as well as the lack of interest on the part of commercial institutions⁵, interest was eventually directed to the NGO community, where many NGOs, including co-operatives, already provided financial services to poor people. The market-oriented institution building approach advocated in the “Pink book” has generally been implemented with the view of upgrading an NGO to become a commercially viable MF/RF service provider. This upgrading has often meant a profound re-orientation from an input/supply driven mode of thinking and operation only, to one which combines development ambitions with the strict commercial rules of the game. It goes without saying that this is not necessarily an easy process.

2.4.2 Global experiences in establishing sustainable MFIs/RFIs

The scale of effort

It is problematic that so little is known about the scale of effort and the achievements in establishing sustainable MFIs/RFIs. Various figures, all debatable or incomplete, are quoted. One estimate suggests that about

20 million people have access to MF services of a potential market of more than 600 million (3%). The same estimate suggests that clients are served by approximately 10,000 MFIs but only 1% (=100) of these are sustainable.⁶ However, this may not be a fair comparison as many of the 10,000 MFIs were probably never intended to become sustainable and the support to them was designed accordingly.

According to CGAP statistics there are eight donor agencies which provide funding to MF of more than USD 50 million, seven provide 10–50 million and fourteen provide 1–10 million annually.⁷ Falling in the last category, Sida contributes only marginally to the sector. *In total the funds are very large.*

The Micro Banking Bulletin, a bi-annual report publishing self-reported performance data on peer groups of MFIs (November 2001), indicates that of 149 MFIs on which they have information, 57 had reached >99.5 % financial sustainability and 83 had reached >90%. Whether these figures represent a complete picture or not is unclear. Reporting to the bulletin by MFIs is voluntary and not all (successful ones) may report. On the other hand, there can be an incentive to report and show up in the rather exclusive club of successes. Whatever the case may be, it seems safe to conclude that only very few MFIs worldwide have yet become financially sustainable.

CGAP argues that the rate at which MFIs become sustainable is expected to accelerate, based on the expanding body of knowledge and the accelerating speed of dissemination. This claim may seem to be somewhat in contradiction with an indirect admission of the difficulties in developing NGOs into sustainable MFIs (which has been the main approach). Maintaining the call for scaling up, CGAP is now suggesting that more attention be given to alternative institutional solutions, including banks, as the NGO graduation model has hardly proven itself for rapid scaling up. However, there are hardly other “models” ready for large-scale replication. Therefore, it seems that we are somehow back to the vicinity of square one where experimentation and testing of diverse options rather than scaling up are called for.

The costs of establishing a sustainable MFI/RFI

It is disturbing to note that there is hardly any information available on the costs of developing a sustainable MFI/RFI. An explanation or a counter argument is that the cost depends on contexts, which differ so widely that it is impossible to give a generalised answer. Accepting this argument it still seems desirable to establish *some type* of rough estimate based on a series of case studies

The fact that such studies are not undertaken (e.g. by CGAP) could be seen as a lack of interest in the costs involved. I also notice that the project documents, business plans, assessment memos and other documents for the 15 selected projects in this review provide no information and discussion on the (accumulated) subsidies that have been given to a particular organisation since its formation. Nor is there a discussion of expected additional subsidy requirements when the particular project period in focus comes to an end.

The time it takes

CGAP suggests that under favourable circumstances it takes something like 4–5 years for an MFI to reach operational sustainability and 7–8 years to reach financial sustainability. These figures are open to question, however. It is true that in a few successful cases, sustainable MFIs have been established within such time limits. However, in many more instances considerably more time has elapsed without the attainment of sustainability. For instance, it certainly took the Grameen Bank much longer to become sustainable. (Many would argue that it is still not sustainable). Pride Kenya, Pride Tanzania and Pride Uganda have received grant support for more than 10 years without becoming sustainable. The Presidential Trust Fund in Tanzania (with Sida support) is considered to be a well performing MFI. It has been in operation 12 years and is not (financially) sustainable⁸. Put differently, if one were to choose a “pick-the-winner” strategy, the time limits suggested above may be realistic but winners are by definition rather few.

There is evidence of different potentials for the development of sustainable MFIs in different regions. It is generally recognised that it takes considerably longer time (and more resources) to develop an MFI in Africa than in Asia or Latin America. Sida’s experience suggests that the development of MFIs in Eastern Europe compares favourably with Latin America and Asia. A number of contextual factors are likely to explain such differences. The factors, which are usually mentioned to favour MF development, include a high level of economic activity, diversity in the economy, growth-oriented macro policies, high levels of education and high population densities. MF development is generally easier in urban areas than in rural areas where many of the factors mentioned are less conducive. In addition there are a range of sector specific conditions such as (co-variant) weather and disease/pest risks, strong seasonal variations in cash flows, often low returns on investments, and the importance of timing of services, which makes it more difficult to develop sustainable MFIs.

The cost of providing services

The measure normally used to indicate the efficiency of a lending operation is the operating cost ratio defined as operating costs divided by average loans outstanding.⁹ Looking at the Micro Banking Bulletin statistics, a (financially) sustainable MFI in Latin America or Asia may have a ratio of 20–30% whereas the ratio in Africa may be in the range of 40–50%.¹⁰ As most MFIs are not yet sustainable, the cost of lending is generally higher and may well exceed 100 %, particularly for MFIs with relatively small portfolios. This means that the cost of managing the loan portfolio is higher than the value of the portfolio or, put differently, the cost of lending one dollar is higher than one dollar. Information has not been available to calculate the ratios for the MFIs in the sample. In one case, which may be extreme, (Pride Zambia) it is known to be close to 200%. In other words lending one dollar costs two.

This does not mean that the clients normally have to pay such interest rates as 100–200%. More modest *nominal* rates often mask considerable additional costs that make the *effective interest rate* much higher. A subsidy is generally needed on top of that for full cost coverage.

The question of whether or not it is justified to provide a service at very high cost levels is discussed below, where it is concluded that empirical evidence suggests that clients often think so.

Impact

There are very considerable methodological problems in assessing impact of MF/RF services. Therefore, impact studies are always open to dispute in terms of the contribution to change (e.g. improvements in income) of a MF/RF service separated from the contribution (positive or negative) of other factors. Furthermore, only a fraction of all MF/RF activities have been evaluated, making it hard to provide a view of the performance of the sector as a whole.¹¹

It is unsatisfactory that the performance of a sector (in terms of impact), which receives hundreds of millions of dollars annually, is not better known.

Some general observations may still be possible.

It is now widely accepted that the euphoric expectations of what MF/RF might achieve that were expressed at the Microcredit Summit (1997) were exaggerated. MF/RF is not a panacea for poverty alleviation.

Some of the exaggerated expectations of MF/RF rested on the assumption that any poor woman or man could be made into a thriving entrepreneur. This is not a realistic assumption. Only a few persons in any population have the talent and the interest to become entrepreneurs.

The available case studies give a mixed picture of performance and suggest, hardly surprisingly, that a number of context specific conditions are significant for the result. This is true for all kinds of interventions but it has specific significance for a service that has a derived demand. (This means that the service itself is only a means to a prime demand – making an investment, paying school fees, meeting medical expenses, etc.)

There is evidence to suggest that financial services have an important potential to reduce the vulnerability of poor people through income smoothing. Many argue that deposit services are particularly relevant for very poor people. Informal MF/RF actors do generally not provide such services.

Hardly surprisingly, evidence also suggests that credit services tend to benefit those with some assets more than those with very few or no assets.

The limited and inconclusive information that is available on the impact of RF/MF interventions could make any supporter of the sector hesitant. However, there is another way to gauge impact and that is to look at demand and willingness to pay at client level. If the services are in strong demand and if clients are willing to pay for them, there are convincing reasons to conclude that *the clients* find the services valuable. And who is in a better position to judge the value of the services than the clients?

We do not know much in detail about levels of demand and levels of unmet demand. What we do know is that clients often are prepared to pay and often do pay dearly for MF/RF services. Nominal interest rates in the range of 20–40 % are not uncommon, and effective interest rates in the tune of 60–80% or more are not uncommon. On top of that clients generally have to incur additional cash and non-cash transaction

costs, which can be substantial. This information rather decisively suggests that MF/RF services often have substantial value, as the clients see it.

This does not mean that cost levels for the services do not matter and that MF/RF institutions should feel complacent to cover their costs at very high costs to the clients. Neither does it mean that willingness to pay always lead to high value return. In risky investments, such as many investments in agriculture, borrowing at high cost may easily end up in indebtedness and further economic strain. Neither is it obvious that high cost borrowing in situations of despair represents high value and impact.

The overall conclusion should not be overshadowed by these reservations, however. Financial services are often valued highly by clients as reflected in their willingness to pay for them.

3 Sida's interventions in the field of MF/RF

3.1 Some figures on Sida's MF/RF portfolio

Sida's MF/RF portfolio will be presented more extensively elsewhere in the Policy Project. Here only some summary observations are made to provide the reader with some basic facts.

Sida's current (2002) MF/RF portfolio amounts to approximately 340 MSEK distributed between 30 contributions as shown in the following three tables.¹²

Development of Sida's total MF portfolio and distribution between regions (amounts in MSEK)

Region	1999	%	2001	%	2002	%	# of active conts. 2002	# of conts. in pipeline 2002
Africa	82	19	80	30	142	41	13	11
Asia	148	35	19	7	19	6	3	3
Eastern Europe	14	3	11	4	41.5	12	5	1
Latin America	181	43	144.5	53	123	36	6	2
Global	0.2	0	15.5	6	17.5	5	3	0
Total	425	100	270	100	343	100	30	17

Distribution between departments

Department	# of conts.	Amount (MSEK)	% of portfolio
Dept. for Natural Resources (NATUR)	3	64	19
Dept. for Infrastructure and Ec. Dev. (INEC)	12	199.5	58
Dept. for Eastern Europe (Sida-East)	5	41.5	12
Embassies	10	38	11
Total	30	343	100

Distribution by type of MF contribution		
Type	#	Amount (MSEK)
Rural integrated	5	95
Urban integrated	4	93
Stand Alone MFI	10	92.5
Legal & Regulatory	2	7.5
Networks	2	2.5
Service providers	2	11
Venture Capital Funds	2	24
Global/internal projects	3	17.5

The tables are self-explanatory.

3.2 Some characteristics of Sida's MF/RF operations

The issues related to the operational aspects of Sida's MF/RF portfolio were extensively dealt with in the CGAP-initiated Peer Review (May 2002). Their main conclusions and recommendations are presented in appendix 2. Consequently these aspects have not been given the emphasis originally foreseen in this study (and reflected in the ToR). Still, it may be justified to document some of the observations made.

Perhaps the most important observation is the *lack of uniformity* in Sida's approach to MF/RF in most of its operational dimensions. The specific designs in terms of instruments used, organisational structure, allocation of portfolio risks, systems and techniques for project preparation, project appraisal, monitoring, use of technical expertise, etc seem to be circumstantial. That they are circumstantial does not necessarily mean that they are superficial or inadequate (sometimes it does). They are different for reasons that only partly stem from the specific type of intervention and from local context specific conditions. Indeed it is this diversity in approaches, which is one rationale for the policy project.

Another broad observation is the ambiguity in the ambitions to adhere to "best practice" principles. Since the entrance of the MF advisor on the scene (1998) there has been a notable shift in this direction reflected in:

- an increase in the number of projects focusing on building sustainable MFIs as defined by "best practice" as well as in the support to sustainable service (training) providers and networks promoting "best practice";
- a stronger emphasis on a (financial) sector-wide perspective which has resulted in support of formulation of a regulatory framework for MF in several countries;
- requirements in respect of the quality of business plans have increased, and best practice standards for assessment of MFIs and their business plans have been increasingly made use of;
- the use of more technically advanced methods for project appraisal and assessment of MF/TRF institutions;
- the use of performance-based agreements;

- an increase in the use of technical expertise;
- support to networks (e.g. AMIZ and ASOMIF) and training service providers (such as SAMCAF) has been based on their interest in promoting best practice;
- innovative ways of providing quasi-equity capital for investments in retail institutions have been developed (AFRICAP);
- a strong linkage with CGAP has been maintained and Sida plays an active role in CGAP. Presently Sida's MF advisor holds the position of chairperson in CGAP's donors committee.

However, limited capacity, as well as the (advisory) role of the MF-unit, has resulted in the somewhat ad hoc appearance of these changes in the MF/RF portfolio. In some projects the credit risk is located with the retailing institutions. In other projects it is not. In some instances loans are used as the support instrument. In others (more often) the instrument is a grant and more recently there have been several examples of combinations of loans and grants. Some projects are appraised by technical expertise. Others are not. There is often no clear pattern explaining why one approach has been used in one situation and another in another situation.

One important aspect of the issue of adherence to "best practice" principles, which has surfaced in the portfolio, is whether financial services (normally targeted credit) as a component in a development project are compatible with "best practice" principles. This important issue will be extensively discussed below in this report.

From the tables in the preceding section one can see that the number of MF/RF interventions is highest in Africa. This position is even higher if projects in pipeline are included, as 11 of the 17 are located in Africa. The distribution by regions is not the result of a policy or a managed process. Rather it is the result of the interest in MF of a few staff members who have been posted in different countries. It is likely that the expansion in Africa had taken place in Latin America if the staff generating the projects in Africa had been posted to Latin America.

Yet another broad observation relates to decision making on MF/RF projects. The extent to which a MF/RF project is subjected to technical scrutiny in the decision-making process seems to differ. For instance, in a large Rural Development project (> 50 MSEK), where financial services (credit) are only a component, the finance service component is likely to be far less thoroughly assessed than in a small stand-alone MF project. The former project will be presented to the Project Committee and decided upon by the Director General. Minutes from the Project Committee (on FondeAgro and PRODEL, for instance) show that there was little or no technical discussion of the finance service activities by the Project Committee. It seems that a credit component, even a large component, can "slip through" without much attention being paid to it in such a project. This is less so with a stand-alone MF project, which is decided upon at department level (generally in INEC).

These and a number of other operational aspects need to be addressed. However, the way in which they should be addressed hinges in several cases on the principles that will be laid down in the policy to be formulated. Therefore, there is no discussion here on how operational efficiency could be improved.

4 Policy issues in Sida's MF/RF contributions

4.1 Distributive implications of providing support to MF/RF development

4.1.1 The issue

Most of Sida's contributions in the MF/RF-sector raise questions on the distributive implications of transfers of funds.¹³ In this review it has become apparent that the issues that are discussed in this section have rarely been addressed and have not been reflected in Sida's MF/RF activities. In itself, this is a reason for bringing them up.

The issue is who obtains control and ownership of the funds provided in the form of support and what is the possibility that some individuals benefit unduly from that control and ownership. At first this may not seem to be a problem that deserves special attention; it is an issue in all types of development assistance. However, in the field of MF/RF it takes on particular significance for two reasons. Firstly, the funds are in the form of *cash* and they are often *substantial*. Secondly, the ambition ensuing from "best practice" principles is to support the formation of commercially viable wholesale and retail MF institutions. This generally means the formation of a private company of one type or another (hitherto mostly NGOs that have graduated into companies). In this transformation process a number of distributive issues may arise, as we will see.

In Sida's portfolio for the development of wholesale and retail MFIs, support is provided to NGOs, which are expected to graduate into regulated MFIs. In the housing projects, trusts have been established. The main support instrument used in both situations is *grants*.

The basis for the following discussion is the assumption that Sida would perceive it as a distributive problem if *individuals* gain *very substantial* benefits, particularly if these individuals are better-off. Clearly this is a highly unsatisfactory "definition" but will suffice for the discussion to follow,

The ways in which distributive problems may arise are the following:

- Abuse of statutes and laws.
- Changes of statutes (for institutions receiving support).
- Favouritism (while keeping within statutes and laws).
- Mission drift (changing the focus of operations).
- Accessing profits (dividends on equity holdings) and income (interest on loans).

- Free rider access to assets not valued in the process of transformation from an NGO to a regulated MFI.

Maybe I should make it explicit that the list above and the discussion to follow do *not* imply that distributive problems will always occur or cannot be mitigated and they do *not* imply that people in general are crooks. It merely presumes that a certain amount of greed is omnipresent, anywhere, and that such greed has a tendency to flourish in permissive environments where law enforcement, checks and balances, and attitudes to corruption may not be the most solid pillars of society.

4.1.2 Support to a microfinance NGO (not yet sustainable, not regulated)

Let us first look at a situation where grant support is provided to a microfinance NGO (the most common Sida approach). As a legal entity, the NGO becomes the *owner* of the grant fund. This does not necessarily prevent the situation that *those in control* of the NGO may use a number of ways to divert benefits to themselves. This can be achieved by outright embezzlement or taking kick-backs, by changing statutes of the NGO to permit remuneration, payments of bonuses/dividends etc in their favour, or by favouritism such as “directed” purchases of equipment, “directed” placement of building contracts, etc. In relation to end clients, the NGO may fall prey to mission drift by shifting its focus from poor to better-off clients, which would involve distributive implications.

Many factors affect the potential for problems of this type. The crucial one is perhaps whom the NGO in question represents and who controls it. An NGO can be a membership organisation with a constituency to which an elected board is accountable. An NGO can also be a handful of individuals (who are the members, the board and the executive at the same time) who are committed to a cause, or who are more or less plain rent seekers. The latter type of NGO is not uncommon, unfortunately. Committed persons may control the NGO today and it may be controlled by rent seekers tomorrow.

The question then arises of whether there should be any criteria for assessing an NGO, and whether any means of influence or control should and can be introduced in order to mitigate the risks discussed above.

4.1.3 Support to a microfinance NGO in a process of transformation to a regulated MFI

Let us now consider a situation in which a microfinance NGO is in the process of transformation into a regulated MF organisation, e.g. a bank. None of the NGOs presently supported by Sida has reached that point yet, but ostensibly the very purpose of supporting them is that they should reach that stage.

International experience suggests that the following is likely to happen. A new legal entity is formed (normally a private company of some sort). The NGO will transfer part of its (net) assets to the new company in exchange for an equity holding and any remaining assets will be put at the disposal of the new entity as a repayable interest bearing loan. In other words, the NGO continues to exist but normally without any operational activities. This process has potentially a number of problems.

The NGO will earn income on the loan provided to the new company and it may earn income from dividends. These earnings can be substantial (and will be earnings on grant funds). This is money without an immediate “purpose” for the NGO and will be exposed to the risks discussed above. The risks increase when the NGO in question is the members-board-executive-in-one type and the same persons hold key executive and board positions in the new company.

At the time of transformation there is an understandable desire not to inflate the price the new entity has to pay for the NGO’s assets. What the new entity is buying is a going concern including clients, administrative and organisational infrastructure, skilled staff, managerial capability and reputation *in addition to* the financial and physical assets. In the case when these former assets are not paid for (as in the case of Acleda Bank in Cambodia), any private investor buying shares in the new entity will receive a “windfall gain”. More broadly they will tap dividends from an investment (building the capacity and capability of the former NGO) that they have no part in but which is an investment primarily, or more often entirely, funded by donors. This argument takes on added strength given that the equity capital is generally a relatively small portion of the liability side of the balance sheet and the liabilities are dominated by loan capital, which was originally a donor grant.

Finally, there is an increased risk for *mission drift* (weakening the poverty focus that the NGO has had) when an NGO is transformed into a regulated MFI. The new entity is a private profit-making business concern, and there is nothing strange or wrong if that business enterprise goes where the profits are. Servicing poor clients can make profits, but generally serving other clients can make more profits and easier profits. The implied pressure for a mission drift is there. Part of the very notable success of the Acleda Bank in Cambodia can be ascribed to mission drift of this type.¹⁴

4.1.4 Establishment of Trusts

In the case of the housing and infrastructure projects in Costa Rica, Guatemala and Nicaragua¹⁵, Sida has established a trust. The prime reason for establishing such trusts has been to secure a continuation of the funding of retail operators for housing loans (sustainability). Grant capital has been given to the trust. In each case the capital is in the magnitude of SEK 50 million or more, which means that it is very substantial.

A trust of this type becomes the owner of the funds transferred to it. As a founder of the trust, Sida can exert a decisive influence on the statutes of the trust as well as on the initial appointments of its board members. Furthermore, as a founder Sida is represented on the board.

The trust fund model has the potential to serve important purposes (sustainability). However, this solution is not without problems.

One important reservation currently under investigation by Sida’s legal department is whether Sida has the legal right and authority to form trusts.

Another aspect is that *Sida* is using funds from a country frame, which is the property of a recipient government, to form a trust. However, in the cases analysed in this review, no objections to this procedure seem to have been voiced by any of the concerned governments.

A trust fund is a rather special development assistance contribution in that it is an asset *in cash* that will remain in cash under one single management. As we have seen, it can be a very major cash asset (SEK 50 million or more). It does not take a conspiracy theory to suggest that such an asset has the potential to attract different interests. The control of such an asset provides a significant power base, apart from the potential it offers to be used for other purposes than its original purposes. In a context with weak law enforcement and corruption, a statute, however well formulated, provides no guarantee against intrusion and change. In such contexts statutes can be changed and board members can be replaced in line with the aspirations of powerful interests attracted by the prospect of controlling the trust. The distributive implications of such possibilities are obviously problematic.

It can be argued that Sida's mandated presence on the board of such a trust provides the necessary insight and a control mechanism. However, apart from the questionable legality of this representation, one can discuss 1) if it is the *role* of Sida to perform such functions, 2) how Sida can shoulder such a role *in perpetuity* and 3) if Sida has the expertise and capacity to accept such a task (in a growing number of trusts).

4.1.5 Options to deal with the potential distributive issues

It seems inescapable that transfers of substantial funds, which are not "consumed" but which remain as liquid assets, may entail potential problems. So does the transformation of non-profit MF/RF NGOs into private profit-making companies of one type or another. The following table may provide a starting point for a discussion on how to deal with these problems. Each option has the following three dimensions:

- What to support.
- Instrument to use.
- Monitoring/control mechanisms.

Note that the discussion of options here is limited to how the potential distributive problems can be handled. Other dimensions obviously have to be added when considering what Sida might support in the field of MF/RF development, and how.

<u>OPTION</u>	<u>PROS</u>	<u>CONS</u>
<u>Option 1</u> <u>What:</u> • Support to creation of an enabling environment (regulatory framework, supervision, etc) <u>Instrument:</u> • Grant <u>Control:</u> • Sida monitoring.	• This option would effectively reduce any distributive problems as funds would either go to government bodies (e.g. central banks) and in relatively small amounts. • This option would put far less capacity demands on Sida than more far-reaching options (2 and 3).	• There is a strong need to assist in the formation and development of wholesale and retail service providers. This option would only indirectly and to a limited extent address this need.

<u>OPTION</u>	<u>PROS</u>	<u>CONS</u>
<u>Option 2</u> <u>What:</u> • Institution building (incl. product development etc) of MF/RF wholesale and retail service providers. • Exceptionally, at an early stage of development, support for operational expenses. No support for loan capital. <u>Instrument:</u> • Grant. <u>Control:</u> • Initial assessment of governance structure (incl. accountability mechanisms) and character assessments of board members, key executives on clear and structured criteria. • Sida monitoring A variant of 2) is to support only MFIs/RFIs close to graduation with no need for loan capital	• The funds will be “consumed” rather than remaining as liquid assets. • Far less money will be exposed to risks. • Provides an incentive to access local funds. —————→	• Institution building without a loan fund to operate may not be meaningful. • Economies of scale make it more difficult to approach commercial viability if loan funds are limited. • Local funds may be difficult or impossible to access for an un-regulated MFI/RFI not allowed to take savings deposits and not able to borrow funds on commercial markets. • Such organisations will be hard to find and those there are will be offered much more from other donors.
<u>Option 3</u> <u>What:</u> • Institution building (incl. product development etc) of MF/RF wholesale and retail service providers. • Exceptionally, at an early stage of development, support to operational expenses. • Provision of loan capital. <u>Instruments:</u> • For institution building grants. • For loan capital loans. <u>Control:</u> • Initial assessment of governance structure (incl. accountability mechanisms) and character assessment of board members, key executives on clear and structured criteria. • Sida approval of new board members (both in NGOs and Trusts). (Clause in loan agreement) • Sida approval of changes in statutes and by-laws (for trusts and NGOs receiving support). (Clause in loan agreement). • External auditing. • Sida monitoring.	• This options removes some of the cons in option 2 by providing loan capital. • Hence, the effort to build viable MF/RF institutions can be more comprehensive. • An important sector need is better addressed. • Cost of capital becomes an issue (as it should). • The loan instrument for loan capital will act as a con-straint on the risk factors discussed in this section. • The loan gives Sida legitimacy to exercise more rigorous controls.	• Unless handled with care provision of loan capital may become a perverse incentive for not mobilising local capital. • Loan capital rather than equity capital in the balance sheet will make it more difficult or even prevent access to commercial capital and savings deposits. • The monitoring task for Sida becomes much more demanding.

<u>OPTION</u>	<u>PROS</u>	<u>CONS</u>
<u>Additional consideration related to a Trust</u> <u>Control:</u> As a founder Sida has a seat at the board.	A seat on the board for the founder apparently provides the opportunity for detailed insight and influence.	- It is questionable is Sida has the capacity and expertise to perform this task. - Sida can appoint representatives (e.g. from the private sector) to be board members. How could they represent Sida's development concerns (e.g. gender, poverty focus, etc)

The options above may reduce some of the risks that levels of benefits accrue to persons, which may not be acceptable under Sida's policy standards. Clearly it is up to Sida to form an operational opinion on what such levels might be.

The options above fail to address two sources of concern about the distributive implications of support to MF/RF development. They both refer to the case in which Sida supports the development and transformation of a MF/RF institution into a regulated profit-making business operation. One of them is the free rider access of private investors to assets not valued in the transformation process. The second is how to mitigate the risk of mission drift, whereby a poverty focus is surrendered in favour of more lucrative markets.

Please add your own options as well as pros and cons!

4.2 Sida as an investor in attempting to implement "best practice" principles

In several recently initiated contributions, we have noted that Sida makes serious efforts to follow "best practice" principles. The following discussion draws upon this experience but is expanded to suggest what the implications are, and will be, from taking "best practice" principles as the platform cross the board for support to MF/RF development.

In chapter 2.4 it was argued that supporting an emerging MF/RF institution to become a commercially viable MFI/RFI is hardly a pure business proposition and hence cannot be regarded as a pure business investment. In particular, one cannot apply the same methods for defining levels of expected return.

However, most of the other considerations when a business investment is made *cannot* be relaxed. The reason is *that the objective is to develop a business enterprise and that takes a businesslike approach of someone supporting that process in order for it to succeed*. The point to reach is definite and discrete. For reasons related to sustainability, outreach and benefits to clients, it is simply not good enough to end up halfway to the target point – commercial viability. Therefore, the support needs to be framed and managed as a business investment.

The first task for a supporting agency is to identify and assess different options (here in the field of MF/RF) in order to select an organisation with potential. From what we know, only a minority of the NGOs providing financial services are likely to have that potential. Therefore, it is important to be able to "pick the winners". The discussion here focuses

largely on the transformation of NGOs since this has been the main strategy for implementation of “best practice” so far. However, the arguments that follow are equally valid for *any* type of organisation that is chosen for development into a viable MFI/RFI.

Assessing an investment opportunity

At times Sida seems to have looked for “winning” investment opportunities where they are not likely to be found. This is reflected in the increasing number of investments in Africa. As discussed in chapter 3.1, this is not the result of a deliberate investment strategy but rather the result of personal interests and geographical posting of some staff members.

An investor has to make an assessment of potential investment opportunities. A successful assessment of MF/RF investments seems to require at least two things. Firstly, the investor/assessor needs to have a good knowledge of MF/RF and assessment techniques and their implications. Secondly, there is a need to have a good knowledge of the market and the business practices in the industry in focus. Knowing the market means knowing the factors that determine the demand for services, and the potential of the investments that clients are likely to make (e.g. the potential of different agricultural activities). This knowledge is important not only for assessing a business plan but also for the crucial assessment of managerial capacity and capability to realise the plan.

By using, among other things, the CGAP guidelines for “appraisal” of MF institutions, Sida has made such assessments with its own staff and with the aid of consultants. When making such assessments, a number of issues have arisen.

While the “appraisal” tools are reliable when it comes to establishing (but not explaining) the performance of a MFI/RFI *in the past*, they are of limited importance and value *per se* when it comes to assessing expected performance *in the future*. In any business plan *a series of important assumptions affecting the projections of costs as well as revenue are made*. It is the ability to make proper assessments of these assumptions that is important. In doing so, it is the knowledge of the market and the business that matters, rather than the mastery of the technical tools for the analysis¹⁶. It should also be added that assessments of this type are difficult to make.

One example where the analysis of a business plan (by an external MF consultant) seems to have focused on the use of the technical “appraisal” tools rather than the assumptions underlying the business plan is the World Relief/FCCN project in Mozambique¹⁷. Half a year of implementation indicates that the demand projections were totally unrealistic.

A second example is the assessment of the business plan for EKI in Bosnia made by Sida. Based on this assessment a performance-based agreement for a four-year programme of support, with annual and bi-annual performance targets for the period, was entered into. In less than one year, EKI had reached the targets for the 4th year and consequently Sida-East released the entire project fund. Apparently the assessment had not succeeded in evaluating the assumptions in the business plan correctly. This time the “mistake” worked in the “right” direction, however.

My conclusion is that it takes a little more market knowledge and business experience than Sida currently has access to in order to make more accurate assessments of business propositions in the field of MF/RF.

Acting as an investor once the investment has been made

When Sida becomes a major investor in an MFI/RFI, as is often the case, the role it chooses to play makes a difference. A major investor in an MFI/RFI, whether the investment is made in the form of equity or as a loan, becomes a *de facto* main owner of the MFI/RFI. In businesses, an investor/owner has a responsibility for the fate of the business and the interest and the duty to exert an influence to ensure success. Some of the people with whom I have had discussions, argue that Sida makes an investment in an MFI/RFI but does not shoulder the responsibility as an investor. This becomes more problematic since those managing an MFI/RFI have rarely made a risk capital contribution themselves. Furthermore, they are seldom accountable to anyone but themselves.

Another view could be that Sida may be a major or dominant external supporter of an emerging MFI/RFI but this should not be interpreted to mean that Sida is the owner of that organisation and has to shoulder the owner's responsibilities.

The task is to develop a commercially viable institution (hitherto normally from a non-business oriented NGO). This takes a supporter/partner who acts as a *business partner* and not as a *development partner*. This is more important when the organisation in receipt of support does not have business experience and a business culture.

A partial counter argument could be that Sida does influence operations by stating performance criteria in agreements and making them conditional for the release of funds, as well as through its monitoring activities and its dialogue. This seems to be a partial counter argument only as Sida would not be in a position to dismiss incompetent managers, make substantive mandatory changes in business plans and the like. The latter is what an investor does. The former is what a development agency does. That is also why, in an extreme case, a (local) director of a six-person strong MF training institution supported by Sida can collect an annual salary of USD 60,000.

It should be noted that the role of an investor is the same in principle whether Sida chooses to invest in building institutions for retail or wholesale MF/RF operations.

Three additional points should be made on the issue of Sida acting as an investor.

Firstly, we will return to the trust funds. As a founder of such a fund, Sida is obliged to take a seat on the board and thus assumes a management responsibility for the fund. The formal question mentioned above of whether Sida has the right to form trusts also applies here: it is a formal question whether Sida can take a seat on the board of a trust.

Sida must not be represented by its own staff on a board of a trust but can designate someone as its representative. This option is used and one instance was mentioned of a director in a major Swedish industrial firm being given this role. This raises interesting questions as to whom and what such a person represents. Is he/she expected to represent Swedish development cooperation policies in general and Sida-specific policies in particular, or is he/she appointed to represent a business expertise?

Secondly, demands in respect of capacity and skills for *any* approach to MF/RF support are very high. The application of the "best practice" principles as an approach very notably increases these demands. If Sida

were to play an active role as an investor in an increasing number of interventions, demands in terms of skills and capacity would be very high indeed. Clearly Sida does not have this capacity at present.

Thirdly, the bureaucratic constraints and slow decision-making processes at an agency such as Sida limits its ability to act as swiftly and decisively, which is often called for in a business operation.

4.3 Options for Sida to fulfil the role as an investor in MF/RF

Assuming that Sida accepts the “best practice” principles, which call for the development of commercially viable MF/RF institutions, the following questions would seem to require an answer.

The first question is whether it is **the role of Sida** (of Swedish development cooperation) to engage in funding the development of commercial business enterprises (in general, and here) in the field of MF/RF (here reference is not made to support related to developing an enabling environment). It could be argued that this is a more likely a task for SWEDFUND

If the answer is no, it seems as if interventions in the field of MF/RF should be limited to improving the enabling environment and possibly to supporting networks and training facilities.

If the answer is that it is within Sida’s role to do so, the question is what arrangements that can be made to provide the skills and capacity that are required to fulfil this role (as discussed above). The following options and considerations seem to present themselves.

<u>OPTION</u>	<u>PROS</u>	<u>CONS</u>
1) Expand in-house Sida capacity and capability (with business experience)	• Closer Sida management control, making it easier to ensure assistance policy perspectives (e.g. a poverty focus, a gender focus)	• Most unlikely that sufficient numbers of positions can be created. • Employment conditions may not attract persons with sufficient skill and (business) experience.
2) Concentration of MF/RF activities to a few countries and employment of local MF/RF expertise at the embassies.	• By definition local expertise would have local context knowledge. • Staff requirements at HQ, where positions are hard to create, would be relatively low.	• A serious constraint in this option is likely to be the availability of such expertise.
2) Outsource the management of the support to SWEDFUND (this would imply a comprehensive transfer of tasks and responsibilities)	• The mandate of SWEDFUND fits better with the task than the mandate of Sida. • SWEDFUND does not face the same formal constraints as Sida. • SWEDFUND can more easily take on the role as a business partner.	• SWEDFUND invests in going enterprises in need of additional capital and is hardly involved in developing enterprises. • It would be SWEDFUND’s prerogative to decide to what extent and with what focus they would engage in MF/RF • Investments. A number of reasons may suggest that the MF/RF market is given low priority.

<u>OPTION</u>	<u>PROS</u>	<u>CONS</u>
3) Outsource the management of the support to SCC	• The present assistance policy of SCC is founded on the notion of co-operatives as commercial business enterprises. • SCC has experience in the field of MF/RF. • Co-operative structures provide an option to reduce the distributive implications of providing support to MF/RF development.	• The choice of SCC would limit the structures to supporting co-operatives. • It is not clear if SCC has adequate capacity to manage more than a small programme and if this capacity can be expanded. • Co-operatives are defunct and have a bad reputation in many countries.
4) Outsourcing to an international institution?	?	?

4.4 Finance services as a component of broader development programmes in Sida's portfolio

The finance (credit) components in broader Sida-supported development programmes (notably in the field of RD and housing) comprise the lion's share of the total SIDA MR/RF portfolio. In this sense the "component projects" are important.

The policy issue in the perspective of "best practice" principles is how such "component projects" fit in, and if there is a misfit, how they can be justified on other grounds. Before facing these issues, some of the characteristics of "component projects" will be presented.

The sample of projects selected for this review contained three rural development projects and two housing and urban infrastructure projects in which credit is a component, namely

PEP in Bangladesh (rural)

ACSI in Ethiopia (rural)

Fonde-Agro in Nicaragua (rural)

PRODEL in Nicaragua (housing)

FDGL in Guatemala (housing)

It should be mentioned that two more in-depth studies on rural finance and housing finance are being commissioned as part of the Policy Project. These studies are expected to add dimensions to the discussion below.

4.4.1 Common characteristics

Although these projects are different, they also share a number of common characteristics.

One basic common characteristic is that the financial service (credit) component was identified *as a consequence* of a problem analysis that focused on other problems. In the case of PEP the focal problem was identified as low income among poor women. In Ethiopia the focal problem was low productive agricultural production and limited diversification of the rural economy. In FondeAgro smallholder development of dairy and coffee production were identified as opportunities and in PRODEL and FDGL a need to improve housing conditions among poor urban dwellers was in focus.

In elaborating ways to address these problems and exploit these opportunities *credit was identified as a requirement*. Hence, a credit component was developed in all projects.

PEP in Bangladesh

In the case of PEP, which has by far the largest credit component of all RD projects, the original design in 1986 attempted to link up with state-owned banks. This failed eventually and the activities have since been implemented by a project organisation. Since its inception, the project has formally been under the Bangladesh Board of RD but all documents complain about the weakness of that organisation and make a point of the fact that the project is operated independently of the BRDB. Discussions on ways to institutionalise the activities once the project comes to an end (planned for 2001 and then extended one year) started only some three years ago. The government now insists that BRDB takes over the activities and the outstanding portfolio of some 70 million SEK. Doubts have been voiced on the sustainability of the project and the fate of the portfolio.

One important consequence of this focus is that *none of the projects has given priority to develop sustainable MF institutions*, although some efforts in terms of institution building have been incorporated.

Another characteristic, which these projects have in common, is that the financial service is *targeted at clients, at purpose and geographically*. Yet another a common characteristic is also that *only one financial service, credit*, is typically offered to the clients. Finally, *technical services and/or training* are offered to the credit clients in all projects.

These characteristics are at variance with several of the principles in the Pink Book and do not represent “best practice” in that sense. A range of services, including savings deposit services, are not offered. Service provision is not demand-driven in the sense that clients decide the purpose for which they want to use a financial service and the service they prefer. The purpose and the service are chosen for them. Institution building is a secondary concern and commercial viability is not an explicit objective.

For reasons that are discussed below, it does not automatically follow that credit as a component should be written off as an approach to MF/RF. However, before we enter that discussion we will take note of some other observations on the component projects.

4.4.2 Observations on credit components in RD projects

In the field of RD there seems to be a difference between old and new projects in terms of institutionalisation of the credit component. Credit components in older projects such as PEP, LSFP in Laos and MRDP in Vietnam were designed with fairly limited considerations of sustainability.¹⁸ In PEP an independent project organisation has implemented the component (see box) and in LSFP and MRDP a project organisation under the Department of Forestry and the Ministry of RD respectively implemented the credit components.

In phase II of LSFP (when I personally was involved in the project), track was eventually lost of a portfolio of no less than some SEK 5 million as a result of weaknesses in design and low levels of efficiency and effectiveness in implementation. A consultant study of the credit compo-

nent in MRDP (Vietnam) voiced serious concern over the limited prospects for sustainability towards the end of the project.

Experience gained in these old projects is conclusive; project organisations implementing credit components offer a safe road to non-sustainability.

NATUR has also made it clear that such institutional arrangements for credit components should not be considered in the future.

Looking at the two more recent projects in the sample, the story is different. It is not clear that the use of existing MFIs for the implementation of the credit components in the Amhara Region Development Programme and in FondeAgro is the result of a policy position, or whether it was the logical choice given their existence. Be it as it may, the result is that such MFIs, rather than project organisations, are being used.

In FondeAgro very conscious efforts have been made to use best practice tools in assessing MFIs bidding for a contract on the credit component and in formulating a performance-based agreement. However, the focus has been on finding an MFI capable of implementing the credit component, not on building the capacity of an emerging MFI to do so. This is possible in a context such as Nicaragua where a number of fairly sophisticated MFIs exist. However, no conditions in respect of sustainability were specified in the requirements in the tendering documents and only limited funds have been allocated for institution building.¹⁹

4.4.3 Observations on credit components in the housing projects

The housing (and urban infrastructure) projects have all been implemented in countries (in Central America) where relatively sophisticated MFIs exist. The two projects analysed in this review expose both similarities and differences.

They are similar in the sense that

- none of them have building sustainable MFIs as a project objective;
- they provide targeted credit for the same purposes and the same categories of clients;
- they make use of existing MFIs as a conduit for credit;
- the establishment of a trust fund is intended to ensure sustainability;
- both projects provide technical services to municipalities and individual clients;
- bidding and assessment procedures (other than those proposed by CGAP, less technical) have been used to select partners;
- no sustainability requirements have been stated in the criteria for selection.

There are also important differences between the two projects.

In PRODEL, a trust fund takes all the credit risk. The retailing partners only administer the credit activities for which they are paid a fee.

The support to infrastructure is given as a grant to municipal councils.

The technical unit of the trust is actively involved in the selection of infrastructure projects. In FDGL the trust provides loans to municipal councils and retailing MFIs. Technical services are provided by the trust but charged for with full cost coverage.

4.4.4 Policy issues and options on credit components

The policy issues related to “component projects” will be discussed by distinguishing between two situations. In the first situation there are one or several MF/RFI institutions that are commercially viable, willing to “implement” the credit component. In the second situation only commercially non-viable institutions are available or interested in getting involved.

A commercially viable MFI/RFI implementing a credit component
In this situation, institution building for commercial sustainability is not an issue. It is rather a matter of inducing an MFI/RFI to develop a new product, and/or approaching a new category of clients and/or locating activities to new (geographical) areas. Different incentive mechanisms can be chosen to make the MFI/RFI willing and interested (risk reduction, cost of capital subsidies, subsidies to cover establishment costs and product development, management fees, conversion of loan capital to (grant) equity, etc). The pros and cons of using a sustainable institution may be summarised as follows:

<u>PROS</u>	<u>CONS</u>
• Client benefits will be higher than if the MFI/RFI was operating below the level of (financial) sustainability. • Sida would be relieved of concerns about institution building. • The prospects for sustainability of service provision are higher than in the case of a (financially) non-sustainable institution. • Assessment and selection of MFI/RFI as well as monitoring of activities become easier.	• Looking at experience gained in the component projects reviewed here, a major constraint is likely to be that commercially viable institutions do not exist (Ethiopia) or that they exist but are not interested unless incentives are set at a level which would distort the market in an unacceptable way. • The fact that the activity is not initiated by the MFI/RFI itself as a result of market incentives but as a result of administrative incentives reduces the prospects for sustainability of the (targeted) service. • Client benefits will be reduced with the amount represented by the incentives.

This option could very well be chosen together with options, which are based more to the letter on the “best practice” principles, *if* the incentives to the MFI/RFI can be set at a level which does not significantly distort the market and at levels which do not significantly reduce client benefits.

A commercially non-viable MFI/RFI implementing a credit component

Unfortunately this is likely to be a far more common situation; there is no commercially viable MFI/RFI to approach, or there are such institutions but they are not interested (at acceptable incentive levels). None of the “component projects” in this review operate with/through commercially viable MFIs/RFIs. This situation is likely to be particularly frequent in rural areas. By summarising a previous discussion we can list the pros and cons of this option as follows:

<u>PROS</u>	<u>CONS</u>
A larger* number of clients will be able to address a need/exploit an opportunity for which a capital constraint has been identified. This is the whole rationale for the credit component. Cntd/ * “Larger” implies that not all intended beneficiaries of the core activity are dependent upon the credit.	- This option reduces the benefits to clients, often substantially. - If operational sustainability has not been reached, the loan capital will be lost to cover operational costs. A continuous subsidy would be required. Cntd/ - If there is inflation, as an additional factor, the loan capital would be lost over time unless a subsidy compensating for inflation is provided. - A service requiring a continuous subsidy is unsustainable in a time-bound project. - Subsidies to the MFI/RFI easily become a disincentive to performance improvement. - Prudence in lending and efficiency in loan collection tend to be subordinated disbursement of credit in support of the core activity (be it house improvement or milk production). - Subsidising inefficient MFIs or RFIs can distort the market and make the development of viable institutions more difficult. - Pushing credit through weak and inefficient institutions can reduce their performance. - Poorly managed credit programmes often undermine borrowers’ repayment morale making the development of viable institutions more difficult.

The more inefficient a MFI/RFI is, the more significant the “cons” become.

The “cons” can be seen as costs. The list of potential costs is extensive. The cost levels will vary, and so will the benefit levels. Furthermore, **how these benefits and costs are valued in the end is not a technical issue, it is a value-based issue.** From this it seems to follow that **one cannot draw a generalised conclusion on the justification of credit components.**

Accepting that both benefits and several cost elements are difficult to estimate, it is **still essential to make an analysis to see if the costs are reasonable in relation to expected benefits**²⁰. A crude rule of thumb for a “cut off” point would seem useful.

It is important to add that technical expertise is equally required in “component projects” as in projects based on “best practice” principles, in order to reduce costs. Furthermore, the component projects are also exposed to the concerns related to distributive implications from transferring funds as discussed in chapter 4.1.

The dilemma in remote and low potential areas

Sida tends to locate RD activities to remote or low potential areas as a reflection of its poverty focus. Credit is often suggested to be a need at the same time as the prospects of finding an MFI/RFI of even modest

capability and capacity to implement the credit component is generally as remote as the area. With the experience of project organisations implementing credit components in mind, Sida finds itself in a dilemma, bearing in mind that provision of credit to an ineffective RFI implies a number of “costs”, the most important of which being the reduction in benefit levels and non-sustainability.

However, there are reasons to question whether this dilemma is misconstrued. In such remote or low potential areas the following questions should be asked:

- Is credit a viable proposition in terms of the expected (cash) return on investments and the risk-bearing capacity of clients?
- Are there enough potential clients (demand) with sufficient risk-bearing capacity?
- Are there other constraints than capital, which are more binding (tenure security, access to technology, access to markets, etc) that should be addressed first?
- What would be the cost of delivering credit, what benefit is a client expected to get and what might be an alternative way of using the funds (subsidies)?
- What services can clients get on the informal financial market?

An analysis of this type is likely to suggest that in many instances there are convincing reasons to avoid providing credit. (The present experience of Niassa in Mozambique may be a case in point).

If this line of argument is accepted, how could that be formulated into a policy position?

4.5 Two basic views on MF/RF

MF/RF project design based on “best practice” principles and project design in which financial services are a component represent two different views on MF/RF (and development in general).

The first view tends to equate MF/RF with *provision of credit*. Credit is seen as an *input*, which together with other inputs (labour, know-how, etc) makes it possible for a farmer or an entrepreneur to undertake an activity (produce milk or set up a shop to increase income, etc). The focus of the analysis is problems experienced by poor individuals or households, such as food insecurity, poor housing, unsafe drinking water, limited diversification of production, untapped market opportunities, etc, etc. Projects are developed to solve such problems or exploit such opportunities, and *credit* is identified as a *project component* to relieve a capital constraint.

Credit as a project component has a number of implications. *Firstly*, the services are (generally) limited to *one* service, credit. *Secondly*, this service is *targeted* in terms of *clients* and *purpose* (housing, well construction, etc). Generally the service is also targeted *geographically*. *Thirdly*, provision of credit during the life span of the project becomes the prime concern. Building a sustainable MF/RF institution generally takes on secondary significance.

When MF/RF is seen as a component, supporting services (technical advice and training for loan takers) are generally provided and such services are normally free of charge (funded by the project).

The second view on MF/RF emphasises *building sustainable MF/RF institutions* that provide a *range of financial services* (not only credit) to reflect the *service demands of poor clients* to be used by them *at their discretion* (no targeting). The perspective is a market perspective whereby market-based MF/RF institutions offer services to clients in response to their demand.

Again this view has a number of implications. *Firstly*, the prime focus is *the institution* rather than a development need. *Secondly*, a prerequisite for sustainability is that the institution operates *on commercial terms without subsidies*. This in turn has far-reaching implications for the operational efficiency with which the institution has to operate. *Thirdly*, projects for MF/RF based on this view hardly become components but projects in their own right.

When the emphasis is placed on building sustainable institutions, supporting services (e.g. technical advice and training) are less likely to be offered and if they are, clients are charged for them.

An elaboration of this second view on MF/RF includes not only MF/RF (retail) institutions but also wholesaling and the financial sector as a whole, including the legal framework and supervision.

We have noted the difference between the two views in terms of their potential for sustainability, outreach and benefits to clients. In addition one can argue that the two views on MF/RF development represent two different approaches to development, understood more broadly. In that perspective it would be to ignore important differences of principle to argue that the two views are complementary.

The component approach seems to represent a social and economic engineering approach to development. In a local context the MF/RF component approach identifies a priority need for a target group and (normally) provides one service (credit) to satisfy that need.

The market-determined approach acknowledges the demand for a wider range of services and leaves to the clients to decide what services to use and for what purposes. Furthermore, and perhaps more important, it focuses on developing sustainable institutions capable of providing such services to a much broader clientele than a specific target group. Finally, this approach goes beyond a local context to encompass the financial sector as a whole.

4.6 Can the component approach and the institution building approach be combined?

The preceding discussion prompts the question of whether the component approach to MF/RF and the approach based on “best practice” principles can be combined. Is it possible to use an emerging (unsustainable) MFI/RFI to implement a credit component and at the same time pursue institution building based on “best practice” principles? The answer to that question firstly seems to depend upon whether one favours a (local) social and engineering approach to development or a (national) policies/systems/institutions approach.²¹ Leaving that basic issue aside, it is suggested that the arguments that speak in favour and those which speak against such an approach are the following.

ARGUMENTS FOR	ARGUMENTS AGAINST
• There is a concern about sustainability and levels of client benefits also in the component approach (a shared concern). • Credit components may be important in broader programmes. A combination including institution building for sustainability would reduce the disadvantages with the component approach. • A combination of approaches may reduce the need for “administrative” incentives (as opposed to market incentives) to make emerging MFIs/RFIs interested in implementing a credit component.	• The selection of an MFI/RFI to channel credit in a component project is not primarily made on the basis of their potential but their (geographical) availability. With a remote area/low potential area orientation this is likely to imply MFIs/RFs with less potential. • Developing sustainable MFIs/RFIs should not start with activities in the most difficult areas and with the weakest clients (which a poverty focus is likely to suggest). • The service promoted by the component approach (targeted credit) may not be the service which should be given priority in a business development plan. • If the credit component is big, it may result in a skewed portfolio with concentration of risk (a problem particularly in rural finance, where the RFIs normally have reasons to provide services in urban areas as well to spread risk). • There may be a conflict of objectives between the ambition to reach a large number of clients with the targeted credit and the desirable pace of expansion of the operations in total and the credit service as one of several services in a business development perspective.

The arguments against are many and potentially strong. At the same time they are not absolute. It “depends”. There *may* be situations where there is an emerging MFI/RFI with high potential (to become a viable commercial MFI/RFI) in the area (geographical or market segment) which can implement the credit component. There *may not* necessarily be a conflict between the focus of a targeted credit component and considerations related to risk or rate of expansion. However, in many instances there will be, and in many instances it would seem likely to be difficult to successfully combine the two approaches.

Situations in which the two approaches may be combined are likely to be characterised by 1) the availability of a mature MFI/RFI relatively close to commercial viability, and 2) a sufficiently large MFI/RFI with a diverse portfolio, which is not unduly skewed by the credit component.

4.7 Putting the key issues together

In formulating a policy on MF/RF it would seem that the following basic questions need to be answered. Answering them would have to be an iterative process.

- 1 The bottom line question is *whether Sida should involve itself at all in the field of MF/RF development*. This question should not be the first question to answer but should be kept in mind as an exit option when the other questions are addressed. These are:

- 2 *Is it accepted that “best practice” principles based on arguments related to sustainability, outreach and level of benefits to clients requiring commercially viable (financially sustainable) MFIs/RFIs is the preferred approach to MD/RF development?* (Please refer to the discussion in chapter 2.4.1.)
- 3 *Is it agreed that the distributive implications of support to MF/RF development is an issue, and if so, what option or options would reduce the problems involved to an acceptable level?* (Please refer to chapter 4.1–4 incl. the table on pros and cons for different options!)
- 4 *Is it the role of Sida to support the formation and development of commercial business entities as required in a “best practice” approach?*
- 5 *If the answer to question 4 is yes, should there be maximum expected cost level for the establishment of a commercially viable MFI/RFI to provide support?*
- 6 *If the answer to question 4 is no, what aspects of MF/RF sector development could Sida consider supporting?*
- 7 *Is there a way for Sida to engage/provide the technical expertise required (skills and capacity) to apply a “best practice” approach and/or a “credit component” approach?* (Please refer to chapter 4.2–3 incl. pros and cons for option to fulfil the role as an investor are discussed!)
- 8 *Under what assumptions related to sustainability, distributive implications and (net) benefit levels to clients is a “credit component” approach acceptable?* (Please refer to chapter 4.4.4 incl. pros and cons for an inventory with different options!)
- 9 *Under what assumptions can a “credit component” approach be combined with a “best practice” approach focusing on the same MFI/RFI?* (Please refer to chapter 4.6 and p.38 where the pros and cons are discussed!)

Annex 1

Excerpts from the Terms of Reference

Background

(.....)

Purpose

The purpose of this review is to assess Sida's current approach to supporting the development of microfinance services (broadly defined as per project document referred to above) in light of the current international understanding of "sound donor practice" as reflected by the Pink Book and GAP's work in general.

The review shall clarify why Sida considers it relevant to the overall development agenda to support microfinance and how this influences Sida's current approach to supporting microfinance. The review shall also identify the areas where and the extent to which Sida deviates from such "sound practices" and reasons for doing so.

(.....)

Scope

The review will seek to respond to the questions under "purpose" above through the analysis of and adequate selection of active and relatively recent Sida funded MF-projects.

(.....)

Key questions to be addressed throughout the process are:

- To what extent is "institutional sustainability" or "sound financial systems" an explicit objective for Sida's support to microfinance, how are these objectives translated into project design and to what extent is there evidence of progress towards these objectives?
- To what extent, how and when in the project cycle is technical expertise brought in?
- What are the incentives and enforcement mechanisms in Sida that shape its current approach to supporting microfinance?
- Are current work practices satisfactory in terms of ensuring sufficient quality of Sida's support to microfinance?

Annex 2

Main recommendations by the donor peer review

The following is quoted from the summary of the peer review management letter to Sida.

Recommendations

The Peer Review team has the following recommendations to build on Sida's strengths, and to improve its effectiveness in microfinance.

- 1) Sida needs **sharper strategic clarity** on the key cross-cutting contribution of microfinance to the agency's overall development goals. This clarity could be achieved through five inter-related activities:
 - *Communicate commitment at high level.* The Director General should communicate how microfinance contributes to Sida's overarching goals. This high-level signal will help to focus staff attention on improving quality in this area of programming.
 - *Embed microfinance in the private sector.* Notwithstanding its cross-cutting nature, it is important for Sida to continue to embed microfinance both conceptually and structurally within a financial systems and market-oriented perspective. A business emphasis is crucial to underline the goal of assuring permanent access to financial services for poor people. This should also help ensure that financial services components are correctly used in support of worthwhile investments, and not simply as incentives to ensure participation by the target "project beneficiaries." Sida should also develop a transition plan to handle on-going projects that do not adhere to these business principles.
 - *Accompany policies with practical "what works" guidelines.* Although Sida's efforts to formulate private sector development and microfinance policies are to be encouraged, the Peer Review team found limited appetite among staff for "yet another policy." The microfinance policy needs to be accompanied by practical, operational guidelines on microfinance, with a focus on brief 2–3 page "what works" documents that can be easily understood and used by non-specialist staff.
 - *Integrate incentives into existing structures.* Given Sida's organizational culture, it is inappropriate to require all programme managers to obtain specialist advice on all credit components. However, the team notes that this specialist advice has greatly improved the quality of project design where it has been obtained. Therefore, the team recommends

that the new version of “*Sida at Work*” includes a few basic questions for the Project Committee and the departmental review committees to safeguard quality in financial services components of larger projects. This mechanism will provide an incentive for staff to seek specialist advice. Examples of questions that could be included are: “Does the credit component plan to work with existing, specialist institutions (as opposed to government ministries or other non-specialist organizations)?” or “What evidence is there of cost recovery and financial sustainability in the project over time?”

- *Consider specialization in “niche” markets.* Given Sida’s limited resources, accumulated expertise and current portfolio in microfinance, Sida might consider specializing in housing finance and rural finance with an emphasis on contributing to increased international learning in these two areas. Sida might also look into co-financing stand-alone microfinance projects and selected industry infrastructure projects (capacity-building, policy work, etc.). These types of programs would also take advantage of Sida’s flexible grant instrument and operating style.
- 2) Sida could strengthen its microfinance operations by **improving accountability for results**.
- *Incorporate performance-based contracts.* It is desirable for microfinance projects or financial services components of projects to include performance-based milestones, with additional funding being released only upon achievement of clearly defined targets. This trend has already begun at Sida and should be encouraged and mainstreamed.
 - *Monitor performance against targets.* Performance-based contracts must be accompanied by rigorous monitoring of performance against expectations, and training of selected staff to provide a basic minimum knowledge on how to interpret and act upon the monitoring reports.
 - *Define an exit strategy from the start.* A final element of the performance-based approach entails a clear exit strategy. Good microfinance services should eventually become financially sustainable – i.e. completely free from subsidies. This requires that Sida’s exit strategy be built into each project design from the very beginning.
- 3) Sida should enhance its **technical capacity** in microfinance, both in Stockholm and in the embassies.
- *Increase technical staff capacity in Stockholm.* Decentralization needs a strong centre. Sida should increase its microfinance staff complement to three full-time specialists in INEC/FINANS, to be shared with urban and rural development departments as appropriate. Stockholm should also provide a helpdesk function. Depending on how Sida chooses to specialize, particular areas of competence—such as experience in rural and housing finance—should be sought in the recruitment process.
 - *Recruit local expertise for embassies.* At embassy level, it is recommended that Sida recruits staff with some specialist microfinance skills in key selected countries where this area of programming is most intensive. Locally-recruited staff could possibly serve as regional resources as well.

- 4) Assuming a commitment to enhance overall technical capacity in microfinance in Sida, the **role of the microfinance unit** should be clarified. The Peer Review team identified four key functions: training of non-specialists, helpdesk, knowledge management, and leveraging resources. Depending on the resources available, the unit may face a trade-off in fulfilling these key internal functions and staying involved in direct project management.

Training of non-specialists. The microfinance unit has proved that it can raise the overall level of technical competence through a programme of orientation and training of staff both at the sector level (urban and rural, specifically) and in the embassies. The primary goal of more systematic training in the future is to ensure that programme managers act as “intelligent customers” of technical assistance, and know when to seek expert advice.

Helpdesk. Much of the microfinance unit’s existing work can be defined as a helpdesk function, i.e. supporting project design and managing short-term technical needs as they arise. The envisioned helpdesk function would be made more proactive and comprehensive, including “hands-on” practical advice, and a more systematic support in the formulation of country strategies, project origination and design and monitoring. For reasons of accessibility and knowledge management, the bulk of the helpdesk function should be internal, that is, the responsibility of the microfinance unit staff. Specific tasks and/or areas of technical expertise, however, could be outsourced.

Knowledge management. The central microfinance unit has an important role to play in ensuring information and knowledge sharing about both internal and external practices. The goal is to launch a process of evidence-based learning that assimilates actual project experience and feeds back more effectively into Sida policies and practices across sectors and regions. One important dimension of knowledge management is to integrate microfinance indicators into the framework of Sida’s on-going rating project, which seeks to track project performance more systematically.

Leverage. As competent as Sida staff may be, they cannot do it all on their own. The central microfinance unit should help link programme managers to external resources, consultants, other donors, and to CGAP members and its Secretariat. For reasons of ease of access and cost-effectiveness, Sida should take more advantage of the Nordic market of consultants when looking for international consultants. In addition, Sida should consider closer engagement with the Swedish NGOs involved in microfinance. Although these links already occur successfully in some places, they could be more systematically pursued.

Annex 3

List of projects reviewed

- 1 PEP, Bangladesh, a rural development programme with credit as a component.
- 2 FondeAgro, Nicaragua, a rural development programme with credit as a component.
- 3 Amhara Regional Development Programme, Ethiopia, a rural development programme with credit as a component.
- 4 PRODEL, Nicaragua, a housing and urban infrastructure project with credit as a component.
- 5 FDGL, Guatemala, a housing and urban infrastructure project with credit as a component.
- 6 Presidential Trust Fund, Tanzania, a stand-alone MFI.
- 7 PRIDE, Zambia, a stand-alone MFI.
- 8 EKI, Bosnia, a stand-alone MFI.
- 9 ADIE, Kosovo, a stand-alone MFI.
- 10 World Relief/FCCN, Mozambique, a stand-alone MFI.
- 11 Asomif, Nicaragua, a network.
- 12 AMIZ, Zambia, a network.
- 13 AFICAP, a venture capital project.
- 14 SAMCAF, Africa, a management service (training) provider.
- 15 Bank of Zambia, a project on supervision and regulation

Annex 4

List of persons interviewed or otherwise contacted (commented in the list)

Rolf Carlman, INEC

Nils Olof Malmer, INEC

Jan Engström, INEC

Camilla Bengtsson, INEC

Gisela Strand, INEC

Per Fröberg, INEC

Lars Berggren, INEC

Anna Rosendal, Sida-Öst

Eidi Genfors, NATUR

Göran Bergman, NATUR

Peter Hertelius, NATUR

Kent Rashem, (former TA in PEP, telephone interview)

Björn Ceder, (former TA and present consultant in PEP,
telephone interview)

Alf Eliasson, Sida-Nairobi, (former desk officer for PEP in Bangladesh,
telephone interview)

Lars Leander, Sida-Addis Abeba, (present desk officer Amhara Regional
Development Programme, e-mail)

Melinda Cuellar, project manager FondeAgro, (telephone interview)

Jenifer Matafu, desk officer MF in Dar-es-Salam, (telephone interview)

Natasha Chimuya, desk officer MF in Lusaka, (telephone interview)

Annex 5

The “best practice” principles as stated in the pink book

Two concepts underpin the principles. First, **outreach** embodies the aim of expanding access to increasing number of low-income clients. Second, **sustainability** provides the means to expand and maintain outreach.

Based on these concepts, section I (of two) outlines the following principles and performance standards for institutions:

A Institutional strength

- high managerial capability
- accurate MISs
- efficient handling of small transactions
- financial reporting of international standard

B Quality of service and outreach

- focus on the poor
- client-appropriate lending (demand driven)
- savings services
- growth of outreach

C Financial performance

- pricing policies for full cost coverage
- high portfolio quality (specified)
- operational and eventually financial self-sufficiency
- move towards financial independence from donors

(Comment:

Taken together these principles imply a demand driven market approach on commercial terms. The focus is on building sustainable institutions.)

Section II contains the following strategy guidelines for donors:

A Appropriate uses of grants

- institutional development (all stages of an institution's life)
- grants for equity (of strategic importance)
- cover operating losses until break even
- purchase of fixed assets

B Appropriate uses of loans

- for lending-based institutions that meet performance standards

C Commercial sourcing of funds

- leverage private investment
- support to second tier operations raising commercial capital
- partial guarantees of commercial loans to NGOs

D Coherence of donor policies

- donor co-ordination, notably on subsidy policies

(Comment:

In courses and written material CGAP emphasises that donors have to act as *investors* and not as project implementers.

It should be noted that “best practice” states a set of principles but does not tell anything about what the implications are to act as an investor in terms of return on investment considerations, modes of operation, etc.)

Annex 6

A summary of the evolving global focus on micro finance and rural finance

During the 1960s and 1970s credit was seen as a critical element in transforming agriculture production. Partly to compensate for administratively depressed producer prices but primarily to speed up the transfer and adoption of new farm technology, subsidised credit was offered in large package programmes funded by donors. Specialised government owned and operated financial institutions such as agricultural banks and agricultural finance institutions were set up. Co-operative structures were extensively used as conduits of credit, notably in Africa. Scale and speed of credit disbursement was often a prime concern rather than operational efficiency and prudence in lending. Operational losses and losses on defaulting loans were underwritten and absorbed by governments. Such credit programmes were prone to political interference as politicians often used them to mobilise support by targeting lending or loan forgiveness. As the focus on smallholders increased, an increasing number of credit programmes targeted small holders.

In retrospect it is arguable to what extent these credit programmes contributed to a technological transformation of agriculture, which largely failed to materialise. Other constraints, notably in Africa, such as depressed producer prices slowed down that process. Furthermore, despite the substantial funds involved only a minority of the farmers was reached. Large farmers rather than small farmers tended to be the main beneficiaries of subsidised credit (regression on income). According to FAO “directed public credit programmes have led to low efficiency, high operational costs, low loan recovery and non-availability of financial services, as well as an overall misallocation of financial resources”²². Since the mid 1980s donor interest in these programmes has notably declined and many of the specialised agricultural credit (finance) institutions have collapsed.

Parallel to these large credit programmes NGOs operating in rural areas often provided financial services often with the same rationale and on the same terms (targeted and subsidised) as the formal institutions. However, many NGOs also introduced savings (in addition to credit) and attempted to build community based financial institutions, generally small scale, highly localised and with varying degree of success.

Neither promotion of income generating activities (by providing financial services) among poor nor a focus on women is something new.

As early as in the 1920s, the Syndicate Bank in India managed to develop a commercially viable micro-finance (savings and credit) operation serving predominantly poor women (which had to be repeated by the Grameen Bank 50 years later to gain recognition). In more recent years MF activities have been undertaken by scores of NGOs, single purpose but more often multipurpose NGOs, with an increasing focus on poor in urban settings. That is why that at present MF is viewed primarily as an urban-based activity.

The structural adjustment époque seems to have affected the views on MF/RF in at least two ways. Firstly, the SAPs introduced market liberalisation as the basic development paradigm. This tended to question several of the premises underlying the conventional modes of operation in the field of MF/RF (targeting, subsidies, etc). Secondly, as the negative distributive implications of the SAPs eventually were accepted (long after they had been observed and recognised), a call for more of a micro focus and a stronger poverty focus gradually grew in strength. This orientation of focus increased the interest in MF/RF.

The significance of the Grameen Bank experience in attracting interest in MF/RF cannot probably be overstated. Despite its shortcomings and present problems the Grameen Bank has stood out as a major success story for a long time. Its charismatic founder has indeed also given the Grameen Bank a very high international profile culminating at the World Summit on MF (1997) at which, maybe, somewhat non-reflected praise was given to MF as a development tool.

The formation of the Consultative Group to Assist the Poorest (CGAP) and increased donor fund allocations to MF/RF are the most obvious concrete effects of these converging interests. It has reached the point where well-informed observers suggest that there is too much money chasing too few good MF opportunities²³.

Endnotes

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- ¹ FAO subscribes to these principles as reflected in FAO, *Agricultural Finance Revisited*, no 1 (1998)
- ² The claim is made on the assumption that no one would be prepared to provide subsidies in perpetuity. This claim may be challenged with the evidence that “social investments” represent. Some investors do not demand a market but a social return on their investments. However, it seems most unlikely that social investments in MF/RF will reach such levels that they will replace the solutions promoted by “best practice” principles.
- ³ These figures are both optimistic and conservative at the same time. They are optimistic (unrealistic) if they were taken to mean that a MFI/RFI reaching financial self-sufficiency immediately and automatically would get access to such levels of external funds. Eventually and over a number of years such a level can be reached. The figures are conservative in the sense that much higher loan equity ratios are generally acceptable practice in the banking business.
- ⁴ At this level of expected return most poor people would probably hesitate to make the investment.
- ⁵ See annex 6.
- ⁶ Estimates by CGAP building on Micro Banking Bulletin, outreach data reported to the Microcredit Summit and other studies.
- ⁷ CGAP, 2002. Member donor typology (draft).
- ⁸ However, in this case a capital constraint has contributed to this outcome.
- ⁹ Operating costs are defined as administrative costs (interest costs + provision for loan losses).
- ¹⁰ These are very crude figures as the Micro Banking Bulletin statistics are broken down by different sizes of MFIs in each region and on sub-regions with a limited number falling in each category. The spread within one region is often considerable.
- ¹¹ CGAP reports a number of impact studies but no assessment of the sector. USAID has taken the initiative (AIMS) to develop evaluation methodology for MF projects. AIMS also report a number of case studies but no sector assessment. These studies hardly give a clear indication of performance.
- ¹² This figure reflects the total agreed amount for active projects under valid agreements.
- ¹³ Support to a central bank for the development of a regulatory framework would not meet with these problems.
- ¹⁴ Observation made on a personal visit to the Bank.
- ¹⁵ In Nicaragua the trust is currently under formation.
- ¹⁶ The use of the technical tools can be elaborated by making sensitivity analyses of key performance indicators by changing projections for key variables and discuss the result. This does not appear to have been done.

- ¹⁷ This may be a misinterpretation. The assumptions may have been assessed, but not very successfully.
- ¹⁸ The projects in Laos and Vietnam were not included in the sample but are familiar to me.
- ¹⁹ The selection process of an MFI is currently under way. At the time of writing there is no information on the performance standards of a winning bidder.
- ²⁰ Perhaps this could be done in the following way:
- (i) Make an estimate of likely levels of core activity, if the credit is *not* made available (it will only be 0 in exceptional cases) in order to suggest the *incremental* effect of the credit.
 - (ii) Establish the *effective* interest rate charged to clients.
 - (iii) Add subsidies to the MFI, including TA. Calculate costs per loan.
 - (iv) Relate the sum arrived at under 3 with expected benefits (a pig, an acre planted for coffee, an improved flat, etc) and discuss whether the costs involved seem to make sense.
 - (v) Make a sensitivity analysis with different assumptions under 1).
 - (vi) Consider other costs elements ("cons") and reflect.
- ²¹ The two views on development deserve a much more elaborate discussion than is possible here.
- ²² FAO, Agricultural Finance Revisited No 1. 1998.
- ²³ Verbal communication by Peter Kooi, team leader for the joint UNDP/USAID/IFC institutional transformation and investment initiative at a Workshop on donors and sustainable MF in Cambodia November 2001 and by David Stanton, Chief Enterprise Adviser, DFID, in connection with the CGAP Peer Review of Sida, May 2002.

Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.



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