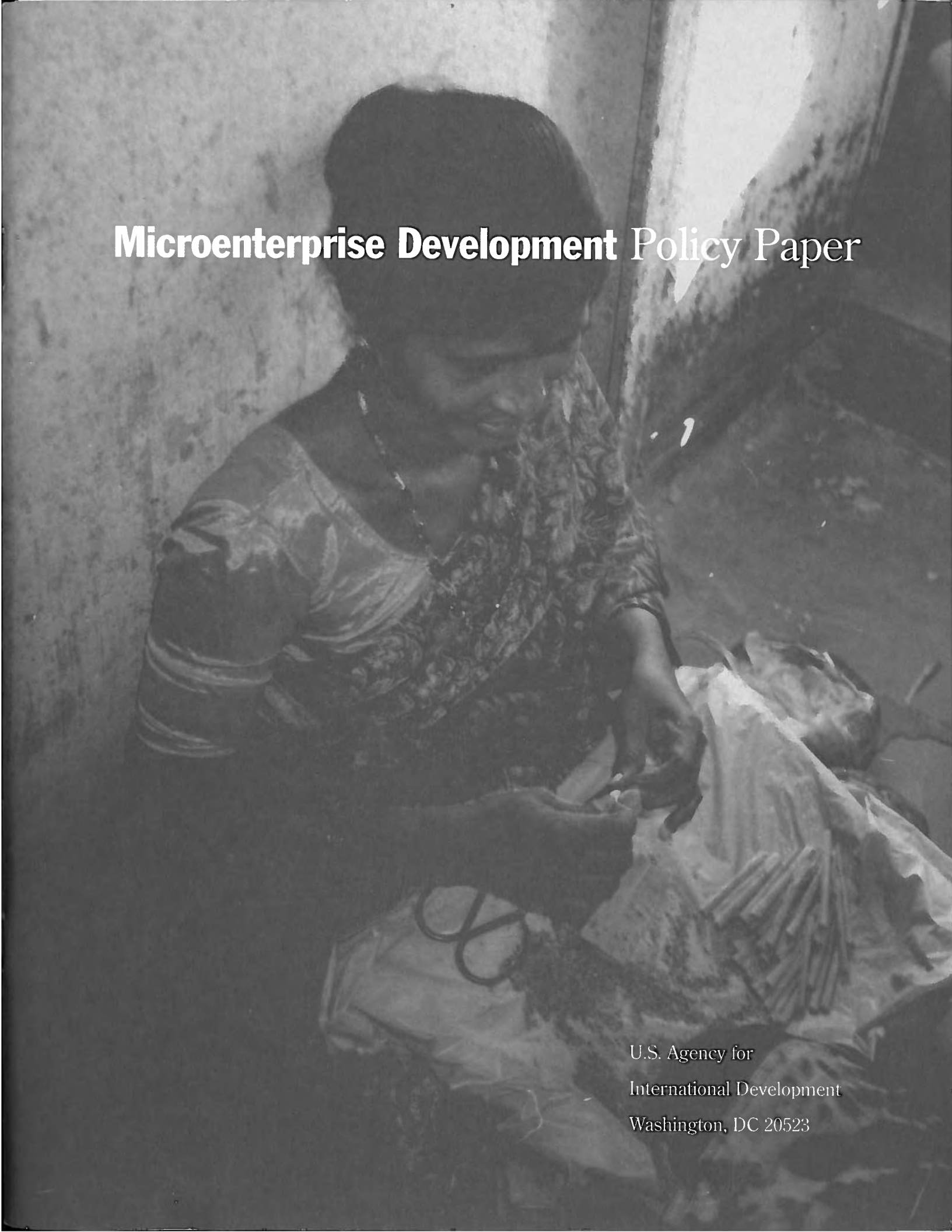

Microenterprise Development Policy Paper

U.S. Agency for
International Development
Washington, DC 20523

Microenterprise Development Policy Paper

U.S. Agency for
International Development
Washington, D.C. 20523

Table of Contents

SECTION I: DEFINITIONS, GOALS, AND OTHER PROGRAM PARAMETERS **3**

I.A. Defining Characteristics of Microenterprises 3

I.B. Development Context 3

I.C. Operational Goals of USAID Microenterprise Efforts: Improved Policies and Development of Effective Service Providers 4

I.C.1. Policy Dialogue 5

I.C.1.a Financial Sector Policies 5

I.C.1.b Non-Financial Policies 7

I.C.2 Development of Organizations 8

I.C.2.a Deep Outreach: poverty lending and reaching very poor microentrepreneurs 8

I.C.2.b Broad Outreach: reaching large numbers of the poor 9

I.C.2.c Emphasis on Female Entrepreneurs 9

I.C.3. Organizationsl Eligibility 10

I.C.4. Programmatic Eligibility 10

I.C.5. In Sum 11

SECTION II: GUIDANCE FOR ASSISTANCE TO ORGANIZATIONS PROVIDING ONLY FINANCIAL SERVICES **13**

II.A Maintaining Program Focus on Target Population 14

II.A.1 Targeting the Poor through Provision of Small Loans/Acceptance of Small Deposits 14

II.A.1.a Poverty Lending 15

II.A.2 Targeting the Poor through Reliance on Collateral Substitutes 15

II.A.3 Organizational Commitment 16

II.B. Providing Financial Services Valued by Microentrepreneurs 16

II.B.1 Credit 16

II.B.2 Deposit Services 17

II.B.3 Market Test of the Value of Services 18

II.C Financial Sustainability and Outreach 18

II.D Operational Efficiency 20

II.E Expected Program Results, MFI Performance, and Reporting Responsibilities 21

II.E.1 Expected Program Results 21

II.E.2 Responsibilities for Reporting Results 21

II.E.2.a Missions 22

II.E.2.b USAID/W 22

	II.E.3	Information Reporting Requirement for USAID-assisted MFIs	22
		II.E.3.a Indicators of Outreach and Focus on Target Population	23
		II.E.3.b Indicators of MFI Financial and Operational Performance	23
	II.E.4	Use of MFI Performance Information	24
II.F	Policy Toward Savings and Deposit Services		24
	II.F.1.	Financial Regulation and Supervision	25
II.G	Identifying Promising Opportunities for USAID Assistance		25
	II.G.1	Country Issues	26
		II.G.1.a Interest Rate Policy	
		II.G.1.b Inflation	26
	II.G.2	Organizational Issues	27
		II.G.2.a Control over Loan Delinquency and Losses	27
		II.G.2.b Full Cost-recovery Interest Rates and Fees	27
		II.G.2.c "Commercializing" Specialized MFIs vs. "Downsizing" Private Banks	28
		II.G.2.d Participation	29
II.H	Structuring Assistance to Microfinance Programs		30
	II.H.1	Typical Forms of Assistance	30
	II.H.2	Performance-based Disbursement	31
	II.H.3	Guarantees	31
	II.H.4	Avoiding Poor Prospects for Microfinance Development	31
SECTION III:	**GUIDANCE FOR SUPPORT TO ORGANIZATIONS PROVIDING NON-FINANCIAL ASSISTANCE**		**33**
III.A	Expected Results		33
III.B	Policy on Cost Recovery vs. Subsidies		34
III.C	Program Results and Cost-effectiveness and Reporting Responsibilities		34
III.D	Other Program Performance Indicators		35
	III.D.1	Outreach	35
	III.D.2	Focus on the Target Population	35
	III.D.3	Financial Reporting	35
III.E	Participation		36
III.F	Additional Principles of Non-financial Assistance		36
SECTION IV:	**GUIDANCE FOR ASSISTANCE TO ORGANIZATIONS PROVIDING BOTH FINANCIAL AND NON-FINANCIAL SERVICES**		**37**
ANNEX:	**MINIMUM REPORTING FOR MICROFINANCE INSTITUTIONS**		**A-1**

Microenterprise Development[1]

The U.S. Agency for International Development (USAID) supports microenterprise development to advance its strategic objective of expanding economic opportunity and access for the poor — specifically, the many poor people who operate or work in microenterprises. Ultimately, USAID's microenterprise development efforts are aimed at helping reduce poverty among microenterprise owners, workers, and their families. This guidance is intended to ensure that USAID's support for microenterprise development makes the greatest possible contribution to these goals. Although the guidance applies to all types of microenterprise development activities, its primary focus is on those in the area of *microfinance development* — efforts to improve poor microentrepreneurs' access to financial services. Microfinance development efforts comprise a substantial majority of all microenterprise development activities, both within and outside of USAID. Although the guidance highlights some of the lessons of experience for program and institutional design, it is not intended as a technical guide in these areas: Missions planning microenterprise development activities should consult with technical offices in USAID/W and/or other sources of expertise to ensure that their efforts conform to best practice.

[1]This guidance supersedes Policy Directive 17, issued October 10, 1988.

In June 1994, USAID launched a microenterprise initiative designed to make microenterprise development a better-established part of USAID's economic growth efforts. Under the Microenterprise Initiative USAID committed itself to four principles in designing and implementing microenterprise programs: (1) maintaining focus on women and the very poor, particularly through support for poverty lending; (2) helping implementing organizations reach greater numbers of people; (3) supporting institutional sustainability and financial self-sufficiency among implementing organizations; and (4) seeking improved partnerships with local organizations in the pursuit of microenterprise development. This guidance is intended to be consistent with these principles, but Missions should consult the Microenterprise Initiative directly for further details. USAID/W technical offices can provide further information on the Microenterprise Initiative and other relevant parameters.

Section I lays out the basic parameters of the USAID microenterprise development program, including definitions, operational goals, and the range of activities USAID includes under the term "microenterprise development." Section II provides guidance for USAID assistance to microfinance programs, emphasizing the need to (1) ensure that assisted programs maintain a focus on the target population and (2) encourage their steady movement toward full financial sustainability as a means to achieve large-scale impact and institutional viability. Section II also spells out reporting requirements applicable to all USAID-assisted microfinance programs; Mission and USAID/W responsibilities for measuring program results; country and organizational characteristics affecting the prospects for program success; and guidelines on structuring assistance to microfinance institutions. Section III provides parallel guidance for assistance to organizations providing only non-financial assistance, Section IV for assistance to those offering both financial assistance and non-financial services.

Section I: Definitions, Goals and Other Program Parameters

I.A.
DEFINING CHARACTERISTICS OF MICROENTERPRISES.

Throughout the developing world, millions of poor families derive an important share of their income from *microenterprises:* tiny, informally organized business activities other than crop production.[2] Common examples include vending on the streets and in market stalls; simple agro-processing operations like rice husking; handicraft production; simple repair services; and a wide variety of other low-technology, labor-intensive activities. Many microenterprises involve only one person, the owner-operator or "microentrepreneur." Many others involve unpaid family workers, while yet others include paid employees. USAID limits the term "microenterprise" to firms with ten or fewer employees, including the microentrepreneur and any family workers.

For purposes of USAID policy, the second defining characteristic of a microenterprise is its low level of assets or income — both of the business and of those working in it. USAID's microenterprise development efforts are specifically aimed at enterprises owned by and employing the poor,[3] including those facing particular socioeconomic disadvantages that contribute to their poverty. In many developing countries, poor women, who represent a majority of microentrepreneurs and who often depend heavily on income from microentrepreneurial activities, face a wide range of such disadvantages. Female microentrepreneurs represent a group of special concern to USAID. Refugees and ethnic minorities represent other groups that may be especially disadvantaged. Missions should ensure that the assistance they report under the heading of "microenterprise development" flows to programs that effectively focus upon the business activities of the poor, and should give particular preference to programs that reach poor female microentrepreneurs.[4]

[2]Many farmers operate microenterprises as sidelines and/or during the off season. Effective lenders to microenterprises generally do not attempt to restrict the uses of funds by borrowers; as a result, microfinance does not have neat boundaries.

[3]Enterprises owned and operated by middle- or high-income people, such as professional partnerships or small consulting firms, are not eligible for support under USAID microenterprise development programs, regardless of the size of those enterprises.

[4]As made clear below, Missions should not encourage microenterprise programs to apply means testing in screening clients. Rather, the most successful microenterprise programs tailor their services to fit the requirements of the poor. An important example is the provision of small loans, using "collateral substitutes" rather than formal collateral to encourage repayment.

I.B.
DEVELOPMENTAL CONTEXT.

To a large extent, widespread microentrepreneurship is simply a reflection of a low level of economic development. In the process of development, some microenterprises will grow and move into larger size categories, while many others will disappear as their owners and workers find higher-paying jobs in larger firms — including some with "micro" origins. Yet others will stay tiny and labor-intensive, but the incomes of their owners and workers increase as rising demand bids up the prices of their services. In the long run, the prospects for satisfactory microenterprise performance and for the emergence of microentrepreneurs from poverty are closely linked to the growth prospects of the local and national economies in which they operate.

In the meantime, microenterprises in almost all developing countries face a wide variety of constraints that limit their growth and the incomes they yield to owner-operators and employees. Microenterprises in most countries face severely limited access to institutional credit, savings facilities, and other financial services. They must rely instead on a narrow range of services offered by moneylenders and

other informal sources, often at very high prices. Microentrepreneurs face many non-financial constraints as well, and for many these pose more daunting barriers to improved enterprise performance and household income.[5] For example, the limited education of most microentrepreneurs, together with their lack of exposure to improved production techniques and business practices, tends to limit the productivity of their operations. Likewise, microentrepreneurs tend to be poorly informed about market opportunities.

In addition to the overall level of economic development, other aspects of the economic environment can add to the number of households seeking incomes from microentrepreneurship, and make it harder for existing microentrepreneurs to emerge from poverty. Workers losing their jobs in larger firms as a result of economic crisis undertake microentrepreneurial activities as a means to survive in countries lacking a formal social safety net. In addition, microenterprises proliferate in some countries because of policy, regulatory, and institutional constraints to the formation of small and medium enterprises. Restrictive labor codes and/or minimum wages, costly and complex procedures for obtaining business licenses, excessive taxes, zoning restrictions, and a host of other constraints can cause firms to remain in the "informal" economy where they largely escape the direct impact of policies and regulations.

This overview suggests that an effective strategy for addressing the problems faced by poor microentrepreneurs requires a balance between efforts to relieve the immediate constraints that inhibit their emergence from poverty and efforts to address the underlying policy, institutional, and market conditions that lead to widespread microentrepreneurship.

[5]For example, Liedholm and Mead recently conducted surveys among microentrepreneurs in six Southern and East African countries, in which the respondents were asked to identify the most serious constraints to the performance of their enterprises. Although microentrepreneurs in three of the six countries identified problems of working capital, credit, and other financial matters as their most serious constraint, those in two countries ranked "problems relating to demand" as more serious, and those in one country pointed to "problems relating to inputs." See Carl Liedholm and Donald C. Mead, "The Structure and Growth of Microenterprises in Southern and Eastern Africa" Evidence from Recent Surveys." GEMINI Working Paper No. 36, USAID, March 1993.

[6]For purposes of this guidance, a financial institution is said to be providing financial services on a "subsidized" basis if the interest and fees collected from clients for those services fail to cover the institution's full long run costs (see Section II C.)

I.C.
OPERATIONAL GOALS OF USAID MICROENTERPRISE DEVELOPMENT EFFORTS: IMPROVED POLICIES AND DEVELOPMENT OF EFFECTIVE SERVICE PROVIDERS.

To advance its strategic objective of expanding economic access and opportunity for the poor, USAID works to (1) improve the policy and market environment in which microenterprises operate and (2) improve the performance and outreach of organizations that directly provide financial services and non-financial assistance to microenterprises. As a major element of these efforts, USAID — along with many other donors, host country governments, and non-government organizations (NGOs) — focuses particular attention on microentrepreneurs' limited access to institutional credit, savings facilities, and other key financial services. USAID works to address this constraint by fostering the development of viable financial institutions offering unsubsidized,[6] high-quality financial services to poor microentrepreneurs. This emphasis on financial services reflects relative confidence in the cost-effectiveness of the program approaches that have been developed to deal with financial constraints. Likewise, USAID supports improvements in host country *financial* sector policies to improve microentrepreneurs' access to financial services. This focus represents one aspect of USAID's broader efforts to promote a more competitive financial system capable of serving the needs of all segments of society.

I.C.1. POLICY DIALOGUE.

A wide range of host country policies affect the economic opportunities faced by microenterprises. For purposes of analysis, these policies can be divided into (1) those that affect the availability of financial services to poor microentrepreneurs and (2) those that affect microentrepreneurs through other channels, including the demand for their outputs, the availability and price of non-financial inputs, the institutional and regulatory environment in which they operate, social and cultural restrictions they may face, and the emergence of better income-earning opportunities for microenterprise owners and workers elsewhere in the economy. In each case, some policies affect microenterprise performance directly and specifically, while others affect a wide variety of firms, including microenterprises.

In designing a microenterprise development strategy, the Mission should start with a relatively broad look at the wide range of potential policy constraints to microenterprise development. Where this analysis reveals complementary policy reforms needed to provide fertile ground for the development of microenterprises and/or of the institutions that support them, the Mission should consider the feasibility of addressing these constraints as part of its overall strategy. In some cases, these may include policy areas too broad to be included under the specific heading of microenterprise development.

In contrast, in reporting their level of funding for microenterprise development, Missions should ensure that any policy dialogue efforts included in this category are directed toward policy changes that can be shown to advance directly the interests of microenterprises and microentrepreneurs, such as policy changes to improve microenterprise access to financial services.

I.C.1.a. Financial sector policies.

Many policy reforms needed to achieve an efficient and competitive financial system will work to the benefit of microentrepreneurs and other traditionally underserved segments of society. For example, interest rate ceilings can reduce the availability of credit to microenterprises and other small borrowers, by preventing potential lenders from charging the higher rates needed to cover the costs of making small loans. Informal government pressure to hold interest rates below market-clearing levels can have much the same effect, though less visibly. Although a formal or informal waiver from interest rate ceilings may be sufficient to allow a specific Mission-assisted institution to reach financial sustainability, the removal of interest rate ceilings will often be necessary to encourage banks and other formal financial institutions to pursue microenterprises and other small borrowers as customers.

Another potential area of financial policy dialogue concerns the supervision and prudential regulation of financial institutions that accept deposits to fund microenterprise lending. Such institutions, like other formal financial intermediaries, will tend to face periodic crises unless they have the benefit of competent independent supervision and prudential regulation. The very limited body of experience to date in the regulation and supervision of microfinance institutions (MFIs) precludes more than a few general guidelines in this area.

(1) The financial dynamics of MFIs differ from those of conventional banks in several ways that impinge on the appropriate standards for their supervision. For example, loan delinquency rates in well-run MFIs tend to be lower than those in commercial banks; however, MFIs' delinquency rates can be much more volatile than those of commercial banks. Furthermore, MFIs operate with higher costs and spreads than banks, so a given level of delinquency will hurt an MFI's cash flow more severely than it will hurt a bank's. These considerations indicate that MFIs should be limited to lower debt-to-equity ratios than required for conventional banks, at least until the supervisory authorities have gained a clear picture of the long-term performance of their portfolios.

(2) On the other hand, it may be appropriate for the supervisory authorities to adjust their standards for rating the quality of outstanding loans, so that they do not unduly penalize MFIs for their reliance on alternatives to conventional collateral in motivating loan repayment.

(3) Reporting requirements on individual loans should probably be less onerous for the tiny loans made by MFIs than for the larger loans made by conventional banks. Likewise, bank examiners might review a proportionally smaller sample of outstanding loans than when examining a conventional bank.

(4) The different technical requirements needed to exercise effective supervision over MFIs compared with mainstream banks suggest that it may be desirable in some settings to establish a separate division of the financial superintendency to handle MFIs, or to delegate that responsibility to a separate entity with the necessary technical skills.

(5) Supervisory authorities should not be encouraged to regulate MFIs less cautiously because of their social purpose.

Efforts to increase the overall level of competition in the financial sector are too broad and indirect to be reported as microenterprise development activities, but can help increase the incentive for formal financial institutions to cultivate new types of customers, including small and microenterprises. The degree of financial sector competition may be important as a background factor in choosing between a microfinance development strategy that emphasizes strengthening specialized MFIs and one that seeks to encourage private financial institutions to reach down to the micro market (see Section II.G.2.c.)

Inflation reduces the real interest rate available to lenders and the incentives to make high-cost small loans wherever formal or informal interest rate ceilings remain in place; higher inflation usually also entails more variable inflation, greatly complicating the problem of setting appropriate interest rates on loans and savings accounts. Finally, MFIs have noted a sharp drop in the demand for loans when nominal lending rates are raised to keep real rates constant in the face of higher inflation — perhaps reflecting potential borrowers' own increased uncertainty about the real rate they will pay on such loans. Bringing

inflation under strict control is thus critical to the development of microfinance. However, the breadth of inflation's impact on the overall economy makes program efforts in this area too general to be reported under the heading of microenterprise development.

Finally, Missions should note carefully that the nature of financial markets makes it particularly likely that financial policy distortions intended to help poor people and/or microenterprises will produce minimal benefits — at least for the intended beneficiaries — and substantial unintended costs. As a result, Missions should urge the elimination of subsidized credit to small and microenterprises by government-owned financial institutions, as well as the removal of requirements that banks channel a specified share of their lending toward small and micro firms. Missions should strongly resist measures aimed at repressing moneylenders, pawnbrokers, and other informal sources of financial services: despite some shortcomings, such informal sources of credit serve a vital role as lenders of last resort to the poor, and can often provide short-term credit more quickly and with lower transaction costs than any other source. In all cases, the aim should be to foster conditions under which financial services can flow toward microenterprises in response to market forces, and to expand the range of financial options available to microentrepreneurs.

I.C.1.**b. Non-financial policies.**

Non-financial policy constraints on microenterprises tend to be country-specific and sometimes hidden from view, but they are no less important as a result. Missions undertaking microenterprise development activities should attempt to identify major non-financial policy barriers to the success of their own program efforts and to microenterprise development in general, and seek to address these barriers where feasible. The following illustrative list suggests some country experiences that may apply elsewhere; USAID/W technical offices can provide a more comprehensive set of examples. Likewise, workshops with host country experts can help to identify local non-financial barriers to microenterprise performance.

- Poorly defined access to space in urban markets can expose vendors to harassment and demands for payoffs from police and to ejection by physical force by other vendors.
- Inheritance and property laws can make it difficult for women to obtain title to business property.
- The collection of value-added taxes from larger but not small or microenterprises can place the latter at a competitive disadvantage as suppliers to larger firms.
- Discretionary allocation of foreign exchange and/or import licenses usually places small and micro firms at a serious disadvantage in gaining access to imported inputs.

At one level removed from these direct impacts, a wide range of non-financial policies can exert strong but indirect impacts on the microenterprise sector. Policies affecting the performance of the

agricultural sector — which maintains close linkages to the rural microenterprise sector in many countries — deserve special mention in this category. The wide range of policy, regulatory, and institutional barriers to the growth of small and medium enterprises inhibit the ability of microenterprises to grow out of the micro range. Subsidized provision of services such as power, water, and telephones reduces providers' cash flow and their ability to invest in additional capacity, making new connections hard to get — especially by tiny firms.

Ultimately, any policy change that contributes to more rapid, sustainable growth of the host country economy will tend to benefit microenterprise owners and workers, through stronger growth in demand for their outputs and the creation of higher-paying job opportunities elsewhere. For example, trade liberalization and the adoption of competitive exchange rates can help stimulate the growth labor-intensive manufacturing for export, a particularly important source of growth in wage employment of low- and semi-skilled workers, including women. While policy efforts at this level are far too general to be included under the heading of microenterprise development, it is useful to recognize these underlying linkages.

Finally, as in the case of financial policies, Missions should discourage the use of market-distorting policies intended to favor small and microenterprises, such as subsidized provision of public utility services, preferential access to licenses, or the reservation of specified goods or services for production by small and micro firms. Such policy distortions tend to be ineffective in achieving their objectives, and whatever benefits they create tend to be captured by those with political influence rather than by the poor.

[7] This category includes both non-profits (NGOs) and for-profits (such as banks) and, occasionally, government-owned organizations.

I.C.2. DEVELOPMENT OF ORGANIZATIONS

Providing Services to Microenterprises. Most USAID funding for microenterprise development moves through the intermediation of, and in partnership with, a wide range of "implementing organizations," which provide financial services and/or non-financial assistance to improve the performance and incomes of existing microenterprises, and/or to help poor people launch new microenterprises.[7] USAID assists such organizations to help them improve their performance, expand the scale of their operations, and extend those operations to include new services or to reach new groups of clients. In contrast, USAID does not provide direct assistance to individual microenterprises. USAID's support for implementing organizations seeks to achieve several goals:

I.C.2.a. Deep outreach: poverty lending and reaching very poor microentrepreneurs.

Many microenterprise development programs attempt to serve very poor microentrepreneurs, and/or encourage very poor people to set up new microenterprises. USAID refers to such programs as poverty lending programs, and describes them as achieving "deep" outreach. USAID's support for poverty lending, elaborated in Section II, reflects the priority USAID places on reaching very poor microentrepreneurs. A program's focus may be exclusive (i.e., all clients are very poor) or mixed (i.e.,

service to the poorest stratum is blended with service to a somewhat higher stratum of microenterprises.) As smaller loan sizes tend to involve higher costs per client, it is more difficult to achieve financial self-sufficiency while serving the very poor. Programs that exclusively target the very poor must seek creative methodologies and often must charge higher interest rates and fees. Programs that serve a broad spectrum of microenterprises can spread their costs across loans of larger average size, and thus have more leeway in reaching financial viability. Several top-performing microenterprise programs that serve a mixed clientele reach large absolute numbers of the very poor, because their financial performance has allowed them to achieve significant scale (broad outreach.) Whether the focus is exclusively upon the poorest or mixed, USAID supports efforts that seek and achieve greater depth of outreach.

I.C.2.**b. Broad outreach: reaching large numbers of the poor.**

For USAID's microenterprise development activities to make a significant contribution to poverty reduction, they must be capable of achieving "broad outreach," i.e., reaching *large numbers* of the poor. Roughly a third of the population of the developing countries — well over a billion people — were living on less than $1 a day in 1990.[8] This figure included well over half the population of Sub-Saharan Africa and South Asia, over a quarter that of Latin America and the Caribbean, and 15 percent of the huge population of East Asia. While few precise figures are available, studies typically estimate that as many as a third of poor households participate in microenterprise activities. These estimates suggest that the number of poor people depending on income from microenterprises (including family members) reaches well into the hundreds of millions worldwide. Under these circumstances, only those activities with the potential to affect tens or hundreds of thousands of microenterprises can make a plausible claim to play a significant role in reducing national or world poverty. Given the scarcity of USAID financial and managerial resources, it is essential to consider an intermediary's potential for scale in allocation decisions.

[8]World Bank estimates, based on 1985 prices and exchange rates reflecting the relative purchasing power of currencies. Equivalent to $1.38 at 1994 prices.

I.C.2.**c. Emphasis on female microentrepreneurs.**

USAID's microenterprise development program places particular emphasis on assisting female microentrepreneurs. In many developing countries, poor women face especially limited access to assets, education, and training. Partly as a result, poor women tend to be heavily concentrated in particularly low-paying micro-entrepreneurial activities such as petty trading, where they in turn suffer especially limited access to financial services and information on market opportunities. Likewise, female-headed households tend to be heavily concentrated in the lower end of the income distribution; many of these households rely on income from microenterprise activities for their survival. USAID views microenterprise development as an important means to help break these vicious circles, and encourages support for programs that make special efforts to assist female microentrepreneurs. As a means of targeting women, Missions should encourage the development of services that meet the specific requirements of female microentrepreneurs, rather than the exclusion of men. As a minimum standard, all programs must be both formally and effectively open to women to be eligible for USAID support. To help ensure that its microenterprise

development program effectively reaches female microentrepreneurs, USAID requires that key program outreach data be reported on a gender-disaggregated basis (see sections II.E. and III.A.1).

I.C.3. ORGANIZATIONAL ELIGIBILITY.

Many types of organizations provide services to, or otherwise work to advance the interests of microenterprises, including:

- local non-government organizations (NGOs) specializing in microenterprise development, including those sponsored by U.S.-based private voluntary organizations (PVOs);
- microenterprise development units of NGOs and PVOs with broader programs;
- business associations of microentrepreneurs;
- credit unions;
- village banks;
- private banks, including those established by NGOs as well as windows created by private financial institutions to handle business with microenterprises;
- government-established agencies; and
- specialized banks or finance companies.

USAID imposes no rigid restrictions on the types of organizations eligible for USAID assistance. Rather, the Mission should judge a particular organization's potential to use USAID assistance effectively on the basis of its performance — its current effectiveness in providing key services to the target population and its commitment to further improvement. The standards to be used in assessing organizational performance are spelled out in Sections II-IV, along with principles for selecting organizations likely to meet these standards. USAID funding should only be provided to an organization that either (1) has already established a performance record that justifies confidence that it will meet the performance standards set forth in Sections II-IV, or (2) is a new start headed by an experienced management team whose past performance justifies confidence that the new organization will attain those program performance standards.

Finally, Missions should recognize that the great majority of government microenterprise development programs have been dismal failures, but that this category includes a few spectacular successes as well. As a result, Missions should exercise a general preference for working through private implementing organizations, but may consider assistance to government financial institutions or other programs whose record demonstrates a clear determination to avoid the typical pitfalls of public ownership and to achieve the performance standards set forth in this guidance.[9]

[9]These pitfalls include (1) a lack of concern with financial performance, in such forms as poor loan recovery, insufficient loan screening, and interest rates set too low to cover the full costs of providing credit; (2) a "soft budget constraint" that permits reliance on budget transfers or infusions of central bank credit to compensate for poor financial performance, and (3) excessive operating costs and limited incentives for staff performance, encouraged by overstaffing, the provision of civil service status to the organization's workers, and high staff salaries relative to local incomes.

I.C.4. PROGRAMMATIC ELIGIBILITY.

The diversity of organizational types is matched by the wide variety of programmatic approaches used to assist microenterprises. Many programs focus on the provision of financial services in forms adapted to fit the needs of microenterprises. For example, microfinance programs offer loans in amounts much smaller than the minimum loan normally available from local commercial banks; the great majority of such programs rely upon some type of "collateral substitute" rather than formal collateral requirements to ensure that poor borrowers repay their loans (see section II.A.2.) An increasing number of microfinance programs and institutions offer savings facilities as well as credit. Some accept (and typically require) deposits only from their own borrowers, while others mobilize savings from the general public.

In addition, many programs provide non-financial assistance to microentrepreneurs, either in isolation or together with financial services. Non-financial assistance spans a wide range of approaches, including basic training aimed at enabling poor people to establish new microenterprises; efforts to link groups of microenterprises to market opportunities at home or abroad; training in production skills; and more intensive assistance in production techniques and marketing, aimed at helping firms shift from low-return to high-return activities as a means to graduate from the microenterprise range into the small or medium range. Finally, organizations have developed a variety of programs that offer credit or other services to encourage participation in activities aimed at achieving goals distinct from microenterprise development, including improved child health and nutrition, environmental improvement, etc.

USAID imposes no direct restrictions on the eligibility of broad program approaches for assistance. Again, the key issue is *results:* the ability of a particular approach to translate limited USAID funding into tangible benefits for large and growing numbers of the target population. This principle implies the need to pay careful attention to the records of different program approaches — a matter on which the relevant technical offices in USAID/W can provide assistance — as well as the need to build strong mechanisms for monitoring and evaluating the performance of different approaches.

I.C.5. IN SUM.

From USAID's perspective, the ideal microenterprise development program is one that translates a given level of USAID support into improved income-earning prospects and other tangible benefits for large and growing numbers of microentrepreneurs. Moreover, the program operates on a financially and institutionally sustainable basis, allowing it to continue providing its services indefinitely without further reliance on support from USAID or other donors. Finally, the ideal program excels in achieving broad outreach (large scale) or deep outreach (service to the very poor), and preferably both. In practice, some tradeoffs may be necessary among these measures of success, while others tend to be mutually reinforcing.

Guidance for Mission support to organizations providing direct services to microenterprises is based upon these principles. The following sections lay out separate guidance for support to organizations providing only financial services, for those providing only non-financial services, and for those providing a mix of financial and non-financial services. In each case, the guidance works back from standards of organizational success to guidelines on structuring USAID assistance so as to improve the prospects that assisted organizations will meet these standards. It then suggests principles for identifying implementing organizations likely to make effective use of USAID assistance and meet the indicated performance standards. Finally, the guidance specifies, for assistance to each type of organization, (1) data requirements needed to measure and guide organizational performance and (2) the division of responsibility between Missions and central technical offices for measuring the results of USAID microenterprise development efforts.

Section II: Guidance for Assistance to Organizations Providing Only Financial Services

Traditional financial techniques make it unprofitable for most mainstream financial institutions in developing countries to provide the kinds of financial services needed by microentrepreneurs and other poor people: small working-capital loans, convenient facilities for small savings balances, etc. This situation reflects both economies of scale in making loans and servicing deposits and reliance on collateral to ensure loan repayment. Interest rate ceilings, where present, further reduce bankers' interest in offering small loans at high unit cost. As a result, poor people in most developing countries have to rely upon moneylenders, pawnbrokers, and other sources of informal financial services, who typically offer only a limited range of services (very short-term, very small loans; no savings facilities), enjoy little integration across geographic regions or with other segments of the financial system, and — partly as a result of these latter limitations — charge very high interest rates on loans.

Microfinance institutions (MFIs) — many the outgrowth of donor or NGO microfinance development efforts — work to correct this situation, offering financial services designed to fit the requirements of microentrepreneurs and other poor people. For example, small loans can help microentrepreneurs take advantage of quantity discounts on their inputs, invest in equipment or facilities to enlarge their sales potential, or cushion the impact of temporary economic setbacks on family consumption. Access to safe and convenient savings deposit facilities can benefit even larger numbers of microentrepreneurs and other poor people, helping them accumulate savings to cover future shortfalls in income, purchase household durable goods, or undertake investments such as education. Access to appropriate financial services may be sufficient to allow some microenterprises to grow substantially, eventually emerging as formal small or medium firms; in these cases, significant growth in employment may result. In other cases, the impact is to allow poor microentrepreneurs to utilize their own and their family's labor more effectively, and to earn a better living as a result.

As previously emphasized, USAID imposes no direct restrictions on the types of organizations or program approaches eligible for its support; performance is what counts. In the case of microfinance programs, recent research highlights a specific and widely applicable standard for assessing program performance. The key finding is that, with very few exceptions, microfinance programs that have vigorously pursued and successfully attained *full financial sustainability* — profitability — while maintaining their focus on the target population of poor microentrepreneurs have achieved far greater outreach than programs that have provided subsidized credit and relied on continuing donor support to make up the resulting losses.[10] Likewise, financial sustainability provides the basis for institutional viability and continuing program growth. In each of these respects, the pursuit of financial sustainability provides the means to ends lying at the core of USAID's support for microenterprise development, helping maximize the results achieved with that support.

Based on these findings, this guidance requires that, to be eligible for USAID assistance, *every* organization providing financial services must provide a credible commitment to attain full financial

[10] See, e.g., *Maximizing the Outreach of Microenterprise Finance: The Emerging Lessons of Successful Programs*, by Robert Peck Christen, Elisabeth Rhyne, and Robert C. Vogel. September 1994. *Full financial sustainability* and *profitability* mean the same thing, i.e. that revenues from interest and fees cover all of a program's financial and operational costs. The accounting methods needed to calculate the profitability of a donor-assisted financial institution differ somewhat from those applied to private financial institutions, because of the need to properly account for the value of grants or low-interest loans provided by donors. These issues are summarized in Section II C and spelled out in detail in the Annex.

sustainability in the medium term, while using USAID assistance to expand the availability of financial services to microentrepreneurs and other poor people.[11] Attaining financial sustainability will invariably require reaching a significant scale of program outreach, and will in turn provide the basis for continued growth in outreach. USAID assistance will generally involve technical assistance to help the organization adopt "best practice" in its operations, including the implementation of an effective management information system (MIS). Where necessary and appropriate, financial support may be provided to help the organization reach a sustainable scale. Organizations that are either unable or unwilling to offer a credible commitment to attain these goals are ineligible to receive USAID microenterprise development assistance.

To date, most efforts to provide financial services to microentrepreneurs have been undertaken by organizations specifically created for that purpose, including many founded by NGOs. Much of what follows reflects this pattern by focusing on means to help such programs grow through the pursuit of financial sustainability. An alternative approach starts from the opposite direction — encouraging existing, for-profit financial institutions to establish windows to pursue the microenterprise market. In this latter case, the relevant challenge lies in finding cost-effective, market-based, and sustainable means to encourage a focus on microenterprises. USAID encourages experimentation with both approaches. The former builds on existing willingness to reach the poor, while the latter has the potential for significant outreach, provided that institutional partners with a genuine interest in reaching micro-level clients can be identified. Section II.G.2.c. considers these issues further.

[11]This requirement, spelled out in detail in section II.C., also applies to the financial operations of organizations providing both financial services and non financial assistance. See section IV.

II.A. MAINTAINING PROGRAM FOCUS ON TARGET POPULATION.

USAID support for any microenterprise development program requires a clear and continuing focus on providing services to poor microentrepreneurs. Maintaining such a target-group focus generally requires both operational mechanisms and organizational commitment. Effective operational mechanisms for targeting the poor include (1) services tailored to meet the specific requirements of poor microentrepreneurs; and (2) elimination of subsidies, that is, charging prices (e.g., interest rates) that cover the full costs of the services provided. Eliminating subsidies helps combat the strong tendency for subsidized services to "leak" to the non-poor, in response to their influence and/or ability to pay bribes.

II.A.1. TARGETING THE POOR THROUGH PROVISION OF SMALL LOANS/ACCEPTANCE OF SMALL DEPOSITS.

Almost all microfinance programs use *small loan size* as a key mechanism to target the poor. The underlying assumption is that the smaller the loan, the poorer the set of people willing to go through the loan application process; fewer poor people are presumed to have access to larger loans. USAID central technical offices will carry out field work to provide further empirical support for the assumed correlation

between loan size and the economic status of borrowers (see Section II.E.2.b.) Pending the outcome of this research, USAID provisionally accepts loan size as an adequate targeting mechanism, at least in the case of loans offered on an unsubsidized basis — that is, at interest rates that cover the full long-run costs of providing them.[12]

USAID does not impose a rigid upper limit on the size of loans that qualify as microenterprise lending; rather, organizations that operate credit programs should be expected to carry out market research to determine the range of loan sizes needed to motivate loan demand from the target population.[13] The Annex requires that assisted organizations collect and report specified information on the size distribution of their loan portfolios, to allow average and median (typical) loan size to be estimated and tracked over time. Similar reporting requirements apply to savings accounts, where offered: savings facilities offering very small minimum balances, liquidity, convenient location, and other features useful to the poor can help attract a set of savers will little or no access to alternative savings facilities, making this an additional means to target the poor.

[12]See section II.G.2.b for further discussion on interest rates.

[13]In particular, note that the loans provided by MFIs in middle-income countries, such as the Newly Independent States (NIS), will typically be larger than those used to target the poor in lower and lower-middle income developing countries.

II.A.1.**a. Poverty lending.**

Poverty lending programs comprise a subset of microfinance programs, using very small loans to reach very poor clients, often with a focus on women. Poverty lending programs are often designed specifically to overcome the cultural barriers affecting the poorest people. USAID uses a reference point of loans with an average balance less than $300 per borrower at 1994 prices as a working definition of poverty lending. Loans under this threshold will be categorically assumed to be reaching the poorest borrowers.

USAID supports the refinement and spread of poverty lending methodologies. USAID's June 1994 Microenterprise Initiative stated that USAID would devote half of its support for microenterprise programs to poverty lending programs and the poverty-lending portion of mixed programs. A program whose loan portfolio includes a large volume of poverty loans, while achieving the other measures of organizational success spelled out below, will be regarded as particularly successful.

II.A.2. TARGETING THE POOR THROUGH RELIANCE ON COLLATERAL SUBSTITUTES.

Most poor people — including most microentrepreneurs — lack the kind of marketable collateral necessary to obtain traditional bank loans. Instead, most microfinance institutions (MFIs) rely upon some form of collateral substitute to ensure repayment of loans to poor borrowers. Collateral substitutes generally fall into one of two categories:

(1) *Group lending.* Borrowers form (or are assigned to) groups, all of whose members must maintain a satisfactory payment record for any group member to be eligible for future loans; or

(2) *Character and/or experience-based individual loans.* Typically, the initial loan requires a character reference from a village chief or other person with a stake in maintaining a reputation for probity and sound judgment. Initial loans are very small, but access to gradually increasing loans is assured as long as the borrower maintains a satisfactory repayment record.

Serious issues exist about the relative merits of these different approaches, and this guidance imposes no preference for one over the other. However, reliance upon some form of collateral substitute provides an important means for MFIs to ensure that the poor have access to their services. As a result, a Mission considering providing assistance to a financial institution that does not rely upon a collateral substitute should seek additional evidence that the institution is actually reaching poor customers.

II.A.3. ORGANIZATIONAL COMMITMENT.

Along with appropriately designed services, an ongoing organizational commitment to provide those services *to the poor* is necessary to ensure that USAID support ultimately leads to a greater flow of financial services (or any other services) to the target population. Without such commitment, MFIs may fall prey to the temptation to abandon the original target population and focus attention upon less disadvantaged clients who are easier to reach using more traditional financial practices. Nevertheless, while an organization's commitment to the poor is *necessary* for it to receive USAID support, such commitment should never be treated as a *sufficient* condition for eligibility. No degree of commitment can make up for a lack of organizational competence and other ingredients of program effectiveness.

USAID's concern is that organizations receiving its support maintain an effective commitment to include the poor in their service delivery, not that they exclude other groups. For example, a private bank might open a specialized window to provide financial services to microenterprises, while continuing to deal with non-poor customers using traditional banking procedures. This kind of organizational diversification offers many advantages, and USAID encourages it. Nevertheless, in all cases the success of USAID microenterprise development support to any microfinance institution will be judged upon its success in improving the availability of financial services *to poor microentrepreneurs, particularly poor female microentrepreneurs.*

As measures of ex-post success in maintaining program focus upon the poor, women, and other target groups, the indicators specified in section A of the Annex should provide adequate information.

II.B. PROVIDING FINANCIAL SERVICES VALUED BY MICROENTREPRENEURS.

The second measure of micro-finance program success is that it provide financial services valued by its poor clients.

II.B.1. CREDIT.

Two key features aimed at meeting the credit needs of microentrepreneurs have already been mentioned: the availability of small loans and reliance upon collateral substitutes. Other loan characteristics that microentrepreneurs typically value include:

(1) reliable access to future loans based on satisfactory repayment of previous loans;

(2) availability of terms that match the enterprise's expenditure patterns and need for working capital — typically short loan terms;

(3) quick turn-around on loan approvals and a transparent approval process;

(4) minimum transactions cost or "hassle," including local availability, simple application procedures, etc; and

(5) few restrictions on use of funds.

Successful MFIs recognize that most microentrepreneurs' household and business finances are intertwined, and that efforts to restrict their use of funds to specified business purposes are typically futile and counterproductive. Similarly, successful MFIs have learned that project analysis — a key step in lending to larger enterprises — imposes prohibitive costs and delays upon microenterprise lending, and have found effective substitutes for it.

II.B.2. DEPOSIT SERVICES.

The evidence demonstrates the value that microentrepreneurs and other poor people place on safe, convenient, and liquid deposit facilities for their small savings balances, and many MFIs have developed deposit services to address this need and as a source of finance for their lending operations. The value of savings deposit services offered by many MFIs is likewise affected by the attention paid to convenience, liquidity, security, and acceptable rates of return. Convenience is enhanced through location and hours that minimize the costs of making deposits and withdrawals, and by low minimum balance requirements. Liquidity is reflected in the ability of savers to withdraw their balances on demand. Security is obviously critical, subjecting most efforts to mobilize deposits from the general public to official supervision and regulation and raising serious technical issues addressed separately in Sections I.C.1.a and II.F.

The security, liquidity, and convenience of deposit services provide savers with part of the return to their savings, the remainder being provided in the form of interest. Real deposit interest rates must be competitive with alternative savings opportunities to attract deposits, but the higher unit costs of providing deposit services to poor savers tend to keep the interest rates paid on these deposits significantly below those available to non-poor savers maintaining substantial minimum balances in urban banks. The scope for paying higher deposit rates will depend on the MFI's efficiency in operating its savings program.

These general principles apply to all micro-finance programs. However, in practice the success of any MFI will depend heavily on the effort it puts into fine-tuning its credit and deposit services to fit the particular requirements of the poor people who comprise its potential market, based on careful, well-designed, and continuing market research.

II.B.3. MARKET TEST OF THE VALUE OF SERVICES.

Poor people's willingness to pay for services provides a direct indication of the value they place on those services. Credit programs which cover their full opportunity costs through interest payments and fees paid by borrowers can make a strong claim that the value of the services they offer fully covers the costs of providing those services; similar claims for programs that rely upon continuing donor subsidies are much more speculative. Likewise, the ability of a program to attract a growing volume of voluntary savings deposits clearly demonstrates that its depositors find its deposit services attractive compared with available alternatives. The fact that financially sustainable MFIs satisfy this "market test" is one among several reasons that USAID requires a credible commitment to the attainment of financial sustainability as a condition for all assistance to microfinance institutions.

II.C.
FINANCIAL SUSTAINABILITY AND OUTREACH.

A *financially sustainable* program is one that collects sufficient revenues to cover the *full opportunity* cost of its activities.[14] Such a program can continue operating indefinitely at a stable or growing scale, without further support from governments, donor agencies, or charitable organizations. Instead, growth in the program's lending and/or other services can be funded on a commercial basis: through reinvestment of profits, loans from commercial banks, equity from private investors, or — in the case of licensed financial institutions — through the mobilization of deposits. For a microfinance program, financial sustainability requires that income from interest and fees charged to borrowers cover (1) the program's operational costs, including salaries and other costs of administration (whether paid by the MFI or received as a donation), depreciation of fixed assets, and losses due to default; plus (2) its financial costs, including both the costs of raising funds through deposits or commercial loans *and* the opportunity cost (including inflation) of any grants or low-interest loans previously provided by donors.[15] A program whose revenues cover its operational costs but not its financial costs has attained *operational self-sufficiency*, a useful interim standard of financial performance.

To paraphrase the principle stated in section I.C.5, the ideal USAID microfinance program is one that translates a given level of USAID support to achieve a sustainable improvement in the availability of financial services to large and growing numbers of microentrepreneurs, including female microentrepreneurs and the very poor. The research cited at the outset of this section strongly suggests that using USAID assistance to encourage the provision of microfinance services on a financially sustainable basis is a far more cost-effective strategy for achieving this goal than an approach that supports the provision of subsidized credit.[16] Although high inflation and certain other conditions can make it harder to reach financial sustainability, that performance goal has been reached in a wide range of economic conditions and social settings. Vigorous pursuit of financial sustainability has helped several MFIs achieve

[14]Opportunity costs differ from accounting or out-of-pocket costs by recognizing the value of all resources used in alternative uses — roughly speaking, their market value. In the context of microfinance, this distinction is important to ensure that the value of funds received through grants or low-interest loans is properly accounted for. The next footnote illustrates this point.

[15]In practice, this opportunity cost adjustment requires adding a cost element equal to the difference between what the MFI actually pays for funds provided by donors or other non-market sources, and what it would have to pay if required to raise the same funds through deposits. For a $1 million donor loan at 2% per year to an MFI in a country where deposit rates are 16%, this adjustment adds (.16-.02)*$1 million = $140,000 to the MFI's cash costs. For a $1 million grant, the adjustment would be (.16-0)*$1 million = $160,000. These adjustments can be very significant for MFIs that depend heavily on donor support.

[16]Christen, Rhyne, and Vogel, *ibid.*

strong and continuing growth in their loan portfolios, reaching hundreds of thousands or even millions of active borrowers. Moreover, these same institutions have also achieved considerable success in the area of deep outreach — providing credit and savings opportunities to large numbers of the very poor. The rapid growth in demand for small loans at fully cost-covering interest rates, with repayment rates as high or higher than those in formal financial markets, suggests that most poor people value continued, reliable *access* to credit and other financial services more highly than interest rate subsidies on a few short-term loans.

> Based on this evidence, this guidance imposes the following requirement:
> Before the Mission signs an agreement to provide assistance to any microfinance institution,the management of the institution must provide the Mission with a credible written commitment to (1) attain full financial sustainability on the MFI's financial service activities within no more than seven years of the initial provision of USAID assistance and (2) use USAID assistance to expand the availability of financial services to microentrepreneurs and other poor people. This commitment must be accompanied by a plan outlining the major steps to be undertaken in the process of achieving this goal, including a realistic timetable for undertaking those steps, and defining periodic benchmarks by which progress toward the goal can be determined.

To reiterate, USAID views financial sustainability not as an end in itself, but as a means to attain large-scale, growing, and sustainable program benefits to poor microentrepreneurs. Financial sustainability is to be pursued in the context of a continuing focus on the poor.

The Mission is responsible for assessing both the organization's commitment to the twin goals of financial sustainability and outreach to the poor, as well as the plausibility of its plan for reaching those goals, availing itself of such support as necessary from responsible USAID/W technical offices.

Several aspects of the preceding requirement require further specification. First, for purposes of satisfying this requirement, *full financial sustainability* refers to the attainment of an adjusted return on operations of 1 or greater, based on the accounting framework laid out in the Annex.[17] Second, seven years should be regarded as the *maximum* to be allowed for reaching financial sustainability, not a target: a program whose current operational and financial situation allows it to attain this goal more rapidly should be strongly encouraged to do so, and the benchmarks used to assess performance and to trigger disbursement of USAID assistance adjusted accordingly. Third, for purposes of this guidance *financial services* encompasses the provision of loans, deposit services, and/or payments services (such as check-cashing or the sale of money orders). Finally, for any program providing both financial assistance and non-financial services, the two sides of the program should be disentangled, and the financial sustainability standard applied to the financial operations side; see Section IV for further discussion of this point.

[17] Alternative measures of financial sustainability — such as net profit, return on assets, and subsidy dependence — can be calculated from the information included in the Annex. Reliance on a particular standard measure of financial sustainability is specified to reduce ambiguity and to ensure comparability across programs.

The *process* of achieving financial sustainability is a technical matter beyond the scope of this guidance. However, MFIs that have reached this goal have generally passed through three stages of development:

Stage 1: The MFI develops a set of financial services that clients demand, along the lines outlined in sections II.B.1. and II.B.2; develops and fine-tunes methods for delivering those services at minimum cost, including both administrative/operational costs and those due to default and/or delayed repayment; and sets interest rates that cover its full expected long-run costs.

Stage 2: The MFI focuses on scaling up its program, and develops the management tools necessary to do so, in areas such as financial management, staff recruitment, training, and information flows. As it progresses through this stage, the MFI may increasingly gain access to commercial bank loans to fund the expansion of its loan portfolio.

Stage 3: The MFI's financial performance improves to the point where it can fully rely upon private sector sources — savings deposits, loans from commercial banks or other financial intermediaries, or both — to support further expansion of its lending activities. In most countries, an MFI must qualify as a full-fledged, licensed financial institution in order to begin mobilizing deposits.

Success in stage 1 typically yields an operationally self-sufficient microfinance program, with a high ratio of clients to staff as well as good control of delinquency and default. The program's growing scale under stage 2 leads to continuing improvements in overall efficiency, as its fixed costs are spread over an ever-larger volume of transactions. Finally, success in stage 3 results in full financial self-sufficiency. At this point, the program no longer needs to depend on further support from USAID or other donors: it can operate on a fully commercial basis, offering investors a return on equity equal to that available elsewhere in the private sector. The profits earned by such an institution can finance further expansion of its lending portfolio, as well as attracting additional equity investment from outside investors. Likewise, those profits encourage other private sector investors to enter the same market in search of the same levels of profitability.

II.D.
OPERATIONAL EFFICIENCY.

The operational efficiency of a microfinance program — its success in holding down administrative costs, plus any losses from bad loans — strongly affects its overall financial performance and its prospects for reaching financial sustainability. Attainable levels of operational efficiency differ according to local circumstances, the methodology pursued by the MFI, and the target group. Nevertheless, for a program to be considered operationally efficient, its annual non-financial costs should be no more than 30 percent of the average value of its loan portfolio after a start-up period of roughly three years. This level should allow programs reaching very poor clients in difficult settings. The cost elements included in this calculation are specified in the Annex.

II.E.

EXPECTED PROGRAM RESULTS, MFI PERFORMANCE, AND REPORTING RESPONSIBILITIES.

II.E.1. EXPECTED PROGRAM RESULTS.

USAID assistance to microfinance institutions is expected to produce the following chain of results:

- the emergence of financially and institutionally sustainable MFIs both capable of and committed to serving the needs of poor microentrepreneurs, leading to
- a sustained expansion in the range, and improvement in the quality of key financial services available to poor microentrepreneurs, and/or a permanent reduction in the price of such services, contributing to
- increased incomes among the microentrepreneurs utilizing those services and their employees, and
- improved household welfare among the families of microentrepreneurs and microenterprise workers.

The extent to which these results are realized will depend on a wide variety of circumstances, only some of which are under the control of any given USAID-assisted MFI. For example, the degree to which the price, quality, and range of services offered by an MFI represent improvements on existing alternatives will partly reflect its own efforts, but will also depend heavily on the competitiveness and level of development of the local informal financial system. Likewise, how much of a difference the availability of improved financial services makes to microentrepreneurs will depend on the severity of all the other constraints they face, matters almost entirely beyond the control of MFIs. Similarly, where improved access to finance does result in increased income for microentrepreneurs, the ultimate impact on household welfare will depend on complex interactions within those households, which may differ from one society to another.

Finally, it must be recognized that the emergence of new sources of financial services will produce losers as well as winners. Traditional sources of financial services may be put at a disadvantage by these developments, reducing their profits and forcing some into other lines of business. This last point reinforces the importance of focusing USAID support on organizations that can be confidently expected to become fully sustainable.

II.E.2. RESPONSIBILITIES FOR REPORTING RESULTS.

The realities of microenterprise finance make it necessary to divide the responsibility for monitoring and reporting results between Missions providing assistance to microfinance organizations and USAID/W technical offices:

II.E.2.**a. Missions.**[18]

Every Mission providing assistance to any organization that offers financial services to microenterprises will be held responsible for monitoring and reporting on two aspects of the results of that assistance: (1) the breadth and depth of the organization's outreach to the poor, as reflected in the size distribution of its loan portfolio (and of its deposit liabilities, where relevant) and the proportion of women among its clients; and (2) the organization's performance as a financial institution, including its progress toward financial sustainability and its operational efficiency. Performance in these two areas will be assessed on the basis of the indicators summarized in the following two sections and detailed in the Annex. These indicators, in turn, are based on information provided by assisted organizations.

USAID officers managing microfinance assistance activities are expected to use these results indicators to track the performance of assisted organizations and to indicate the necessity for intervention if their performance lags. It is incumbent upon these activity managers to verify that assisted institutions are able to supply accurate information. In some cases, improvements in the assisted organization's management information system (MIS) may be necessary to ensure accurate reporting. In such cases, Missions should consider supporting such MIS improvements as part of their assistance package. Finally, Missions may be required to provide additional data as necessary to allow USAID to inform Congress and the public about the Agency's microenterprise development activities.

[18]These same responsibilities will lie with any USAID/Washington unit providing financial support to MFIs directly (i.e., other than through OYB transfers to Missions.)

II.E.2.**b. USAID/W.**

Meanwhile, USAID/W technical offices will carry out research on the direct and indirect impacts of microfinance development efforts that extend beyond the doors of the sponsored financial institutions themselves: These include (1) the extent to which the financial services offered by USAID-sponsored micro-financial institutions represent improvements relative to existing sources of finance available to microentrepreneurs, in terms of types of financial services available, service quality, and price (interest rate); (2) the direct impact of improved access to financial services on microenterprise performance as well as on living conditions within the families of microentrepreneurs and microenterprise workers; (3) the impact of the emergence of new sources of financial services on the local financial system, including changes in the availability and price of financial services offered by informal sources; and (4) empirical evidence on the assumption that loan size is a reliable tool for targeting poorer borrowers. In contrast to the results reporting requirements assigned to Missions, USAID expects these latter efforts to be undertaken on a sample basis, with a view toward strengthening the basis for assessing the *overall* impact of micro-finance development efforts, including, to the extent possible, their impact relative to alternative ways of using the same level of resources.

II.E.3. INFORMATION REPORTING REQUIREMENT FOR USAID-ASSISTED MFIS.

To ensure that Missions have the necessary information on which to base their results reporting and their disbursement decisions, USAID imposes the following requirement:

Every agreement to provide USAID assistance to any microfinance institution must include requirement that the assisted organization provide USAID, on an annual basis, with a report of its financial and operational performance and outreach which includes all of the indicators specified in Sections A-D of the Annex. This requirement applies whether or not the assisted organization regards financial services as the primary focus of its program.

II.E.3.**a. Indicators of outreach and focus on target population.**

The size distribution of loans and savings deposits and the proportion of female clients provide basic evidence of a microfinance program's outreach and target orientation. Section A of the Annex includes several indicators of outreach. Average (mean) loan size can be calculated from the overall value of the program's loan portfolio (i.e., total unpaid balance on outstanding loans, indicator 1) and the total number of loans (indicator 2). The size of the median (typical) loan is revealed by sorting outstanding loans into quartiles by size (indicator 3) and reporting the largest loan balance in the second quartile; the median loan can differ substantially from the mean in situations where a few large loans pull up the mean. Total small saver deposits and the number of such accounts (indicators 8 and 9) permit the mean deposit account to be calculated. Finally, the percentage of female borrowers (or clients, as appropriate to the program) provides a rough measure of outreach to women.

Missions should carefully monitor these measures for evidence of the MFI's breadth of outreach (numbers of poor people affected); depth of outreach (numbers of the very poor affected); and inclusion of women. In addition to these standardized data, the Mission should occasionally revalidate its initial assessment of the organization's commitment to targeting the poor, based on such circumstantial evidence as the neighborhoods where it offers its services; reliance upon collateral substitutes; etc. Missions should not encourage assisted organizations to use means-testing of potential clients or to attempt to track the specific uses to which they put borrowed funds. Likewise, Missions should *not* require assisted organizations to report on the nature of the microenterprise activities that their clients undertake.

Financial institutions serving both poor and non-poor clients should base their reporting of the required indicators of portfolio and outreach (Annex Section A) on their activities focused on microentrepreneurs and other poor clients.

II.E.3.**b. Indicators of MFI financial and operational performance.**

Sections B-D of the Annex specify indicators of interest rate policy and of financial and operational performance that must be reported by every USAID-assisted institution providing financial services to microentrepreneurs or other poor clients. These comprise the minimum set necessary to allow USAID (and the MFI itself) to obtain a basic picture of the institution's financial performance and operational efficiency.

Financial institutions serving both poor and non-poor clients may report the indicators in Sections C and D based on their overall financial portfolio, and may draw this information from their standard

financial reporting documents. However, the information reported under Section B should in all cases relate specifically to interest rate policy on loans targeted toward poor clients and on savings deposit services focused on the poor.

II.E.4. USE OF MFI PERFORMANCE INFORMATION.

The information reported under Annex Sections A-E provides the basis for a set of analytic performance indicators described in Annex Section F.[19] Taken together, these indicators allow an assisted organization's performance to be tracked both over time and compared with other organizations. USAID officers charged with managing the assistance activity are expected to use these indicators — particularly the outreach indicators in Annex Section A and the analytical performance indicators in Annex Section F — to track the assisted organization's performance relative to the goals negotiated with the Mission, and to consider these elements of performance in disbursement decisions.

[19]Mission should reach agreement with MFI management as to who will take responsibility for tracking the indicators of the opportunity cost of funds (Annex Section E).

Although this guidance requires annual reporting *to USAID* as a minimum standard, a much more important issue is the MFI's own use of financial and operational performance data. To perform effectively, *every* financial institution — regardless of size or market niche — must gather information on key aspects of its financial and operational performance on a more or less continuous basis; skillfully analyze that information; and use the results of that analysis to make appropriate adjustments in its operations. Good financial reporting is also indispensable for any organization to gain access to non-donor sources of funding, either through raising deposits (which will require that it provide such information to local banking supervisors) or through borrowing from banks (which will require evidence of the organization's financial performance). Mission staff should pay close attention to (1) the effort the organization puts into gathering financial and operational performance data and (2) the extent to which it uses those data in its decision making, and must consider these factors in its decisions regarding disbursement of USAID assistance to MFIs. Likewise, Missions should encourage MFI management to use analytical performance indicators like those in Annex Section F to obtain a clearer picture of the organization's performance, and should consider the desirability of supporting training and/or other improvements in the organization's MIS capabilities necessary to help them do so.

II.F. POLICY TOWARD SAVINGS DEPOSIT SERVICES.

The balance between the benefits and risks of offering deposit services is one of the most difficult and controversial issues in micro-financial development. Some of the benefits have already been emphasized in this guidance: for poor savers, a much more attractive savings vehicle than otherwise available; for microfinance institutions, a means to fund further expansion in lending while reducing reliance upon donor support. Mobilizing savings offers further important benefits to an MFI: it establishes

the program as a full-fledged financial intermediary rooted in the community and not just a conduit of external funds. Mobilizing savings from among the community of borrowers can also enhance loan repayment: when borrowers see their neighbors and relatives as the ultimate source of their loans, they may have more incentive to repay than if the credit comes directly from an external donor. Savings can also act as implicit collateral on loans and provide valuable information for screening out poor credit risks. Those without the discipline to save, even in modest amounts, may lack the discipline both to succeed as entrepreneurs and to repay loans.

At the same time, accepting savings also puts a heavy responsibility on the microfinance program. Poor depositors stand to lose their vital savings if the MFI fails due to poor management decisions or simple bad luck — a risk that is magnified in direct proportion to the MFI's success in leveraging its capital into a larger volume of loans through borrowing or mobilizing deposits.[20] As a result, Missions should discourage assisted organizations — particularly NGO-sponsored credit programs — from mobilizing savings from the general public until they have accumulated considerable experience and skill in the management of a credit program.[21] Rather, such organizations should be encouraged to fund their initial drive toward financial sustainability through loans from commercial banks or other financial institutions. A partial USAID guarantee may be provided to help an MFI obtain access to such lending, under conditions spelled out in separate guidance.

[20]These risks apply whenever an institution raises funds through voluntary savings. Some micro-finance programs require involuntary savings accounts as conditions for receiving loans. Forced savings eliminate many of the risks connected with voluntary savings, but also many of the benefits as well: forced savings may be construed as authoritarian, paternalistic, and lacking economic benefit. Forced savings also raise the effective cost of borrowing and make the cost of credit difficult for borrowers to assess.

[21]Note that this concern does not apply to savings mobilized solely among an organization's own members, such as credit union shares and savings deposits required as a condition for access to loans (forced savings).

II.F.1. FINANCIAL REGULATION AND SUPERVISION.

In addition to verifying the financial management capabilities of an organization seeking USAID support for a program that mobilizes savings to fund its lending operations, the Mission should also verify that either (1) the existing institutional and legal framework for the prudential regulation and supervision of financial institutions is adequate to handle the special issues raised by microfinance institutions, or (2) the government is willing and able to make the necessary improvements in the framework in time for the initiation of savings mobilization. If neither of these conditions is satisfied, only plans involving borrowing from other financial institutions should be considered. Missions should carefully avoid contributing to a situation in which poor people's savings are placed at risk through inadequate prudential regulation and supervision. The failure of either or both of these conditions may indicate an opportunity for the Mission in the area of policy dialogue and/or training of bank supervisory staff.

II.G. IDENTIFYING PROMISING OPPORTUNITIES FOR USAID ASSISTANCE.

The preceding sections intentionally set high performance standards for organizations offering microfinance services to be eligible for USAID assistance. Missions considering providing such assistance must carefully consider both the country economic environment and the characteristics of potential partner organizations to ensure that these performance standards are likely to be met.

All of the country and organizational conditions identified in this section should be satisfied for the Mission to provide any microfinance institution with the full range of USAID assistance, including capital contributions to bolster the MFI's loan program. In cases where the specified country conditions are not currently satisfied but the Mission judges that they are likely to be satisfied in the foreseeable future (e.g., a transitional period of high inflation reflecting exchange rate adjustment or price decontrol), the Mission may provide such technical and/or commodity assistance as it deems appropriate to programs that meet the indicated organizational conditions. However, no capital contributions should be provided in such cases. In all other cases — where potential partner organizations fail to satisfy the indicated threshold conditions, or where country conditions are not judged likely to satisfy the necessary conditions in the foreseeable future — USAID assistance should be limited to advice, literature, and other such low-cost technical assistance to help organizations and host country officials understand the rationale behind USAID's approach to microenterprise finance and the preconditions for USAID assistance.

[22]As noted in I.C.1.a, higher rates of inflation also appear to suppress client demand for loans at a given real interest rate, and can thus pose a constraint upon program growth.

II.G.1. COUNTRY ISSUES.

At the most general level, the benefits that microentrepreneurs are likely to gain from improved access to financial services will depend on the extent to which the overall economic environment is conducive to growth. The more severely the prospects for growth and sustained poverty reduction are constrained by poor overall policies or other factors, the stronger is the rationale for using USAID resources to confront those constraints directly, either prior to or alongside the provision of support to microenterprise development organizations. Missions must also consider specific aspects of the country policy environment to ensure that they will not undermine the success of assisted organizations:

II.G.1.a. Interest rate policy.

A microfinance program's ability to achieve financial sustainability depends critically on its ability and willingness to set interest rates and fees on loans high enough to cover all of its program costs. The host country government must provide full and effective freedom for assisted MFIs to set lending rates and fees at full-cost-covering levels. Depending on the context, a formal waiver from existing interest rate ceilings may or may not be necessary to provide the required latitude: practice is what counts. Conversely, even a formal waiver may not be sufficient: a program operating under a waiver within an otherwise repressed financial sector may be subject to pressure to keep its interest rates below full cost-recovery levels to avoid being seen as "exploitative." Before signing an agreement to provide assistance to any MFI, the Mission must determine that the institution has full and effective latitude to set interest rates and fees at full-cost-covering levels.

II.G.1.b. Inflation.

Rapid inflation, together with the high variability in inflation that usually accompanies it, greatly complicates the problem of setting appropriate interest rates[22] Large losses on outstanding loans and on

cash balances held in local currency can easily result. To avoid subjecting U.S. assistance to such losses, the Mission should — as a minimum standard — avoid entering into an assistance agreement involving capital contributions to support an MFI's lending program under circumstances where there is a strong likelihood that inflation will exceed 50% during any year within the life of the agreement. Likewise, Missions should not disburse such capital contributions during any year when the inflation rate is running above 50%; assistance agreements should reflect this condition. In situations where inflation is below the 50% threshold but nevertheless substantial (e.g., above 20% per year), Missions should attempt to limit any capital contributions to only those MFIs that have established a track record of adjusting lending rates and fees so as to preserve the real value of their assets.[23] Where USG and host country policy permits, the possibility of holding MFI cash balances in U.S. dollars or another hard currency should be explored as a means to protect against inflation-induced losses.

[23]Where the Mission is in a position to forecast future inflation rates rather than simply observing past trends, it should take these forecasts into consideration in its disbursement decisions.

II.G.2. ORGANIZATIONAL ISSUES.

A second, equally important set of issues surrounds the identification of organizations likely to make effective use of USAID assistance and achieve the performance standards set forth in preceding sections. Some of these issues can be resolved through a careful examination of data on the current operational and financial performance and target-group orientation of the organization in question, but the Mission will also need to make judgment calls on the organization's willingness and ability to make the changes necessary to succeed.

II.G.2.a. Control over loan delinquency and losses.

Bringing loan delinquency and losses under control — through appropriate incentives for repayment and vigorous pursuit of borrowers who fail to make timely loan payments (or fail to pay at all) — is an indispensable first step in building an effective microfinance program. As a result, before signing an agreement to provide assistance to any microfinance institution that is already providing loans, the Mission must determine the MFI has brought loan delinquency and losses under control. As a minimum standard, the MFI must document delinquency rates — percent of total portfolio in loans with payments over 90 days past due — below 10% and loan loss rates below 5% in order to qualify for USAID assistance beyond the limited technical assistance cited in section II.G.

II.G.2.b. Full-cost-recovery interest rates and fees.

Before signing an agreement to provide assistance to any MFI, the Mission must determine that the institution's management is prepared to charge interest rates and fees on loans that are high enough to cover the program's full long-run costs, on an opportunity-cost basis. Missions and program managers should clearly understand that the rates needed to cover the full costs of making small loans to microentrepreneurs will almost inevitably be *much higher* than rates available on larger loans to the non-poor. Long-run cost levels should be estimated by adjusting current cost levels to reflect *clearly feasible*

improvements in operational efficiency and economies of scale. The prospects for such improvements should be conservatively estimated, based on the experience of organizations following similar approaches under roughly similar conditions. In many cases, technical assistance will be needed in estimating long-run costs. Together with information on the likely costs of mobilizing non-donor funds and other cost factors, the lending rate necessary to allow the program to reach full financial sustainability within the expected time horizon can be estimated. USAID officers responsible for managing the assistance agreement should ensure that the MFI has raised lending rates to this level before disbursing any capital contributions to support the MFI's lending program. Moreover, the organization should commit itself to adjusting its lending rates upward as necessary should subsequent experience show that prospective costs were underestimated.

II.G.2.**c. "Commercializing" specialized MFIs vs. "downsizing" private banks.**

In designing its approach to microfinance development and in choosing among potential partner organizations, the Mission should remain sensitive to the merits and challenges of two broad approaches: (1) helping specialized MFIs reach financial sustainability and commercial scale; and (2) encouraging commercial banks and other profit-making financial intermediaries to target poor microentrepreneurs as customers.

In most cases, NGOs have played the principal role in the initial development of microfinance, establishing specialized MFIs for that purpose. Most exhibit a strong and enduring focus on the poor. However, managers and employees of some NGO-founded MFIs may find it very difficult to adapt to the changes in organizational culture necessary to attain profitability: a single-minded pursuit of growth, relentless cost-cutting efforts, strict attention to financial performance, greater reliance on technical skills, etc. Some observers argue that this adaptation requires a fundamental transformation of organizational structure to one owned by shareholders. Although growing numbers of NGO-founded MFIs appear to have successfully met these challenges, the record is too short to allow taking for granted the long-run viability of financial institutions in which no private owners are spurred to diligence by having placed large amounts of personal funds at risk. Finally, helping such an organization attain commercial scale usually requires committing scarce USAID grant funds to enable the program to expand its lending program, even though it may be operating in a setting where credit is not scarce overall, but simply inaccessible to the poor. In these respects, profit-making banks offer a variety of potential advantages, including a commercial outlook and relatively sophisticated financial skills. In addition, they are already operating on a financially sustainable basis, so that they mainly require (relatively inexpensive) technical assistance to move into microfinance, rather than large injections of grant funds. Based on these considerations, Missions should remain open to opportunities for helping profit-making financial institutions expand their range of services to meet the requirements of poor microentrepreneurs.

Despite the advantages just cited, Missions must clearly recognize the serious challenges presented by such a "downsizing" approach. First, succeeding in microfinance requires substantial adaptation of traditional financial practices used in dealing with non-poor clients, particularly the development of collateral substitutes appropriate to the economic and cultural setting in which they operate. Second, banks may need to open new branches to reach poor clients. Both steps represent investments which may not be recouped for several years. Third, depending on the cultural and political setting, bank owners may reasonably fear that operating a window lending small amounts to the poor at interest rates several times those charged on larger loans to the non-poor could expose them to a populist backlash, regardless of the advantages provided to their poor customers relative to available alternatives. Finally, in most cases market forces will exert pressure to focus upon the easiest-to-reach, least risky clients, tending to limit deep outreach. Taken together, these barriers tend to limit the circumstances under which profit-making financial institutions will actively pursue the microentrepreneurial market. Two factors likely to contribute to such a shift are (1) a clear demonstration that the local microentrepreneurial market offers opportunities for profit — typically in the form of a specialized MFI that has achieved profitability and commercial scale; and (2) a highly competitive market for financial services that forces financial institutions to search for new markets. These considerations suggest the need to encourage both NGO and private approaches to microfinance development, as well as the linkage of the policy environment in the broader financial sector to the long-term prospects for the development of microfinance.

Finally, Missions should note that opportunities to support microfinance are not necessarily limited to an either/or choice between NGO-sponsored specialized MFIs and private banks. Rather, they should be alert to opportunities to foster creative partnerships between banks and NGOs, combining the banks' financial management skills and links to broader financial markets with the NGOs' experience among, and focus upon the poor.

II.G.2.**d. Participation.**

To be effective, every microfinance program must ensure that its services are well-adapted to the particular requirements of its potential clients; systematic market research to help guide this process of adaptation is a hallmark of serious program management. In other respects, different approaches to microfinance vary greatly in the extent to which clients are expected to participate in the financial operations of the MFI: At one extreme, credit unions and village banks are operated by the clients/members themselves; at the other, several highly successful MFIs maintain an arm's-length relationship with their clients and insulate their lending decisions from direct influence by borrowers. While recognizing that clients can benefit from participation in the management and operations of microfinance programs, Missions choosing among prospective partner organizations should examine the impact of participation on their respective prospects for attaining broad and/or deep outreach, financial sustainability, and operational efficiency.

In contrast, Missions should ensure that microentrepreneurs are engaged in all phases of the design, execution, and monitoring and evaluation of their assistance activities in support of microenterprise development.

II.H. STRUCTURING ASSISTANCE TO MICROFINANCE PROGRAMS.

The USAID strategy toward enhancing access by microenterprises to appropriate financial services is to foster institutional development among organizations that directly provide those services, helping them achieve large scale and full financial sustainability through improvements in operational efficiency and economies of scale. Having reached that condition, organizations should be able to rely principally upon non-donor sources of funding to support further growth. Organizations that do not offer a strong likelihood of reaching that condition should not be assisted in the first place.

II.H.1. TYPICAL FORMS OF ASSISTANCE.

In general, USAID assistance to organizations providing microfinance services involves some combination of technical assistance, training, commodities, and/or transitional financial support. In particular,

- Technical assistance will generally be used to help organizations identify ways to improve their operational efficiency, financial management, staff practices, etc. The general aim is to help organizations adopt "best practice" in all areas of their operations, based upon the experience of organizations in other environments.
- Training can help address the scarcity of MFI managers and personnel with an understanding of best practice in microfinance.
- Commodities are likely to include computer hardware, software, and other elements of the management information system needed for financial reporting and effective control over operations.
- Transitional financial support may be needed to help an MFI reach a financially sustainable scale, or to encourage an established financial institution to broaden its operations into microfinance. Typical examples include contributions to cover operational losses during a start-up period, and/or to expand the organization's capital base and thus the potential scale of its lending operations; guarantees on loans to MFIs by commercial banks or other formal lenders; and/or partial guarantees on loans to microenterprises.

II.H.2. PERFORMANCE-BASED DISBURSEMENT.

The assistance agreement should clearly specify interim performance benchmarks over the life of the agreement, and should provide for tranched disbursements of assistance based upon the achievement of those benchmarks. Consideration for any follow-up grants should similarly be based upon performance during the grant period. Expert TA is likely to be needed in setting the interim performance standards, since the range of international experience and the peculiarities of local conditions must all be taken into account. The Mission should carefully avoid reinforcing failure, or creating the expectation that it will do so. Where performance falls short of expectations, technical assistance to diagnose and help correct problems should be relied upon rather than financial resources to cover up the failure.

II.H.3. GUARANTEES.

Partial guarantees can useful in encouraging established financial institutions to enter into microenterprise lending, by sharing in the perceived risks involved in such lending. Assistance agreements should be structured so that guarantees are phased out over a relatively short period; by the end of this period, the institution should be expected to have developed the necessary skills in microfinance, as well as a realistic estimate of the underlying risks of microenterprise lending. In the meantime, the share of any loan defaults borne by USAID should not be so great as to deter vigorous efforts at loan recovery; in no case should 100 percent guarantees be provided. More generally, Missions should avoid offering guarantees to any financial institution that has not shown a strong motivation to move into the microfinance market; risk-sharing arrangements cannot make up for a lack of such motivation on the part of the institution.

II.H.4. AVOIDING POOR PROSPECTS FOR MICROFINANCE DEVELOPMENT.

Missions and Bureaus should carefully avoid attempting to force the pace at which an assisted organization expands its volume of services above that shown to be feasible by the experience of similar organizational types in similar settings. Factors affecting the feasible rate of expansion include: the organization's initial size and level of efficiency; its ability to improve operational efficiency; the quality and stability of its governance; its ability to maintain firm control over a decentralized, growing network of branch offices; its ability to recruit, train, and motivate staff; its ability to maintain high repayment rates among a growing set of borrowers, based largely upon an appreciation of the advantages of continuing, reliable access to credit; its ability to convince commercial lenders and/or private savers that it will exercise effective stewardship over their funds; and a host of other factors. The prospects for success in many of these areas can be severely and expensively compromised by efforts to force the program to grow too fast.

For similar reasons, microfinance development efforts should *not* be viewed as an early response to alleviate the large-scale human suffering created by wars, civil conflict, natural disasters, etc.

Opportunities for successful microfinance development may present themselves among populations affected by such crises, particularly once social conditions have calmed down and normal economic activity has begun to re-emerge. Nevertheless, such opportunities must be carefully evaluated against the same standards of policy environment and institutional promise discussed elsewhere in this guidance. It is critically important that Missions and Bureaus anticipate and resist pressures to establish and/or scale up credit programs quickly under such circumstances, in an attempt to use microloans as a form of emergency assistance. Bowing to these pressures will inevitably conflict with the basic requirements of building a sound financial institution: careful selection of borrowers with strong prospects for repayment, building a reputation for taking timely repayment seriously, building managerial and staff capabilities to handle the increasingly complex demands of a growing program, etc. Ignoring these requirements in the interest of "moving the money" can easily do lasting damage to the prospects for establishing healthy, sustainable financial institutions both willing and able to serve the poor.

Likewise, Missions should not condition their support of MFIs on expansion into particular "under-served" geographic regions. Many MFIs have paid a heavy price for ill-advised or untimely geographic expansion prompted by the lure of donor funding.

Section 3: Guidance for Support to Organizations Providing Non-Financial Assistance

Most studies of the microenterprise sector stress the importance of non-financial constraints on the growth and prosperity of microenterprises. For many or even most active microentrepreneurs, weak business management and marketing skills and/or limited knowledge of production techniques and market opportunities pose more serious barriers to growth than a lack of finance. In addition, many poor people who might benefit from undertaking microentrepreneurial activities lack the basic skills to get started.

Many microenterprise development programs offer a variety of non-financial services to help microentrepreneurs (and potential microentrepreneurs) overcome such non-financial constraints. They provide training and technical assistance in business management and production skills, as well as help in identifying and developing markets. Training and technical assistance, in turn, range from the most basic help in setting up a new business to training in improved production methods to more sophisticated help in making the transition to small business status; effective organizations take pains to tailor the content of their training/TA to the requirements of their clients. Other organizations work at a systems level rather with individual microentrepreneurs, developing marketing channels, improving technologies, and the like. Finally, some organizations lobby for improvements in the policy environment in which microenterprises operate. Few programs provide only non-financial services; most provide them along with credit, some independently, others as components of a fixed package of services. Nevertheless, this section isolates non-financial assistance for the sake of clarity. As the following section emphasizes, the guidance provided here fully applies to the non-financial operations of mixed programs.

USAID officers should note carefully that, in general, evaluation has not established a high level of cost-effectiveness among non-financial interventions for microenterprises, given currently available methodologies, although there may be some promising models that deserve further investigation. As a result, Missions should exercise caution in supporting such activities, funding them on an experimental basis and ensuring that USAID assistance is linked to a monitoring and evaluation framework sufficient to provide a clear basis for judging whether the benefits achieved through such activities outweigh their costs.

III.A.
EXPECTED RESULTS.

USAID assists organizations providing non-financial assistance to microentrepreneurs in order to achieve a chain of results that closely parallels that set forth in section II.E for microfinance programs. The only differences lie in the first two links. In the present case, USAID assistance is expected to achieve:

- increased outreach and improved cost-effectiveness of involved in non-financial assistance to microentrepreneurs, whether through direct or system-level inventions; leading to
- sales and productivity among microenterprises.

Just as in the case of financial services, these links are expected to result in increased incomes and improved household welfare among microentrepreneurs. Overall results will be a function of the number of clients affected and the resulting changes in enterprise performance and, ultimately, in household incomes and welfare. All other factors held equal, improvements in income and welfare will be viewed as more valuable to the extent they accrue to poorer households.

The critical difference between these results and those expected from assistance to microfinance programs lies in expectations regarding program sustainability and the associated standards for program success. Experience as of this writing gives no basis for expecting most programs to recover the full costs of providing non-financial services from their clients/beneficiaries. Rather, with a few exceptions the general pattern has involved greater or lesser degrees of partial cost recovery, with remaining costs covered by subsidies from donors, governments, and/or NGOs/PVOs.

III.B.
POLICY ON COST RECOVERY VS. SUBSIDIES.

To the extent feasible, cost recovery is always desirable for the evidence it provides about the value clients place on the services they receive, and may actually enhance that value. Similarly, charging significant user charges in rough proportion to the cost of providing different types of services yields valuable information about which services clients value most. This is particularly true if clients can choose those services they find most useful rather than being offered a fixed package of services on a take-it-or-leave-it basis; USAID strongly encourages this kind of client choice. Finally, greater cost recovery helps stretch USAID support to cover a larger volume of services. As a result, USAID policy encourages the greatest degree of cost recovery consistent with a program's ability to serve its target population.

In general, this means that Missions should expect implementing organizations serving relatively less poor target populations to achieve higher levels of cost recovery. Likewise, assistance should generally be conditioned on efforts by the assisted organization to increase cost recovery over the life of the assistance agreement. On the other hand, very poor clients may not have the cash to pay up-front for even highly valuable services. As a result, Mission funding for the subsidized provision of non-financial services can be appropriate as a means of reaching the very poor, to the extent that the cost-effectiveness of those services can be demonstrated.

III.C.
PROGRAM RESULTS AND COST-EFFECTIVENESS AND REPORTING RESPONSIBILITIES.

The fact that subsidies will almost always be involved in providing non-financial services means that additional evidence must be gathered on their cost-effectiveness in producing the desired results; the greater the degree of subsidization, the stronger this additional evidence should be. Assistance agreements must

require that the assisted organization provide annual reporting on a set of program impact indicators that the Mission determines is sufficient to allow an assessment of the program's cost-effectiveness. Missions should work with assisted organizations to identify appropriate indicators of program impact and cost-effectiveness, and condition assistance on regular reporting on these indicators. Because of the diversity of non-financial services provided by different organizations, the appropriate indicators will tend to be fairly case-specific, and sometimes qualitative. Missions should give strong preference to indicators of changes in the economic well-being of clients that can be clearly related to improvements in the profitability of their enterprises.

USAID/W technical offices will carry out studies of impact of different types of non-financial services on enterprise performance and household welfare of clients, on a sample basis. Again, the aim of the latter is to add to the body of knowledge on "what works," and to strengthen USAID's basis for resource allocation decisions within microenterprise development and between microenterprise development and other approaches to poverty reduction.

III.D. OTHER PROGRAM PERFORMANCE INDICATORS.

The following highlights other performance reporting areas which may require adaptation from the approach used for financial service programs.

III.D.1. OUTREACH.

The number of clients provided with each type of service must be tracked and reported, on a gender-disaggregated basis.

III.D.2. FOCUS ON THE TARGET POPULATION.

In contrast to financial services, it will generally be necessary to track more qualitative indicators relating to target group focus. Useful indicators include:

- the types of services provided (e.g., level of sophistication of training provided);
- methods used to select clients;
- neighborhoods in which program operates; etc.

In addition, the Mission should gather qualitative information on the organization's governance structure and management relating to its commitment to maintain focus on the poor.

III.D.3. FINANCIAL REPORTING.

Financial reporting for a program that offers only non-financial services is considerably less challenging than for a microfinance program. In general, standard budgets, balance sheets, and profit/loss

statements should suffice. The organization's different sources of funds, major cost elements, and the extent of subsidies in the provision of its services should be clearly reported. As section IV emphasizes, the same principle applies to the non-financial operations of programs offering both financial and non-financial services, but the latter case requires a clear distinction between the two sides of the program in order to allow the performance of each to be separately tracked.

III.E.
PARTICIPATION.

As with support to microfinance institutions, Missions should ensure that microentrepreneurs are engaged in all phases of the design, execution, and monitoring and evaluation of their efforts in support of non-financial assistance to microenterprises. In contrast to microfinance development, Missions should encourage organizations providing non-financial assistance to ensure active participation by their clients/beneficiaries in their own operations, as a means to ensure that such assistance meets the needs of clients/beneficiaries. This form of customer feedback is especially important where cost recovery is limited. Missions should take the degree of participation into account in selecting among potential partner organizations in the area of non-financial assistance.

III.F.
ADDITIONAL PRINCIPLES OF NON-FINANCIAL ASSISTANCE.

Studies suggest that training and extension services are more effective in reaching the poorest or smallest enterprises when:

- The training is simple and builds on existing knowledge relevant to microenterprise level needs, keeping in mind the fact that most microentrepreneurs acquire their skills informally;
- They advise or serve as a broker in dealing with government regulations and licensing procedures; and
- Clients are organized into groups or associations, particularly according to trade group, thus reducing the unit costs of reaching them

Evaluations of relatively successful technical assistance efforts aimed at assisting microenterprises and small scale enterprises indicate a number of common traits:

- Focus on a "single missing ingredient" rather than addressing multiple constraints;
- Targeted to addressing the needs of particular industries and problems, rather than treating all microenterprises as alike;
- Concentrate support on established enterprises, rather than attempting to create new enterprises.

Section 4: Guidance for Assistance to Organizations Providing Both Financial and Non-Financial Services

Many microenterprise development programs provide both financial and non-financial services to their clients, judging that the latter face both a lack of access to financial services (especially credit) as well as critical constraints on the non-financial side: a lack of business skills, market connections, etc. According to this reasoning, microentrepreneurs will not realize their full potential unless both financial and non-financial constraints are addressed. On the financial services side, almost all such programs provide small loans, while some offer (voluntary or forced) savings facilities as well. As reviewed in section III, non-financial services vary widely according to the socioeconomic environment and the perceived constraints faced by the target population. A different type of mixed program combines credit (and possibly savings) with non-financial services aimed at non-business objectives: training in health and nutrition, family planning, environmental activities, etc. A gray area arises in the case of programs that concentrate on providing financial services, but that take advantage of their contacts with poor borrowers to promote social objectives at little or no cost. Grameen Bank's "Sixteen Decisions" — e.g., commitments to avoid dowries, boil drinking water, and use pit latrines — may be seen in this light. Where social messages do not burden or constrain financial service delivery, they may achieve a useful symbiosis.

USAID guidance on assistance to programs providing both financial and non-financial services is based on two simple principles:

First, clients should generally be able to choose which services they need, rather than being offered a fixed package of financial and non-financial services on a take-it-or-leave-it basis. An exception may be appropriate where an organization integrates social messages or similarly limited non-financial assistance with the delivery of financial services, to the extent that it does so without compromising the effectiveness of its financial service delivery. Likewise, an exception may be appropriate where the organization can demonstrate that a particular type of training or other service strongly contributes to loan repayment rates by enhancing the productivity of clients' enterprises. Assertions that such services are needed to ensure loan repayment should be viewed with caution, in view of the high repayment rates achieved by many MFIs that provide only financial services.

Second, each side of the program must meet USAID performance expectations in its own right. For an organization to be eligible for USAID assistance, its financial operations must fully satisfy the requirements for assistance to finance-only programs laid out in section II, including appropriate financial reporting (as detailed in the Annex); a credible commitment to attain full financial sustainability (on financial operations) within seven or fewer years, while maintaining target group focus, minimum standards for default rates and operational efficiency; and so on. Likewise, the non-financial operations of the organization must meet the requirements indicated in section III, including the provision and tracking of acceptable indicators of cost-effectiveness and appropriate levels of cost recovery. As indicated in section III, USAID will consider providing partial subsidies for the provision of non-financial services that address

well-defined constraints to microenterprise performance in a cost-effective manner. However, any such subsidies must be transparent in the organization's financial reporting and must be confined to the non-financial side of the program. In particular, assisted organizations may not provide loans on a subsidized basis in order to induce participation in activities with objectives other than improved microenterprise performance (e.g., health, environment, democracy, etc.)

Assisted organizations must provide separate financial and program impact reporting for the financial and non-financial sides of their programs, to allow performance in the two sides to be tracked. Implementing this requirement may raise practical problems in allocating program costs between financial and non-financial operations. In general, the direct costs of providing any training or other non-financial service that the organization deems essential to ensuring loan repayment should be included in the costs of the financial side of the program. Pure overhead costs — such as headquarters buildings and senior staff compensation — may be allocated between the financial and non-financial sides of the program according to any method that the Mission and program management agree reasonably reflects the relative weights of the program's financial and non-financial efforts. One simple way to do this is to calculate the number of program employees involved full time in the financial side of the program as a proportion of total program staff, and to allocate this proportion of overhead costs to the financial side of the program.

In cases where programs provide, at little or no additional cost, social messages or other limited non-financial assistance alongside financial services, the Mission may judge that it is impractical to require separate financial and results reporting for financial and non-financial program elements. Based on such a judgment the Mission may agree with the managers of the program treat it as a pure financial services program for reporting purposes, following the guidance provided in Section II and the Annex. In such cases all program costs must be included in the program's financial reporting. In making such a judgment, the Mission should consider the nature of the non-financial activities, the extent to which their delivery is closely linked to delivery of financial services, and the apparent share of such activities in the overall costs of the program.

Annex
Minimum Reporting for Microfinance Institutions

Every USAID agreement involving grant or loan assistance or loan guarantees to any institution providing financial services to microenterprises must include a requirement that the MFI provide accurate reporting of the financial and operational performance indicators described in Sections A-D of this Annex, on at least an annual basis. USAID assistance activity managers should base funding decisions on satisfactory performance as measured by these indicators and by the analytic performance indicators described in Section F. The following indicators comprise the minimum raw data that should be reported, together with the simplest of analytic indicators: operating efficiency and return on operations. The intent is to ensure the quality and comparability of data so that financial analysis can be conducted in a way that both USAID and program managers can interpret. For programs providing both financial services and non-financial assistance, these indicators apply to the financial services side of the program. A financial institution serving both poor and no-poor clients may base its financial reporting (Sections C and D) on its overall portfolio. In contrast, indicators of portfolio and outreach (Section A) and of interest rate policy (Section B) must exclusively reflect activities targeted toward microenterprises and other poor people.

[1]That is, for a program with 1,000 outstanding loans, report the mean unpaid balance on the largest 250 loans, the second-largest 250, and so forth down to the smallest 250 loans.

[2]Some additional information on the size distribution of loans may be needed to satisfy USAID's obligation to report on its support for poverty lending. These requirements are covered in separate guidance.

[3]For this purpose, the borrower is the person who signs the loan document.

[4]Many programs require clients to deposit minimum amounts or pay into savings funds in order to be eligible for loans.

A. PORTFOLIO AND OUTREACH

1. Total unpaid balance on outstanding loans to target group, at beginning and end of reporting period.
2. Total number of outstanding loans to target group, at beginning and end of reporting period.
3. The size distribution of outstanding loans to target group, by quartiles: Sort all such outstanding loans by unpaid balance, divide the total number of loans into four equal groups, and report the maximum, minimum, and mean unpaid balance within each group;[1,2]
4. Amount of loans disbursed to target group during reporting period.
5. Number of loans disbursed to target group during reporting period.
6. Percentage of female clients or borrowers.[3]
7. Arrears, on a loans-outstanding basis: Report unpaid balance of loans with payments overdue more than 30 days. In addition, provide report on aging of arrears, reporting, for example, the unpaid balance on loans overdue 31-60 days, 61-90 days, and 91 days-one year. As a minimum standard, all loans overdue more than one year should be written off as uncollectible, with stricter standards where the institution judges appropriate.
8. Total amount in small saver deposit accounts, at beginning and end of reporting period. Show compulsory and voluntary savings separately.[4]
9. Number of small saver deposit accounts, at beginning and end of reporting period. Show compulsory and voluntary savings separately.
10. Number of staff involved with targeted credit and/or savings activities.

B. INTEREST RATE POLICY (see also Analytical Performance Indicators, 49-50 below)

11. Effective annual interest rate paid by target group clients (incorporating all required fees, and calculated on a declining balance basis), in nominal terms.[5]
12. Effective annual rate paid on small savings deposits, in nominal terms.

C. INCOME AND EXPENSE INFORMATION

INCOME:

13. Interest and fee income from loans, on cash basis. Exclude accrued uncollected interest on non-performing loans.
14. Income from investments.
15. Other operating income from financial services.

EXPENSES:[6]

16. Staff expenses.
17. Other administrative expenses, including depreciation.
18. Loan losses (extraordinary write-offs). Institutions should provide an explicit statement of the criteria they use in classifying non-performing loans as uncollectible and writing them off. Institutions should be encouraged to set standards that realistically reflect the prospects that delinquent loans will be repaid. As a minimum standard, all loans over one year in arrears should be written off, unless the institution is subject to regulations that require a longer period.
19. Interest and fee expenses, itemized by source of funds.
20. NET OPERATING PROFIT (Sum of items 13-15, minus sum of items 16-19.)
21. Non-operating income.
22. Non-operating expenses.

DONATIONS:

23. For operating expenses.
24. Capital contribution. Identify purpose, e.g., loan fund, equity, fixed assets.

[5]Information on how to calculate effective interest rates is available from G/EG/MD.

[6]Staff and administrative expenses should be those that relate to the provision of financial services. If an institution has significant non-financial activities, it should account for those costs separately, including the proportion of overhead expenses needed to support those activities. Costs paid directly by donors, such as expatriate salaries, should be included.

D. BALANCE SHEET INFORMATION

ASSETS:

25. Cash on hand and in banks
26. Mandatory reserves
27. Short-term investments
28. Loans outstanding
29. Loan loss provisions
30. Net portfolio outstanding (item 28 minus item 29)
31. Long term investments
32. Fixed assets
33. Other assets
34. TOTAL ASSETS (sum of items 25-27 plus sum of items 30-33)

LIABILITIES:

35. Savings and time deposits from target group clients
36. Other deposits
37. Loans from Central Bank
38. Loans from other banks
39. Other short term liabilities
40. Other long term liabilities

EQUITY:

41. Paid-in equity (shareholders)
42. Donated equity
43. Retained earnings
44. Other capital accounts
45. Current year profit or loss
46. TOTAL LIABILITIES AND EQUITY (sum of items 35-40 plus sum of items 41-45)

E. INDICATORS OF OPPORTUNITY COST OF FUNDS[7]

47. Local interbank lending rate, stated in annualized terms.
48. Local 90-day CD rate, stated in annualized terms.
49. Local annual inflation rate: percentage change in consumer price index, comparing CPI at end of the institution's financial reporting period vs. CPI one year previous. Give source.

[7]May be supplied by Mission or by institution as appropriate.

F. ANALYTIC PERFORMANCE INDICATORS

50. Total administrative expenses: Sum of salaries, administration, and loan losses — indicators 16, 17 and 18).
51. Adjusted financial expenses: Multiply average target-group loans outstanding during the period (average of indicator 1) times the interbank lending rate (indicator 47), the 90-day CD rate (indicator 48), or the inflation rate (indicator 49), whichever is highest.
52. Total adjusted expenses. Sum of total administrative expenses (indicator 50) and adjusted financial expenses (indicator 51).
53. Operational efficiency: Divide total administrative expenses (indicator 50) by the average outstanding balance on target-group loans over the reporting period (average of indicator 1). Express as a percentage.
54. Adjusted return on operations: Divide total client revenues (indicator 13) by total adjusted expenses (indicator 52). For purposes of this guidance, an institution with an adjusted return on operations of 1 or greater will be regarded as fully financial sustainable.
55. Loan loss rate: Divide loan losses over the reporting period (indicator 18) by the average value of target-group loans outstanding over the reporting period (average of indicator 1).

USAID expects that every assisted institution — and the USAID officers responsible for managing the assistance activity — will actively use such analytic indicators to monitor the institution's financial condition.

U.S. Agency for International Development
Washington, DC 20523