

Guidelines on Microfinance



MAKING FINANCIAL MARKETS WORK FOR THE POOR



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Preface and Brief Acknowledgements

While developing these Guidelines, we have aimed at striking a balance between vision and operational practice, between specific situations and general principles. Our ambition has been to formulate Guidelines which can assist Sida programme managers in everyday decision-making while recognising that every context is unique and demands its own analysis. When the time comes to revise these Guidelines to incorporate new experience, we hope that our Sida colleagues will have benefited from a work tool which has helped them to ask the right questions, gain a deeper understanding of the issues involved and improve the quality of Sida's support to microfinance.

These Guidelines would never have seen the light of the day had it not been for the collective efforts of a large group of people. The foresight and continuous support from the Steering Group of experienced decision-makers from various departments at Sida reminded us of the "policy gap" which needed to be filled and gave us inspiration. Renowned Swedish and international experts assisted in the analysis of Sida's MF project portfolio and "international best practice" in the form of various background papers. Donor colleagues from other agencies provided highly relevant feedback and Sida colleagues in all fields of expertise took a passionate interest in the end product, enriching it with their own experience and perspectives. Finally, the hardworking colleagues of the Financial Systems Team never lost faith in the process and in the possibility of finding yet new words and images to help convey the message of "why and how" microfinance. Thank you for all your efforts.

The world's poor, as everyone else, dream of gradually improving their lives. Access to safe savings services, affordable credit, reliable money transfer services and adequate insurance services can, under favourable circumstances, make the difference between dreams and reality.

Stockholm in September 2004,

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Head of Department
INEC
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Abbreviations

BDS	Business Development Services
CGAP	Consultative Group to Assist the Poor
CVECAs	Caisses Villageoises d'Épargne et de Crédit Autogérées
DFID	Department for International Development, United Kingdom
FAO	Food and Agriculture Organisation
FMO	The Netherlands Development Finance Company
FSAs	Financial Services Associations
FSD	Financial Sector Development
HMF	Housing Microfinance
ICT	Information and Communication Technology
IFAD	International Fund for Agriculture Development
IFC	International Finance Corporation
IFIs	International Finance Institutions
KfW	Germany's Development Bank
MDGs	Millennium Development Goals
MF	Microfinance
MFO	Microfinance Organisation/Operator
MIS	Management Information Systems
Pink Book	Micro- and Small Enterprise Finance: guiding principles for selecting and supporting intermediaries
PSD	Private Sector Development
RMF	Rural Microfinance
SACCO	Savings and Credit Organisation
TA	Technical Assistance
UNCDF	United Nations Capital Development Fund
WOCCU	World Council of Credit Unions

1 Definitions and Purpose

There is no one definition of what microfinance is although attempts have been made to provide definitions in terms of loan amounts or lending methodology. However, these definitions quickly tend to become invalid as the field evolves. In the context of these policy guidelines, microfinance is simply taken to mean small-scale financial services for those who are excluded from the formal financial system¹, usually the poor in the informal sector, agriculture and household-based activities. The very existence of microfinance is a symptom that the financial sector does not yet have the required depth and width it needs to serve the local economy. However, as the microfinance industry grows and diversifies, the borderlines between what is referred to as microfinance and the regular financial sector become increasingly blurred. Over time, the aim is to make microfinance services an integral part of the formal financial system.

These Guidelines for Sida's support to Microfinance (MF) have been developed as a complement to Sida's Policy on Financial Sector Development² in order to define and communicate Sida's position on MF, both in-house and to external stakeholders. They clarify and argue why Sida should support MF, how Sida can better align its support with international consensus in the field and what Sida's priorities are. It is hoped that these Guidelines will help improve the overall quality of Sida's MF project portfolio and thereby poor people's access to viable financial services.

2 Financial services for the poor – the client perspective

Access to financial services, such as savings, credit, money transfers and insurance, contributes to expanding poor people's choices and improves their ability to respond to opportunities. It helps reduce vulnerability by providing the means to smooth consumption and bridge crises. Access to financial services thus responds closely to Sida's view on poverty as stated in Sida's key strategy document "Perspectives on Poverty" (2002):

The essence of poverty is not only lack of material resources but also lack of power and choice [...]. Access to MF has also demonstrated a strong correlation to many of the Millennium Development Goals (MDGs)³, which have a central place in Sweden's new policy for global development⁴.

Only a fraction of the world's poor, regardless of definition⁵, have access to institutionalised financial services⁶. Estimates of the total number of MF clients in the world range from 30 to 100 million⁷. There is thus vast unsatisfied demand and quite some ground to cover before MF services are available to a significant share of the world's poor.

After years of mixed experience of support to the development of financial services for poor people, experts, practitioners, the donor community and not least the service recipients themselves, advocate a "client-centred approach". The reason is simple. All people, including the poor, need and use financial services for a variety of reasons. Impact studies worldwide⁸ underline the following reasons why clients demand and value access to MF services.

2.1 Asset building and risk management

Poor clients appear to primarily value financial services as a tool for building up basic assets and coping with risk and crises. Access to finance, both savings and credit, helps to provide the lump sums required to invest in basic household assets such as land, housing, health and education. Assets which can be drawn upon in times of crisis also serve as a form of protection against risk. They include physical assets (land, housing, equipment), financial assets (savings, jewellery), human assets (education, apprenticeship) and social assets (friends, neighbours, networks, relationships). People also protect against risk by diversifying their income sources. When struck by external crises (death, theft, fire, drought), access to savings, credit or insurance can prevent erosion of the household asset base.

2.2 Business growth and income generation

Most small and micro-entrepreneurs finance their business from personal savings or with capital from family and friends. But this source of capital may not suffice. Small and micro-entrepreneurs usually rank access to credit as their number one constraint to growth. Impact studies indicate that micro-enterprises which borrow tend to increase their net returns, thus improving income for the entrepreneur and her/his family.

The bigger the business and the loan, the greater is usually the impact on business returns. However, methodological limitations make it difficult to single out the effects of access to credit from other favourable circumstances promoting business growth, such as new technology, improved business premises, enhanced management skills or a more dynamic business environment⁹. Causality between access to credit and business growth cannot be proven but strong correlation can be demonstrated.

2.3 Cash flow management

More importantly, poor people regularly use savings or loans to manage their household and business cash flow. Income, especially in rural areas, is often seasonal and needs to be put aside for future needs. Important expenditures such as school fees, medical fees or life-cycle events (births, weddings, burials) demand the ability to generate larger lump sums. Access to credit and savings services helps smooth consumption during these periods.

2.4 Empowerment

Finally, studies from different parts of the world have confirmed the role of MF in contributing to empowerment of poor people in general as well as of particularly disadvantaged groups, including women, indigenous people, victims of ethnic or cultural discrimination and not least the growing numbers of persons infected with HIV or suffering from AIDS. Access to MF contributes to building self-esteem, a sense of recognition and achievement and often points to alternative ways of overcoming poverty and marginalisation.

Many microfinance organisations (MFOs) deliberately target women as an inherent feature of their business model. Impact literature shows that access to financial services tends to improve a woman's bargaining position within and outside the household and increase her physical mobility and participation in social networks. Women's empowerment and control over economic resources in turn have important effects on the well being of the entire household, in particular the children. However, there are also critics who argue that MFOs in some instances may actually take advantage of women's vulnerability to social pressure to increase repayment rates without verifying whether the woman actually has control over the use of the money she borrows.

3 Rationale for donor support to microfinance

There is thus strong evidence that access to microfinance can significantly contribute to reducing poverty. However, despite poor peoples' demand for financial services and their ability to pay for them, commercial investors have not yet responded to this business opportunity on any significant scale. The reasons are many, including unfavourable policies, incomplete market information, and lower and slower returns than alternative investment opportunities¹⁰.

Initial examples of profitable MFOs have therefore to a large extent been donor-funded. There are strong arguments for donors to play this "demonstration role" as it generates market information for future investors and identifies constraints in the policy environment which can subsequently be addressed (thereby addressing both market and government failures). Nevertheless, to provide the desired demonstration effects, it is critical that donor support is designed in such a way that it encourages commercial pricing (i.e. full cost recovery), efficient operations and sound market development, allowing the phasing out of subsidies (grants, technical assistance and soft loans) in a predictable manner.

Since the appearance in most countries of successful demonstration models¹¹ showing that small-scale financial services can be offered profitably, private and quasi-commercial capital¹² is increasingly finding its way to the MF sector.

4 Vision and Objective of Sida's support to microfinance

Poverty reduction is the overall goal of Swedish development cooperation¹³. Financial services for the poor, or microfinance, are important tools in the efforts to achieve this.

The development of efficient and competitive markets¹⁴ is the key to increase access to financial services for the poor in the long run and at a significant scale. Efficient markets are characterised by free and fair competition, no barriers to entry, effective systems for expelling failing enterprises and mechanisms to address market failures and equity concerns. As outlined in Policy Guidelines for Sida's support to Private Sector Development, this applies to all types of markets, including markets for financial services¹⁵.

Box 1

Sida's Objective for support to Microfinance

Sida's support to MF should aim to promote the development of efficient and competitive markets for financial services, with a particular focus on the inclusion of the poor. Sida should contribute to creating favourable conditions for:

- Increased access to financial services by the rural and urban poor and other under-served client groups;
- The emergence and consolidation of sustainable financial service providers;
- Diversified financial products and service providers;
- Efficient operation of service providers, markets and supervisory authorities.

There is at present strong consensus on how donors can support the development of financial markets that serve the poor. This is much thanks to the role played by CGAP, an international donor consortium in MF¹⁶. As an active member of CGAP, Sida adheres to the vision which guides CGAP's work over the five-year period from 2003–2008.

Box 2**Sida's Vision for Microfinance**

“The new vision is a world in which most poor people enjoy permanent access to a wide range of financial services delivered through a variety of convenient mechanisms by different types of institutions”.

5 Microfinance in the context of financial systems development¹⁷

Improving long-term access to financial services for poor people requires viable financial institutions which operate without continuous subsidies. Rather than depending on donor funds to finance the expansion of their loan portfolio, institutions should be able to mobilise funds on local or international capital markets, whether through deposits, loans, share capital or other instruments. Taking deposits which are subsequently on-lent or invested – i.e. engaging in “financial intermediation” – implies putting other people’s money at risk. Such organisations must therefore comply with public regulation and oversight in order to prevent mismanagement of funds and to maintain public trust in the financial system.

Public regulation is also concerned with the functioning of financial markets. Markets characterised by sound competition, rather than predominance by one or a few service providers, tend to offer clients a better choice, based on correct and comparable information. This is expected to lead to innovation and efficiency which will eventually benefit clients through reduced interest rates and a diverse range of products.

Thus, as MF services become more sophisticated and MF markets more competitive, MF must be seen in a broader context. This context is referred to as the financial system. The financial system comprises all financial institutions, markets and instruments, the legal and regulatory framework governing the functioning of financial markets, and the public authorities mandated to oversee compliance with regulation.

Box 3

The role of the financial system

The financial system mobilises surplus capital (savings) and identifies the best opportunities for its investment, thereby contributing to a continuous process of economic restructuring which in turn generates growth. It eliminates the need to physically move money by offering payment services, transfers and remittances, all of which lower the risk and cost of doing business. It also provides important information on risk and helps manage risk by dividing and distributing risks over different investments and investors and over time.

Box 4**Addressing systemic constraints rather than symptoms**

Most MFOs offer only short-term loans (3 to 12 months maturity) whereas many clients demand medium-term loans (1–5 years) for investments in agriculture, equipment or housing. Many MFOs find it difficult to access medium-term capital for on-lending, despite the fact that they are profitable and creditworthy. In such a situation, donors often propose to resolve the problem by providing the MFO with medium-term funds, through grants or loans, i.e. addressing the symptom. This is however only a temporary solution. Instead, or in parallel with short-term measures, donors should seek to address the systemic reasons for lack of access to medium-term capital. Examples include:

- A corporate form of MFOs which is not conducive for mobilisation of long-term capital: MFOs are often NGOs with no owners who can contribute additional equity capital. Donors can facilitate the transformation of NGOs into semi-formal or formal financial institutions.
- Lack of licensing as a financial institution which prevents MFOs from mobilising savings, issuing bonds and accessing public sources of re-financing. Donors can support the licensing of MFOs by addressing the legal framework or by encouraging MFOs to fulfil criteria and apply for a licence.
- Imbalances in the financial system, such as high yielding treasury bonds, may discourage formal banks from lending to riskier clients such as MFOs, as the bonds offer a safer investment opportunity. Providing financial institutions with donor funds under such circumstances may discourage the sound development of the financial system unless government domestic borrowing and budget deficits are addressed simultaneously.

Before designing donor interventions in support of the development of pro-poor financial markets, it is critical to understand the existing financial system. Donors must identify the true constraints, whether at the retail (micro) level, sector (meso) level or policy and regulatory (macro) level. Box 5 provides examples of actors and activities at each level of the financial system which could be the subject of donor support.

Box 5: Framework for description and analysis of donor interventions in support of the development of the microfinance sector¹⁸

Level	Objective of donor support	Topic to be addressed	Actors which could be supported	Illustrations of donor support activities
Macro	(1) Enabling environment for microfinance	(a) Financial sector policy	• Prime Minister and Cabinet • Ministry of Finance	• Develop and adopt a national MF policy. • Improve awareness of parliamentarians and civil servants of the role of microfinance. • Integrate MF into national financial sector development strategy.
		(b) Legal and regulatory structure	• Parliament • Central bank or other govt agencies mandated to regulate and supervise MFOs • Capital market regulators	• Develop a regulatory framework for MF activities, aiming at creating a level playing field for all actors willing to engage in MF. • Developing strategies to implement adequate but cost-efficient supervision of microfinance. • Revise prudential regulation for banks to allow lending to MFOs without excessive provisioning for bad debt.

Level	Objective of donor support	Topic to be addressed	Actors which could be supported	Illustrations of donor support activities
Meso	(2) Sector wide development	(a) Market linkages and wholesale finance	- Local commercial and state-owned banks - Other capital market actors such as pension funds or insurance companies - Specialised funding vehicles and MF investment funds	- Promote linkages between local banks and strong MFOs by addressing the lack of information and the need for adjusted credit analysis. - Guarantee schemes to reassure commercial lenders during initial lending to MFOs. - Enable and support MFOs to issue bonds on local capital markets to raise capital. - Establishing or strengthening specialised commercial MF investments or loan funds.
		(b) Business services for retail financial providers	- Specialised MF training providers - Audit firms specialised in MF operations - Specialised ICT and MIS service providers¹⁹	- Trade fairs for ICT and MIS providers - MF training curriculum development - Strengthening the technical skills of business service providers to the micro-finance sector - Technical guidelines for MF audits
		(c) Knowledge generation and dissemination	- Universities - Central banks and supervisory authorities - MF industry associations - Local and regional research institutes - Specialised MF rating firms	- Research into key sector level questions (demand for specific services, client dropouts, consumer protection issues). - Survey of financial service providers' geographical coverage, depths of outreach, competition and poverty alleviation impact. - Co-ordination of different stakeholders' efforts to monitor MF sector development. - Codifying industry standards of good practices for MFOs. - Improved transparency of the financial performance of individual operators and the MF sector as a whole.
		(d) Advocacy capacity and industry dialogue	- MF industry associations - Cooperative apex organisation	- Seminars or discussion fora on sector wide issues. - National MF industry association engaging in regulatory development process. - Strengthening of MF industry association's capacity to adequately represent its members.
Micro	(3) Retail capacity development	(a) Selective capital provision	- Banks - SACCOs - NGOs - Others	- Capital grants allowing MFOs to reach full financial sustainability or minimum capital requirements for transformation. - Loans or capital grants on a matching basis with commercial capital to encourage leverage and commercial borrowing. - Investment in start-up innovative MF service providers (so called "greenfield operations")
		(b) Capacity building of retail financial providers	- Banks - SACCOs - NGOs - MF delivered through other retail chains	- Increased outreach by establishing branch offices in rural areas. - Product development and staff training for formal financial institutions entering micro-finance markets ("down-scaling"). - Support for MFOs transforming into regulated financial institutions. - Support to good governance/board capacity building. - Strengthening of internal control and audit.

Level	Objective of donor support	Topic to be addressed	Actors which could be supported	Illustrations of donor support activities
		(c) Product development	• MFOs • Consultants/TA providers • Research institutes	• TA to microfinance service providers for the development & rollout of new products. • Demand surveys on products which may include SME financing, housing MF, rural MF, micro-insurance, remittances.
		(d) Stimulating demand and building capacity of clients	• Clients • MFOs • Media	• Market neutral information on the importance of household cash management, incl. savings and loans. • Comparable information on sources and prices of financial services. • Information campaigns on consumer rights and complaint procedures.

Describing the financial system in terms of its different levels (micro, meso and macro) offers a static picture of the financial system at a given point in time. A complementary and more dynamic approach to analysing and describing the microfinance sector in a given country is to look at the maturity of the market in relation to certain conceptual phases: the start-up phase, the expansion phase, the consolidation phase and the integration phase²⁰. A typology of these phases is outlined in Annex 1 and can serve as an analytical framework while bearing in mind that a country's financial sector seldom develops in this linear way but rather through periods of crisis and consolidation. It is also very common that different market segments and different financial institutions find themselves in different "phases" (start-up, expansion, consolidation or integration) at the same point in time.

Finally, poverty can only be sustainably reduced as the entire economy grows which calls for financial intermediaries which are not confined to serving the poor and the poorest only (and always), but can grow and diversify together with its clients and with the local economy where it operates.

6 Guiding principles for Sida's support to microfinance

The first donor consensus publication in the field of MF is referred to as the Pink Book²¹. It was published in 1995 when microfinance was still a new phenomenon and the challenge to donors was primarily how to support the development of financially viable MFOs. Today, most countries have several microfinance operators and multiple sources of donor support for MF. The challenge for donors thus becomes the ways in which they best promote a sound development of the MF and financial sector as a whole while coordinating donor efforts, for maximum leverage and impact.

6.1 A sector development perspective

The role of donors will differ depending on the stage of maturity of financial markets. In early stages of MF sector development, Sida should focus on building retail capacity, institutional viability, sound competition, and outreach to various geographical areas and client segments. This will typically include direct support to microfinance service providers, including grant funds or soft loans to establish new MFOs, to increase the number of branch offices and cover operational losses during the start-up period, and technical assistance to improve management capacity.

As markets mature, Sida's role must change. Financial assistance should be limited to the creation of (sector level) public goods such as favourable legislation, efficient supervision, access to market information, linkages between MFOs and formal financial institutions, market research, training and industry associations (Bank Associations, MF Networks). There may still be arguments for supporting retail level MF service providers if such support is expected to generate demonstration effects from which all players can benefit. This includes product development (financial products are usually easy to copy and quickly adopted by others), transformation from NGO status into licensed, regulated financial institutions (creating role models and a learning experiences for supervisory authorities) and experimentation with innovative institutional set-ups or delivery mechanisms reaching out to poorer or more remote clients (e.g. Village Banks in Central America, Financial Service Associations in East Africa, CVECAs in West Africa and the Safe Save Scheme in Bangladesh).

In mature financial markets, donors should seek to forge linkages between MF and the formal financial sector. Provision of capital should be avoided or tied to leveraging donor funds with commercial funds. Capital should be priced at near market terms to avoid market distortions. Where local capital markets are not yet ready to invest in MF, capital should be channelled through existing specialised MF investment vehicles which are better placed than Sida to identify and analyse good investment opportunities. These MF investment vehicles usually have a regional or global scope in order to ensure sufficient demand and risk diversification²².

6.2 Donor co-ordination

Harmonisation of donor support to MF will enhance its effectiveness. Donors need to agree on a common vision and performance standards for support to the development of MF services. Despite the consensus which exists at the international level, as expressed through CGAP, donors are frequently incapable of co-ordinating their support at the national level, or at the level of individual MFOs, although the worst examples of subsidised interest rates or unsustainably low repayment rates are fortunately not as commonplace as they used to be.

In many of the countries where Sida supports the MF sector, there are attempts to render donor support more effective through various forms of donor co-ordination²³. The most advanced types are multi-donor funded “pro-poor financial sector development programmes”. These programmes take different shapes²⁴ depending on the context and the participating donors. However, they have the common characteristics of buying into a national strategy for the development of the MF sector, spelling out a division of roles and responsibilities among the different donors and the national stakeholders, multiple funding sources – whether pooled or separate, standardised reporting and shared performance standards. Where possible, Sida should always seek to participate in existing sector programmes rather than developing its own MF projects.

In countries where Sida has a significant MF project portfolio but where no framework yet exists for a consolidated sector development programme, Sida should seek to initiate such a programme in close dialogue with other donors and national stakeholders. As a minimum, Sida should always take active part in donor co-ordination fora, formal or informal, in every country where Sida supports MF, in order to be aware of national policies and other donor programmes. Sida should never approve new MF interventions without first mapping and analysing the role of other donors and stakeholders in the sector.

6.3 Use of grants and “smart” subsidies

Subsidies in the context of these guidelines is taken to mean all sorts of grant and concessionary funding. It is believed that subsidies can be used strategically to address market and government failures as long as they are temporary and designed to have an impact beyond individual business operators. Market distortions should be minimised but donor support to individual MFOs or business service providers (auditors, trainers, MIS providers) can occasionally be justified by its demonstration effects or other types of positive externalities. Subsidising prices to the end client

discourages market development and is unaffordable over time. It should therefore be avoided. Instead, subsidies should be used for capacity building and (sector level) public goods. There should always be a credible strategy for the phasing out of subsidies.

6.4 A conducive policy environment

The development of efficient and pro-poor financial markets requires a conducive policy environment and stable macro-economic conditions²⁵. Financial regulation must evolve to also accommodate the specific characteristics of MF (specialised service providers, non-collateralised lending, flexible deposit services, etc.). In countries where this is not the case, Sida should focus on improvement of the policy and macro-economic environment before or in parallel with investing in institution building and market making. Policy dialogue is best undertaken by local stakeholders. The role of Sida should be to strengthen the analytical and dialogue capacity of the MF industry, its representatives and public authorities, and to create fora for policy dialogue. Sida can also provide direct support to the development, reform or implementation of appropriate regulation and adequate supervision, while making sure that local stakeholders are consulted throughout the process²⁶.

Box 6

Market development through (de)regulation

MF markets have more often than not developed through donor support to the establishment of various types of MFOs. However, there are countries where MF markets have developed without donor or public support, thanks to a favourable policy environment, solvent client demand and available risk capital. South Africa is a case in point where the consumer credit market has boomed since the South African government deregulated interest rates.

However, it is a market that only offers short-term credit (1 to 3 months) to wage earners at very high interest rates. Donors (including Sida) and South African policy makers therefore seek to support the development of better functioning markets by strengthening consumer protection mechanisms and alleviating constraints to medium-term loans for housing and micro-enterprises. These improvements are expected to take place both through new legislation and donor support to product development and new market entrants.

In other countries, MF market development is enforced by legislation which imposes a requirement on banks and other financial institutions to direct a certain proportion of its lending to under-served client groups. This is, for example, the case in India where legislation requires banks to lend to poor clients through a system of wholesale lending to “self-help groups” which either use the loan for a collective investment or on-lend it to individual group members.

6.5 Commercial viability, sound governance and local ownership

A basic premise of a market-oriented financial system is that financial service providers, whether specialised microfinance institutions, banks, credit unions or NGOs, strive to become commercially viable. This often entails considerably higher interest rates on micro-loans than those pre-

vailing in the formal banking sector in order to allow for full coverage of the increased costs of processing numerous small loans rather than a few big ones²⁷. Sida's support to MF must allow for the development of financial institutions capable of covering all of their costs through interest and other incomes paid by their clients. It means inter alia that usury laws that put a ceiling on interest rates may have to be alleviated for MF services while still encouraging MFOs to reduce interest rates through competitive pressure and donor performance targets.

Sida views MF and other financial services as a private sector good to be provided primarily by privately owned financial institutions. This includes member-owned organisations (SACCOs, credit unions, FSAs and CVECAs). State-owned or politically controlled entities may be justified where the private sector fails to serve certain client groups but carries the risk of the state crowding out private initiative. As stated in Sida's policy for financial sector development (FSD), "support to government controlled commercial financial institutions will be restricted to the restructuring of such entities as a step towards corporatisation or privatisation and in areas where no private parties have shown an interest to enter".

Various not-for-profit corporate forms without direct owners (associations, non-governmental organisations, foundations or companies limited by guarantee) may be conducive to the establishment of new MFOs dependent on grant money. At early stages of institutional development and experimentation, management autonomy, commitment and competence have proven more important for success than the ownership form. However, over time, as such organisations seek to integrate into the formal financial sector, they need to transform to a corporate form recognised by the regulatory authorities, usually a company limited by shares or a member-owned organisation. Sida should encourage and support such transformation for all mature, non-regulated MFOs receiving Sida support, provided an appropriate legal framework exists.

Whatever the corporate form, Sida should ensure and encourage strong and competent governance of the MFOs receiving Sida assistance. This includes inter alia adequate board competence and composition, incentives for performance, sound remuneration schemes, clear lines of accountability, separation of duties and strong internal control. Unfortunately, MF is as prone to fraud and mismanagement as all other sectors and donors need to be vigilant, requesting total transparency in operations and strong internal and external controls. Sida should also promote significant and preferably majority local ownership (which may include staff and client minority ownership). Locally owned financial institutions are more likely to continue to serve local markets and to attract local capital. They contribute to domestic resource mobilisation which is the key to stable economic growth.

6.6 Appropriate financial instruments

Sida can support the expansion of MF services through its various financial instruments, including grants, loans and guarantees. In each specific case, the instrument and terms which cause the least distortion to the market should be used while taking into account the desired demonstration effects and the need to reach or maintain stipulated levels of capital adequacy or minimal capital when funding individual MFOs. The Pink

Book makes detailed recommendations on the use of grants (for technical assistance and capacity building) versus loans and guarantees (for portfolio expansion). These recommendations are still valid guidelines but must always be further analysed in each particular context.

Credit and guarantees are more sophisticated instruments, involving long-term ownership of funds (Sida) and the need for complex incentives (guarantees). These instruments therefore tend to be more labour and expertise-intensive and may therefore only be justified for fairly large investments and in situations where other donors specialising in these instruments (International Finance Institutions such as IFC, FMO, KfW and others) are either willing to take the lead (allowing Sida to make a parallel investment) or are unable to invest for reasons which have nothing to do with the performance of the potential investee.

Equity investments are critical for the long-term development of MFOs and contribute to professionalizing board governance. However, as a government agency, Sida is unable to assume the role of direct equity investor. Sida could provide convertible loans at par with equity, but needs to delegate governance responsibilities to a third party. Sida's capacity and competence to play even a limited or indirect governance role in financial institutions are limited and such roles should therefore be avoided.

6.7 Sufficient specialist expertise

Building efficient and stable financial systems, with the capacity to serve a majority of the poor population, requires specialist expertise. Sida must ensure that all Sida-supported interventions have access to and make use of relevant expertise whether through the recipient or implementing organisations, consultants, other donors co-funding the same intervention or through Sida staff.

6.8 The impact of HIV/AIDS on MF development

The HIV/AIDS pandemic is reaching unimaginable proportions and many of the widespread effects of the disease are still to be seen. Microfinance, in particular in Sub-Saharan Africa, is already affected by HIV/AIDS. Clients' repayment capacity is hampered as they become responsible for larger households with more dependants when relatives pass away or when their own work ability is reduced because of HIV-related infections. Repayment rates are not necessarily affected, but clients demand lower average loan amounts and may stop taking loans altogether. It is also frequently observed that MF clients who often fall sick due to HIV infections are excluded from group lending schemes.

MFOs are also affected by increased staff absenteeism and turnover. HIV/AIDS in Sub-Saharan Africa is thus expected to reduce the growth rate and performance of MFOs although the direct relationships may be difficult to establish. All MFOs receiving support from Sida should be requested to have a strategy for dealing with the consequences of HIV/AIDS, for both its clients and staff, that is non-discriminatory.

Access to financial services, including savings, can assist households in building safety nets to deal with the impact of HIV/AIDS but some caution is warranted. The more vulnerable a household is, the less likely it is to be able to use microfinance effectively. Indebtedness may be a last

resort for these households but should not be encouraged since it may even accelerate the depletion of household assets in order to repay the loan. Safety nets, social services and various forms of grant programmes are better alternatives where available. Experience also shows that it is unwise for an institution to deviate from its core business in order to offer HIV/AIDS information, counselling, health care or insurance products for clients affected by HIV/AIDS. It has proven more effective to link up with other organisations specialising in the provision of such services. Sida should encourage such linkages in order to discourage discrimination of clients affected by HIV/AIDS.

7 Design features to be careful about

Past experience has taught Sida and other donors useful lessons of what works less well in MF. Project design features discussed in the following section require special attention, since they may harm or delay the long-term development of the financial sector. An analysis from a financial sector development perspective is therefore needed and alternative solutions to identified problems should be examined in order to avoid such risks.

7.1 MF components in integrated development projects

Access to credit is often perceived as a critical constraint to achieving specific project objectives in area-based or sub-sector approaches to development. Farmers need fertilisers and improved seeds to increase productivity, micro-entrepreneurs need working capital and new equipment to improve the quality and level of production and the urban poor need better housing and local infrastructure to improve their livelihoods. All of this points to the need for credit. However, past experience has demonstrated that when credit is only offered as “seed capital” for the achievement of ulterior objectives (such as reaching as many clients as possible in the designated target group), loan recovery, cost coverage and long-term institution building suffer.

Where MF or credit components already exist or must be included, Sida should seek to separate these components from the management of other project activities and apply “sound MF practices”. This includes involving specialised financial expertise in the design and implementation of the MF component, working with specialised financial institutions (rather than setting up a temporary retail credit mechanism), allowing the MFO to select and screen its clients without project intervention, separating the accounting of the MF component from the rest of the project, and requesting reports on financial performance according to established MF practice²⁸.

7.2 MF in multi-purpose organisations²⁹

There are situations when it makes sense for the same organisation to offer a range of services, including finance, even when finance is not part of its core competence or business idea. For example, in remote areas, unstable urban slum areas or in a post-crisis environment with acute

needs, limited trust and few service providers, this may reduce transaction costs and increase immediate impact. However, in a more stable setting and in competition with specialised service providers, multi-purpose organisations often find it difficult to ensure sufficient in-house expertise, to separate costs and to price different services correctly. This is particularly pronounced if fee-based services such as credit are combined with free services such as education or health. Organisations offering both business advice and credit also find it difficult to avoid conflicts between correctly assessing clients' repayment capacity and the wish to see clients expand and diversify their businesses. Therefore, Sida should avoid imposing or encouraging provision of services beyond the service provider's core competence unless they are initiated by the service provider itself and have proved to make "business sense".

7.3 Imposing too narrow client targeting

All financial institutions target different market niches with different products, seeking to control market shares in specific market segments. MFOs are a case in point where lending methodologies and savings services are specifically designed for people with low incomes and no conventional collateral. However, donors often require that MFOs apply additional targeting criteria – whether geographical, income level or purpose-driven – in order to qualify for concessionary donor funds. The more narrow and multi-layered the targeting, the greater the risk that sufficient solvent demand will not be found. Strictly applying and verifying donor "target group criteria" also puts a high administrative burden on the MFO. Sida should therefore avoid too restrictive targeting. A more efficient way to reaching out to new, poorer and more remote client groups is to support market research and product design of MFOs committed to exploring new market segments and ready to invest the necessary resources into developing new products³⁰. Donors, including Sida, that are interested in understanding and monitoring the poverty outreach of an MFO or an entire MF sector, i.e. how poor MF clients are, can apply analytical tools specifically designed for this purpose, often referred to as "poverty audits"³¹.

7.4 Wholesale organisations

Donors, including Sida, are attracted to using wholesale mechanisms to channel funding or technical assistance (TA) to several MFOs in a given country. This is perceived to reduce the market distortion inherent in direct support to individual MFOs. It is also believed to reduce the administrative burden of dealing directly with individual MFOs. However, in most countries (with some notable exceptions such as Bangladesh, Ethiopia and India), the domestic MF sector is too small or too weak to sustain a commercially viable second-tier lender. However, there may be a case for a wisely designed temporary national level funding mechanism to support the formalisation of MF and to build bridges to commercial capital markets as long as market distortions and "crowding out" effects are minimised³².

If technical assistance is to be provided through a temporary wholesale mechanism, TA should be individually targeted and adapted to the specific needs and efforts of the MFO. Nevertheless, Sida should support

MFOs in their own efforts to identify the most appropriate type and source of TA for their specific needs. Over time, Sida should seek to encourage the development of national or regional markets for diversified and commercially viable TA and consultancy services, in line with recent thinking on market development for Business Development Services (BDS).

7.5 Channelling support to private sector entities via public agencies

Sida has often channelled its support to MF through public agencies or local governments, as a component of integrated development programmes. Although there are examples of successful state-led provision of financial services (BRI in Indonesia, NABARD in India and ACSI in Ethiopia), the failure of state-implemented credit schemes has been more the rule than the exception. There are significant risks for undue political influence, confusion about future ownership or inefficiencies in the transfer of funds. Thus, Sida should seek to channel its support directly to the recipient organisation or through private, specialised, independent local or international organisations.

7.6 “Crowding out” local capital and expertise

Local capital, including savings – a valuable service for poor people, risks being “crowded out” by excessively cheap or easily accessible donor funds. Instead, Sida should promote access to existing local capital markets by removing obstacles for such investments. Likewise, Sida should avoid crowding out local competence by excessively strong reliance on international consultants and implementing organisations. Instead, Sida should use local or regional expertise where it exists and seek to build local capacity where it is still weak by linking it to international expertise.

7.7 Funding gaps

The development of financially sustainable institutions usually requires a significant amount of funding and time. Abundance of funding may lead to operational inefficiencies but insufficient funding may equally harm the MFOs’ development. It is a tricky balance to strike. Sida should either agree to cover the entire funding gap, adjust performance targets to available funding or withhold its funding until complementary funding sources are secured.

8 Applying Sida's Guidelines on MF: special challenges and thematic priorities

These guidelines are generic and do not take into account Sida's capacity to develop the necessary technical skills and staff capacity to implement them. Clearly, Sida cannot "do everything everywhere" but needs to be selective in the role it chooses to play in MF. Challenges to implementing these guidelines include a definition of Sida's comparative advantages in the broader MF donor community, quality assurance of MF support in a decentralised organisation and the development and maintenance of sufficient technical expertise at different levels.

8.1 Sida's comparative advantage

In a typical Sida partner country, financial services are only accessible for a narrow segment of the population. MFOs exist but with one or two exceptions most are still weak, with limited client outreach and unviable operations. The national policy framework is not yet adapted to MF or is currently being reformed. Donor involvement in MF is strong but fragmented. Better co-ordinated donor support within a sector development framework will require a long-term perspective, strong field presence and a willingness to collaborate with other donors, characteristics which correspond closely to Sida's profile.

However, a sector development approach to MF will also require strong technical skills in the field and a good understanding of local financial markets. MF donors must have the ability to make and monitor "investment decisions", to design incentives for market players to change behaviour and to translate experience into policy dialogue and suggestions for regulatory reform within the perspective of a financial system. Not least it will require willingness to fund projects which are labour and expertise-intensive but entail only limited disbursement of funds. Here, Sida's comparative advantage is less obvious, its technical resources limited and its track record mixed³³. Sida should thus be well placed to take on the role of an active, dedicated co-donor, albeit not the leader, in MF sector development programmes (or frameworks) or in donor consortia aiming to support individual MFOs, MF investors or regulatory authorities.

8.2 MF Competence Development and Quality Assurance within Sida

The responsibility for MF project implementation and monitoring will remain with different sector divisions and departments within Sida and increasingly with “delegated embassies” which also have full decision-making powers over projects. Sida will not be able to ensure sufficient expertise in MF throughout the organisation. Instead, Sida’s Financial Systems team (located in Sida’s Division for Market Development) will continue to assume the responsibility for consolidated quality assurance – based on these guidelines – of Sida’s MF project portfolio, through regular monitoring and analysis of the project portfolio, pro-active advisory services and shared or (to a limited extent) delegated project management responsibility. Project managers in other departments or in the field will be encouraged to seek early involvement of the Financial Systems team in project design and appraisal. A detailed suggestion for the role of the Financial Systems team in implementing these guidelines is outlined in Annex 3.

8.3 Thematic priorities

With a sector development approach, each specific context will determine the focus of Sida’s support to MF in that country. However, based on Sida’s history and active MF project portfolio, as well as the unsatisfied demand in most countries, Sida will pay particular attention to the promotion of rural and housing MF services.³⁴

Sida’s support to rural MF (RMF) should increasingly be characterised by pilot testing and strengthening of cost-effective institutional set-ups or innovative service delivery mechanisms which reduce transaction costs. It should seek to understand and improve risk management, for example through the distribution of credit risks over a diverse portfolio and diverse household income sources. A particularly important area of intervention in rural MF is support for innovative approaches to building commercially viable savings and credit co-operative (SACCO) systems. Challenges which need innovative solutions in the field of SACCOs include the rethinking of the role of traditional apex structures, appropriate regulatory frameworks, enhanced governance structures, capital provision and linkages to other types of MFOs and the formal financial sector.

Likewise, *housing MF (HMF)*, which mostly translates into housing improvement loans, will remain a strong strategic priority for Sida. Sida’s support to HMF should increasingly be characterised by a systematic product development approach where housing loan products are developed on the basis of identified market demand while ensuring that the necessary institutional capacity and competence to manage the new product is available³⁵.

9 Checklist for assessment of project proposals

Below there is a checklist designed to help programme managers identify and assess sound proposals for the development of efficient and competitive MF markets. For more precise guidance on these and other MF topics, see Annex 2 or CGAP's Information Resource Centre (CGAP DIRECT)³⁶ which includes a series of easily accessible, -two-page "donor briefs" on these and other recurrent topics in MF.

1. *Is MF the best intervention to address the identified development problem?*

Given its current popularity among donors, MF risks becoming a "one size fits all" solution to poverty alleviation. The very first question to ask oneself is thus if MF really is the most appropriate intervention³⁷.

2. *Is there a comprehensive analysis of the national MF and financial sector and its stakeholders?*

What are the systemic reasons behind the identified problems?

Will the proposed project design contribute to the long-term development of efficient markets or is it only a temporary measure?

Where it exists, Sida should adhere to national MF policies, in-country donor co-ordination guidelines or national MF Networks' industry standards.

3. *Do the board and top management of recipient organisations share Sida's vision of priority target groups?*

The vision, mission and values of the recipient organisation's board and management have proven more important in determining its commitment to serving poor people than targets stipulated by the donor. A satisfactory poverty outreach can be determined through a sector or institution level "poverty audit".

4. *What is the track record of implementing partners?*

All recipients of Sida funds should be subject to assessments of their capacity to handle funds responsibly and their likelihood of reaching agreed targets. Sida should be selective in its support to MFOs and apply the following criteria:

- a credible trend towards institutional sustainability;
- strong governance and competent management;

- catalytic effects in attracting capital and knowledge;
 - innovation and demonstration effects beyond the individual MFO³⁸.
5. *Are there reasonable and clearly formulated expectations for performance?*
Donors increasingly apply “performance based contracts” where funding tranches are released on the basis of satisfactory performance in respect of agreed targets. Sida has developed a model contract for performance-based funding of MFOs³⁹ which can be adapted to other types of organisations. The next generation of performance targets, currently being developed and tested, will include sector level indicators of access, diversity and efficiency. An excellent source of regional and international performance data of MFOs which can be used for benchmarking is the MicroBanking Bulletin⁴⁰.
6. *Are Sida’s reporting requirements harmonised with those of other donors, the central bank and the reporting capacity of the partner organisation(s)?*
CGAP’s 29 member donors have agreed on “Disclosure Guidelines for Financial Reporting by Microfinance Institutions”. These guidelines do not prescribe accounting policies or any particular format for financial reporting. Rather, they indicate the minimum information that should be included in financial reports, regardless of how that information is presented⁴¹. Sida’s requirement should adhere to central bank reporting requirements and to in-country donor guidelines on reporting⁴², where these exist.
7. *Is there an appropriate and explicit exit strategy for Sida’s support?*
Such a strategy should be built into the project design, whether in terms of a gradual phase out of subsidies or transfer of ownership of Sida funds. Sida should avoid having to assume a governance role, even indirectly. Sida should also avoid funding agreements longer than five years since projections for institutional or market development beyond this time limit is highly uncertain. Long-term support is often required but should be developed in separate phases.

Annex 1

A conceptual framework for the development of a microfinance sector

Financial institutions and markets develop gradually, through periods of crisis and consolidation, rather than linearly as outlined below. With this caveat, the framework below is still helpful in understanding and “labeling” different stages of maturity of MF markets and what challenges each phase present. The framework has been adapted from Peter Kooi (UNCDF).

In the **start-up phase**, semi-formal microfinance activities are introduced as experimental pilot projects. In this phase, initial products are developed and tested in the market. The emphasis at this stage is on building a human resource base capable of delivering products with good levels of repayment. This is also the phase of awareness by clients and the public at large that the poor can be credit-worthy. Some pilot projects fail due to low repayments while others gradually discover techniques that are applicable to the local context. At the end of this stage, one or two microfinance operators are likely to have developed a successful business model. Other microfinance operators replicate their approach.

In the **expansion phase**, the successful MFOs concentrate on expanding the scale of operations. The success of their business model allows them to replicate their activities and to capture a large share of the potential market. The emphasis, at this stage, is on expansion of existing activities and on resource mobilisation to finance the expansion. The expansion leads to economies of scale and higher efficiencies allowing successful MFOs to finance their operations through income generated from interest and fees. At this stage, microfinance operators are still subsidised by grants and soft loans to finance the expansion. The increased scale of operations requires further institutional strengthening particularly in the areas of management systems and procedures.

In the **consolidation phase**, some microfinance operators start to focus on their long-term sustainability and on strengthening the institution as a whole. This stage is characterised by organisational formalisation. Management supervision, organisational policies, procedures and systems are made more formal. The microfinance sector also formalises by gradually establishing generally accepted industry norms. Subsidies from donors diminish in order to avoid continuous subsidisation of the market and market prices. Consequently, MFOs are required to further increase their productivity, to expand in scale and scope and to adjust their pricing policies to ensure profitability.

In order for the sector to enter into the next phase, the integration phase, it is important that at the end of the consolidation phase a special regulatory framework is in place that is conducive to the development of the microfinance sector and allows for effective prudential regulation by the central bank (or the financial supervisory authority). The development of such regulations normally takes place at the end of this phase when a critical mass of MFOs is willing and able to integrate into the formal financial system.

In the **integration phase**, leading MFOs have become an integral part of the formal financial sector, regulated by the central bank and offering a range of demand-oriented products for the lower segments in the market. This integration is required for the sector to be able to further finance its growth by attracting capital from commercial sources (deposits from the public, loans and equity). The integration phase is characterised by transformation of MFOs into regulated financial institutions. Commercialisation of microfinance and the gradual disappearance of subsidies for the microfinance sector stimulate down-scaling of commercial banks that have become aware that the lower segments of the market can be targeted in a profitable manner.

Annex 2

References for further reading

A good general starting point when searching for further information on many aspects of microfinance is CGAP's website www.cgap.org. This site contains a lot of useful information on MF for both MF "practitioners" and donors. From this site, it is also possible to link up with the *Donor Information Resource Centre (DIRECT)* which offers easy-to-use information on microfinance good practices for donor staff. Another useful webpage is the *Microfinance Gateway*, www.microfinancegateway.org, which contains research and publications, specialized resource centres, organization and consultant profiles, and the latest news on microfinance.

Below are some more specific suggestions on where to find more information on aspects of microfinance that are of particular relevance to Sida staff. These references should be seen as a starting point for further reading and include only a few suggestions on each topic.

Sector analysis and design of sector support programmes

- "How Donors Can Help Build Pro-Poor Financial Systems"; CGAP Donor Brief No 17 (2004)
- "Microfinance Donor Projects: 12 questions about sound practise"; CGAP Donor Brief No 1 (2002)
- "Microfinance Systems – Designing quality financial services for the poor"; Graham A N Wright (2000)

Appraisal of MF institutions and design of support interventions

The following tools and guides for appraisal and design of support can be found at www.cgap.org/publications/financial_transparency.html:

- "Resource guide to Microfinance Assessments"; CGAP Focus Note No 22 (2001)
- "Disclosure guidelines for financial reporting by microfinance institutions"; Donor Consensus guidelines (2001)
- "Microfinance transparency and reporting to donors"; CGAP Donor brief No 7 (2002)
- "Focus on Financial Transparency – building the infrastructure of a microfinance industry"; CGAP (2000)
- "Format for Appraisal of Microfinance Institutions: A Handbook"; CGAP (www.cgap.org/publications/technical_handbooks.html)

- “Micro- and small enterprise finance: guiding principles for selecting and supporting intermediaries” (the “Pink Book”); Committee of Donor Agencies for Small Enterprise Development and Donors’ Working Group on Financial Sector Development (1995) (www.ilo.org/employment/sedonors)
- “Microfinance rating and assessment fund”; CGAP and IDB (<http://www.ratingfund.org/>)

Enabling Regulation and effective supervision

- “Guiding principles on Regulation and Supervision of Microfinance Institutions; CGAP” (August 2003)

Rural microfinance – Specific challenges and sound practices

- “IFAD Rural Finance Policy”; IFAD (2004)
- “Financial Services for the Rural Poor”; CGAP Donor Brief No 15 (2003)
- “Rural MF: Policy Recommendations for Sida’s Programs”; Hans-Dieter Seibel (2003)
- “IFAD Decision Tools in Rural Finance”; IFAD (2002)
- “Agricultural Finance Revisited Series”; Volume No 1–6; FAO and GTZ (1998–2000)

Housing microfinance – Specific challenges and sound practices

- “Housing Microfinance – a guide to practise”; edited by Franck Daphnis and Bruce Ferguson (2004)
- “Shelter Finance for the Poor – series synthesis”; Cities Alliance (2003)
- “Policy Recommendations for Sida’s housing microfinance programs”; Frank Daphnis and Ingrid Faulhaber (June 2003)
- “So, you want to do housing microfinance? – a guide to incorporating a home improvement loan program into a microfinance institution” (Cooperative Housing Foundation 2001)
- “Housing Microfinance Initiatives – synthesis and regional summary: Asia, Latin America and Sub-Saharan Africa with Selected Case studies”; The Centre for Urban Development Studies, Harvard University (USAID/DAI 2000)

MF products and product development

- “MicroSave-Africa – project to promote financial services for poor people at www.microsave-africa.com”, initiative by Austria, CGAP, DFID and UNDP
- “A Technical Guide to Remittances – the credit union experience”; WOCCU (2004)
- “Potential Products and the Product Development Process”; UNDP and DFID
- “The Microbanking Bullentin – Focus: Savings”; Issue No 9 (2003)
- “Why Donors Need to Understand Product Development”; CGAP Donor Brief No 8 (2002)

- “Savings in Africa – a collection of Studies from MicroSave-Africa”; UNDP and DFID (2000)

Micro-insurance

- “Making Insurance Work for Microfinance Institutions – a technical guide to developing and delivering microinsurance”; ILO (2003)
- “Donor guidelines for funding microinsurance”; CGAP working group on microinsurance (Draft, October 2003)
- “Mutual Health Organization (MHO) – five years experience in West Africa”; GTZ (2003)
- “Small Enterprise Development; an international journal of microfinance and business development – theme issue: Microinsurance”; Volume 12, Number 1 (2001)

Post-crisis MF

- “Introduction to microfinance in conflict-affected communities”; ILO, UNHCR and DFID (2002)
- “Microfinance in the Wake of Natural Disasters – Challenges and opportunities”; DAI/USAID (1998)

HIV/AIDS and MF

- “Microfinance and HIV/AIDS”; CGAP Donor Brief No 14 (2003)
- “How to Invest for “Future Generations” – Guidelines for Integrating HIV/AIDS in Development Cooperation”; prepared for Sida by Social Development Consultants (2002)

Support to MF industry associations

- “Recommendations on Donor Guidelines for Microfinance Associations: Draft 2”; Africa Microfinance Network (AFMIN) and GTZ (2004)

Poverty outreach and impact

- Assessments, tools and guidelines on poverty outreach and impact can be found at http://www.cgap.org/priorities/poverty_outreach.html and at <http://www.usaidmicro.org/pubs/aims/>.
- “Is MF a good poverty alleviation strategy – evidence from impact assessment”; Ranjula Bali Swain (forthcoming, Sida, June 2004).

Annex 3

The role of the Financial Systems Team in implementing Sida's Guidelines on MF

- Undertake or facilitate MF sector analyses in the context of country strategies and identify priorities for Sida intervention.
- Provide technical advice on project design, monitoring and evaluation. Seek early involvement in these processes in order to have optimum impact.
- Attend department level project decision committees where MF projects are presented. When appropriate, make joint presentations together with the responsible programme officer.
- Provide written comments to Sida's Project Committee when MF projects or project components are discussed.
- Collect and systematize lessons learned from experience gained by Sida and other donors in supporting MF and disseminate this experience to Sida staff and the Swedish resource base
- Report annually on Sida's MF portfolio and its compliance with Sida's Guidelines on MF.
- Provide or refer Sida staff, Swedish NGOs and consultants to relevant training and competence development in MF.
- Establish and maintain a database of good Swedish and international consultants in MF. Monitor Sida's procurement of "call off consultants" in the field of MF.
- Provide strategic advice to Swedish NGOs and to the Swedish resource base at large. Support the strengthening of a Swedish MF network for experience sharing and debate outside Sida.
- Participate actively in international fora for debate and exchange on how to further develop the field of MF, in particular within CGAP.
- Participate in country or regional level policy dialogue on MF, preferably together with embassy staff in partner countries.
- Identify countries that are particularly suitable for participating in or initiating multi-donor MF sector development programmes.

Endnotes

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- ¹ See also CGAP Donor Brief no. 11: Microfinance means financial services for the poor
- ² Sida's Policy on Financial Sector Development (June 1997) can be downloaded at www.sida.se (Sectors/Economy/Finance Markets)
- ³ This is further developed in CGAP Donor Brief no. 9: Microfinance and the Millennium Development Goals
- ⁴ See further Government Bill 2002/03:122; "Shared responsibility: Sweden's policy for global development"
- ⁵ For example, it is estimated that approximately one billion people live on less than USD2 a day, i.e. in absolute income poverty.
- ⁶ This does not include informal financial services such as rotating savings and credit associations (ROSCAs), burial societies, moneylenders and informal savings collectors. Although informal financial services in many respects are more accessible and flexible than microfinance, they are also less reliable, more expensive, limited in amount and duration or only accessible to a closed circle of friends or neighbours.
- ⁷ It is difficult to generate reliable figures. The lower numbers are based on existing databases such as the MicroBanking Bulletin (www.mixmarket.org) or the Microcredit Summit (www.microcreditsummit.org) which only covers specialised microfinance institutions. It is much more difficult to provide realistic estimates of the number of poor people who have loans or savings accounts with formal financial institutions or the cooperative sector since such statistics tend to be provided in "dollar" rather than "people" terms.
- ⁸ This chapter draws primarily on information from the following sources: – "Microfinance, Risk Management and Poverty"; Synthesis Study by Jennefer Sebstad and Monique Cohen (The AIMS project, March 2000) and other studies under the AIMS project (see www.usaidmicro.org/pubs/aims). – "The Poor and Their Money" by Stuart Rutherford (2000) – "Is MF a good poverty alleviation strategy – evidence from impact assessment", by Ranjula Bali Swain (forthcoming, Sida, June 2004).
- ⁹ Sida's position paper "Making Markets Work for the Poor – Challenges to Sida's Support to Private Sector Development" (October 2003) has identified micro and small businesses in the informal economy as a priority target group for Sida support to PSD. The paper therefore discusses a series of constraints, including finance, to improving the performance of this large sub-sector of the economy in many developing countries.
- ¹⁰ These and other causes are discussed in "Making Markets Work for the Poor" (Sida, October 2003) in terms of government and market failures. Reasons for such failures as well as the potential role of donors in addressing these failures are elaborated in more detail than what is possible here.
- ¹¹ Depending on the country or region, successful models have either been NGOs (non-governmental organisations), Banks or Savings and Credit Co-operatives (SACCOs).
- ¹² The term "quasi-commercial" capital refers to investors with moderate return expectations compared to fully commercial investors. This includes investors operating fully or partly with public funds or philanthropic capital, i.e. funds which are raised for a dual purpose of generating returns AND contributing to sound and just development.

- ¹³ Sida's understanding of poverty and poverty reduction is expressed in "Perspectives on Poverty" (2002).
- ¹⁴ See further "Policy Guidelines for Sida's support to Private Sector Development" (October 2003).
- ¹⁵ The term market should be understood broadly to take into account features of demand, supply and regulation. Context specific analyses should determine the focus of Sida's support – whether the development of markets for pro-poor financial services is best served by stimulating demand, supply or the general business environment. For a more detailed discussion of donor support for market development, see "Making markets work for the poor; challenges to Sida's support to Private Sector Development" (2003) and "Business Development Services for Small Enterprises: Guiding principles for donor intervention" (2001, also known as the "Blue Book").
- ¹⁶ CGAP stands for "the Consultative Group to Assist the Poor". It is a multi-donor consortium working to promote best practices in MF worldwide. It functions as a communication platform and a service centre to the entire MF industry, including the MF donor community. CGAP was formed in 1995 and Sida became a member in 1996. Find further information at www.cgap.org.
- ¹⁷ This chapter draws, inter alia, on concept papers developed by David Ferrand (DfiD) for the "Financial Sector Deepening" (FSD) programs in Tanzania, Kenya and Uganda (2003–2008), a summary paper by Brigit Helms and Ruth Goodwin prepared for CGAP's Annual Meeting in October 2003 ("Towards a Framework for a Financial Systems Approach to Expanding Poor People's Access to Financial Services"), the booklet entitled "Business Development Services for Small Enterprises: Guiding principles for donor intervention" (also known as the "Blue Book", prepared by the Committee of Donor Agencies for Small Enterprise Development, 2001) and on other donors' policy and strategy papers.
- ¹⁸ Adapted from David Ferrand, DfiD: Tanzania Pro-poor financial sector deepening program: strategy paper (2003).
- ¹⁹ ICT refers to Information & Communication Technology and MIS to Management Information Systems, i.e. software packages for accounting and portfolio reporting, etc. Computerised management tools and on-line telecommunication are becoming increasingly important to MFOs as they reached scale and have to manage millions on transactions on a daily basis.
- ²⁰ Adapted from Peter Kooi (UNCDF).
- ²¹ The full title is "Micro- and Small Enterprise Finance: Guiding Principles for selecting and supporting intermediaries" (www.ilo.org/employment/sedonors). It is a ten-page publication which substantiates the vision of building viable institutions by outlining the performance standards that should be pursued – underpinned by the twin objectives of outreach and sustainability, the proper use of different donor instruments (such as grants, loans and equity) and the minimum donor reporting requirements for useful monitoring.
- ²² Examples of existing funds are Africap, LA-CIF, ShoreCap, ProFund, Blue Orchard, Oikocredit, to mention but a few. More information can be obtained through www.mixmarket.org
- ²³ See CGAP Focus Note no. 19 on "In Country Donor Coordination" (April 2001).
- ²⁴ MF sector development programmes may be implemented through government authorities, independent basket funding mechanisms (such as "a project account" or a Trust Fund) or through a Memorandum of Understanding spelling out the roles and responsibilities of different stakeholders and funders.
- ²⁵ A favorable policy and macro-economic environment is characterised by low inflation, stable economic growth, liberalised financial markets, a competitive environment and good public and corporate governance. Prerequisites for successful financial sector operations are further developed in Sida's FSD Policy, page 3.
- ²⁶ See a more detailed discussion on the subject of regulation and supervision at www.cgap.org/publications/guidelines.html in particular the paper entitled "The Rush to Regulate: Legal frameworks for microfinance", by Robert Christen and Richard Rosenberg (CGAP Occasional Paper No. 4, April 2000).
- ²⁷ For a more detailed discussion of this issue, see CGAP Donor Brief no. 6: Making sense of microcredit interest rates
- ²⁸ More information and guidelines on credit components can be found in CGAP's Donor Brief no. 10: Credit Components

- ²⁹ Note that in this context, the definition of “multi-purpose organisations” usually excludes community based organisations (CBOs) and people’s voluntary organisations (PVOs) which provide community services to their members, including land titling, neighbourhood upgrading, members’ savings, fee collections or small loans. These organisations rarely strive to become financial intermediaries or to be commercially viable. Sida’s guidelines for MF are thus NOT applicable unless it is suggested that Sida support the expansion of a sustainable savings or credit component.
- ³⁰ See CGAP Donor Brief no. 8: Why donors need to understand product development
- ³¹ Tools and guidelines for assessing and improving poverty outreach can be found at http://www.cgap.org/priorities/poverty_outreach.html
- ³² See CGAP Donor Brief no. 5: Apex institutions in MF
- ³³ See the background study “Micro and Rural Finance – A Review of Sida’s Experience” by Birgegård (November 2002), CGAP’s Peer Review – Letter to Sida’s Management (July 2002) and “Poverty Oriented Financial Services and Systems – Project instruction for Sida’s Policy and Competence Development Project” by Camilla Bengtsson (March 2002).
- ³⁴ For a more detailed discussion of these two thematic areas and of Sida’s experience in supporting these two areas, see the background studies “Rural MF: Policy Recommendations for Sida’s Programs” by Prof. Hans-Dieter Seibel (January 2003) and “Housing MF: Policy Recommendations for Sida’s Programs” by Franck Daphnes (June 2003).
- ³⁵ See CGAP Donor Brief no 8: Why Donors Need to Understand Product Development.
- ³⁶ See www.cgap.org/direct/. CGAP Guidelines are developed through a consultative process among member donors.
- ³⁷ CGAP Donor Brief no. 2: “Microcredit – One of many intervention strategies” provides further guidance on when microcredit is likely to be successful and what other interventions may strengthen the livelihood of the poor.
- ³⁸ CGAP’s “Format for Appraisal of Microfinance Institutions: A Handbook” is a good tool. It can be downloaded from www.cgap.org/html/p_technical_guides04.html. Credit worthiness ratings provide another more recent and sophisticated approach for appraising the performance of MFOs. More information about ratings can be found at <http://www.ratingfund.org/>
- ³⁹ This model contract can be requested from Sida’s Financial Systems team in Stockholm. CGAP’s Focus Note no. 9: “Anatomy of a MF deal” provides further background and detail on the spirit and design of performance based contracts.
- ⁴⁰ See www.mixmbb.org/en/index.html.
- ⁴¹ Download these guidelines from www.cgap.org/html/p_technifsg.html
- ⁴² See also CGAP Donor Brief no. 7: Microfinance Transparency and Reporting to Donors.

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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