

## MAXIMIZING AID EFFECTIVENESS IN MICROFINANCE

*Five core elements of effectiveness are key to improving the way in which development assistance agencies and other funders support financial systems for the poor. These core elements emerged from the 17 Microfinance Donor Peer Reviews facilitated by CGAP and have been formalized in the updated “Donor Guidelines on Good Practice in Microfinance.”*

### **Why has donor support not reached its potential in microfinance?**

Tackling aid effectiveness is one of the biggest challenges facing international development, and microfinance is no exception. Despite substantial investments by public and private donors, hundreds of millions of poor households remain without access to financial services. Country-level constraints play a part, but aid agencies also share the blame. Their own procedures, practices, and systems can make it difficult for them to apply good microfinance practices. Incentives are skewed more toward disbursing funds and less toward the ultimate impact on clients. While many donor agencies have accepted international donor guidelines on good practices in microfinance, these guidelines are often not reflected in operations on the ground.

### **What does it take for donors to be effective?**

Although not exhaustive, five core elements (see the “effectiveness star” at right) shape an agency’s effectiveness in microfinance, and in all probability, other areas of development as well. At the country level, other elements such as influence and commitment to collaboration are also important. While not every agency can be equally strong in each area, a minimum level of performance in all areas is critical for donors to at least abide by the “do no harm” principle.



### **Strategic Clarity and Coherence:** *Agency-wide vision in line with international good practice.*

Most donor staff has a narrow perception of microfinance and how it contributes to broad development goals. They see credit as an input to a larger program or a one-time resource transfer to specific target populations. Agencies with strategic clarity understand the importance of building inclusive financial systems and align their operations with that vision. The backbones of such financial systems are sustainable institutions that can continue serving clients once subsidies are no longer available. Rather than stifle diversity and creativity, a coherent approach promotes consistent application of good-practice principles. A sound microfinance policy is important, but by itself is not enough: it must be internalized by staff and translated into results on the ground.

### **Strong Staff Capacity:** *Sufficient technical expertise to manage operations.*

Because most donor agencies are short on microfinance expertise, many projects are designed and managed without good technical inputs. The majority of microfinance funding is handled by staff members who are either generalists or specialists in non-financial areas. Agencies need a few dedicated microfinance experts—either individuals or a central unit—who serve as an internal resource for technical advice and quality assurance. Project managers should also have enough training in microfinance basics to ask the right questions, select qualified consultants, and interpret performance reports. An agency’s incentive structure should encourage project managers to take advantage of its microfinance experts.

### **Accountability for Results:** *Transparency about microfinance programming and performance.*

Most agencies do not even know how much money they have invested in microfinance, much less how these projects are performing. Agencies need appropriate systems that make it possible to identify projects with a microfinance component and hold project managers accountable for accessing technical input at the design

stage. Decisions on whether to continue, terminate, or replicate a program should be guided by performance against measurable objectives, such as key financial indicators. In many agencies, especially the multilaterals, pressure to approve and disburse projects often takes precedence over setting up systems to ensure accountability.

**Relevant Knowledge Management:** *Systematic application of lessons learned.*

Ideas and experience are not communicated well within and among agencies, so mistakes are often repeated and successful approaches not incorporated into new program designs. Capturing information about what works is only the first step. Deliberate communication strategies are needed to insure that this information is actually applied to operations. Agencies need to get the right information to the right people at the right time. To do so, they need to make knowledge management a performance objective, for example, through job descriptions and thematic network participation.

**Appropriate Instruments:** *Ability to work directly with the private sector.*

It is harder to do good microfinance if donors must channel support through governments. Yet, even when agencies can work directly with the private sector, they do not always use funding instruments in a flexible and performance-based manner. Other common problems include poorly designed credit components of multi-sectoral projects; lack of proper sequencing of instruments (e.g., using debt instruments for start-up technical assistance); and slow and burdensome procedures. Effective agencies choose those instruments—grants, loans, guarantees, and equity participation—that best respond to market needs and seek to complement, not displace, private capital. They also link disbursements to the attainment of clear performance goals.

**How can donors maximize aid effectiveness?**

Using the five core elements, donors should assess their internal systems and identify areas for improvement. Such an analysis can help donors identify their comparative advantage and determine their optimal level of involvement in microfinance. Possible scenarios include:

**Expand.** Agencies that rank high across all elements may wish to make microfinance a strategic priority. They would need to invest in maintaining and enhancing strong performance in the five elements and could play a leadership role in microfinance.

**Consolidate.** Agencies with limited resources for building capacity in all five elements, but with a good track record in a particular geographical or technical area, should consider specializing in that niche market. Consolidating the portfolio where the agency has a comparative advantage will yield greater impact for the same amount of funding.

**Delegate.** Several agencies have limited comparative advantage, yet wish to remain involved in microfinance. For these donors, the best option may be co-funding or other types of agreements where the design, implementation, monitoring, and evaluation of microfinance projects are delegated to an agency with a clear comparative advantage in pro-poor financial sector work.

**Phase-out.** Based on limited or non-existent comparative advantage, agencies can decide to stop developing new microfinance operations and wind down their existing portfolio. They can then transfer those resources previously committed to microfinance to other development sectors for greater effectiveness.

**Author:** Tamara Cook, with input from CGAP staff. **Sources:** Brigit Helms and Alexia Latortue, “Elements of Donor Effectiveness in Microfinance: Policy Implications,” CGAP Aid Effectiveness Initiative (Washington, DC: CGAP, April 2004); Eric Duflos, Brigit Helms, Alexia Latortue, and Hannah Siedek, “Global Results: Analysis and Lessons,” CGAP Aid Effectiveness Initiative (Washington, DC: CGAP, April 2004); *Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance*, (Washington, DC: CGAP, December 2004).

**For more information:** On the Microfinance Donor Peer Reviews, see [www.cgap.org/projects/donor\\_peer\\_reviews.html](http://www.cgap.org/projects/donor_peer_reviews.html). On aid effectiveness, see David Dollar and Victoria Levin, “The Increasing Selectivity of Foreign Aid, 1984–2002,” in *Development Economics* (Washington, DC: The World Bank, 2004); William Easterly, “The Cartel of Good Intentions: The Problem of Bureaucracy in Foreign Aid,” *Policy Reform* 5, no. 4 (2002); DAC Task Force on Donor Practice, *Harmonizing Donor Practices for Effective Aid Delivery*, DAC Guidelines and Reference Series (Paris: OECD, 2003).

**Aid Effectiveness in Practice**

- **Strategic clarity and coherence.** **NORAD**'s new strategy consolidates funding on relatively high-risk innovations and industry infrastructure (i.e., training providers and credit bureaus), implemented through Norwegian NGOs.
- **Strong staff capacity.** **UNCDF/UNDP** is rolling out a targeted training course for non-microfinance operational staff.
- **Accountability for results.** **IFAD** partners with the **MIX** ([www.themix.org](http://www.themix.org)) and field-based specialists to conduct project reporting and monitoring.
- **Relevant knowledge management.** The **Dutch Microfinance Platform** brings together both public and private players to learn from each other and shape future programming decisions.
- **Appropriate instruments.** **AFD** made an exception to average project size to allow for smaller microfinance projects.