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EXECUTIVE SUMMARY

These Guidelines seek to raise donor staff awareness of good practice and improve the effectiveness of donor operations in microfinance. The lessons learned during 30 years of support to the sector are translated into practical, operational guidance for donor staff.

CGAP’s 28 member donors have defined a vision for the future of microfinance: a world in which poor people everywhere enjoy permanent access to a wide range of financial services, delivered by different types of institutions through a variety of convenient mechanisms. To improve their financial lives, poor clients require responsive financial services beyond microenterprise credit, encompassing savings, transfers, payments, and insurance. However, financial services are not the magic bullet for all poor people. The destitute are often in need of other development interventions such as safety net programs.

Large-scale sustainable microfinance can be achieved only if financial services for the poor are integrated into overall financial systems. The key to donor effectiveness is to complement, not replace, private capital and accelerate innovative market solutions. Concessional finance has a role in building institutional capacity of service providers and underwriting the development of experimental services (micro-level), supporting infrastructure such as rating agencies, credit bureaus, audit capacity, etc. (meso level), and fostering an enabling policy environment (macro level).

The backbone of financial systems remains micro level or retail institutions that provide services directly to clients. A wide range of financial and non-financial institutions are required to serve the needs of poor people. Financial sustainability is essential to reach significant numbers of poor people and to realize long-term social returns.

The meso level refers to the overall infrastructure of the financial system comprising quality auditors, rating agencies, networks and associations, credit bureaus, transfer and payments systems, information technology and technical service providers. Donor support at this level aims to extend these services to microfinance so as to help mainstream rather than marginalize it.

At the macro level, a conducive and stable macroeconomic and policy environment is necessary to underpin a pro-poor financial system. Government entities have a constructive role in supporting interest rate liberalization, controlling inflation and providing prudential regulation and supervision of institutions that take deposits. Donors should not support direct provision of financial services by the government.

All donors cannot work at all levels of the financial system. Rather, each should act upon its comparative advantage. The five elements of donor effectiveness 1) strategic clarity and coherence, 2) strong staff capacity, 3) accountability for results, 4) relevant knowledge management, and 5) appropriate instruments, help agencies to define their specific strengths and find partners to complement their capacities.

Despite significant learning about how to be effective in microfinance, frontier issues like rural finance, product development in microinsurance and remittances, social performance measurement, and others require further experience to define good practice.
FOREWORD

Financial services for the poor, or microfinance, can be powerful tools to fight poverty. Access to financial services such as savings, credit, transfers, payments, and insurance can help poor people to take control of their financial lives. When good practice is applied, access may empower them to make critical choices about investing in businesses, sending their children to school, improving health care for their families, covering the costs of key social obligations like marriages, and protecting themselves from crises like sickness, death, and natural disasters. However, microfinance should not be seen as a panacea for poverty reduction; other social and economic investments are also required.

The donor community spends an estimated US$800 million – US$1 billion per year on microfinance and cares particularly about microfinance because access to financial services can contribute to poverty reduction and achieving the Millennium Development Goals (MDGs) by 2015. The MDGs describe concrete outcomes related to the multiple dimensions of poverty, including income, health, education, and improving the international development system.

Commitment to applying good practice in microfinance comes from the highest level within donor countries and agencies. In June 2004, the Group of Eight (G8) endorsed the Eleven Key Principles of Microfinance at the meeting of Heads of State in Sea Island, Georgia (see Box 1). These Principles were drawn up by CGAP, a consortium of 28 public and private member donors and a clearinghouse for microfinance. The Guidelines contained in this document translate the 11 Principles into concrete operational guidance for donor staff.

Also, the Microfinance Donor Peer Reviews launched by CGAP donor members in 2002 involved 17 international development agencies that collectively addressed aid effectiveness from the perspective of internal agencies’ procedures, processes and systems. In February 2004, the heads of the participating 17 agencies discussed the outcome of the Peer Reviews and underscored the importance they place on improved aid effectiveness in building inclusive financial systems. They agreed on a Joint Memorandum, and a program of work to codify good practice.

These Donor Guidelines on Good Practice in Microfinance build on this high-level commitment and the overall emphasis on donor harmonization on standards and practice. They provide practical guidance for donor staff on how to best interact with and support the various actors in microfinance.

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2 The term “inclusive financial systems” refers to the integration of microfinance into formal financial systems to ensure permanent access to financial services to significant numbers of poor people. This delivery of all forms of financial services by a large range of institutions requires the development of the system on all three levels: micro (retail-level financial institutions and other providers), meso (financial infrastructure) and macro (enabling policy environment).
**Box 1: Summary of the Eleven Key Principles of Microfinance**

(prepared by CGAP and endorsed by G8)

1. **Poor people need a variety of financial services, not just loans.** In addition to credit, they want savings, insurance, and money transfer services.

2. **Microfinance is a powerful tool to fight poverty.** Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.

3. **Microfinance means building financial systems that serve the poor.** Microfinance will reach its full potential only if it is integrated into a country’s mainstream financial system.

4. **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people.** Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.

5. **Microfinance is about building permanent local financial institutions** that can attract domestic deposits, recycle them into loans, and provide other financial services.

6. **Microcredit is not always the answer.** Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.

7. **Interest rate ceilings hurt poor people by making it harder for them to get credit.** Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.

8. **The role of government is to enable financial services, not to provide them directly.** Governments can almost never do a good job of lending, but they can set a supporting policy environment.

9. **Donor funds should complement private capital, not compete with it.** Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.

10. **The key bottleneck is the shortage of strong institutions and managers.** Donors should focus their support on building capacity.

11. **Microfinance works best when it measures—and discloses—its performance.** Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. MFIs need to produce accurate and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served).
OBJECTIVES AND STRUCTURE OF THE GUIDELINES

Existing donor principles for microfinance (known as the “Pink Book”) were developed in 1995 jointly by the Donors’ Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development.

The Pink Book has stood the test of time with regard to funding retail-level microfinance institutions. However, microfinance is a dynamic field that has evolved significantly since the Pink Book was published. Today, microfinance is increasingly seen as an integral, and no longer marginal, part of the financial system. This realization not only offers the potential for massively increased outreach to the poor, but also implies a much broader, more diverse, and complex set of issues and institutions.

There is increasing consensus about what is needed to ensure permanent access for poor people to financial services through sustainable institutions. Through some 30 years of experience and more recently through active participation and exchange with CGAP and other fora, donors have learned much about what works and what does not work in supporting the emergence of pro-poor financial systems. There is still a lot to be learned, however. With most poor people lacking access to basic financial services, microfinance – and donors’ support for it – has yet to reach its full potential. In fact, the agreement among technical staff on basic good practice is still not consistently reflected in donor operations on the ground. This experience led CGAP to facilitate a process for drafting the updated good practice Guidelines and incorporating new learning.

These Guidelines seek to raise donor staff awareness of good practice and improve the effectiveness of donor operations in microfinance. The key question addressed throughout is: what is the best use of subsidies? To achieve this objective, the Guidelines compile lessons learned over the past several years about the basic conditions for successful microfinance, with an emphasis on donor support to the sector in partnership with primarily private partners. Drawing on these lessons, the Guidelines also provide practical, operational guidance for donor staff in the field and at headquarters who conceptualize, design, implement, and monitor programs related to improving poor people’s access to financial services. The intent is not to dictate “one way” to support microfinance, but rather to support a diversity of approaches and priorities within the framework of basic principles of good practice. The Guidelines also highlight issues that remain unresolved and require further experience before reaching consensus on good practice.

The Guidelines were developed by and for CGAP members that include bilateral donors, foundations and multilateral development banks, all of which are often referred to as international development partners. They are also applicable for many other organizations that fund microfinance or design and manage microfinance programs on behalf of donors like international NGOs, Project Management Units (PMUs), apex facilities, social and commercial investors, and consultants. In these Guidelines the term ‘donor’ encompasses all these development partners.


4 Microfinance institutions (or MFIs) are financial institutions whose business focus is on providing microfinance services encompassing various types of formal (banks), semi-formal (cooperatives, NGOs, village savings banks) and informal financial institutions (savings and credit groups).

5 For more information on CGAP, visit www.cgap.org. A subcommittee was established among CGAP’s Executive Committee to lead the process, in consultation with all CGAP member donors and stakeholders. Subcommittee members include Brian Branch, WOCCU; Frank DeGiovanni, Ford Foundation, and David Stanton, U.K. Department for International Development.
These Guidelines have four parts. Part I introduces a “new vision” of financial systems that work for the poor majority and discusses the role of donors. Part II addresses the financial services needs of poor clients (the demand side). Part III looks at the financial system (supply side) on three levels: micro (retail-level financial institutions and other organizations like retailers, agricultural traders, marketing intermediaries, and input suppliers that provide financial services directly to poor clients), meso (industry infrastructure), and macro (enabling policy and government role). Both the second and third parts provide lessons learned and practical operational guidelines. Finally, Part IV explores basic principles for improving donor effectiveness, harmonization, and collaboration in microfinance, drawing from the ongoing aid effectiveness work implemented by CGAP member donors. It also lists a number of “frontier issues” where less consensus exists at the time of publication – but which require more work in defining good practice.

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6 “Financial institution” refers to any institution (public or private) that collects funds (from the public, donors, or other institutions) and invests them in financial assets such as loans, bonds, or deposits rather than tangible property. In a financial system the industry infrastructure comprises quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology and technical service providers. These actors make up what is referred to as the meso level in this document.
PART I. INTRODUCTION

A. Vision
"The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector...Together, we can and must build inclusive financial sectors that help people improve their lives."  
Kofi Annan, UN Secretary General, 2003

Financial services can play a critical role in reducing poverty. Permanent access to financial services may enable poor people to increase incomes, build assets, and reduce their vulnerability to external shocks. Financial services can put power into the hands of poor households to progress from a state of hand-to-mouth survival to planning for the future, acquiring physical and financial assets, and investing in better nutrition, improved living conditions, and children’s health and education. And because financial services can be delivered sustainably, these benefits can be enjoyed on an ongoing basis, well beyond the duration of donor or government programs.

Through a highly participatory process involving multiple stakeholders, CGAP’s 28 member donors have defined a vision for the future of microfinance. This new vision is one in which poor people everywhere in the developing world enjoy permanent access to a wide range of financial services, delivered by different types of financial and non-financial institutions through a variety of convenient mechanisms. Financial services for the poor encompass savings, credit, payment and transfer services, and insurance. Providers include non-governmental microfinance institutions, savings and credit cooperatives, commercial banks, community-based organizations with bank linkages, insurance companies, state banks and other institutions. These Guidelines aim to codify what is already known about basic principles of good practice that will lead to the realization of this vision.

B. Inclusive Financial Systems

The new vision recognizes that large-scale sustainable microfinance can be achieved only if financial services for the poor are integrated into all three levels of a financial system: the micro level (retail financial institutions and other providers), the meso-level (financial industry infrastructure), and the macro-level (policy environment). 7 In general, this integration allows more access to capital by institutions serving the poor, better protection of poor people’s savings, and increased legitimacy and professionalization of the sector. Integration into the financial system could ultimately open financial markets to the majority of people living in developing countries, including poorer and more geographically remote clients than currently reached.

Success in building inclusive financial systems hinges on the contributions of a wide range of actors and their ability to work together effectively. In addition, financial systems for the poor depend on existing conditions such as infrastructure, access to markets, production technology, and availability of information

7 These Guidelines refer to the “financial system” as encompassing all three of these levels (micro, meso, and macro), where many of these actors are not exclusively dedicated to work in the financial sector (e.g., auditors, agroprocessors, technical service providers). The “financial sector” is defined more narrowly as including those actors directly involved in providing financial services or supervising financial institutions.
to mitigate risk. The backbone of financial systems remain retail-level institutions that provide services directly to clients – referred to as the “micro” level in these Guidelines.

In addition, a supporting infrastructure comprising quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology, technical service providers and trainers, is required to reduce transactions costs, increase outreach, build capacity, and foster transparency among retail institutions. This infrastructure, known as the “meso” level, can also transcend national boundaries and include regional or global actors.

Finally, a conducive and stable macroeconomic and policy environment is necessary to underpin a pro-poor financial system. Central banks, ministries of finance, and other national government entities constitute the main “macro” level players.

It is important to note that all aspects of the inclusive financial systems approach may be difficult to apply in every country. As in every other area of development, one of the most important starting points should always be the country context. For instance, in countries with dysfunctional or non-existent financial systems, the entry point for building permanent access to financial services for poor people will differ from countries with flourishing financial systems. Unequal access to financial services is also present in countries with sound financial systems, and interventions may be required to remedy market failures and expand access. A functioning financial system should be seen as a necessary, but certainly not a sufficient condition to assure permanent access to financial services for poor people.

C. The Donors’ Role
International development partners have played an important role in supporting the emergence and development of microfinance. However, because donors’ programs on the ground do not consistently reflect their commitment to following good practice, they have not always achieved desired impacts. In some cases, they have retarded the development of inclusive financial systems by distorting markets and displacing local commercial initiative with cheap or free money. Donors need to recognize that they only play a supportive role, and that their partners on the ground are the ones actually delivering services. At the very least, these Guidelines seek to enforce a sort of “Hippocratic oath” for donors to “do no harm”.

As microfinance evolves and becomes more complex, donors face an even greater challenge of enhancing professionalism and applying good practice. They must engage with a much broader range of actors at the micro, meso, and macro levels, and allow private and public sector partners to take up their appropriate role. The role of donors in the future of microfinance will change to address new challenges in expanding and deepening access that may not be addressed by the private financial system automatically. All donors cannot necessarily work on all three levels of a financial system, but each intervention at whatever level should promote the growth of the sector as a whole. Additionally, the role of donor interventions on the different levels depends on the stage of development of the larger financial system.

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A microfinance network is a group of institutions (usually international or regional) generally centered around a network support organization with the goal of fostering the launch of new institutions, developing standards, wholesaling funds, providing technical services, implementing knowledge management and/or leading policy reform efforts. A credit bureau is a repository or data base that keeps information about consumers including demographics, payment patterns of various types of credit obligations, and bad debt records.
One key question for donors is how to deploy the range of instruments at their disposal to best support the emergence of inclusive financial systems. These instruments range from grants by bilateral donors and foundations for technical assistance, loan funds, institutional capacity building, and development of industry infrastructure; to soft loans from multilateral development banks to governments for a range of activities including strengthening the enabling environment, supporting the development of industry infrastructure, and providing financial institutions with technical assistance and loans (which increasingly are priced at or near market rates); and commercially-priced loans, quasi-equity and equity from public sector banking institutions.

Donors increasingly engage with national governments to integrate financial deepening and financial sector reforms within such country-level mechanisms as Financial Sector Assessment Programmes (FSAPs), Poverty Reduction Strategy processes (PRSPs), sector-wide approaches (SWApS) and budget support. The donors most involved in such reforms, such as the World Bank, IMF, and multilateral development banks, should highlight access to financial services within this broader framework. It is up to donors, working through national stakeholders like governments, civil society, and the private sector, to maximize the coherence of microfinance-related activities within this larger picture, using the good practice guidelines outlined in this document. Perhaps one outcome of this country-level process could be a set of rules of engagement or code of conduct among international development partners.

PART II. UNDERSTANDING POOR CLIENTS’ NEEDS

The microfinance community has made great strides in learning about how poor people use financial services, and the impact of these services on their lives. Earlier models of microfinance delivery were mostly supply-driven, with an emphasis on replicating specific credit methodologies. It is increasingly recognized that, to be effective, financial services for the poor must be market-driven and client-responsive. Donors generally do not engage directly with the ultimate clients of microfinance services (although some international and local NGOs may do so). However, it is important that donor staff understand the financial reality of the poor to ensure that operations are consistent with meeting demand.

This section outlines some of the key lessons learned about microfinance clients. Many of these lessons are counterintuitive and debunk firmly held beliefs (some would say “myths”) about the poor.

Lessons Learned

- Poor clients need and are willing to pay for a variety of financial services (e.g., credit, savings, transfers, payments, insurance), not only microenterprise loans.

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9 **FSAPs** are joint IMF-World Bank reviews aimed at promoting the soundness of the financial systems of member countries; **PRSPs** are prepared by IMF member countries through a participatory process and describe a country’s macroeconomic, structural, and social policies to reduce poverty over a medium-term horizon, including external financing needs; and **SWApS** is a funding modality whereby all significant funding for a sector supports a single government expenditure program with heavy government ownership.

10 **National stakeholders** encompass the array of partners that donors engage with at the country level, including government, private sector, and civil society.

11 The Guidelines do not attempt to define the ‘poor’, but rather try to capture the whole range of people currently excluded from access to financial services. Each donor agency will define its own group of potential or existing microfinance clients.

12 Additional resources on understanding client needs are found in Annex 2.
Poor people save, even very poor people. Often savings are made informally, in kind, and in relatively insecure ways (e.g., animals, jewelry, or cash under the mattress).

Financial services for the poor should be client-responsive, not supply-driven. Attempts to import credit methodologies from other contexts have had mixed results.

Financial institutions and other financial service providers, not donors, are best placed to understand client needs and design appropriate services because they have direct contact with poor clients on a daily basis.

The destitute have very limited absorption capacity for debt, and microcredit may not be the most appropriate solution for them. Similarly, microcredit may not be appropriate for every situation, e.g., refugee resettlement.

Targeted anti-poverty, social safety net programs, and investment in infrastructure, and production technology can offer better alternatives than microcredit for the destitute or especially vulnerable groups (e.g. feeding programs, wage employment from small and medium enterprises).

Consumer protection initiatives like ensuring transparency of financial disclosure and consumer education can protect microfinance clients from predatory lenders.

Operational Guidelines

- **Verify that credit is a binding constraint** to the achievement of donor goals, especially in projects where microfinance is not the main component. Donor-funded projects often assume credit is needed when the main constraints lie elsewhere (e.g. weak infrastructure, poor production technology, limited market access) and other financial or non-financial services would be more appropriate. They also often neglect to take informal financial arrangements into consideration in project design. In some cases, the support of savings or insurance services might be more relevant than credit.

- **Do not use microcredit merely as a resource transfer mechanism** for high-risk groups. Other methods may be more efficient for the purpose of resource transfer, e.g. safety net programs to extremely vulnerable groups. Programs that channel credit to specific groups without applying good practices may dilute financial discipline, resulting in poor repayment from clients, and collapse.

- **Conduct due diligence to ensure that financial intermediaries/providers have sufficient institutional capacity and commitment** before engaging in product development; do not push financial institutions to develop services that overload their capacity.

- **Provide flexible funding** to cover research and development and technical assistance for capacity building, enabling partners to introduce innovative financial services and delivery mechanisms. This work includes market studies by financial institutions or other appropriate market players that determine the specific needs of potential clients. These activities should be funded with grants.

- **Support consumer protection** laws aimed at safeguarding poor clients from predatory lenders.

**PART III. BUILDING INCLUSIVE FINANCIAL SYSTEMS**

The key to donor effectiveness is to find ways to complement, not replace, private capital and international social capital to accelerate innovative market solutions. In many countries, dependence on funding from

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13 In this document, the term “destitute” is used to describe people too poor to use financial services effectively, and who need different kinds of development assistance (e.g., safety nets, food programs, employment programs, etc.).

14 **International social capital** refers to private capital that seeks investment opportunities based on a combination of social and financial criteria.
donors and governments – including government-financed development banks – should diminish in relative terms as local financial institutions and private capital markets mature.

However, concessional finance is still needed at all levels of the system. These subsidies apply to building institutional capacity of service providers and supporting them in the development of experimental services (micro-level). Funding can also be used to build an infrastructure of rating agencies, credit bureaus, audit capacity, etc. (meso level) to offer services to the retail level. Donors should also foster an enabling policy environment (macro level) that allows both micro- and meso-level actors to flourish. Donors’ added value lies in promoting innovation through research and development, forging linkages, promoting increased transparency and competition among retail providers of financial services, and building capacity at all levels. These kinds of interventions do not generally require large amounts of funding, but rather are more intensive in technical inputs. In all cases, the purpose of subsidized funding should be to reduce real or perceived risks and transactions costs among local, mostly private sector actors, to engage them more fully in the sector.

In some cases, longer-term subsidies may be required to reach sparsely populated and otherwise difficult-to-reach populations, since institutional viability is harder to achieve. Also, there may be cases where well-run financial institutions are unable to obtain sufficient funds for on-lending because of imperfections in local capital markets. In many markets, however, money for onlending can damage and distort local markets.

This section describes lessons learned and offers operational guidelines for donor support at three levels of the financial system: the micro-level (retail financial institutions), the meso-level (financial industry infrastructure), and the macro-level (policy environment).\(^{15}\)

A. Micro-Level: Promoting Strong Retail-Level Institutions\(^ {16}\)

Donors have a long history of supporting the delivery of credit to specific target groups. They also have helped build today’s microfinance by supporting individual microfinance institutions, primarily (but not exclusively) NGO microcredit organizations. But in fact, the range of retail-level financial institutions with potential to serve poor people is much more broad, encompassing private and state-owned commercial banks, postal banks, credit unions or savings and credit cooperatives, member-owned community organizations, other non-bank intermediaries like finance or insurance companies, and others. Furthermore, non-financial institutions are often important providers of financial services.

Even though there is general agreement that a wide range of institutions should be supported, there is some debate about whether donors should “pick winners” and support promising institutions on an individual basis, or whether they should offer broader capacity-building and other services competitively to a range of institutions. Some donors pursue both strategies. In either case, donors should not crowd out the market. Care should be taken to encourage specialization among financial institutions and to support collaboration, while at the same time promoting competition (or at least avoid anti-competitive behavior).

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\(^{15}\) Additional resources on the different levels of the financial system are found in Annex 2.

\(^{16}\) These Guidelines draw heavily from the existing “Pink Book”. In fact, much of the specific Pink Book guidance remains valid for the micro-level, particularly for traditional microfinance institutions such as NGOs and NGOs that have transformed into licensed financial intermediaries.
The lessons and guidance in this section refer mainly to support for individual financial institutions and other financial service providers, while the “meso” section provides guidance on interventions that support several institutions simultaneously.

**Lessons Learned**

- The lack of strong, competent retail capacity remains the main bottleneck for extending financial services to large numbers of poor people, especially in rural areas.
- Credit components, designed as inputs to larger projects with limited life spans, often perform poorly and run the risk of failing to provide permanent access to financial services.\(^{17}\)
- A wide range of national financial and non-financial institutions are required to serve the needs of poor people, including institutions with existing capacity for widespread outreach such as commercial banks and postal outlets. Specialization is encouraged to serve distinct market needs.
- Ownership and governance (management oversight) are critical determinants of success in donors’ support to financial institutions. Donors generally do not make good owners of financial institutions, and they rarely have the appropriate expertise and capacity to provide adequate board oversight.
- Financial sustainability is essential to reach significant numbers of poor people and to realize long-term social returns.\(^{18}\) This means, among other things, charging interest rates consistent with full cost recovery to ensure profitability and growth. Over time, competition and increased accountability for results will drive costs (and thus interest rates) down.
- The time required to achieve financial sustainability is highly variable. Current guidelines suggest that financial sustainability can be achieved within a period of 5-10 years. However, this timeframe can vary by country context, local market conditions, and clients served. It is important to specify a time horizon for each institution to encourage the most effective use of donor subsidies.
- Improving the efficiency of microfinance operations offers higher quality and lower cost services to poor people. Institutions can achieve greater efficiencies, and thus reduce costs, by investing in quality management information systems and technological improvements.
- Institution-building requires a long-term commitment by donors, but this should be balanced with the need for temporary and time-bound funding support. Ad hoc technical assistance and abrupt withdrawal might fail to build domestic capacity, as opposed to a long term, strategic commitment by the donor. However, long-term dependence on foreign technical service providers rarely builds and might even replace domestic capacity.
- If not applied properly, grants, subsidized loans and excessive guarantees to financial institutions can undermine or crowd out national or international commercial capital markets or domestic savers.

**Operational Guidelines**

- **Find institutions that share the donors’ vision on reducing** poverty and building sustainability, rather than imposing an external vision or targeting a specific social group.

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17 Also known as credit lines, revolving funds, and community development funds, **credit components** constitute an input of funding to larger projects (e.g. agriculture, education, health, etc.) ranging from large credit lines to small revolving funds. Credit is often targeted at a particular group of people for the purpose of purchasing an input or changing behavior.

18 **Sustainability** in microfinance entails meeting the operating and financial cost of providing financial services on a permanent basis, independent of donor or government subsidies.
- Adapt funding to the institutional stage of development of a financial institution. Support needs to be structured according to the specific needs during different stages, e.g., start-up, growth, etc. Do not support institutions that require instruments and capacity that the donor agency cannot provide or hire in effectively.

- Do not drive key strategic and operational decisions about the business of providing financial services. Support to financial institutions should be demand-driven and managers of the specific institutions should take the lead, not donors.

- Support financial institutions progressively to intermediate commercial funds and/or deposits (when permitted by law) without supplanting local equity and loan markets. However, avoid encouraging NGOs to transform into formal financial institutions unless they have sufficient potential to do so. Donors need to analyze the costs and benefits of transformation in order determine the appropriateness of supporting this long and arduous process.

- Do not intervene with financial institutions’ pricing policies, for instance by compelling financial institutions to charge below-market interest rates on loans to clients (or rates lower than what is necessary to cover costs over the medium term). Encourage institutions to be transparent about their pricing.

- Assess financial institutions properly, looking at such factors as: vision, mission and strategy, ownership structure and governance, human resource capacity, quality of services and outreach, financial performance, and portfolio health.

- Pay specific attention to governance issues such as board composition, risk management, fiduciary responsibility, transparency, and potential conflicts of interest. Ensure appropriate checks and balances between management and the board, the existence of key board committees (e.g., audit, compensation, investment). Ownership and governance are especially important for member-owned institutions like savings and credit cooperatives.

- Use performance-based funding:
  - Employ performance-based contracts with agreed performance targets (including donor exit strategies).
  - Include a few core indicators to track performance (outreach in general, outreach to the poor, portfolio quality, profitability/sustainability, efficiency). Avoid overburdening financial institutions with too many indicators.
  - Require regular financial reporting. Ensure that reporting requirements are harmonized with those needed by management and governing bodies, other funders, and supervisors.
  - Tie renewal or continuation of support to achievement of meaningful and clear performance targets.
  - Be prepared to exit from institutions that do not perform as agreed, either by discontinuing subsequent tranches of support or requiring reimbursement (when feasible).
  - Live up to the donors’ responsibilities under the contract (e.g., predictable funding patterns, timely disbursement, prompt responses to reports.

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20 See Annex 3 for sample indicators that can be used by donors to track performance.

21 As of late 2004, there is a lack of clear understanding and consensus on appropriate social performance and impact indicators for microfinance (beyond simple measures like loan or savings size, compared to national GDP, for instance). A number of efforts are under way to define this concept more clearly and develop indicators (see Annex 2 for more information).
• **Build exit strategies** that define the life of the relationship into contracts from the beginning of a project, including a timeframe to achieve financial sustainability.

• When cost-effective methods to measure social performance have been established, and depending on whether social performance is a key goal of the donor in question, **include regular social performance monitoring** in the performance measurement system.

• **Support improvements in efficiency** (streamline procedures, introduce new technology, etc.), **governance structures and learning**, to reduce costs for poor clients. Donors should support the development of standardized tools and instruments on topics like financial projections and product development.

• **Take informed risks on promising but unproven institutions** with the potential to reach large numbers of unserved clients. Let commercial private sector funders support the strongest institutions with the capacity to absorb market-rate investments.

• **Price loans at commercial or near-commercial rates** to financial institutions to avoid undermining incentives to mobilize deposits or tap other local sources of capital. Loans may be priced at lower rates to assist financial institutions to serve sparsely populated or otherwise difficult-to-reach populations as long as these institutions charge a rate that allows them to cover all their costs to their borrowers.

• **Structure guarantee instruments** (e.g. guarantees to national banks on-lending to microfinance institutions) with incentives to **forge permanent linkages** between the two parties. Risk sharing with the bank is key to ensuring that the amount of resources going to microfinance over the medium term exceed the amount that would have been available without the guarantee.\(^{22}\)

• **Provide loans and guarantees only when financial institutions are unable to attract adequate and appropriate capital** from local or international capital markets, or to fill the gap of medium – and long-term funding (i.e., medium- to long-term funds are not available on the domestic market).

• **Gradually phase out grants and subsidized loans** to financial institutions as national or international commercial capital markets or domestic savers evolve and take over.

• **Promote potential linkages among the various financial service providers**, i.e. collaboration between formal financial institutions and various types of smaller financial institutions to increase outreach, or between financial institutions and non-financial providers like retailers and agricultural input suppliers that provide financing. Facilitate mergers and consolidation in those countries where too many financial institutions exist relative to market demand.

### B. Meso-Level: Supporting Industry Infrastructure

The meso-level refers to the overall infrastructure of the financial system. This infrastructure can facilitate or obstruct the emergence of financial intermediaries. Limited availability or lack of specialized knowledge among credit bureaus, rating agencies, auditors, payments systems, and other services can seriously constrain the ability of retail financial institutions to expand their services to poor clients. An emerging area is access to international and domestic financial and capital markets, for instance through investment funds, bond issues, securitization, etc. Whatever the intervention, donor support should emphasize local ownership to guarantee continued existence after donor support phases out. Donor support at the meso level should aim to extend these services to the microfinance sector so as to help mainstream rather than marginalize it. The meso-level is a relatively new area of activity and knowledge, with fewer concrete lessons and guidelines.

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\(^{22}\) A credit **guarantee** is a financial instrument that encourages financial institutions, and in particular, commercial banks to lend to microfinance institutions, enterprises, or individuals that have good prospects of success but are unable to provide sufficient collateral or do not have a sufficient record of financial transactions to proof their creditworthiness.
Lessons Learned

- Building markets for support services, and sharing risk, are vital for the long-term viability of retail financial institutions.
- The majority of apex institutions (sometimes referred to as second-tier or wholesale institutions) have produced disappointing results, often because they were set up in countries without a critical mass of good financial institutions with the capacity to absorb apex funding.\(^{23}\)
- Investments in industry infrastructure benefit most financial institutions.
- Weak institutional and human capacity are among the key constraints at all levels (micro, meso, and macro).
- National-level microfinance associations, a particular kind of network that is member based, can potentially support capacity building of retail institutions, promote transparency, and influence the policy agenda in a specific country.\(^{24}\)
- Accurate, standardized, and comparable information on the financial performance of retail institutions is imperative for bank supervisors and regulators, donors, investors, and clients to adequately assess risk and returns.\(^{25}\)
- Advances in technology are crucial to increase market knowledge and spur investments that reduce transaction costs.
- Some ongoing subsidies may be required, especially those that clearly accelerate development of support services markets or those considered public goods (e.g., establishing national and regional networks or action research programs).
- Information disclosure, contract enforcement and security of transactions are necessary to instill confidence and increase the breadth and depth of financial transactions.

Operational Guidelines

- **Comply with** the “Blue Book” standards on business development services when supporting private service providers to stimulate market development and with the CGAP Consensus Guidelines on Financial Reporting and Definitions of Financial Terms when promoting increased transparency and higher quality information flows.\(^{26}\)
- **Work with existing service providers**, including “mainstream” organizations, at the national, regional, and global level, to build their capacity to offer market-based and demand-based services. Avoid creating separate support structures that do not match the level of retail-level activity.

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\(^{23}\) **Apex institutions** are wholesale mechanisms that channel funds, with or without supporting services, to retail microfinance institutions in a single country or integrated market.

\(^{24}\) **Microfinance associations**, either national or regional in scope, are member-based associations made up of independent microfinance institutions operating in similar markets.


\(^{26}\) **Business Development Services** refers to a wide range of services used by entrepreneurs to help them operate efficiently and grow their businesses. The *Blue Book* is the Committee of Donor Agencies for Small Enterprise Development publication entitled *Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention*, for use by donors when supporting private service providers to stimulate market development.
Building Inclusive Financial Systems:
Donor Guidelines on Good Practice in Microfinance

- **Funding or creating apex institutions** involves a rigorous financial and operational analysis of the apex and potential recipients of funds, a strong strategic focus, minimized disbursement pressure, political independence and performance-based disbursement. Donors should ensure sufficient retail-level capacity to absorb funds before supporting an apex.

- **Consider technical assistance in organizational and institutional development** as well as emphasis on appropriate product development at the system level to improve capacity.

- **Support research and development** in technology for points of service, transfer and payments mechanisms, credit bureaus, etc. Try to avoid developing software that has already been created by others, but rather collaborate to create standards in managing information.

- **Fill human resource gaps** through building training programs, disseminating standards, and sharing technology. To ensure long-term capacity, donors should also promote the integration of a microfinance curriculum into formal education.

- **Support international networks and country level associations** as a means to build the capacity and voice of multiple financial institutions, as well as the opportunity to disseminate microfinance knowledge. Apply the same rigor of appraisal and performance-based funding as for retail-level financial institutions. Proof that members value network services, through cost sharing and other means, should be built in to all donor support.

- **Facilitate funding of global or multi-country networks or programs** that span the different levels of the financial system (micro, meso, macro). Seek linkages between these networks and other, country-level associations, and avoid undermining the development of country-level networks or associations.

- **Develop performance indicators** to be used by donors for measuring success and impact at the meso level.

- **Encourage financial standards by developing standardized reports and audits.**

**C. Macro-Level: Fostering a Conducive Policy Environment and Ensuring the Appropriate Role of Government**

Historically, governments have used credit schemes as a way to transfer resources to specific target populations, and these programs continue to exist today, often with donor support. The negative impact of most of these schemes (low repayment rates and creation of poor credit culture, decapitalization of funds, diversion of subsidized loans to wealthier citizens, etc.) led many donors and experts to advocate for disengagement of national governments from microfinance. This approach has not always produced the desired effect: some government programs still undermine microfinance markets.

However, there is increasing clarity that governments do have a constructive role in building financial systems that work for the poor. Governments are the only ones that can ensure an enabling environment that promotes competition among a wide range of financial service providers while also protecting consumers from predatory or fraudulent practices. Governments are the main partners for many donor agencies and often play a similar role in financial systems development. Therefore, especially for the micro and meso levels, these Guidelines also apply to governments. The key for donor support at the macro level is to ensure that policies that they encourage governments to promote reflect the true needs of retail-level financial institutions and their clients.

**Lessons Learned**

- The government’s primary role is as an enabler, not as a direct provider of financial services.
The government’s most critical contribution is to maintain macroeconomic stability.

Interest rate ceilings restrict poor people’s access to financial services by inhibiting the financial sustainability of service providers.

Government-run credit programs generally distort markets, as they are subject to political rather than commercial imperatives. This impairs the sustainability of institutions providing financial services to the poor. Government-controlled apex funding organizations rarely perform well.

In special situations such as market failures that cannot be overcome by the financial system itself, government funding for sound and independent microfinance institutions may be warranted, when other funds are lacking. In such cases, clear “firewalls” that separate political considerations from provision of financial services must be in place.

Governments have the responsibility to ensure that legal and supervisory systems support, and ensure the soundness of a range of financial organizations, including prudential regulation for financial institutions that collect savings from the public.

Work at the policy level requires donor staff with specialized technical capacity and operational experience. Policy changes, especially legal reform, are more permanent than other levels of intervention. They are often irreversible and affect the sector as a whole (for better or worse).

Operational Guidelines

- **Support interest rate liberalization** through education and advocacy, both directly and by working with stakeholder networks. Support alternative methods for protecting consumers, like measures to promote transparency on loan costs to clients, consumer education, and consumer complaint mechanisms.

- **Build on existing policy frameworks and dialogue** (e.g., PRSP, financial sector reforms) to promote the legitimacy of inclusive financial systems.

- **Do not support direct provision of financial services by the government**, government-mandated portfolio quotas, directed credit, borrower loan guarantees or operational subsidies. In some cases, an exception can be made to this rule for governments to provide financing, subsidies, or guarantees to well-run financial institutions that are unable to obtain sufficient financing from local capital markets, especially those serving hardest-to-reach populations.

- **Support financial institutions directly rather than through government entities**. When this is not possible, as in the case of multilateral development banks, ensure that proper procedures and controls are in place to minimize political interference and ensure adherence to good practice principles contained in these Guidelines.

- Encourage adaptation of policy and legal frameworks to **reduce barriers to market entry** to increase competition, ultimately improving the quality of services available to poor clients. Regulation should not prohibit market entry and development, for instance by requiring a single legal structure for all licensed microfinance providers.

- **Help governments adjust the regulatory and supervisory framework**, without pushing for premature or restrictive legislation (“do not rush to regulate”). Before recommending prudential

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27 Mandated portfolio quotas are government requirements for banks to invest or lend a specified amount or percentage of their assets for social purposes; directed credit is government credit assistance to specific target groups (e.g. farmers, women, etc.) providing loans or loan guarantees, often on a subsidized basis.
regulation, make sure it is really necessary to protect the safety of savings, that there is a critical mass of retail-level institutions qualified for such regulation, and that supervisory capacity exists.

- In cases where non-bank institutions like NGOs need explicit legal authorization to lend, encourage regulatory changes that allow credit-only institutions to lend without prudential licenses and supervision.
- **Build capacity of key government staff** in ministries of finance and central banks (including supervisory capacity). Also, engage **members of parliament** on key issues like cost recovery pricing to influence political decision-making.
- **Support improvements in the legal framework for collateral, taxation and registration** in a transparent and enforceable manner.
- **Promote the development of socioeconomic statistics** on the population by the government or other relevant bodies to facilitate market research by financial institutions.

**PART IV. ENSURING DONOR EFFECTIVENESS**

Effectiveness ultimately depends on the ability of donors to respond to the needs of various actors within the sector on a demand-driven basis and in a collaborative way while avoiding over-funding private sector initiatives or distorting markets. In any given country, this means obtaining a clear picture of existing initiatives before moving forward to avoid duplication and working at cross-purposes with others. It also means identifying and building on each agency’s comparative advantage and collaborating with those that have complementary strengths.

**A. Elements of Effectiveness**

The Microfinance Donor Peer Reviews, conducted from May 2002 to November 2003, examined the modus operandi of 17 bilateral and multilateral agencies, yielding five core elements of donor effectiveness: 1) strategic clarity and coherence, 2) strong staff capacity, 3) accountability for results, 4) relevant knowledge management, and 5) appropriate instruments. These elements help shape an individual agency’s ability to apply good practice to its microfinance operations – thus achieving greater impact in the lives of poor people. A minimum level of performance in each of the five elements is critical for donor effectiveness in microfinance and, in all probability, other areas of development as well.

- **Strategic Clarity and Coherence:** The coherence of an agency’s vision of microfinance, and the relationship between this vision and accepted standards of good practice, affects quality of implementation and results. Strong policies are not enough; management and staff must internalize these policies to be effective.
- **Staff Technical Capacity:** Staff with solid microfinance technical expertise is a precondition for quality microfinance operations. One proven strategy is establishing strong technical focal points (individuals or teams of technical specialists) that prioritize spreading good practices among non-specialist colleagues at headquarters and in the field. Non-microfinance specialist staff who handle microfinance programs should also possess basic technical knowledge.
- **Accountability for Results:** Transparency about performance of microfinance programs is critical for aid effectiveness. Only with accurate information can agencies make sound decisions on whether to continue, extend, terminate or replicate a program. Depending on the donor agency’s strategy and mission, accountability includes a thorough assessment of the financial and social performance of its portfolio on a regular basis.
Knowledge Management: When knowledge management enables agencies to learn from their own and others’ experience, it greatly contributes to effectiveness. Additional funding for increased knowledge generation and dissemination can have a major impact to improve aid effectiveness and should be incorporated in individual projects or programs.

Appropriate Instruments: Donors should manage a wide range of funding instruments flexibly and work directly with private sector players depending on the agency’s expertise and strategy. Many agencies have recognized that credit components (also known as credit lines, revolving funds, and community development funds) within larger multi-sector programs do not produce the intended results, and should be avoided. At the very least, when unavoidable, these components should be implemented in line with good practice (e.g., clearly separated from grant components and other types of support). Donors should collaborate in support of government-owned strategies for financial sector development, making aid more coherent and manageable for Ministries and Departments, banks and civil society.

B. Comparative Advantage, Harmonization and Collaboration

Building financial systems that work for the poor – the majority of the world’s population – is a daunting task. The range of required donor engagements encompass working with diverse types of financial intermediaries at the micro-level (e.g., banks, cooperatives, postal systems), helping to build industry infrastructure at the meso level, and entering into policy dialogue with governments and other stakeholders at the macro level. But not every agency can or should work on all these different levels.

Donors should identify their comparative advantage in promoting financial services for the poor. In fact, donor leaders are increasingly realizing the need to align their actions with their strengths. Combined with other agency-specific considerations, the five elements of effectiveness can help guide donor actions in a given country context and/or type of intervention. For example, decentralization of decision-making and technical expertise is an important success factor for microfinance operations that require constant dialogue and technical support, especially policy work. Similarly, a long track record in a particular country or region can be critical for credibility and give an agency a local comparative advantage. Some possible action scenarios might include: expand (microfinance as strategic priority), consolidate (retention of volume of microfinance funding), delegate (involvement in microfinance, but delegation of direct intervention), phase out (termination of new microfinance operations).

As donor agencies identify their respective comparative advantage, they can build on one another’s strengths, and form alliances to harmonize their collective approach. Collaboration permits more consistent application of standards of good practice, a greater range of funding instruments and partners, and reduced transaction costs to partners, donors and government. Donors can achieve far more collectively than they can individually.

Options for collaboration range along a wide spectrum. At one end, individual donors can agree on a common strategy for working in a particular country. Each agency can then engage with specific financial system stakeholders based on its own strengths. At the other end of the spectrum, donors can pool resources and conduct joint programming with harmonized procedures and one voice. Many other collaborative approaches lie in between. Collaboration does not include only donors, but is needed among all stakeholders. Regardless of the model chosen, preliminary experience suggests that the foundation of success and greater collaboration is a clearly articulated vision shared by all donors. It is hoped that these Guidelines can help move donors forward in crafting that shared vision, both internationally and at the country-level.
C. Frontier Issues
The donor community and larger microfinance world have learned much over the past few decades about the best ways to support the emergence of inclusive financial systems. However, many core issues remain unresolved. Some examples of frontier issues include:

1) extending rural (and especially agricultural) finance in sparsely populated areas;
2) expanding the outreach to poor people of services like microinsurance, leasing, and remittance management;
3) improving social performance measurement and monitoring;
4) defining the lower limits to viable microfinance and when other interventions including grants might be more appropriate;
5) developing replicable strategies for unlocking country-level capital markets for microfinance;
6) identifying the role of donors relative to international equity and loan funds; and
7) finding cost-effective and sustainable ways to combine non-financial development services with financial services.

Intervention in these areas pose particularly difficult challenges for donors. However, innovation in these and other frontier areas should not be seen as a justification for projects that do not follow good practice guidelines. Many financial institutions, supporting networks, and other actors are making breakthroughs on a regular basis on these issues. It is hoped that donor guidelines in these and other areas can be continuously updated to reflect the state of the art.
Annex 1: Glossary of Terms

Apex institutions
Wholesale mechanisms that channel funds, with or without supporting services, to retail microfinance institutions in a single country or integrated market.

Blue Book
A publication of the Committee of Donor Agencies for Small Enterprise Development, entitled Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention, for use by donors when supporting private service providers to stimulate market development (www.bdsknowledge.org under Donor Committee and Donor Committee Guidelines)

Business Development Services
Business Development Services refers to a wide range of services used by entrepreneurs to help them operate efficiently and grow their businesses.

Destitute
In this document, the term ‘destitute’ is used to describe people too poor to use financial services effectively, and who need different kinds of development assistance (e.g., safety nets, food programs, employment programs, etc.).

Directed credit
Government credit assistance to specific target groups (e.g. farmers, women, etc.) providing loans or loan guarantees, often on a subsidized basis.

Donor
For these Guidelines, the term ‘donor’ encompasses a range of international development partners, including bilateral donors, foundations and multilateral development banks. The Guidelines are also relevant for other organizations that fund microfinance or manage microfinance programs on behalf of donors like international NGOs, Project Management Units (PMUs), apex facilities and social and commercial investors.

Credit bureau
Repository or data base that keeps information about consumers including demographics, payment patterns of various types of credit obligations, and bad debt records.

Credit components
Also known as credit lines, revolving funds, and community development funds, credit components constitute an input of funding to larger projects (e.g. agriculture, education, health, etc.) ranging from large credit lines to small revolving funds. Credit is often targeted at a particular group of people for the purpose of purchasing an input or changing behavior.

Financial Sector Assessment Programmes (FSAPs)
The FSAP, a joint IMF and World Bank effort introduced in May 1999, aims to promote the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, the program seeks to identify the strengths and vulnerabilities of a country's...
financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses.

**Inclusive Financial Systems** Integration of microfinance into formal financial systems to ensure permanent access to financial services to significant numbers of poor people. This delivery of all forms of financial services by a large range of institutions requires the development of the system on all three levels: micro (retail-level financial institutions and other organizations or individuals like retailers, agricultural traders, marketing intermediaries, and input suppliers that provide financial services directly to poor clients), meso (financial infrastructure) and macro (enabling policy environment).

**Financial Institution**
Any institution (public or private) that collects funds (from the public, donors, or other institutions) and invests them in financial assets such as loans, bonds, or deposits rather than tangible property.

**Guarantee/ Guarantee instruments**
A credit guarantee is a financial instrument that encourages financial institutions, and in particular, commercial banks to lend to microfinance institutions, enterprises, or individuals that have good prospects of success but are unable to provide sufficient collateral or do not have a sufficient record of financial transactions to proof their creditworthiness. The guarantee absorbs a specified percentage of all losses that may occur. Borrower loan guarantees are directed at individuals or enterprises, and tend to work better for small and medium sized firms rather than microenterprises.

**Industry Infrastructure**
In a financial system the industry infrastructure comprises quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology and technical service providers. These actors make up what is referred to as the meso level in this document.

**International Development Partner**
For these Guidelines, the term ‘international development partner’ encompasses all bilateral and multilateral development banks, and foundations, as well as other parties that fund or manage microfinance programs such as NGOs, Project Management Units (PMUs), apex facilities and social and commercial investors.

**Microfinance Association (MFA)**
Microfinance associations, either national or regional in scope, are member-based associations made up of independent microfinance institutions operating in similar markets.

**Microfinance Institution (MFI)**
Financial institutions whose business focus is on providing microfinance services encompassing various types of formal (banks), semi-formal (cooperatives, NGOs, village savings banks) and informal financial institutions (savings and credit groups).

**Mandated portfolio quotas**
Government requirement for banks to invest or lend a specified amount or percentage of their assets for social purposes.

**Micro, Meso, Macro**
The three levels refer to the levels of a financial system: the micro level (retail financial institutions and other financial service providers), the meso-level (financial industry infrastructure), and the macro-level (policy environment).

**National Stakeholder**
The array of partners that donors engage with at the country level, including government, private sector, and civil society.

**Networks**
A microfinance network is a group of institutions (usually international or regional) generally centered around a network support organization with the goal of fostering the launch of new institutions, developing standards, wholesaling funds, providing technical services, implementing knowledge management and/or leading policy reform efforts.

**NGO**
A non-profit agency not affiliated with any government, devoted to managing resources and implementing projects with the goal of addressing social problems.

**Pink Book**
The Pink Book is the commonly used term to refer to the existing donor guidelines in microfinance (Guiding Principles for Selecting and Supporting Intermediaries) published by the Committee of Donor Agencies for Small Enterprise Development in 1995.

**Poor**
For this document, the term ‘poor’ refers to everybody excluded from access to financial services who might potentially be able to use financial services effectively.

**Poverty Reduction Strategy Papers (PRSP)**
Poverty Reduction Strategy Papers (PRSP) are prepared by IMF member countries through a participatory process involving domestic stakeholders as well as external development partners, including the World Bank and International Monetary Fund. PRSPs describe the country's macroeconomic, structural and social policies and programs over a three year or longer horizon to promote broad-based growth and reduce poverty, as well as associated external financing needs and major sources of financing.

**Sector-wide Approaches (SWAps)**
Method of working between government and donors implying that all significant funding for the sector supports a single sector and expenditure programme, under government leadership, adopting common approaches across the sector, and progressing towards relying on government procedures to disburse and account for funds.

**Sustainability**
Sustainability in microfinance entails meeting the operating and financial cost of providing financial services on a permanent basis, independent of donor or government subsidies.
Annex 2: Additional Resources

This annex contains references related to the main topics raised in these Guidelines.

General:


CGAP’s Donor Information Resource Center DIRECT offers easy-to-use information on microfinance good practices for donor staff. It offers a wide range of information products addressing critical issues in microfinance, including: 1) short two-page briefs; 2) 15-minute PowerPoint presentations with speaker notes; 3) 3-hour training modules; 4) case studies, and 5) links to other resources. All materials are cross-referenced and indexed for ease of reference. Visit [www.cgap.org/direct](http://www.cgap.org/direct)
The Microfinance Gateway is a comprehensive source on microfinance. It lists publications of CGAP and other microfinance-related documents. It provides summaries and reading recommendations of selected documents, glossaries, and information on upcoming events. It lists links to relevant implementers, consultants, research and donor institutions, journals and publications at www.microfinancegateway.org

Understanding Poor Clients’ Needs


The website of MicroSave-Africa, a DFID/UNDG/CGAP initiative, lists a number of interesting field studies, essays and synthesis papers under it’s “study programme” section, as well as links to other selected publications. Visit www.microsave-africa.com

The USAID Assessing the Impact of Microenterprise (AIMS) project produced a plethora of research and writing on the impact of microfinance projects, including in-depth academic impact assessments, cost-effective and practical tools to track and assess the impact of programs, and other pieces. Visit www.usaidmicro.org/pubs/aims/

Micro-level : Promoting Strong Retail-level Institutions


CGAP DIRECT Case Study No.7: Donor Collaboration and Transparency: Standardized Donor Reporting in Uganda. CGAP DIRECT, 2003


National MFI performance monitoring tools


*Examples of social performance work:*

CERISE (Comité d’Échanges, de Réflexion et d’Information sur les Systèmes d’Epargne-crédit) is a platform of France-based, leading MicroFinance support organizations: IRAM (Institut de Recherches et d’Applications des Méthodes de développement, Paris), CIDR (Centre International pour le Développement et la Recherche), CIRAD (Centre de coopération internationale en recherche agronomique pour le développement), GRET (Groupe de Recherches et d’Echanges Technologiques)

Visit: www.cerise-microfinance.org

Imp-Act is a three year action-research program designed to improve the quality of microfinance services and their impact on poverty through strengthening the development of impact assessment systems. Building on the priorities and agendas of Microfinance Organizations (MFOs) and their clients, Imp-Act is designed to develop credible and useful impact assessment. The program therefore seeks to empower organizations to be proactive in developing their own learning systems, both to inform internal decision making and to satisfy the requirements of external stakeholders. Visit www.imp-act.org

The SEEP working group on Client Assessment is developing practical social performance indicators for use by practitioners (financial institutions and networks that make up its membership). These indicators will be part of a more general framework that outlines the purpose and benefits of social performance management and defines sound practices in this area, with a focus on process as well as outcomes (e.g., how to do it from an operational perspective).

In 2003, the US Congress passed an amendment to the Microenterprise for Self-Reliance Act, requiring USAID to develop, field test and certify at least two tools for assessing the poverty level of its microenterprise clients. USAID has been working with the IRIS Center at the University of Maryland to field test tools to guage their accuracy and the practical implications for their implementation. Tools will be finalized in the fall of 2005; more information on the project can be found at http://www.povertytools.org.

**Meso-level: Supporting Industry Infrastructure**


**Rating Companies**

- www.microrate.com
- www.ratingfund.org
- www.planetfinance.org
- www.accion.org
- www.classrating.com
- www.standardandpoors.com/LatinAmerica/Spanish/opinion/micro.html

The MIX (Microfinance Information exchange) is a non-profit organization whose mission is to help build the microfinance market infrastructure by offering data sourcing, benchmarking and monitoring tools, as well as specialized information services. The MicroBanking Bulletin (MBB) is available at its website at [www.mixmbb.org](http://www.mixmbb.org)

The interagency exchange on the Business Development Services (BDS) website provides information on emerging practices around making markets work for the poor – with particular reference to supporting services for women and men in small enterprises. Visit: [www.bdsknowledge.org](http://www.bdsknowledge.org)

**Macro-level: Fostering a Conducive Policy Environment and Ensuring the Appropriate Role of Government**


Annex 3: Minimum Performance Indicators for Retail-level Financial Institutions

At a bare minimum, donor staff who design or monitor projects should measure performance of microfinance institutions that they fund in five core areas:

1. **Outreach**—how many clients are being served?
2. **Depth of outreach**—how poor are the clients?
3. **Portfolio quality**—how well is the financial institution collecting its loans?
4. **Financial sustainability**—is the financial institution profitable enough to maintain and expand its services without continued injections of subsidized donor funds?
5. **Efficiency**—is the financial institution providing services at the lowest possible cost to clients?

Indicators in these four areas do not capture all relevant aspects of MFI performance. Most funders, and certainly all MFI managers, will want to monitor a longer list of indicators. And there are important dimensions, such as governance quality, that simply cannot be quantified. These five performance areas represent a minimum that should be

- treated in all project designs (reporting past performance of all participating institutions and insuring that systems are in place to measure these indicators during the project);
- included in all appraisals or evaluations of existing institutions; and
- reported and monitored during implementation

<table>
<thead>
<tr>
<th>Minimum indicators</th>
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<tbody>
<tr>
<td><strong>1. Outreach</strong>: number of active clients or accounts</td>
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<tr>
<td><strong>2. Depth of outreach</strong>: average outstanding balance per client or account as a proportion of GNI per capita [to be strengthened in the near future with more precise social performance indicators, as they become available and as increased consensus is reached on them].</td>
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<tr>
<td><strong>3. Portfolio quality</strong>: Portfolio at Risk &gt; 30 days (PAR) and Write-off ratio or Annual Loan-loss Rate</td>
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<tr>
<td><strong>4. Financial sustainability</strong> (profitability)</td>
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<tr>
<td>• for unsubsidized institutions: Return on Assets (ROA) or Return on Equity (ROE)</td>
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<tr>
<td>• for subsidized institutions: Adjusted Return on Assets (AROA) or Financial Self-Sufficiency (FSS)</td>
</tr>
<tr>
<td><strong>5. Efficiency</strong>: Cost per client or Operating expense ratio</td>
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</table>

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28 For calculation of these ratios, please refer to the *Consensus Guidelines on Definitions of Selected Financial Terms, Ratios and Adjustments: Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis and Monitoring;* or (for collection ratios) *Measuring Microcredit Delinquency.*