CGAP

DONOR BRIEF

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Helping to Improve Donor Effectiveness in Microfinance

MICROFINANCE MEANS FINANCIAL SERVICES FOR THE POOR

With an estimated untapped market of nearly a billion poor people, microfinance now stands at a crucial crossroad. Successful microfinance institutions have proven that financial services can be an effective and powerful instrument for poverty reduction, helping poor people to increase incomes, build assets, and reduce their vulnerability in times of economic stress. There is greater consensus than ever before about what is needed to make microfinance sustainable. Yet, with the exception of a few countries such as Bangladesh and Bolivia, microfinance has failed to reach massive scale.

Over the next decade, microfinance will either realize its vast potential for improving the lives of large numbers of the poor—or it will remain an unfulfilled promise. This brief summarizes the vision and strategy of CGAP's 29 member donors to bring microfinance to the scale required to serve millions worldwide.

Microfinance: A continuing evolution

As recently as a few years ago, the term "microfinance" was easily understood: a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working-capital loans to microentrepreneurs (or potential microentrepreneurs). Today, microfinance has become far less clear and more nuanced. Several basic premises are now being challenged:

- All poor people, not just entrepreneurs, use and need financial services beyond working-capital loans, such as savings, credit, insurance, and money transfer services.
- Existing credit methodologies have reached a relatively narrow range of clients, often leaving behind both extremely poor and geographically remote clients, as well as the less-poor with larger enterprises.
- Microfinance NGOs have been crucial for experimenting with new models, conducting research and development, and proving that microfinance can successfully reach poor clients on a sustainable basis. However, NGOs have neither systematically reached massive scale nor become independent of donor funding, although there are major exceptions to this rule.
- Institutions with large existing infrastructures, such as commercial banks, state-owned banks, credit union networks, financial cooperatives, and even retail chains, could play a significant role in scaling up financial services for the poor.

Financial services for the poor are part of the financial sector

Microfinance has largely developed outside the realm of the formal financial sector. Governments and donors addressing financial sector issues talk about banking reform, averting or coping with financial crises, and capital markets—not microfinance. For its part, the microfinance community has insisted that microfinance is highly specialized with separate standards, techniques, and/or legal frameworks. These arguments have contributed to the marginalization of microfinance as a sector isolated from broader financial systems.

Large-scale sustainable microfinance can be achieved only if financial services for the poor are integrated into the overall financial systems of developing countries. This integration allows more access to capital, better protection of poor people's savings, and increased legitimacy and professionalization of the sector. The result is opening markets to increasingly poor and geographically remote clients. The challenge is to achieve this integration without compromising the social mission of microfinance.

What is needed for microfinance to reach its full potential?

- ***Diverse institutions and delivery mechanisms.*** Achieving large-scale sustainable microfinance requires engaging a more diverse range of delivery organizations with different objectives, services, and needs for subsidy. Strong microfinance NGOs must continue to be strengthened and their successes replicated wherever possible. In some countries, however, reaching scale may mean using national distribution networks of selected state banks or credit unions. In others, it may mean using alternative delivery mechanisms such as post offices, supermarkets, beverage suppliers, or manned telephone booth networks.

  In South Africa, a network of 8,000 armored trucks equipped with thumbprint recognition and smart-card technology deliver pension payments of about $60 each month to 4.5 million South Africans. Imagine the potential of this vast infrastructure to offer pensioners other kinds of financial services.

- ***Diverse financial services.*** Poor people need a wide array of flexible financial services. A demand-driven approach will encourage portfolio diversity by offering the poor savings, insurance, and cash transfer services in addition to various loan products.

- ***Improved information.*** Ensuring the availability of high-quality, reliable information on the financial and social performance of MFIs is critical to integrating microfinance into the formal financial sector. Accurate information will raise the quality and lower the cost of supervision, audits, and ratings; encourage greater flows of commercial and private funding; and allow microfinance providers to track their performance against one another.

- ***Sound policy and legal framework.*** Rather than act as direct providers of financial services, governments need to create an environment that encourages a diversity of institutions and financial products to serve the poor. Sound policy and legal regimes must safeguard poor people's money, promote competition, and develop the technical expertise of their supervisory and regulatory authorities. An example is eliminating interest rate caps that hamper long-term viability.

What can donors do to support the new vision of financial services for the poor?

- ***Embed microfinance conceptually and organizationally within financial sector development.*** Donors should develop a clear and coherent strategy for microfinance that adheres to accepted good practice and forms an integral part of the financial sector. Ideally, a microfinance focal point should hold primary responsibility for implementing the strategy and offering operational guidance to staff.

- ***Clarify the role of subsidies.*** Donors need to establish consensus on when and how subsidies should be used to support microfinance and when other instruments would be more appropriate. Clarifying the role of subsidies can also assist donors to identify their respective comparative advantages.

- ***Support innovation.*** Donors should take risks by working with less well-known but promising institutions of all kinds, leaving commercially viable MFIs to graduate to private investors. Grants or limited subsidies to institutions developing new products or technologies are recommended. Special efforts should be directed towards encouraging institutions that develop savings-based products.

- ***Introduce appropriate instruments.*** The development of financial systems that truly address the needs of the poor requires flexible funding instruments to support research and development, capacity building, and initial operational subsidies. It also requires encouraging—not competing with—new kinds of investors that offer commercial and quasi-commercial debt and equity instruments.

- ***Intensify collaboration.*** Greater collaboration and cooperation, both globally and at the country level, would permit donors to combine expertise and funding instruments to promote a wide range of financial services for the poor. Collaboration should extend beyond donor agencies to build strategic alliances with other organizations such as insurance companies and information technology firms.

Author: CGAP staff. **Source:** *CGAP III Strategy, 2003-2008* (Washington, D.C.: CGAP, January 2003.) **Where to go for more information**: Alexia Latortue, "Tackling Aid Effectiveness from the Top: Donor Peer Reviews Synthesis Report," CGAP (December 2002): www.cgap.org.

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