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Microfinance and Poverty Reduction

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1. Purpose of this Communication

There has been a recognition by the EC and Member States that microfinance, developed mainly by NGOs, can be an important instrument, amongst others, in the fight against poverty. *A key principle is that donor agencies support the development of financially sustainable institutions, rather than separate projects.* These are frequently in the private sector, but support is generally channeled through the public sector.

Although the numbers of microfinance institutions have increased substantially over recent years, the establishment of microfinance as a sustainable instrument in the fight against poverty is faced with various constraints of a policy and institutional nature. EU assistance, along with that of other donors, can be beneficial in overcoming these constraints.

The main aim, therefore, of this Communication is to provide, in response to a request by the Council, a coherent policy framework for Community microfinance operations and a basis for coordinating activities with Member States. The policy set out in this Communication has relevance, therefore, to both the EC and the Member States.

The Communication is one of several papers that deal with different aspects of support for the private sector. The main aim of this paper is not promoting the development of the private sector, but with developing the capacity of microfinance activities to reach the poor. Nonetheless, in crucial areas it is consistent with the approach adopted in the other papers.

In Section 2 the challenge of poverty for EC development policy and practice is outlined. The main components of the policy and instruments for the EC to meet this challenge is then set out. Section 3 then defines microfinance as a new instrument for the EC to meet the challenge of poverty. This section looks at some of the factors that help in the fight against poverty and contribute to the rapid growth of microfinance institutions. A key concern has been to ensure that these institutions remain financially sustainable. Section 4 discusses how the Community and Member States, along with other donors, can give support to microfinance. Crucial issues are the need to create a favourable policy framework, the types of support that can be given at different stages in the life cycle of the institutions, and the adoption of common standards for donor support. The final section deals with the issue of donor coordination, at the international, European and country levels.

2. Meeting the Challenge of Poverty Reduction

Poverty is still the greatest problem facing the world, despite successes by some countries in reducing poverty and improving human development indicators. More than one quarter of the people in less developed countries are poor. More than 1.3 billion people live in poverty, and more than half of them go hungry every day.

There is general agreement among donors that sustained economic growth is important for reducing poverty, either by increasing employment or by generating resources to improve social services. However, the World Bank and UNDP note that the growth rate achieved, especially in Sub-Saharan Africa, has been insufficient to prevent the rise in poverty. There is now general agreement that action needs to be taken so that economic growth benefits the poor more directly, for example by stimulating employment and productivity. This general agreement is also in line with EU policy, as outlined below.

2.1 *Poverty reduction: policy framework*

The 1992 Treaty on European Union [Article 130u], puts the fight against poverty in developing countries as one of its three aims. The Resolution on the Fight against Poverty in Developing Countries, adopted by the Council on 2 December 1993 on the basis of a communication from the Commission [COM(93) 518 final, dated 16 November 1993], more specifically defined the issue as a priority. It is well known that women are disproportionately represented among the poor. The Council Resolution on Integrating Gender Issues into Development Cooperation [12847/95 (Presse 374) dated 20 December 1995] recognises that redressing gender disparities is a crucial issue for development, and that the formulation of all policies should take account of this issue. The requirement to integrate the poverty and gender issues into general development policy was further strengthened by the Resolution on Human and Social Development [11913/96 (Presse 329-G) dated 22 November 1996]. The Communication to Council on cooperation with ACP countries [COM (97) 537 final, dated 29 October 1997] refocuses Community policy on employment generating economic growth, poverty reduction, and integration into the world economy.

These texts establish, in a coherent manner, the principles, objectives, conditions and broad outlines of a gender sensitive poverty reduction policy within the framework of development co-operation. At the same time they emphasise the importance of strengthening co-ordination with the Member States in this field.

2.2 *Poverty Reduction: Main Areas of Activity*

The European Commission has engaged in the following areas of activity in the fight against poverty:

Support to the Social Sectors

Microprojects Programmes

Support to Food Security.

Decentralised cooperation, including NGO cofinancing.

These activities have been funded through various financial instruments - European Development Funds (EDF) allocated to National and Regional Indicative Programmes, funds in association with Structural Adjustment (e.g. STABEX funds, Structural Adjustment Support Funds (SASF), Counterpart Funds), funds for decentralised cooperation..

These areas of activity will remain fundamental in the EU fight against poverty, but there is scope in the fight against poverty for developing new areas of activity, such as microfinance.

3. The role of microfinance

3.1 *Trends in EC support to savings and credit*

There have been two co-existing models of assistance:

credit as a component of an integrated project

support to decentralised financial institutions

A study in 1993 of 22 EC projects in Asia and 33 in Latin America showed that the first (project) model had been dominant. It estimated that 35% of the funds were allocated to credit (i.e. 272 million ECU), as a component of larger projects. The first model had been dominant within ACP countries, according to a recent evaluation of rural savings and credit in 60 ACP countries but, from 1994, there had been an evolution towards the second (institutional) model. From their database, the evaluators identified some 40 examples of the second model in ACP countries, with an allocation of about 90 MECU.

The second model is supported by current thinking among donors and practitioners. There is an international consensus that microfinance institutions are more sustainable than credit components of projects, and that donors should provide support to the development of such institutions.

3.2 *Microfinance: Some Definitions*

There is a wide range of activities involving finance at the micro level in the different geographical areas covered by the European Union development agencies.

For the purpose of this communication, working definitions have been adopted as follows:

> "Microenterprise" refers to productive activities undertaken in the informal sector, whether these activities are to produce or distribute goods, or provide services. Typically, in ACP countries, a microenterprise employs fewer than 5 workers, usually family members, and has fixed assets of less than $10,000. The microentrepreneurs need to make use of finance services to build up their businesses.
>
> "Microcredit" refers only to the provision of loans. The loans are usually small - less than $1000. These loans are often used to start up or expand microenterprises. Some lending institutions began by giving credit and then extended their services to savings.
>
> "Microfinance" describes the provision of a range of financial services (eg savings, credit, and insurance). Savings deposits are small and regularly made. Loans are also small; the first loan may be only $50, depending on the institution and its clients. A good repayment record may lead to larger loans, or access to other services.
>
> A "Microfinance Institution" has clients, women and men, who are mostly from poor households, self-employed, or engaged in microenterprise. It provides services in various forms to suit the clients' needs. A limited range of non-financial services (eg business advice) might also be included. All the services are provided on a sustainable basis. The institutions have the ability to become financially viable within a reasonable time frame and achieve a significant level of outreach.

Formal banks have not generally been interested in small savings and loan accounts and do not undertake microfinance directly.[1] The staff do not have the required economic or social skills. A facilitating or intermediary institution, closer to the poor, is usually needed. This institution links an appreciation of the social context with formal economic and financial management considerations. Various kinds of institution that have developed into microfinance institutions. They may be savings and credit institutions, local associations, credit unions, NGOs, and rotating and non-rotating institutions.[2] Occasionally they may be more formal sector institutions like a post office savings bank, or rural bank.

According to the World Bank there are presently several thousand of these microfinance institutions.

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1 There are a few cases of commercial banks that run successful microfinance schemes; Bank Rakyat Indonesia is one such example, but the scheme is separate from normal banking operations.

2 There are various rotating or non-rotating institutions such as *Arisan* in Indonesia, *Paluwagan* in Philippines, *Chit fund* in India, *Sittu* in Sri Lanka, *Ho* in Vietnam, *Jia* in China, *Esusu* in Nigeria, and *Djanggi* in Cameroon. The terminology "rotating" and "non-rotating" refers to the way funds are accessed by participants.

3.3 *Poverty reduction and financial sustainability*

Developed mainly by NGOs, microfinance institutions have become an important, and relatively new, element in the fight against poverty. Many practitioners, recognising that the poor already made savings in non-financial forms such as livestock and trees, regard financial savings services as more important than credit. The primary aim of microfinance, therefore, is to provide a financially sustainable vehicle for savings by the poor. Since poor people require a range of services, other financial services are also being developed, such as insurance. By mobilising these savings among poor people, credits can be made available for a variety of productive purposes. Loan security is provided in various ways.[3]. Over time, as repayments are made, people can take larger loans and thus progress out of poverty.

Organisers of microfinance institutions usually try to achieve two objectives: to extend their outreach to the poor and remain financially sustainable. There can be tensions between the two objectives. Small scale savings and loans operations can be an effective mechanism for reaching the poor but there has often been a drift away from the poor as the institution seeks financial sustainability.

Such a drift away from the poor is not an inevitable consequence of having two objectives. Microfinance institutions seek to expand their client base by developing innovative products for greater numbers of clients, and by charging appropriate rates for services. These institutions try to create greater access to groups of people who have so far been excluded from financial services. This is a large potential client group including the poor, women, youth, and the elderly with diverse requirements. By creating a new market for financial services among these neglected groups and managing the costs of service provision, microfinance institutions can attract, over time, the support of commercial lending institutions. In this way, the microfinance institutions aim to become financially sustainable.

Because of the difficulty of gaining access to formal financial services,[4] the poor regard access to these financial services as more important than the cost of the services. These clients are willing and able to pay for financial services suited to their demands. Even with interest rates set to cover the full costs of operations, the cost of the services is less than the credit of a money-lender.

There are inherently greater costs associated with providing financial services to the poor (for example, many small savings accounts in remote, sparsely populated, rural areas rather than a few large loan accounts in urban areas). The microfinance institution must therefore seek to reduce costs, even as it extends its outreach. One instrument for this is, of course, good financial management of the institution, trying to reduce costs where possible. Another is to develop alternative financial services that respond to the needs of the clients. By reaching out to greater numbers of poor people, the overall costs can be reduced by reducing the proportion of overhead costs within the overall costs of the services. Some difficult decisions may also have to be made, such as deferring the provision of services to some difficult to reach groups until the institution has more solid financial foundations.

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3 The most famous example is provided by Grameen Bank that pioneered the idea of peer pressure within a group of five beneficiaries. Other institutions have adopted their own forms of security appropriate to the local culture.

4 Informal financial services are widespread. They do not usually provide a basis for achieving sustained increases in income levels for a large number of people, though there are examples in the West African literature of entrepreneurs financing, over a reasonable time, the growth of relatively large scale businesses through rotating institutions. In general informal financial services serve diverse purposes of financing consumption, providing for school fees, and health insurance.

Although the microfinance institutions can reach many excluded groups and remain financially viable, studies have shown that, while they reach people below the poverty line, they do not reach down to the very poorest 10-15% of the population (lacking financial resources). At present, the needs of the poorest will continue to be met mainly by non-financial services (eg social sector support). Many microfinance institutions are trying to develop alternative financial services that respond to the needs of the poorest.

There is increasing recognition that governments and donors aiming to support the development of microfinance to reduce poverty should give policy support to the sustainability of the microfinance institutions. The problem has been to know, in detail, the effects on sustainability of particular instruments of government and donor assistance. What is regrarded at present as the best practices are set out in section 4.

3.4 *Economic and sociological context*

For Microfinance schemes to be successful in reducing poverty, there must be potential economic opportunities, however small, for local people to exploit. These opportunities are not necessarily in the rural areas where most of the poor live. It has been noted that many rural savings flow out of the countryside to urban investments, where the returns are better. Microfinance schemes may not be successful in remote rural areas with very poor, sparse populations, poor transport infrastructure and other links to towns. It may be that other methods of poverty reduction, such as improvements to social infrastructure, including rural roads, are better suited to these conditions. Alternatively, microfinance schemes may have to develop other financial instruments, such as insurance against agricultural risks, to be successful in such areas.

Microfinance appears to be particularly successful in communities where there is a high degree of social trust. (The selection of women's groups appears to increase this. Gender issues are dealt with below). The institutional arrangement of having small savings groups builds on such relationships of trust.

There are many other social and cultural issues that are not fully understood. Cultural attitudes to money and savings, systems of local social control, and local practices must all be properly understood and addressed in designing a successful scheme. The practice adopted by microfinance institutions is to ensure that local organisers are close to the local situation and to allow flexibility in the procedures. This works well enough when microfinance activities are starting up, but may pose some problems when institutions are larger, trying to manage a diverse clientele and provide management information to commercial partners.

There has been relatively little research on the above issues, compared to institutional studies of successful schemes, so there is still work to be done to understand effectiveness. Further research should include:

Market research (what do the poorest need?)

Operational research (How are they best served?)

Social research (Attitudes and behaviour relevant to the sector, geographical conditions, relevance of social trust).

3.5 *Gender aspects*

To be effective at reaching those people who are under the poverty line, microfinance institutions must give attention to gender issues i.e. taking into account the needs and constraints of both men and women when designing and delivering financial services.

To improve their poverty focus, many institutions have given emphasis to the targeting of women. There is some justification for this.

Conventional Rationale for Targeting Women

* · More women are poor, and their poverty is usually greater than men's.
* · They often handle small amounts of cash and do not seek high value and risky investments.
* · Women usually have responsibility for the family so the impact on poverty reduction tends to have greater impact than when men gain services.
* · Concerned with family welfare , they are more inclined to save than to indulge in conspicuous consumption (e.g. alcohol).
* · Women's access to financial services is more constrained than men's, usually because they lack land or collateral. Therefore they are very conscientious about protecting their access to credit by paying back loans.
* · They are able to work effectively in small groups, so the selection of women further strengthens the degree of social trust.

Whether the rationale for targeting women is universally valid is open to question, but these ideas about the role of women appear to be held by the organisers of microfinance institutions. The exact role of gender relations in microfinance is still subject to discussion. The importance of the issue is whether these beliefs will prove useful to microfinance organisers as microfinance activities increase, and the constraints on women gaining access to credit and making larger investments are reduced.

Many microfinance institutions have often targeted women, but they deliberately avoid an exclusive focus on women. When men are denied access to financial services, loans to women are hijacked and domestic violence against women may increase. The financial discipline of men may also be enhanced when they have to access credit through their wives.

A more gender sensitive approach is to provide differentiated services that respond to the needs of women and men. For instance, hire purchase schemes can allow women and men to pay for larger assets. Other institutions are developing health insurance, life insurance, with profit endowment policies etc.

Some Microfinance Services Convenient to Women.

* Small loans.
* Rapid access to loans (approval in less than a week).
* Flexible repayment schedules; regular and frequent repayments with a first small loan.
* Collateral using items women likely to have, eg jewelry. (Otherwise, group security).
* Small savings accounts.
* Credit delivery and savings collection procedures to suit women's schedules and the increased need for physical security.

3.6 *Growth and development of microfinance institutions*

There has been substantial growth in the numbers of microfinance operations during the present decade. The World Bank estimates that loans and savings are increasing by 30% per year, generated by the increased number of institutions being established. While there are evident risks in the fast growth of new unregulated institutions, much of the growth is experienced by established institutions.

In supporting the development of microfinance, donors have increasingly taken the approach of trying to help bridge the gap between commercial financial services and these microfinance institutions. To do so, there has been a move towards institutional development of the microfinance organisations themselves and a search for innovations in financial services which will attract the large scale formal financial sector to become involved in microfinance. Some donors have developed start-up programmes, focusing on how to create new microfinance institutions, while others have been concerned with the development of established institutions.

4. Supporting Microfinance Operations

4.1 *Policy Objectives*

The overall objective of the EU development policy is to promote sustainable and equitable economic growth. There are three major aspects to this aim:

To reduce poverty

To promote economic growth

To ensure development is sustainable

There are several lines of action and instruments available to the EU to reduce poverty, both indirectly and directly. Microfinance institutions are recognised as another instrument. It responds to all three aspects of the EU objective.

There is a need for a coherent policy framework and donor standards for the EU support of microfinance institutions. These factors are discussed in the following sections.

4.2 *Favourable policy environment*

Microfinance requires a favourable policy environment to thrive.[5] The EC and Member States should therefore appraise carefully the policy environment, and work together to resolve some of the problems that constrain the development of microfinance.[6] The EC is also producing a Communication on Private Sector Development in ACP countries. This will reinforce some of the points made in this section about support to microfinance and microenterprise.

The macroeconomic policy framework and other policy issues which affect the microfinance sector should be discussed at a high level with governments. Donors with an overview of the sector and macroeconomic issues could be involved in this.

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[5] Microfinance can survive as an enclave in an adverse policy environment for a short time, but its ultimate sustainability and capacity for growth are impaired. For further information on the favourable policy environment see the Communication on support for private sector development.

[6] The appraisal of these issues is taken up in section 4.3.2.1.

There are several elements in a favourable environment, as discussed in the following sections.

4.2.1 Macroeconomic policy

The informal sector has generally has experienced the fastest growth in less developed countries, and is especially important for creating jobs. There are many constraints to the growth of individual small and microenterprises, including credit constraints, and the sustainability of these small and microenterprises is also a major concern. Although microfinance can help to resolve these credit constraints, inappropriate macroeconomic policies can result in conditions which hinder microfinance development (e.g. high interest rates). Macroeconomic policy should generally encourage private sector developments as the vehicle for achieving equitable economic growth. It should help promote a climate favourable to savings and investment at all levels and the development of microenterprises

At present the level of transactions in microfinance is small, but growing, compared with the level in national economies as a whole. It would therefore be rather early (in 1998) to be overcautious about the development of the microfinance sector and its potential effects on the management of the macroeconomy.

4.2.2 Financial Sector

There should be particular attention to the financial system. The following issues should be assessed, and where appropriate, introduced into policy dialogue with governments by donors with interests in microfinance.

4.2.2.1 *Preconditions of donor support*

Donors need to establish the minimum acceptable criteria for support. Before becoming involved in microfinance development operations, donors should expect to find the following conditions exist within the financial sector:

Institutions are allowed to charge interest rates which cover the full cost of operations[7]

Legislation can be adapted to facilitate microfinance operations. For instance, financial institutions should be allowed to develop savings and to diversify their operations into other fields such as leasing or risk capital

There should be a regulatory framework setting out the rights and obligations of microfinance institutions to ensure that markets operate competitively.[8]

The EU should only provide support when these preconditions have been met, and when governments express a strong commitment to continue policy reforms.

There are particular difficulties with conditionality when there is a need for a long term partnership for institutional development. Many events can undermine governments' ability to carry out policy reforms that will promote the steady development of the sector. Donors have to exercise judgment whether the policy changes will adversely affect the sector, and, if so, when the policy reforms can be continued.[9] Abandoning what has been planned to be a

7 This includes not only the costs of providing the services directly to the clients, but also the indirect costs of recruiting and training staff, monitoring perfomance, developing the business, and management etc.

8 Improving the operation of this framework in practice can be a focus for technical assistance.

9 The mechanistic application of penalties when conditions have not been met should be avoided if the aim is to establish a long term partnership.

long term commitment, though, is a last resort if it becomes clear that a government has effectively renged on its commitment to the reform process.

4.2.2.2 *Links to commercial financial services.*

Until recently, banks and commercial financial services have not usually been interested in small savings and credit operations.[10] This lack of interest has provided a constraint on the extent to which microfinance institutions could grow. They were unable to access commercial loans or equity investments.

There are several reasons for the lack of interest of the commercial sector in these institutions. Often the scale of operations was too small to offer an attractive investment opportunity. Returns were likely to be small and risky. Moreover the operations of the institutions were not transparent, since financial reporting systems were underdeveloped.

Financial sector reforms should seek to reduce transactions costs and other constraints on microfinance, by bringing financial services closer to the people, and encouraging linkages between the microfinance institutions and the banking system.

4.2.2.3 *Regulatory environment*

The regulatory environment should encourage microfinance institutions to start and grow. For example, in countries where there are restrictions on the setting up of savings societies, these should be reformed. In countries where there are restrictions on the level of interest charged, which undermine the potential sustainability of the microfinance institutions, there should be reform consistent with the encouragement of microfinance.

These reforms of the regulatory environment need to avoid potential negative consequences. The regulations should ensure that microfinance institutions are managed according to sound financial practice. In particular, reforms should retain a concern to protect savers from fraud. There needs to be a monitoring system which provides for constant vigilance regarding the effects of the regulations.

4.2.2.4 *Donor support*

There is clearly a role for donor support in the development of the financial sector, to take account of the needs of microfinance, especially at the early and middle stages of institutional development.

The aim is to create a development partnership between donor and microfinance institution. Support should be given to the institutional development of microfinance institutions.

Strengthening financial audit arrangements is an immediate need for technical assistance. Longer term aims might be to develop other forms of audit. Given that microfinance is intended to reach the poor, the skills of social audit would be needed to see if the microfinance institutions are meeting the objectives of their primary clients.

However, many observers have cautioned against the rapid deployment of substantial donor funds within the microfinance sector. The dependence of microfinance institutions on grant support can undermine effective financial management and act against the development of entrepreneurship, which is the essence of private sector development, and undermine prospects for sustainability. More established microfinance institutions will eventually replace donor support with commercial loans.

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10 There have been some exceptions, for instance BRI in Indonesia. In another case, discussed in an internet forum in late 1997, the Bank's interest appeared to be for publicity purposes only.

4.2.3 Good governance and microenterprise

Urban management policies should be encouraging to microenterprises, not imposing various petty restrictions on the economic opportunities of the poor. For example, in less developed countries, it is unfortunately common to see local officials and police harrassing petty commodity traders. The promotion of microfinance requires action to reduce the numbers of petty urban regulations and to fight such corruption.

Rural development policies should encourage the development of agro-based small enterprises. This can be done in various ways, such as improving market intelligence and access to inputs.

4.2.4 Removing Gender Biases

Women's activities are often the source of growth in the agricultural micro-enterprise and microfinance fields but there are several aspects of policy that restrict women's access to financial services, and therefore limit the growth of their businesses. For instance, the provision of collateral is constrained when women are not able to own land. The rules of inheritance may be a disincentive for women to accumulate capital. Women may need the endorsement of men in the household to take a loan.[11]

Removing these gender biases in policy would help to encourage the development of microfinance.

4.3 *Working with Microfinance Institutions:*

When working with microfinance institutions, donors should try to help them grow and become sustainable in the long term. The path that has emerged involves: [12]

> attention to identification and detailed appraisal of the potential of the institution, taking account of present capacity and vision
>
> institutional development support at the beginning to help establish the institutions
>
> further support later to strengthen links with commercial sources of funds

Such a path for donor support does not fit neatly into the normal 3 year project framework, and involves a commitment to enter into partnership for at least 7 to 10 years. Such a partnership imposes specific requirements on donors to calculate and take acceptable risks during appraisal and establish monitoring systems which encourage joint learning from experience. This approach has put great emphasis on the need to learn lessons, and to develop and apply principles of good practice.

These points are set out below in relation to the project cycle.

4.3.1 Identification

To obtain the support of the EU, the wider objectives of microfinance institutions we support should be in line with EU economic and social policy objectives: to reduce poverty by facilitating the take up by the poor of sustainable economic opportunities. These opportunities involve production of goods and services that rely on local inputs and readily accessible markets.

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[11] See section 3.5 for a fuller treatment of gender issues.

[12] A precursor for working with the institutions is analysis of the policy framework. This has been discussed above in section 4.2.

Many microfinance institutions have a social orientation to reach the poor and have adopted the microfinance mechanism as an appropriate one for reducing poverty. The specific aim of the microfinance institution is to offer flexible financial instruments, not usually available from commercial banks, to greater numbers of the poor to meet local needs.

Although many microfinance institutions will fulfil these general criteria, the EU donor agencies should take care over their selection of microfinance institution.

The EU should use the following selection criteria:[13]

vision (clear development strategy, focus on generating local savings)

institutional strengths (sound governance, free from political interference, existing licensed institution, institutional capacity, accurate management information systems and good reporting standards);

quality of services for the poor (focus on the poor and increasing outreach, appropriate and flexible lending, savings services);

financial performance (appropriate pricing, portfolio quality, reduction of dependence on donors, and capacity to mobilise commercial funds to reach independence).

openness to advice (acceptance of need for change, ready to engage in dialogue).

4.3.2 Appraisal

Many institutions are unlikely to become viable in the long term. There is a wide variety of conditions in less developed countries which constrain the viability and sustainability of the institutions.

4.3.2.1 *External factors*

Since the development of a microfinance institution is a fairly lengthy process it can easily be disrupted. Some attention should be given to assessing the external risks to the Institution, such as:

natural events of predictable frequency and severity which impact on the community at large e.g. droughts, floods, cyclones, earthquakes

illness and epidemics which have severe impact but be unequally distributed among households e.g. HIV/AIDS; some such illnesses may be seasonal

civil conflict

Risks also include changes in the policy environment, possibly following a change of government. These issues have been dealt with above.

All these possible events can have impact on the sustainability of microfinance systems and need to be integrated into planning as many risks have a predictable frequency. There would be differences in dealing with those risks which develop slowly (e.g. drought or civil conflict) and those which are more sudden (e.g. earthquake). In assessing the risks, care would need to be taken over calculating the severity of the potential impact on the microfinance institution.

[13] This list draws on criteria established by multi-donor networks, especially the Committee of Donor Agencies for Small Enterprise Development and Donors' Working Group on Financial Sector Development **Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries** October 1995.

The practical consequences for the microfinance sector may include:

setting cost recovery charges at a level that reflects such known risks

diversification of the microfinance institution's portfolio

development of affordable insurance services.

4.3.2.2 ***Internal factors***

The aim of the institutional appraisal is to establish whether the appraisal team believes "the Microfinance Institution will develop into an institution which can expand independently of further donor resources, reaching massive numbers of very poor clients with funding that is predominantly commercial." The team must consider the extent to which the MFI's vision is focused in this direction.

To reach this judgement, the team must assess the financial and non-financial factors bearing on the ability to reach independence, the operating changes required, and other hurdles to be overcome.

Overall the appraisal[14] covers a whole set of institutional factors, services and market, strategic objectives, and financial performance. From these it is possible to set out the essential elements (see box below) in appraising whether to accept or reject support to the microfinance institution.

Essential appraisal elements

- Location
- Other Donors' experience
- Leadership
- Financial Manager
- Strategic Financial Planning
- Income Statement and Balance Sheet
- Profitability
- Voluntary Deposit Service Analysis

There is a danger in setting out the principles of good practice in appraisal that donor agencies will apply the most rigorous standards in a mechanical way, not paying attention to the real conditions in society and the informed judgement of the microfinance institution. In practice, donors are looking to support the development of better standards during a process of institutional development.

4.3.3 **Implementation: Start Ups**

Where a microfinance institution does not exist, there are difficult decisions about whether to start them or leave the area.

[14] In assessing the factors within the Microfinance Institution, this section draws on guidance presented in the **Format for Appraisal of Microfinance Institutions** (Secretariat of the Consultative Group to Assist the Poorest, February 25, 1997).

Some donors have experimented in startups. There are several profound and critical dilemmas to resolve, but there is little understanding of the conditions for success and failure. Donors which have skilled technical assistance to deploy might consider this option.

These activities do not necessarily require large funds.

In the circumstances, the EC will not become involved in this area.

4.3.4 Implementation: Establishment

Much of the advice about microfinance institutions comes from detailed assessments of established microfinance institutions.

Supporting the growth of established institutions is a less risky option than start-ups, but still requires donors with strong technical assistance in traditional areas of business management. During the implentation stage, the donor gives support to build up the technical capacity, product portfolio and client base of the selected institution. This can be done by using capital grants for buildings and equipment, and technical assistance to strengthen financial management information systems.[15] At a later stage, loans and equity financing can be used to support the growth of the institutions.

It is likely that most donor agencies will wish to develop support to MFIs in this stage of development. This will help with their own development of institutional capacity to offer support to the microfinance sector.

4.3.5 Implementation: Integration into Commercial Systems

Donors should help Microfinance Institutions integrate into commercial lending systems and capital markets. Different mechanisms can be proposed and special forms of support are often needed. Funding may be needed to help leverage private sources of capital or to provide guarantees for commercial bank loans.

The two most commonly tried have been through the provision of Guarantee Funds and the development of Apex Organisations. Specialist technical assistance should support such activities.

4.3.5.1 *Guarantee Funds*

There have been several attempts by donors to provide guarantee funds to encourage investors to take risks and to induce them to become involved in lending to microfinance institutions. Many of these attempts have failed because the donor funding has undermined financial discipline in the system. More recent attempts to introduce guarantees distribute risks to all the stakeholders to correct for this problem.

There has been some recent professional scepticism about the "sustainability" and "additionality" of guarantee funds.[16] The cost of providing the guarantees also adds to the costs of the microfinancial services, making it more difficult for the institutions to become sustainable in the long run.[17]

[15] Some donors also argue that support can even be given to the operating costs, but this must be for a strictly limited period (usually 2 to 3 years). This is an area of some debate.

[16] For example, recent discussion in an internet forum on development finance. The discussion highlighted both problems and possible solutions.

[17] This point was made strongly by the Austrian representative in the Expert Group meeting in 1997, and reiterated in the Council working group on development cooperation.

There are possible solutions to these problems but more study and reflection is required on guarantee funds, and the alternatives, before they are acceptable instruments for major donor support. On this issue, the EU should continue to collaborate with the Consultative Group to Assist the Poorest in its learning activities.

4.3.5.2 *Apex Organisations*

Most Apex[18] organisations are best considered facilitators of the growth of the microfinance industry, rather than a formal system of financial intermediation in the banking sector.

The perceived need for these organisations arises as the number of microfinance institutions increase and practitioners see the potential benefits of an organisation that can provide a link to the formal sector and a number of common services (e.g. staff training).

The development of these facilitating organisations poses problems of a different nature from traditional MFIs. While there is a need for funding to help leverage commercial sources, there are also problems that require skilled technical assistance.

At present there are few such organisations so information about their functioning and success is limited. Further research is needed on these organisations before they can be a recognised area of EU support.[19]

4.3.6 Implementation: Monitoring performance

EU donors provide funds for loan capital and capacity building. The intention to reinforce the institutions and sustain their operations requires adherence to certain recognised principles of good practice in the design of assistance as discussed in relation to appraisal.[20] During monitoring of microfinance institutions, particular attention should be given to the following key issues:

- search for self sufficiency - for instance through progressive reduction of grants and move towards commercial finance
- good governance - accountability to the poor and consistency with financial safeguards
- transparent reporting - to encourage investment by commercial partners
- good financial management - to encourage the reduction of costs of services
- interest rates charged by the microfinance institution should cover the costs of operations and changes should be governed by the market not by political interference on the governing Board
- targeting of financial resources - for instance, to support institutional development, but not to subsidise interest rates
- savings services should be encouraged from the beginning, rather than focusing on the provision of credit
- a professional approach to loan appraisal and monitoring
- support the information networks that support microfinance institutions

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[18] An Apex organisation provides common services for a group of participating microfinance institutions, and is funded primarily by contributions from these institutions.

[19] This is another area where participation in the CGAP learning activities is important.

[20] This section draws on the CGAP appraisal format.

4.3.7 Evaluating Impact

An important area of activity for the the microfinance institutions and donors is the evaluation of impact. There are several dimensions that should ideally be considered in the evaluation:

- ◊ Poverty orientation: To what extent does the MFI reaches the poor? What types of poor are reached?[21] Are there any unanticipated consequences of targeting?
- ◊ Income effects: To what extent do the activities supported raise the incomes of the members? Are these income effects sustainable? Could more be expected?
- ◊ Social effects: To what extent have the institutions contributed to the empowerment of the poor in other areas? Has there been an increase in organisational capacity?
- ◊ Growth of the institution: What has been the coverage of the population and the microfinance services? What would be a reasonable expectation of growth in future?
- ◊ Environmental effects: To what extent have the enterprises supported through the microfinance institutions been beneficial or detrimental to the physical environment? Are the enterprises sustainable?

The intention of such an evaluation is to feed back the results to achieve better targeting of operations, better advice to microfinance clients, and to enhanced the contribution of microfinance to development processes.

4.4 *Common standards of donor support*

4.4.1 Donor funding: a careful approach

The European Commission can use several financial and non-financial mechanisms to support the microfinance sector: the provision of capital, credit guarantee schemes, supply of credit in kind, equity financing, and institutional support. Other donors have a similar portfolio of mechanisms. The issue arises which to deploy for best advantage in this field.

There is no doubt about the great demand for microfinance services, but it is advisable to sound a note of caution about the capacity of microfinance to absorb substantial donor funds at the present time. Despite the pressure of some institutions themselves, CGAP believes there are already too many funds chasing too few viable institutions. It is necessary to develop a strategy for providing support according to the demand. It is generally accepted that capital is not the main constraint on the formal sector institutions becoming involved in microfinance, but rather the lack of infrastructure (both financial and other kinds) to allow the funds to be delivered effectively to low income groups. The emphasis, therefore, has to be on the careful establishment of the sector and growing more viable institutions with healthy savings, which can over time absorb more funds from commercial sources.

A certain amount of confusion has surrounded the effects of the instruments of assistance to the sector. On the one hand, there is general agreement that a subsidy (e.g. a grant to the capacity building of the institution, or guarantee funds) might be required at different stages in the life cycle of a microfinance institution to establish it and help it to grow. On the other hand, there is now general acceptance that other subsidies (e.g. to interest rates) which would be unsustainable in the long term, should be avoided.

The approach to microfinance of supporting institutions and developing the microfinance sector has brought to attention the need for common standards among donors. Without these, coherent development of the sector would be adversely affected. It has taken time for donors to agree the common standards.. The Committee of Donor Agencies for Small Enterprise

[21] The information here should be disaggregated by gender.

Development, and Donors' Working Group on Financial Sector Development produced a set of Guiding Principles in October 1995.

The EU should adopt these common standards, and work with others to develop the standards in innovative areas.

4.4.2 Strategies for Donor Support

The EU should follow the Guiding Principles regarding the strategies for donor support as follows:

> Grants for institutional development are appropriate at different stages. At start up, grants can support the costs of establishing the institution - premises, equipment, staff training, technical assistance. Later they can be used to help the institutions join the formal sector.
>
> Grants for capitalisation. This can help generate domestic mobilisation of funds.
>
> While, in general, it is preferable to avoid covering operating costs, in practice, this can be done for limited start up period. This might be 3 years, and should certainly not exceed 7 years.
>
> Loans are used by institutions that have reached a certain level of operation. They might support the move to full commercial operations. This transition might be supported by the creation of guarantee funds.

Many committed microfinance institutions try to develop even better practice. For instance, they may attempt to develop alternative financial services to reach the poorest, while adhering to the basic principles. The EU can provide funding and technical assistance to help with these learning processes.

Different options for support may arise at different stages of development of the institution, so managing transitions from one kind of support to another is important.

In addition to the above common strategies for donor support to the financial sector, the EU might give technical assistance to help with adapting legislation, or engage (alongside other donors) in policy dialogue regarding the macroeconomic framework and financial sector reform to allow diversification of financial instruments.

Several detailed lessons about sustainability have emerged from evaluation and other studies of past credit operations. There is now a growing consensus about the previous practices that undermined sustainablility. These practices and the results are shown in the table. They should be avoided.

PRACTICES	RESULTS
Subsidised interest rates	Rapid depletion of funds
Focus on credit, without generating savings	Programmes dependent on external sources of funds
Non-financial services offered	Very costly programmes
Small number of borrowers	Costs not covered by revenue
Lack of financial discipline	Poor loan repayment record
Inadequate attention to financial skills of staff	Loans poorly managed
Systems planned in centre	Not fit local practices

5. Donor coordination

It is useful to consider the various roles that can be played in the development of the microfinance sector. Given the different capacities and institutional arrangements of Member States and European Commission Directorates General, each of the European Union development agencies should carefully consider its own comparative advantage.

The Council Resolution draws attention to the need to consider coordination at different levels.

5.1 *International level*

The main existing network for coordination of policy and practice on microfinance is the Consultative Group to Assist the Poorest (CGAP). Its overall objective is to further the development of microfinance services for very poor clients. It does this by facilitating learning about successful approaches to microfinance and helping to strengthen donor agencies' own operations. Since it was launched in 1995, the CGAP Secretariat has produced several documents setting out ideas of good practice in this field.

CGAP, up to the present, has focused on the issue of financial sustainability . There is also a need to consider other policy objectives. For instance, many small businesses have an impact, often adverse, on the environment. Although it is unlikely that environmental monitoring would be done by microfinance institutions themselves, consideration should be given to how this might be done.

The EC and Member States active in the field of microfinance should actively support the development of CGAP, and any follow up network of donors. This will require funding support for the work of the Secretariat, and active participation in the learning and dissemination activities. EU members should share information from their own evaluations. It would be useful to present the results of operations and assess the socio-economic impact of the different assistance programmes on the target populations.

5.2 *European Union: Community and Member States*

There is a need for EU donors to agree to coherent policies. There have been situations in which different members of the EU have pursued different policies, or the same donor has followed incompatible policies in different parts of the sector. Such confusion undermines the development of microfinance and reduces the impact on development. So there is a clear need to agree on financial sector policies within a country, appropriate interest rates given to particular institutions, and other terms for assisting the sector.

In the case of the members of the EU, the present Communication and Council Resolution provides the basis for such a common policy, and should be integrated into bilateral policy statements.

In this fast moving field, policy formulation has to respond to further developments in our common understanding, perhaps resulting from lessons learned in the international forum or from our bilateral experience and research. The EC should therefore call together a Microfinance Expert Group of Member States to discuss the emerging issues on an annual basis, and to consider amendments to the EU policy framework.

Implementation of a policy on microfinance will depend on concerted efforts by staff and consultants. There might be coordination in their training.

5.3 *Country level*

The EU has an interest in supporting microfinance institutions to become sustainable, but this can be undermined by competition among donors at the country level. Operations of some donors may be seen as undermining the operations of another. Governments have an important role in coordinating the activities of donors in the microfinance field. Donors should also share information about planned operations.

Microfinance institutions often make applications to different donors. It would be helpful to use others' appraisals of microfinance institutions, as suggested in the CGAP **Format for Appraisals**. There are also possibilities for better coordination in monitoring, management information systems, performance standards and reporting arrangements.

The government of the concerned country should be involved in discussions. In many cases there is a lack of governmental capacity in this field which constrains the development of a conducive policy framework, regulatory environment, and supervision. Donors can coordinate their efforts to support the necessary institutional development.

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