CGAP

DONOR BRIEF

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Helping to Improve Donor Effectiveness in Microfinance

HOW DONORS CAN HELP BUILD PRO-POOR FINANCIAL SYSTEMS

Donors increasingly recognize the importance of integrating microfinance into formal financial systems to ensure permanent access to financial services for significant numbers of poor people. This approach means the delivery of all forms of financial services by a range of institutions to everyone who needs them. Some development assistance agencies, like GTZ and DFID, have long applied a financial-systems approach in their microfinance operations. This donor brief builds on these and other initial experiences to outline a practical way that donors can work, individually or in collaboration, to build pro-poor financial systems.

A framework for action

In a given country, preliminary experience indicates that donors can more effectively support pro-poor financial systems by collaborating with each other. Various forms of collaboration—such as agreeing on joint principles, sharing a sector strategy, or pooling funds—help individual donors leverage their resources and enhance impact. The following framework suggests steps that donors can take to apply a financial systems approach.

1. **Analyze the priorities and constraints of financial system stakeholders** from the perspective of expanding services to poor people. Stakeholders include government institutions that provide political and administrative oversight, all types of financial intermediaries, services that pool risk, payment systems, financial infrastructure, and clients. Some donors categorize these roles into three levels: macro (policy), meso (infrastructure), and micro (retail financial institutions). Constraints range from interest rate caps to the high costs of providing financial services in rural areas to limited retail-level institutional capacity.

2. **Identify potential donor engagements** with each stakeholder to create a menu of possible actions. The wide range of possible engagements include directly investing in financial institutions, minimizing political interference in state-owned banks by building a "fire wall" between viable credit and savings products and subsidized programs, and providing technical assistance to credit bureaus to cover microfinance clients.

3. **Select an appropriate course of action** from the menu. Taking a financial-systems approach does not mean that each agency should work at all levels of the system. Donor options range along a spectrum. At one end, individual donors engage with specific financial-system stakeholders based on agency comparative advantage. At the other end, donors pool resources and conduct joint programming with harmonized procedures and one voice. Many possible, innovative collaborative approaches lie in between.

   These options are consistent with some elements of new aid modalities (e.g., sector-wide approaches—SWAPs) and can deepen harmonization initiatives and country-strategy work (e.g., poverty reduction strategy papers—PRSPs). All of the options are based on a shared comprehensive view of the sector, improved donor coordination (including regular information exchange), and increased local ownership.

   However, financing through government budgets is <u>not</u> appropriate for building pro-poor financial systems.

Individual donor action according to comparative advantage

Certain characteristics determine which donors are best suited to engage with specific financial-sector stakeholders. Before taking action, each donor should assess if they have the characteristics that give them a comparative advantage for that type of engagement. The following box provides selected examples.

Role	Examples of potential donor engagements	Some characteristics of best placed donors
Financial Intermediaries (micro)	▪ Take risks on lesser known promising MFIs ▪ Plan for exit/graduation to commercial funds ▪ Provide funds for new product development	▪ Tolerance for risk and private sector credibility ▪ Appropriate instruments (e.g., technical assistance for capacity building)
Financial Infra-structure (meso)	▪ Train auditors in microfinance standards ▪ Build market for local training services	▪ Specialist staff ▪ Patient, long-term vision
Policy (macro)	▪ Dialogue on financial-system expansion ▪ Develop financial-depth indicators that emphasize client numbers, not just assets ▪ Support appropriate regulation and supervision to build public confidence	▪ Decentralized donors with specialist field staff ▪ Expertise in regulation and supervision ▪ Large donors with long-term vision and significant political clout ▪ Technical assistance instruments

Joint programming using pooled funding

Some donors (particularly small agencies with grant funding and thin technical capacity) may find it more effective to leverage their resources through joint programming at country, regional, and even global levels. Pooled funding can allow the consistent application of shared principles, a greater range of funding instruments, better leverage of specialist resources, and reduced program administration costs—enabling donors to achieve more together than any single donor could achieve alone.

How DFID, CIDA, Sida, and RNE are joining forces to fund pro-poor finance in Tanzania

- **Common donor goals:** Each agency's microfinance/rural finance strategy recognizes the interconnectedness of the financial system and the need to expand pro-poor finance. They all also have a commitment to donor harmonization.
- **Supportive and appropriate government policy:** The Tanzania Pro-poor Financial Sector Deepening Program (FSD Program) supports the Government of Tanzania's National Microfinance Policy.
- **Joint principles for pro-poor financial system development.** The donors agreed on joint principles for action. For instance, they agreed on a business-like approach to building the market, including an exit plan and allowing instruments to evolve as markets develop (e.g., from start-up grants to commercially-priced loans for more mature institutions).
- **Harmonization of donor procedures:** The practicalities of combining funding posed serious challenges in operationalizing the FSD program, including accounting and reporting requirements and procurement policies.
- **Establishment of trust mechanism:** A professionally-managed trust is being created specifically to facilitate joint programming. The trust will support a range of market initiatives, from developing retail capacity (credit unions, banks) to infrastructure (credit rating) to policy and regulation.

Emerging principles to improve effectiveness of donor support to pro-poor financial systems

- ***Strong retail financial intermediaries remain the major bottleneck*** to expanding financial services. Most donors' support should help financial institutions innovate to reach large numbers of poor people.
- ***Build local capacity and markets*** (e.g., local providers of capital and technical services): at macro, meso and micro levels. The skill of local leaders and institutions will determine ultimate success, not donors.
- ***Avoid reinventing the wheel*** if others have already analyzed the financial system—collaboration also means analytical work can be more widely shared and used.
- ***National governments play an important role*** in ensuring an enabling policy framework, but success depends on private sector initiative. Donors should not channel financial services through governments.
- ***Harmonize standards and procedures*** to increase efficiency of all types of donor engagements.
- ***Use subsidies to make financial markets work for poor people***, not undermine them. Every financial service project design needs to outline how the donor subsidy complements or stimulates private capital.

Authors: Brigit Helms and Ruth Goodwin-Groen, with input from CGAP staff. **Sources:** David Ferrand, "DFID's Experiences in Eastern and Southern Africa," presentation for 2003 CGAP meeting, Paris, France; CGAP Staff, *Microfinance Means Financial Services for the Poor*, CGAP Donor Brief No. 11 (Washington, DC: CGAP, March 2003); Interviews with Dirk Steinwand, Carlos Cuevas, Klaus Maurer, Hege Gulli and David Ferrand. **For more information:** World Bank, *Finance for Growth: Policy Choices in a Volatile World* (Oxford: Oxford University Press, 2001). **Web:** www.worldbank.org/finance/html/about.html, www.gtz.de/themen/economic-development/english/financial-systems/ **Acronyms:** GTZ–Gesellschaft für Technische Zusammenarbeit; DFID–UK Department for Internat'l Development; Sida–Swedish Internat'l Development Agency; RNE–The Royal Netherlands Embassy; CIDA–Canadian Internat'l Development Agency.