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Microfinance:

Sustainable Tool for Urban Poverty Alleviation

Policy recommendations, research agenda, and investigation into national & donor stakeholder activity

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1. Executive Summary

This policy working paper examines microfinance as a sustainable tool for urban poverty alleviation in Latin America and the impact government actors have on the sector.

The paper begins by defining the value of microfinance and its role in development within the urban Latin American context. Initial findings established priority policy recommendations to maximize microfinance effectiveness. However, given the challenges in acquiring clear information and the complexity of the data discovered, the initial foray was expanded to establish an agenda for ongoing research on the subject.

Government actors can make important contributions to the microfinance industry, but they must act carefully to ensure their efforts result in positive impact. Developed-country government activity is often channeled through bi- and multi-lateral aid agencies (implementing agencies), typically in the form of direct funding to individual microfinance institutions, financial intermediaries, or other industry actors. Government actors in developing nations impact the sector through economic policy, financial institution regulation, and also supervision.

Governments and their implementing agencies shape the overall environment in which microfinance institutions operate. They can also be influential in linking microfinance to other productive financial flows, particularly remittances. Stakeholders leading oversight of the sector are encouraged to legislate prudently in consultation with microfinance industry and civil society actors to end with functional and meaningful oversight, rather than pernicious or short sighted rule making that limits productivity for consumers.

‘Sustainable microfinance’ is first defined and then considered in light of two goals – on a micro level, financially self-sufficient institutions able to provide services without external funding; and on a macro level, industry ‘massification’ to rapidly extend outreach to reach more people and make microfinance a meaningful vehicle for poverty alleviation. Test factors of sustainability include: 1) market-driven cost of services to clients, 2) institutional financial soundness, 3) repeat clients, and 3) an ongoing industry. Actor behavior is evaluated based on the success of these indicators.

Last, the paper provides a research agenda to develop deeper support for policy recommendations. Key themes and specific research projects are proposed, along with tools developed to carry them out.

2. Background

This Working Policy Paper initiates research into – and shares findings to date on – how to maximize the impact of microfinance as a sustainable tool for urban poverty alleviation in Latin America. Worldwide, more than 1 billion people live on less than $1 a day, and 3 billion are estimated to live on $2 a day.[1] Furthermore, poverty has increased in the last generation.[2] The income gap continues to widen, with countries like Brazil documenting the widest margins.[3] In 2002, 40% of Latin Americans lived in poverty, with few prospects for improvement in the short term.[4] To ameliorate this situation, the United Nations Millennium Goals aspire to cut poverty in half by 2015. However, societies lack blueprints to guide accomplishing this goal.

The success of microfinance – the provision of financial services to the 'unbanked' or poor[5] – has been documented extensively in academic, policy, and development arenas.[6] While the provision of financial services to the informal sector has existed since biblical times, microfinance as an industry experienced a renaissance in the 1970s with the emergence of more formal, urban efforts. Almost simultaneously, models emerged in both Asia and Latin America.[7] Grameen Bank in Bangladesh has now disbursed more than $3 billion cumulatively in small loans (averaging well below $200) to poor women. The Bolivian market fostered the institution now called BancoSol, one of fewer than 30 companies listed on that country's stock exchange.[8]

Today, microfinance boasts attractive statistics. The industry has achieved annual growth rates of 30% annually for over a decade, and the more than 10,000 Microfinance Institutions (MFIs) worldwide hold an estimated loan portfolio of $50 billion.[9]

Every country in Latin America and the Caribbean has successful MFIs. Latin America is host to nearly one-half of the institutions tracked by the Micro Banking Bulletin (MBB), a benchmark data compilation of 124 MFIs throughout the world, and their average loan portfolio is 75% greater than that of their peers.[10] According to data from the Consultative Group to Assist the Poor (CGAP), microfinance market penetration in urban areas in Latin America exceeds 60%, the highest level in the developing world.[11] This is

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[1] Grameen Foundation Newsletter, Fall, 2002.
[2] Cooper, M. *Blame the IMF Crowd*. LA Times, 5/01.
[3] Friedman, T. *The Lexus and the Olive Tree.*
[4] United Nations Economic Commission for Latin America and the Caribbean, www.eclac.cl
[5] Industry terminology is regularly debated. For this paper, see terminology in the Virtual Library on Microcredit (www.gdrc.org/icm). 'Microfinance' is a range of financial services for the poor. 'Microcredit' is a synonymous term. Cooperatives and Credit Unions are included in this discussion, differentiated as institutions that capture member savings and take deposits. Laws prohibit microcredit institutions from doing so.
[6] For example, Nitin, B. *Inner-City Entrepreneurship Development,* and Von Pishke, J. D. in Carr, J & Yi Tong, Z. *Replicating Microfinance in the United States*
[7] See Rhyne, E. *Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and Came of Age in Bolivia.* p. 8
[8] Grameen Bank website, www.grameen-info.org, and BancoSol, www.grameen-info.org,
[9] Virtual Library on Microfinance Fact Sheet, www.gdrc.org/icm. Note MicroCredit Summit Annual Report reports lower figures due to a lack of presence in the region.
[10] Miller, J. *Benchmarking Latin American Microfinance*, 2003.
[11] Christen, B. *Presentation at the 6th Interamerican Microenterprise Conference*, Inter-American Development Bank, 9/03.

correlated with the explosion of civil society activity in Latin America in the current democratic era. NGOs are valued as stakeholders with increasingly important voices at the community level. As a Nicaraguan MFI Executive Director noted, "the industry has grown from nothing in our country to a vibrant, pivotal contributor to human rights and other areas of development in less than a generation."[12]

However, for all of microfinance's accomplishments, the term and the industry remain relatively unknown. Access to credit has been cited as the fourth most important development need, exceeded only by food, health, and education.[13] Nevertheless, while everyone has heard of 'health' and agrees that it is a core development need, few people have heard of microfinance.[14]

There is lobbying for greater acknowledgement of microfinance and its role in development. Sam Daley-Harris of the Microcredit Summit Campaign states, "Microcredit is not a panacea, but it is the most powerful intervention we have toward cutting absolute poverty in half by 2015."[15] Muhammad Yunus, Director of Bangladesh's Grameen Bank, views microfinance as a 'Fundamental Right'. He defines microfinance as, "A foundational need upon which other rights are built, and which fosters other opportunities for betterment.[16]

Likewise, the United Nations' (UN) Millennium Development Goals specifically speak to microfinance and its potential to contribute to the goal of halving the number of people living in poverty by the year 2015. In addition, the UN proclaimed 2005 as the 'Year of Microcredit'.[17]

3. Government Actors in Microfinance

Government actors are important stakeholders in microfinance. Their participation in microfinance can be charted visually, based on their financial and legal contributions (see figure below).

National and multinational entities direct countries' development activities. Governments fund bilateral and multilateral agencies, which in turn support development initiatives (including microfinance) through a combination of grants, loans, and technical assistance. These implementing agencies have helped, through a range of financing efforts, to fund 1,000s of MFIs.

For example, the United States (US) has taken several significant actions related to microfinance. In 2001, the US government passed a law establishing microenterprise development as an integral part of the country's foreign assistance strategy. In addition, the United States Agency for International Development (USAID) adopted guidelines in 2004 dictating at least half of all project funding be documented used on the poor. The

[12] Conversation with Nicaraguan NGO Executive Director, 3/02.
[13] CGAP survey of microfinance managers' pressing needs.
[14] Conversation with Sam Daley-Harris, Executive Director, The Microcredit Summit, 6/2003.
[15] Daley-Harris, S. *Presentation to the UN Social and Economic Council (ECOSOC) Brainstorming Session*, 3/2003.
[16] Grameen Bank materials, see www.grameenbank.org and www.grameenfoundation.org.
[17] United Nations' Millennium Goals website, www.un.org/millenniumgoals.

Government Accounting Office (GAO) is currently preparing an evaluation of US bilateral aid effectiveness to determine which programs accomplish poverty alleviation goals.[18]

In addition, developing-country governments influence the growth of the microfinance industry in their respective countries. Their greatest impact on microfinance is through policies and regulations for the economy and financial services.. Federal oversight typically involves legislation, establishing rules for regulation and supervision. Government regulation and supervision are most important with regard to deposit-taking institutions, since it is important to maintain the public trust and ensure savings deposits are safeguarded.

Some argue that regulation and supervision are less important (or even irrelevant) for lending-only institutions, as few borrowers would be hurt financially if the institution declared bankruptcy and they did not have to pay back their loan.[19] Typical regulatory challenges for the microfinance industry include educating government supervisors as to how MFIs should be treated differently from banks. For supervisors, the challenge is how to provide cost-effective institutional oversight, given that most MFIs are so small.[20]

Latin America, in particular, has a strong representation of microfinance institutions that have transformed from non-governmental organizations (NGOs) into regulated financial entities. For example, within ACCION's regional network, 9 of its 17 members are now regulated institutions.[21]

Despite this trend, over 90% of MFIs are small NGOs.[22] Generally, they operate as unregulated and unlicensed institutions. In some cases, they are technically operating 'illegally' in that they provide financial services often with only tacit government approval to do so.[23] As industry growth attracts more attention to microfinance and MFIs, host governments are increasingly confronted with the issue of how to address them. In Latin America, twelve countries have enacted microfinance-related legislation since 1999.[24]

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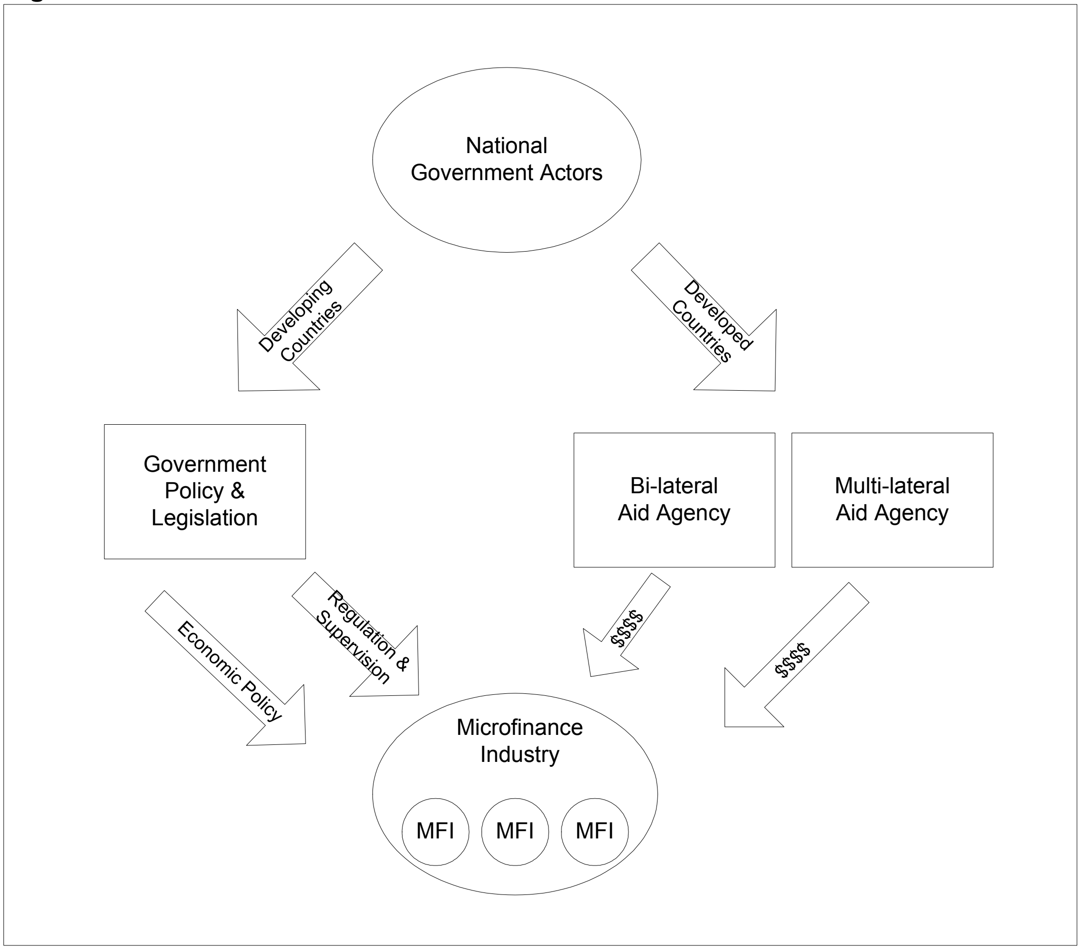
[18] Conversation with senior US Treasury Department officials, 9/03.
[19] Hanning, A & Katimbo-Mugwanya, E. (eds.) *How to Regulate and Supervise Microfinance?* FSD Series No. 1
[20] Jansson, T et al. *Principios y prácticas para la regulación y supervisión de las microfinanzas*. Inter-American Development Bank. 2003.
[21] ACCION's full list of partners is available online at www.accion.org
[22] State of the Microcredit Summit Campaign Report 2004, available at www.microcreditsummit.org
[23] *E.g.,* Conversation with Satterthwaite, D. CEO of Prisma Microfinance. The institutions fall outside of the legal framework for financial institutions in their country, but operate with the implicit approval of the government.
[24] Silva, S. *The Devil is in the Details*. MicroEnterprise Americas, Autumn, 2003.

Figure 1 – Actors and Flow of Power



While this increased attention to microfinance is desirable, its effectiveness is unknown, as there is little oversight to ensure that actions are appropriately carried out and are effective. Key questions that must be answered include: How do government actors determine that their behavior will have a positive impact on the microfinance industry? What measures are used to determine if this impact in turn reduces poverty? These questions are key motivators that led to research to determine non-US national actors' activities and behavior.

4. Sustainability in Microfinance

In order for microfinance to be valuable as a tool for poverty alleviation, it must continue. Sustainability, or the potential to continue as a closed, self-generating system, if therefore important. It is considered in three facets. The Consultative Group to Assist the Poor (CGAP), the World Bank's group dedicated to microfinance, estimated in 2003 that 1 billion people lack access to convenient, affordable, and appropriate financial services.[25] As of 2004, the number of clients benefiting from microcredit services (institutions primarily providing loans and other debt products) was 80.9 million.[26] Approximately 65 million more people were served through cooperatives and credit unions (as of 2003).[27] Accordingly, less than 10% of the existing market has been satisfied in the thirty years since microfinance's renaissance began in the 1970s.

The concept of sustainability is considered for individual MFIs. Although MFIs are considered to be development-oriented organizations, the microfinance industry is increasingly assuming characteristics of for-profit businesses, while maintaining a mission focus.[28] Organizational performance is important; for commercial banking institutions, financial results (the 'bottom line') are a key driver. However, given that the overwhelming majority of MFIs are charitable NGOs, profitability is an unpalatable term. Other terms substitute for profitability, including: Operational Self-Sufficiency (OSS), which measures whether the revenue generated in daily operations is sufficient to cover daily expenses; and Financial Self-Sufficiency (FSS), which measures whether revenues cover all costs, including financing and inflation.[29]

Sustainability in this sense equates to the ability to continue to provide service. To do so requires capital which must come internally by generating profits or found externally. Typical institution behavior is to seek outside philanthropic funding. When no outside funding is available, a sustainable institution must be able to survive without assistance.

A second aspect of sustainability is that of the industry as a whole. The microfinance sector must continue to provide services to more people; otherwise, microfinance will not make a meaningful dent in the demand for financial services and the poverty now confronting its potential clientele. 'Massification' is a word adopted from Spanish that the industry uses to denote rapid scaling-up. This word suggests that such growth has a sustained, increasing, and positive impact on poor people.[30] The advent of the United Nations' Millennium Development Goals (MDGs), provides an additional opportunity for the microfinance industry to assert its necessity for continuation, which fosters more attention, theoretically more capital, and fuels the first point on sustainability, above. With donor agencies contributing an estimated $500 million to $1 billion a year in capital, it is insufficient source to accomplish the goal.[31]

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[25] Littlefield, E. *Building Financial Services for the Poor*. Finance for the Poor, Vol. 4, No. 2, 2003. Asian Development Bank. p. 3
[26] Microcredit Summit, *State of the Industry Annual Report*, 2002.
[27] Littlefield, E. p. 2
[28] Helms, B. *Microcredit for enterprise development vs. microfinance as an industry: what is the difference?* CGAP paper.
[29] *Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance*. Seep Network, www.seepnetwork.org.
[30] *See, e.g.,*, de Sousa-Shields, M. *Financing Microfinance Solutions to Poverty.* IADB 4th Latin American Conference on Microenterprise.
[31] Ivatury and Abrams, *CGAP Focus Note: Investment in Microfinance*.

Third, this paper considers government stakeholder activity in the Latin American urban context and its impact on the continuation of microfinance. The research question focuses upon the consequences of their most significant actions, whether these actions maximize microfinance sustainability, and the subsequent impact on poverty. This is considered in light of two representative, proxy indicators:

- *Market-Driven Cost of Services to Clients*: The less that financial services cost (without being subsidized) the better for customers, who can retain a larger share of the wealth. In addition, given economic principles of supply and demand, more people will be able to benefit from the financial services as the price falls.

- *Institutional Safety and Financial Soundness*: A country's economic success requires trust in – and the proper operation of – its financial institutions, both at the federal and commercial level. Therefore, monitoring the health and proper operation of its institutions is imperative to guard against financial impropriety, ensure good performance, and maintain the public's trust.

The next section presents policy recommendations generated from preliminary research findings and follows with a proposed research agenda to support ongoing developments.

5. Government Stakeholder Policy Recommendations

Initial research on the topic confirms a consistent set of facts that point to core policy recommendations for government actors. These initiatives were generated from investigations involving prominent literature in the field, conversations with industry leaders, and communication with the actors themselves.

Primary policy recommendations address how government actors should contribute to the growth and sustainability of microfinance. Additional research strategies to substantiate the case for these recommendations are detailed in the next section. The recommendations are to:

A. Foster increased transparency within aid agencies
B. Create an enabling environment in the local economy
C. Involve other stakeholders in decision-making
D. Channel remittance flows to productive uses via microfinance

The four points emphasize building upon what already exists and utilizing available resources. They begin with simple concepts consistent with good management practices for any institution. While these recommendations are fairly straightforward, they have far-reaching impact. Many initiatives to support the recommendations may be performed at little or no cost (although some are enhanced by investment of resources). As such, it is surprising how few are currently adopted in a consistent policy framework.

A. Foster Increased Transparency within Aid Agencies

This recommendation applies to government actors from both developed and developing countries. Given that government actors mandate transparency from MFIs from the reporting required of MFIs to donor agencies and supervision through federal institutions, it seems equitable that community stakeholders should be able to request the same from donors, government agencies, and policymakers.

This point was raised after an initial investigation into donor funding of microfinance yielded little information from bilateral and multilateral agencies.[32] Publicly available information was lacking. In addition, institutions readily admitted that they could not determine meaningful figures to quantify their involvement in microfinance. Those polled at the World Bank did not have any better information, although they recognized the value of it.[33]

Increased transparency encompasses a range of behaviors for donors, but suggests an overall culture of openness. Specific action items include:

- *Develop a Plan:* Establish clear development policy at the national level. Then, have agency actors state the institution's position on microfinance. Both the nation and the agency should have a strategic plan that includes detailed plans for microfinance. The website of the Danish Ministry of Foreign Affairs is an excellent example, save for the fact that they do not appear to focus on microfinance. The Canadian International Development Agency (CIDA) sought to develop a new plan for microfinance, due at the end of 2003, which was a broad statement and not a specific work plan.[34] Likewise, a recent report to the US Congress by the President's office sought to express concern for the context of US bilateral assistance. This also coincided with the development of the Millennium Challenge Corporation or MCC, which was supposed to enable local governments to set their own develop agendas, but has yet to actually fund a project.[35]

- *Measure and Track Information*: Once a plan is established, track progress towards meeting its goals. Even basic data about microfinance-related agency activity are helpful. Information measurements are needed to evaluate plans and gauge program effectiveness. Nevertheless, the initial research findings mentioned above indicated a paucity of available information. A positive example, however, has been set by GTZ of Germany, which conducted a detailed review of information for microfinance which led to a change in course for the agency in its approach to more technical assistance.

- *Establish a Central Donor Funding Database:* Preliminary research was unable to determine the amount of funding that donors channel towards microfinance.

[32] Initial research included a detailed investigation of eight bilateral and multilateral aid agencies, elaborated upon in the following Research Agenda section. Websites were scanned, annual reports reviewed, questionnaires sent, and conversations held with staff.
[33] Communication with World Bank and CGAP staff, 9/03.
[34] Danish Ministry of Foreign Affairs, www.um.dk/english & Canadian International Development Agency, www.acdi-cida.gc.ca.
[35] *President's Report on Microenterprise Development*, USAID, 8/03.

The authors remain hopeful that such information exists. A particularly effective method for sharing donor funding information with others is to gather it in a regular, systematic fashion, thereby maximizing comparability over time and between institutions. The Internet provides a vehicle to make information much more accessible. Information exchange is also a first step towards collaboration. The Department for International Development (DFID), for example, has emphasized co-investment and program partnerships as core strategies for its involvement in microfinance.[36]

Given the number of agencies that support the microfinance industry, platforms already exist for this information. The MicroCredit Summit solicits Annual Action Plans from MFIs and other involved stakeholders. CGAP is a coordinating body for 28 donors and tracks significant donor information. The Mix Market is an online information platform. Donors could report their activities, just as MFIs already do.

Transparency contributes to sustainable microfinance and improves both proxy indicators. Transparency decreases costs, particularly for information gathering and transactions. This can reduce financial risk for business and development transactions, thereby creating investment opportunities. Increased transparency also helps partners, enabling them to better coordinate their activities. These action items facilitate partnership, collaboration, and coordination, all of which speed interaction and can improve efficiency.

B. Create an Enabling Environment

Establishing a stable environment is an indirect but vital policy action for sustainable microfinance. It includes a wide variety of factors, ranging from overseeing the macroeconomy (for example, managing currency value) to supporting industry infrastructure improvements (such as credit reporting). Such efforts are beyond the purview of MFIs; the responsibility lies with other appropriate actors.

A fundamental indicator of a stable environment is an increase in cash flow through investment. Chile is a prominent example of the impact that increased investment has on a nation, which it experienced when it adopted new legislation in 1985. Microfinance-oriented literature has consistently emphasized that the industry needs more capital, as only 10% of estimated demand has been met. The current funding structure, however, which places donors firmly in the center, is insufficient to meet the need. Unfortunately, private investment, while long heralded, has yet to materialize on a significant level.[37]

National actors have extensive latitude in this area to foster investment by making substantive changes and changing how their country is perceived by others. Donors, too, can affect national actor behavior in subtle and unobtrusive ways.

At the country level, a number of action items contribute towards this goal:

[36] Department for International Development, www.dfid.gov.uk.
[37] Tulchin, D. *Microfinance and the Double Bottom Line*, 2003.

- *Uphold the Rule of Law / Judiciously Enforce Local Regulations:* Developing-country governments must enforce the rule of law, provide access to civil courts for small claims, enforce regulations that do exist, and seek to simplify inefficient regulations. Given the legal relativism in some countries, they must legislate more logically and consider the long-term repercussions of poor governance. Corruption, while often culturally pervasive, is controllable. In particular, solidifying the legal rights of the poor to their assets will allow them to leverage these assets for productive purposes, as the rich already do.[38]

- *Maintain a Stable Macroeconomic Environment:* Microfinance does not operate in a vacuum. Stable economic conditions help operations and reduce costs. Latin American capital markets are anemic; in practice, Miami is the *de facto* economic capital of most of Latin America. Also, the track record of local businesses warns against investment, as Latin American-based mutual funds performed even worse than US funds from 2001-2003.[39] Governments must create favorable policy environments for all investment; an appropriate policy infrastructure that protects investment is essential.

Likewise, there are a number of actions that would help to create an enabling environment for microfinance in Latin America for which donors are well suited. For example, donors can reduce the risk associated with private investment in historically economically unstable countries by leveraging their capital to increase cash inflows from other investors, rather than through direct involvement. Ideally, donors should build relationships with investors.

Donor support is also particularly well suited for risky investment that fortifies the sector without providing direct financial return. For example, 'infrastructure' needs include central credit bureaus and credit scoring. These are key tools to a stronger sector, and their presence is likely to foster investment from new players. However, since they may not themselves generate a profit, they are unlikely to be taken up by the private sector.

Both macroeconomic and industry efforts contribute to the sustainability of microfinance. The best measure of success in this regard is cash inflow for investment, which is likely to help institutions to become financially self-sufficient while growing rapidly. Affordable capital is most readily available in an environment characterized by competition, low country risk, and a desirable investment climate.

An increase in resources for microfinance impacts the proxy indicators. Low cost of capital for MFIs minimizes expenses, thereby lowering costs for customers. More investment funds more institutions, which increases competition and reduces costs to clients. Economic logic, while not foolproof, dictates that large, stable organizations operate more efficiently and with lower costs, leading to lower pricing.[40] Healthy operating environments better enable safe, sound institutions. While weak institutions will still exist in any country, healthy macroeconomies better support efficient institutions.

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[38] de Soto, H. Instituto Libertad y Democracia (ILD) website, www.ild.org.pe
[39] The Motley Fool, www.motleyfool.com, emailed newsletter, 8/03
[40] Industry research documents rapidly decreasing operating costs in growing organizations. However, information data are mixed on cost improvements above 50,000 clients. The data are complicated in Latin America, as many of the largest MFIs are in countries in deep recession, like Bolivia, Columbia, and Peru. These institutions have posted better results that the formal banking sector in the country. See study by CGAP and Inter-American Development Bank.

Furthermore, infrastructure development provides more tools that can be used by investors and MFIs to further reduce risk.

C. Involve Other Stakeholders in Decision-Making

Both developed- and developing-country government actors are encouraged to foster an open decision-making process. Community stakeholders – whose own future is being directly affected by high-level decisions – can be the strongest proponents of a cause. These stakeholders include MFIs, NGOs, and the end-users themselves – the 'unbanked', typically poor people. They are closest to the issues, best understand the problems, and have ideas on how to solve them.

There are several cases in which such an approach has been successful.[41] For example, El Salvador has piloted an attractive model for facilitating citizen involvement in local government decision-making. Salvadorian government officials also collaborated with Hometown Associations in the United States to co-invest in infrastructure priorities identified by the local population. An independent board was established to lead this effort.[42]

There are also examples of government working with microfinance industry associations. Guatemala and Honduras both have active microfinance networks. These networks are working with government actors to strengthen the industry infrastructure through self-regulation and by establishing a central credit bureau.

Donors also would be well-advised to involve the end user of their resources in the decision-making process. Such efforts have been documented to improve program design, effectiveness, and impact.[43] While difficult, time consuming, and requiring upfront costs, such efforts will ultimately achieve better results, since they engage the local population in identifying and solving its own problems.[44]

Involving MFIs and the clients (poor people in need of financial services) in the decision-making process should help to foster a strong MFI environment focused on client cost and institutional strength. It is assumed that the clients and the MFIs are motivated to minimize costs, and that they are in the best position to understand how to do so effectively. Therefore, involving them in decision-making will increase the likelihood of success.

In terms of institutional safety and financial soundness, national actors do not need to relinquish control. Multiple Wall Street scandals – involving high-level executives and even the former CEO of the New York Stock Exchange – demonstrate the frailties of self-governed systems. Nonetheless, consulting with MFIs during the development of regulatory measures – since they are going to be directly affected by the regulation –

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[41] The Woodrow Wilson International Center for Scholars has hosted a number of seminars on this topic. Citation forthcoming,www.wilsoncenter.org.
[42] Nosthas, E. *El impacto de las remesas en la realidad salvadoreña y un mecanismo de acción*. 3/2003
[43] See for example World Bank details on Participatory Rural Appraisal (PRA) www.worldbank.org/poverty/impact/methods/pra.htm
[44] Student Non-Violent Coordinating Committee. *Towards Community Change*. 1966

and encouraging their participation makes it more likely that better institutions will emerge.

D. Channel Remittance Flows to Productive Uses via Microfinance

Remittances in Latin America provide an immense economic opportunity in conjunction with microfinance. Remittances consist of money sent by emigrants back to their families in their home countries. They are estimated to create a $32 billion annual wealth transfer from the US to Latin America,[45] representing the largest and most democratic transfer of capital from the developed to the developing world.[46] In 2003, remittances exceeded foreign direct investment (FDI) activity in the region.[47]

This economic activity appears well-matched for microfinance, since remittances are established capital flows to the same customer base as that for microfinance borrowers. An average remittance is $200, which is better suited to microfinance's relatively small deposits and loans, as compared to commercial banks.[48] Government actors are highly motivated to move remittances from the informal to the formal sector, and into institutional investment. Doing so facilitates tracking the capital, allows taxation, and incorporates remittances into macro-economic data. Likewise, current trends in the microfinance industry are emphasizing formalization and institutional investment.

Specific activities proposed include:

- *Work with the Private Sector to Reduce Costs:* Remittance companies claim that their greatest costs are incurred due to transfer requirements. Particularly in the post-9/11 world, government actor involvement increases the cost of transferring small amounts of capital across borders. Government actors -- legislators and aid agencies from both developed and developing countries – can play important roles here. The goal is to generate cost savings to be passed on to consumers.

- *Support Existing Civil Society Efforts:* Government actors can facilitate remittances and tie them to productive development. Clear opportunities exist to leverage capital in the private sector (as per recommendations above). For example, an estimated 2% of remittances are collective.[49] Latin American 'Hometown Associations' have been working from the United States to benefit their home communities. In pilot programs in El Salvador and Mexico, US-based citizen groups are providing matching funds to local governments for social programs like building schools or buying ambulances.[50]

Remittances are an attractive potential input towards microfinance sustainability. Regarding the first proxy indicator for sustainability, market growth should foster competition, thereby driving down costs (at least theoretically). Industry experts

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[45] Orozco, M. Inter-American Dialogue website data and publications.
[46] Panel commentary at IADB-MIF Guatemala Roundtable on Remittances, 9/03.
[47] Wall Street Journal article 5/2003, author and title forthcoming.
[48] See Orozco, M. *Remittances and Their Impact*. Paper from presentation made at the Jamaican IADB conference, 2002.
[49] Petree, J. *The Remittance Market in Switzerland*. 6/03.
[50] Conversations with J. Smith, USAID, and E Nausthaus, FISDL, El Salvador, 9/03.

prognosticate that remittance costs can come down from 15% on average to 5-10%.[51] This would leave customers with more of their own money. In addition, MFIs view this cash flow as an affordable source of capital, which could fuel growth.

The impact of remittances on the second sustainability indicator, institutional safety and financial soundness, is less clear.. The technical requirements to integrate remittance services into operations may improve MFI capacity and monitoring. In addition, the opportunity to accept remittances may motivate an MFI to formalize in order to benefit from remittance flows, or legislation may require formalization. On the other hard, a hazard to institutional soundness, although slight, is if an MFI were to become dependent on remittances.

These policy recommendations cover a range of actions – both internal and external – to be taken by government and non-government actors. While the authors are under no illusion that they will be adopted *en masse*, identifying utility and points of entry is a first step towards change.

6. Research Agenda

This section summarizes the research agenda. First, the research methodology is detailed. Next, key research themes are listed. Finally, specific projects are outlined and correlated to the work accomplished to date.

Research Methodology

This investigation is being carried out through Internet searches, literature review, conversations with industry stakeholders and donor agencies, and formal questionnaires to government actors. The goal is to generate accurate data of behavior by government actors and donors that impacts the sustainability of microfinance. The data will be aggregated and evaluated for general impressions, as well as used for side-by-side comparisons.

Literature survey impressions are informative. Key reading on industry topics includes:

Topic	Best Sources for Literature
Government Regulation and Supervision	IADB, Microfinance Gateway, USAID
Donor Behavior	CGAP, Microfinance Gateway
Remittances	Inter-American Dialogue
Microfinance Best Practices	Microfinance Gateway, Planet Finance, Virtual Library on Microfinance, USAID
Microfinance and the Capital Markets	Microfinance Gateway
Impact Assessment	Imp-Act, USAID AIMS project

With the exception of remittances, all topics have sufficient volume and quality of literature for in-depth analysis. The writers' perspectives are relatively congruent, with the exception of the divergent approaches of the 'Welfarists' and the 'Institutionists' within Microfinance Best Practices.[52]

[51] Terry, D. *Presentation at Guatemala Roundtable on Remittances*, MIF-IDB, 9/03.
[52] Woller, G. et al., *Where to Microfinance*? Paper, Marriott School, Brigham Young University.

Key Research Themes

1. Donor Transparency

   - How much cash flows into microfinance annually?
   - What is the breakdown of sources by donors, nations, and private investment for Latin America?
   - How accessible is donor agency information –- both online and from within the institution – for entities active in the urban Latin American context?

2. Uniform Standards and Measurements for Poverty Alleviation

   - How is microfinance impact on poverty alleviation measured?
   - How do donors measure the effectiveness of their funding?
   - What are donors doing to improve uniform standards and measurement
   - What are donors doing to establish uniform standards and measurements in particularly with regards to impact assessment and effectiveness?
   - Are there regional standards for Latin America to account for?

3. Remittances

   - Can donors play a productive role in facilitating remittances? If so, what?
   - What is happening with collective remittances from the US to Latin America?
   - What is the link between remittances and microfinance?
   - How can remittances be mobilized to contribute to microfinance sustainability?

4. Regulations

   - What are best practices for national regulation of microfinance institutions?
   - Which stakeholders do policy leaders and supervisors consult?
   - Is there South-South exchange on this topic, and how can more be fostered?

Specific Research Projects

- *Donor Agency Website Survey*: Conduct a detailed review of the websites for developed-country government donor entities (bilateral and multilateral aid agencies). The first step is to establish a count of included institutions. The next step involves honing the research tool. A draft survey tool is provided as Attachment A, (Website Transparency: Donor Involvement in Microfinance) with explanation key, associated research questions, and data compiled from one source. Once the tool is finalized, it will be used to conduct a systematic review, analyze data, and document conclusions.

  To date: Ten donor agency websites were thoroughly investigated to generate the tool for measuring level of transparency and amount of microfinance information. Overall, transparency was fair, but the tool initially found little information on microfinance. Therefore, the original survey tool was revised.

- *Donor Agency Funding Questionnaire:* A short one-page questionnaire is being developed for use in a comprehensive survey of donor agencies to determine their funding for microfinance and impact assessment practices. This will generate comparative and aggregate data on donors' funding for microfinance, the extent of their efforts to measure impact and their own effectiveness, and any initiatives they are taking in the field of remittances.

  Surprisingly, industry data on aggregate donor microfinance funding do not appear to exist. CGAP, the microfinance-oriented arm of the World Bank and *de facto* industry apex organization, stated that they did not know, but estimated "between $500 million and $1 billion a year."[53]

  A preliminary survey was submitted on a trial basis to eight agencies (see below). In general, agencies claimed either that they did not track the requested information or that it was very difficult for them to obtain. As a result and in conversation with donors, the survey tool is being revised (see Attachment B – Financial Support of Microfinance by Bilateral and Multilateral Donors).

  To date: The survey was tested on eight donor agencies. Four provided extensive data, although only two used the questionnaire. Two did not respond, and two intend to provide the information in the near future. All expressed difficulty in completing the information accurately, leading to a revision of the questions.

- *Donor Effectiveness Metrics*: Donors commonly fund measurement of microfinance impact assessment so that an MFI can measure and track the results of its activities. The same lens can be used to evaluate donors by considering their funding effectiveness (the quality of their work and what it produces). Donors do not uniformly engage in such introspection, and no set standards or metrics exist.

  As there is increasing donor activity in both areas (emphasized earlier in particular by US agencies),[54] research is recommended to generate more standards for donor effectiveness. There is already sufficient attention in the industry as to what MFIs are doing.[55] However, there is little information widely available on donors' self-impact assessments. Data potentially exist but have not yet been located. Data should be gathered and 'best practices' considered. A desired result would be to establish a preponderant standard and consistent measurement tool, but such a goal is quite distant.

  To date: Work to date has yielded inconclusive results. Questions relating to this research topic were tested in the donor agency survey, and comments from discussions with donors have been integrated into the research agenda. Literature review generated extensive information on MFI impact assessment, but the data emphasize that there is no uniform metric or standard. Donor effectiveness is proving to be quite complex, as there is no set definition of what it even means. In

[53] E-mail correspondence with CGAP staff, 9/03.
[54] USAID reports, President's Report on Microenterprise, and anticipated US GAO study.
[55] An industry leader is the Imp-Act project through the University of Sussex. *See* Imp-Act, www.imp-act.org.

conversations, many donors have expressed interest. In addition, CGAP led a peer review of its 28 member donors, providing excellent resources to be analyzed.[56]

- *Remittances and Microfinance Institutions*: Remittances are well documented in Latin America. Much more research, however, is needed to determine donors' roles in remittances and the links between remittances and microfinance. This research is vital to achieving the policy goal of channeling remittances into productive investment while fostering a source of capital for MFIs. While there is increased donor attention to remittances, as of yet no agency has stated a strategic plan to include remittances in the development agenda.[57]

  Two important research considerations are what donors are doing with remittances and whether there is a link between remittances and microfinance. This will be examined through survey questions, conversations with donors, and attendance at relevant conferences to track emerging topics in the field.

  The development field is often accused of creating 'silos,' isolating practices that are integrated in the field. In the US, NGOs are beginning to discuss the 'blended value proposition' of multiple interventions and uniform measurements for common social ills.[58] Remittances and microfinance are a test case for potential synergies and cross-fertilization. However, it is unclear at this time if donors add value in this area. Also, there is no evidence that remittances contribute to the sustainability of microfinance (as defined in this paper). Still, a logical connection would appear to exist between the two. Small pilot projects are underway by the IDB and USAID in Mexico.[59] These and other programs will be tracked.

  Donors need to thoughtfully consider if they have a role to play. The logic, although not proven, is that remittances can be channeled to more productive purposes through formal financial institutions than through current delivery channels.[60] Customers receiving remittances through an MFI would be expected to save more, although there is no clear evidence yet on the subject. As the remittance market is much larger than current MFI funding, it is also an attractive source of capital. In Latin America, a maximum of $600 million is available for MFIs, and donor-supported investment funds currently total $130 million.[61] Therefore, research is desirable to determine how the $32 billion remittance market might be tapped to support microfinance.

  To date: Research to date has consisted of literature review, discussion with donors, and attending conferences. Little information is available. The donor survey includes a question on remittances.

[56] CGAP Donor Dialogue and Donor Peer Reports.
[57] IADB-MIF's roundtables on remittances are increasing in size and frequency. Conversation with agency staff, 9/03.
[58] Emerson, J. *The Blended Value Landscape*, www.blendedvalue.org. Hewlett Foundation.
[59] Conversations with agency staff, 9/03.
[60] Bendixen, S. *Presentation on survey results of remittance recipients in Guatemala, El Salvador, and Honduras*, IADB-MFI Guatemala Roundtable on Remittances, 9/03
[61] De Sousa Shields, M. *Intermediating Capital to MFIs*, Presentation given at the 6th Conference on Microenterprise, BYU, Utah, 3/2003.

- *Latin American Country Legislation & Regulation Review and Information Exchange*: Given the high volume of related legislative activity in Latin America, microfinance regulation is coming into sharp focus in the industry.[62] Twelve countries in Latin America have passed legislation on the topic since 1999. The research topics, currently less considered in the industry, address how government actors make their decisions and what type of South-South exchange exists on this topic. The key question is whether there is particular regulatory behavior that is more likely to have a positive effect on the microfinance industry.

  This research will begin with an assessment of developments in each country with respect to microfinance policy based on legislation, regulation, and supervision. The overall environment is considered with regard to their potential impact on sustainable microfinance.

  Convening a forum to host a roundtable on the topic is recommended. This provides a uniform platform to ask research questions on a set of subjects. Potentially more important, it establishes a forum for South-South exchange on the subject. A model example is the Central Bank of Uganda's hosting an event in 2000 with the support of GTZ.[63] The conference yielded useful information and resulted in a well-written publication. A Latin American regional effort building upon this body of knowledge would be an attractive complement.

  To date: Research to date consists of literature review and communication with donors on the subject. In addition, conference attendance yielded extensive information. A data-gathering tool is drafted and available in the attachments (see Attachments C and D). However, it is preliminary and does not yet incorporate any questions as to communication and how decisions are made.

7. Conclusion

Microfinance is considered to be a valuable tool for the alleviation of poverty around the globe. In order for microfinance to realize its full potential, it must be sustainable and capable of expansion beyond the limitations imposed by a reliance on development assistance. Both developing and developed nations are key actors in this regard.

Developed-country bilateral aid programs and multilateral institutions should focus efforts on defining common standards by which to measure the effectiveness of microfinance in reducing poverty. Donor policies should encourage sustainability by avoiding subsidies for lending and by using grants to help developing nations create a favorable policy and institutional infrastructure for microfinance; a key policy goal should be to ensure the safety and financial soundness of depository microfinance institutions. Donor programs should meet the transparency test and use merit-based frameworks for the allocation of scarce grant resources. Financial regulators and supervisors in developing countries should ensure prudent oversight by soliciting input from microfinance institutions and other civil society stakeholders.

[62] Counts, A. & Sobhan, S. *Recommendations for the Creation of Pro-Microcredit Regulatory Framework.* 2002.
[63] Hanning, A. Mugwanya, E. & Eds. *How to Regulate and Supervise Microfinance? - Key Issues in an International Perspective*. GTZ, 2000

Several key questions require additional research and analysis to develop useful guidelines regarding microlending as a means for reducing poverty in urban areas. To address some of these issues, a comprehensive review of donor policies will be required. Bilateral and multilateral agencies should be surveyed to solicit the information directly.

Central investigative themes include: What is the aggregate amount of microfinance service offered by MFIs globally and in Latin America (broken down by urban and rural areas)? What is the total amount of development assistance to microfinance (with particular emphasis on aggregating bilateral and multilateral donor information)? What are the most appropriate metrics for determining the impact of microfinance on poverty reduction and the effectiveness of microfinance-oriented donor programs (and what standardization methods are used)? What is the optimal national microfinance policy and regulatory framework that balances consumer protection with need for "massification"?

This paper recommends exploring means to leverage additional capital for MFIs. One interesting area is remittances. Aggregated, these are large transfers and represent significant cash flows from developed to developing economies. Linking these funds with microfinance would help to channel these resources to the formal, productive sector. Furthermore, using microfinance institutions to link remittance flows to asset accumulation – such as purchasing a home or financing micro and small businesses – would represent a significant step forward in using remittances to contribute to sustainable microfinance.

These issues and research agenda items provide a particularly rich opportunity to measure the impact of microfinance on urban poverty reduction in Latin America. This should lead to valuable conclusions regarding donor programs and national policies in this sector.

8. Attachments

A. Website Transparency: Donor Involvement in Microfinance

B. Financial Support of Microfinance by Bilateral and Multilateral Donors

C. Table – Regulatory Choices for Government Actors in Developing Countries

D. Policy, Regulation, and Supervision Comparison of Latin American Countries

A. Website Transparency: Donor Involvement in Microfinance

(Note: B = Billions, M = Millions, K = Thousands)

Website Transparency:
- Transparency of information available on the website (high, medium, low).
- Availability of annual report and completeness of annual report (standard is complete financial accountability – excellent, good, acceptable, poor, none).
- Number of clicks to identify key statements and policies from home page.

Statements on Development Policy & Microfinance:
- Does the institution explicitly state its development policy?
- Does it have a role for microfinance outlined?
- How does it carry out its development agenda?

Financial Commitment, Project & Program Involvement:
- Total amount of capital spent..
- Number of projects / programs.
- Capital spent on microfinance
- Number of microfinance-related projects/programs.

Agency	Website Transparency	Statements on Development Policy & Microfinance	Financial Commitment, Project & Program Involvement
Bilateral			
Danish Ministry for Foreign Affairs www.um.dk	Highly transparent website, although no search feature. Annual report available. Quality – acceptable. 3 clicks to content.	No apparent role or statement on microfinance. Development policy and priorities are stated. Most development efforts are through other agencies.	Microfinance involvement unknown. $496 M in 15 Program Countries and South Africa. Over 200 projects, including projects with EU, World Bank, UN, UNDP. World Bank- $74.5 M Development Banks $54.5 M
The Canadian International Development Agency – CIDA www.acdi-cida.gc.ca			
Department for International Development – DFID www.dfid.gov.uk			
Finnish Ministry for Foreign Affairs http://formin.finland.fi/english/			
France Development Agency www.afd.fr			
German Development			

Bank (KfW) www.kfw.de			
Agency	**Website Transparency**	**Statements on Development Policy & Microfinance**	**Financial Commitment, Project & Program Involvement**
Multilateral			
Consultative Group to Assist the Poor - CGAP (World Bank) www.cgap.org			
The European Bank for Reconstruction & Development – EBRD www.ebrd.org			
Inter-American Development Bank – IADB www.iadb.org			
Inter-American Development Bank, Multilateral Investment Fund – MIF www.iadb.org			
International Fund for Agricultural Development – IFAD (Agency in UN) www.ifad.org			
Organization for Economic Co-operation & Development - OECD www.oecd.org			
UN Capital Development Fund (UNCDF) www.uncdf.org			
United Nations Development Program www.undp.org			

B. Financial Support of Microfinance by Bilateral and Multilateral Donors

Thank you for assisting in our research study. Our thesis – which we wish to document – is that microfinance is a sustainable tool for urban poverty alleviation. One facet of the study is to consider and compare bilateral and multilateral donor activity in microfinance. Your assistance is appreciated.

Name of Country: ____________________

Name of Aid Organization: ____________________

For the latest year for which the information is available:

Number of projects/ programs involving Microfinance		**Funding/ disbursements (US$) involving Microfinance**	
Total Number of Projects		**Total Funding (US$)**	
Ratio		*Ratio*	

Year of this data:

Source of data:

- **Please give the titles of or describe BRIEFLY two or three of the latest microfinance projects funded or larger projects that involve microfinance:**

- **Does the organization have a mission, strategic plan, or stated value for microfinance?**

YES / NO

If yes, please elaborate:

- **Has the organization done evaluations of the *effectiveness* of microfinance?**

YES / NO

If yes, please elaborate:

- **Is the organization supporting any projects, programs, or efforts on remittances?**

YES / NO

If yes, please elaborate:

Does your organization have an opinion as to how remittances can be connected to development and to microfinance?

C. **Table – Regulatory Choices for Government Actors in Developing Countries**

Regulation Choice	**Description**	**Market-Driven Cost of Services to Clients** (Improve or worsen)	**Institutional Safety & Financial Soundness** (Improve or worsen)
No regulation	No laws are designated for MFIs. MFIs operate informally, illegally, or at least with benign neglect of government oversight. *For example - Brazil*	**Neutral** Does not strengthen the sector. Lowers barriers to entry, good for competition, but does nothing to safeguard institutional quality. No oversight against predatory lending. Does nothing to help MFIs grow.	**Worsen** No MFI oversight, no motivation to improve institution, no protection against malfeasance.
New designation within existing regulation	A new financial institution designation is established within existing regulation and supervision environment. *For example - Bolivia*	**Improve** Assuming decent regulation, legal consistency creates a stable business environment. Open competition is also beneficial for client cost.	**Improve** Assuming decent regulation, a new designation matching the MFI profile allows MFIs to operate effectively. Separates MFI supervision requirements from those of other financial institutions.
New regulation	New laws passed for regulation and subsequent supervision of MFIs. Defines MFIs separately from other financial institutions. *For example - Mexico*	**Neutral** Depends on quality of the law. Assume no change in the short term, potential improvement in the long term.	**Neutral to Improve** Depends on quality of the law. Successful regulation helps larger/ stronger institutions, but is difficult/costly for smaller ones.
Consumer protection legislation	Legislation theoretically designed to protect customers. This ideal is attractive. However, making good laws is complicated, and local institutions often are unable to comply. A common example is 'Usury Laws' setting interest rate ceilings. *For example - Nicaragua*	**Depends** Designed to improve cost of services. For usury law, improves in short term, but harmful in long term. Not a market-based solution. Institutions often cannot succeed financially. Doesn't differentiate clients by interest rate risk.	**Depends** Supposed to improve with additional consumer accountability. For usury laws, decreases transparency, as MFIs obfuscate actual cost of capital through fees, etc. Decreases revenue and profitability. Doesn't allow risk-adjusted customer differentiation. Encourages illegal activity.

D. **Policy, Regulation, and Supervision Comparison of Latin American Countries**

Country	Mexico
Legislation	
Regulation	Law impacting cooperatives and select MFIs
Supervision	In line with regulation, supervision guidelines not yet clear
Newest Law	
Year Adopted	2002
General Policy Environment	Good
Overall Grade	Fair