EUROPEAN COMMISSION

EuropeAid Co-operation Office

Guidelines for EC Support to Microfinance

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INTRODUCTION BACKGROUND AND PURPOSE OF THE GUIDELINES

The European Commission (EC) has supported the development of microfinance for several years and has committed itself, together with several other donors, to help ensure that poor and low income people have sustainable access to a wide range of financial services.

Experience shows that such access plays a critical role in reducing poverty. The poor need financial services (not only credit but also other products and services such as savings, insurance, money transfers, etc) to help them take control of their lives. Access to financial services on a permanent basis can put power into the hands of poor households, allowing them to plan for their future, acquiring physical and financial assets and investing in better nutrition, improved living conditions and children health and education, all the while acknowledging that for the most vulnerable people, who cannot be reached by microfinance, social systems of cash transfers are more adapted to their needs.

The EC supports the creation and development of local financial systems that reach out to include poor people and enable them to benefit from access to various financial services. Such financial services can be provided by banks and specialised retail institutions, but also by non-governmental organizations active in developing countries (directly or through their local partners). Many microfinance institutions have a social orientation to reach the poor and have adopted the microfinance mechanism as appropriate for reducing poverty. The specific aim of a microfinance institution is to offer flexible financial instruments, not usually available from commercial banks, to greater numbers of the poor to meet local needs.

BOX 1 BASIC DEFINITIONS

Microfinance refers to a wide range of financial services (credit, savings mobilisation, insurance schemes, payment systems, etc.) aiming at serving the poor population (normally neglected by the formal financial system) made up of both micro enterprises and poor households.

Microfinance institutions (MFIs): Financial institutions that focus on providing microfinance services. MFIs encompass various types of institutions, ranging from formal (banks) to semi-formal (cooperatives, NGOs, village savings banks) to informal (savings and credit groups).

Microcredit refers to the delivery to poor families and micro-enterprises of very small loans to help them engage in productive activities or develop their own tiny business. In contrast to the typical loan awarded by a commercial bank a microcredit loan is basically an unsecured loan (where there is no perspective of the legal enforceability of the security element) Micro-credit loans are considered small in view of the local context and standards (and are generally no higher than the following indicative amounts: €2,000 for sub-Saharan Africa, Asia and the Pacific; €3,000 for Middle East & North Africa; €4,000 for Latin America and Caribbean; €10,000 for Eastern Europe & NIS).

Revolving fund: a source of money from which loans are made and to be repaid with interest, so the fund is maintained and money can continue to be lent.

Credit line: a credit line consists of capital made available to a financial institution or an MFI for further on-lending. It can be assimilated to a revolving fund as it is implicit that when a credit line is put in place for on-lending it is managed as a revolving fund, where the loans are going to be reimbursed by the end users.

Guarantee fund: a capital set aside to guarantee a financial institution against the inability/unwillingness of borrowers to honour their liabilities in time.

Financial institutions: institutions (public or private) that collect funds (from the public, donors, or other institutions) and invest them in financial assets, such as loans, bonds, or deposits, rather than tangible property.

Development Finance Institutions (DFIs): specialised financial institutions – bilateral or multilateral – which provide long-term finance for private sector enterprises in developing countries. DFIs provide funds, either as equity participation, loans or guarantees, to foreign or domestic investors. The financial support they bring to relatively high-risk projects helps to mobilize the involvement of private capital, bringing in such diverse actors as commercial banks, investment funds, or private businesses and companies.

Non-governmental organisations (NGOs): non-profit agencies not affiliated with any government and devoted to managing resources and implementing projects with the goal of addressing social and socio-economic problems.

Over the past decade, many changes have taken place in the overall microfinance landscape. Microfinance has strongly expanded in many countries, assisted by technological advances, new opportunities emerging alongside the traditional microcredit model and new players entering the industry to capitalise on these opportunities. Today's situation is characterized by increasing involvement of Development Finance Institutions (DFIs), investment funds and other institutional investors in microfinance business. It is about opening up new markets, reaching the untapped potential of the world's poor (the so-called "bottom of the pyramid") and anticipating future market expansion in this sector and its progressive integration in the formal financial sector.

After several years of experience, a consensus has now been reached on good practices to support the development of inclusive financial systems. Microfinance is no longer just about microcredit, but includes the provision of a range of financial services, such as savings, insurance and money transfers. On the other hand, despite years of efforts and significant learning experience, extending financial services to large numbers of poor people in rural or remote areas is still an important challenge. While microfinance plays an increasing role in rural economies, the poor face considerable difficulties in accessing it. This reflects poor information, high risks linked to agricultural activities, lack of collateral, physical distance from service providers, and small individual transaction requirements. Together, these factors increase the cost of servicing the rural poor. The challenge is to find innovative ways to reduce and share costs, rather than supporting subsidized, unsustainable schemes.

BOX 2 CHALLENGES OF RURAL FINANCE

Supplying rural finance (i.e. finance for agricultural production) is often perceived as more difficult than supplying urban finance for several reasons:

- At the macro level, urban biased policies manifest themselves in restrictive agricultural price policies for inputs and outputs and financial policies such as interest rate controls and usury laws. As a result, the returns earned on rural investments are often low. Moreover, subsidized and directed credit policies implemented in many countries undermine and crowd out efficient rural financial institutions.
- Clients for rural finance are more dispersed than urban clients due to lower population densities. They often demand relatively small loans and savings accounts, so per-unit transaction costs are high for financial institutions. Information costs for providers and users are higher because the rural transportation and communication infrastructure is usually less developed.
- Rural incomes are subject to seasonality, and involve a slow turnover of economic activities that are risky. Agricultural loans are usually perceived as being less sound because of the production and marketing risks involved. Moreover, in rural areas many non-farm and off-farm activities are invariably linked with farm activities.
- Many rural clients have little acceptable loan collateral, either due to lack of assets or unclear property rights for the assets they do possess.

On donors' side, this evolution has been reflected through strong support to closer cooperation among donors (including several DFIs as well important private donors in this area) who have grouped themselves in the Consultative Group to Assist the Poor (CGAP). For several years now CGAP has played an essential role in making sense of the changes taking place in the microfinance landscape and in assisting donors in defining appropriate policies.

As part of that process donors, assisted by CGAP, undertook a series of peer reviews during 2002-2003 in order to assess the level of adaptation of the donors' policies and capacities to the changes in the field. The peer reviews revealed significant weaknesses and led to important changes in the policies of some of the donors, including that of the Commission.

A key element in the consensus now shared among the donors is the awareness that, most of the time, the major obstacle for reaching the poor is not the lack of liquidity in the markets but rather the limited capacity to make use of it in a way that makes microfinance attractive for commercial players, financial institutions and investors. Access to capital for microfinance institutions might nevertheless still be a constraint in specific cases where the market lacks liquidity or for start up activities when no viable microfinance provider exists. This might also apply to established microfinance institutions trying to develop their services in rural or remote areas.

To improve this situation, donors need to base themselves on their respective comparative advantages, in which financial business is taken care of by international and local financial institutions, both established and emerging ones, whereas ODA-providing donors are better positioned to provide funding for the much needed capacity building in this field.

A peer review of the EC's microfinance operations was conducted in 2003. In line with the peer review recommendations, a decision was taken in March 2004 to phase out direct financing of credit lines for microfinance and to focus on supporting capacity building of microfinance actors (EuropeAid's Director General Instruction Note 3959 of 4 March 2004). Since then we have undertaken significant efforts to improve the quality of our support to microfinance.

As a result, and after consultations with various stakeholders, it was decided to maintain some possibilities for financing capital needs – in addition to capacity development – of microfinance institutions supported by NGO interventions, recognizing the role which NGOs may play in expanding microfinance to reach the poor, while confirming the need for a focus on institutional capacity building.

The purpose of these guidelines is to inform the Commission's country Delegations and HQ services on the approach taken and to provide them with the necessary guidance on how this approach is to be implemented.

The guidelines gain a further relevance at this specific moment of publication in connection with the present overall policies to reinvigorate agricultural development in response to the recent increases in food prices. In this context, the guidelines are to assist in the choice of the appropriate tools to improve access to finance for small farm holders and agricultural producers, avoiding falling back into bad donor practices of the past.

PART 1 GUIDING PRINCIPLES FOR IMPLEMENTATION OF EC SUPPORT TO MICROFINANCE

1.1. GUIDING PRINCIPLES AND FOCUS OF EC SUPPORT

Overall objective

The overall objective of the EC support to microfinance is poverty alleviation through economic growth facilitated by the development of inclusive financial systems adapted to the needs of the poor.

The EC support aims at strengthening local providers of financial services to poor populations (microfinance institutions), networks of such providers, intermediary lending institutions, financial industry infrastructure, and appropriate regulatory frameworks in order to improve their outreach, efficiency and sustainability. It will do this through a strong focus on capacity development.

Beneficiaries of EC support

EC will target its support to professional microfinance actors. Grant recipients have to demonstrate sufficient expertise (i.e., the capacity to provide financial services according to agreed international standards of good practice) and experience (i.e. proven track record of providing financial services to the poor), and under conditions which will ensure the best chance for sustainability of the actions.

BOX 3	REQUIREMENTS FOR GRANT RECIPIENTS IN THE AREA OF MICROFINANCE
Sector-specific Experience	Experience in providing technical support in at least 3 similar initiatives that supported the development of sustainable microfinance in the last three years. OR Experience in providing microfinance services on a sustainable basis (or approaching sustainability) for at least three years preceding the grant application.
Sector-specific Expertise/Capacity	Evidence of present in-house technical staff dedicated to microfinance, with sufficient knowledge of microfinance good practice[1] obtained through appropriate training and/or experience (as reflected in organisational charts, number and description of microfinance-related functions and profiles, CVs).

Implementation framework

EC-supported microfinance actions should be operationally and financially autonomous initiatives. Ideally, they should be entirely dedicated to microfinance (stand-alone). Where the microfinance action/component is a part of a larger integrated development programme, the microfinance initiative needs to be separate and clearly distinguishable (e.g. separate accounting and governance structures, dedicated management etc.) and show clear promises of becoming sustainable on its own, ensuring in particular that a significant focus is placed on institutional development.

[1] As encapsulated in *Good Practice Guidelines for Funders of Microfinance: Microfinance Consensus Guidelines* (CGAP, 2nd edition, October 2006), available at http://www.cgap.org/p/site/c/template.rc/1.9.2746.

Measuring results: monitoring implementation by using appropriate performance indicators

To maximise impact and sustainability as well as ensure an appropriate level of monitoring, the EC will require the use of an effective result-oriented monitoring system based on appropriate definition of performance baseline, targets and key financial, social and efficiency indicators. For loan-giving microfinance institutions standard performance indicators should, as a minimum, cover the five core areas of (1) breadth of outreach; (2) depth of outreach; (3) portfolio quality; (4) efficiency; and (5) sustainability. These performance indicators are based on international consensus and best practice; they serve to define the baseline at the time of the grant award and to establish concrete, measurable targets for monitoring performance in the future.[2]

BOX 4 STANDARD PERFORMANCE INDICATORS FOR RETAIL FINANCIAL INSTITUTIONS

1. Breadth of Outreach
   -- Number of Active Clients *or* Accounts

2. Depth of Outreach
   -- Average Outstanding Balance per Client *or* Account

3. Portfolio quality/Collection performance
   -- Portfolio at Risk (PAR)
   -- Loans at Risk (LAR)
   -- Current Recovery Rate (CRR) *together with* Annual Loan-loss Rate (ALR)

4. Efficiency
   -- Operating Expense Ratio (OER)
   -- Cost per Client

5. Financial sustainability (profitability)
   for commercial institutions:
   -- Return on Assets (ROA)
   -- Return on Equity (ROE)
   for subsidized institutions:
   -- Financial Self-Sufficiency (FSS)
   -- Adjusted Return on Assets (AROA)
   -- Subsidy Dependence Index (SDI)

It must be stressed that for interventions to have the desired development effect, the achieving of permanence of delivery capacity is crucial. Clients need permanent supply of financial services (where they can count on continuing access to future and larger loans, for example) in order to avoid disruptions in their livelihoods and business opportunities. The length of time that an individual has been a client of an institution has a positive correlation with impact. Sustainable institutions ensure ongoing impact by providing clients with permanent access to financial services. *(Part 2 provides more details on measuring performance and indicators.)*

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[2] The Commission encourages the use of additional indicators beyond the standard ones listed above where appropriate, especially as regards social performance.

1.2. FOCUS ON BUILDING OF INSTITUTIONAL CAPACITIES

Supporting the development of strong domestic financial systems that work for the poor requires strengthening capacities of actors at different levels of the financial systems in order to improve their outreach, efficiency and sustainability – from local providers of financial services to poor populations (microfinance institutions or MFIs), networks of such providers, the financial industry infrastructure, to appropriate regulatory frameworks.

Support for development of institutional capacities is the main focus of EC support

Lack of institutional and technical capacities, especially at the level of retail MFIs, is considered to be one of the major bottlenecks for developing domestic financial systems that serve the poor. As a grant donor, the EC has a comparative advantage in supporting development of institutional capacity of microfinance actors. By focusing its support on institutional capacity building and working with partners that have an excellent track record in microfinance and the necessary monitoring capacity in place to ensure the quality of their actions, the EC can respond best to the needs of the sector, enabling it to push farther the frontier of poverty outreach and to extend the offer of financial services to more people or those living in more remote areas.

Box 5 provides a non-exhaustive list of possible areas of intervention where EC grants can be used to support microfinance operations.

BOX 5 INDICATIVE AREAS FOR INTERVENTIONS IN SUPPORT OF MICROFINANCE				
Activities	**Macro level (Regulatory environment)**	**Meso level (Industry infrastructure)**	**Micro level (Retail MFIs)**	**Remarks**
Funding of research on policy/regulatory frameworks	X			
Training for regulators, TA on regulatory aspects	X			
Design and setting up of credit bureaus		X		Credit bureaus store information about consumers, including demographics, payment patterns of various types of credit obligations, and records of bad debt
Strengthening of local expertise at the level of service providers in areas related to audit, financial and risk management		X		
Enhancement of rating practice		X		Including the funding of rating agencies and funds, awareness raising activities and contribution to activities of training and research & development of rating agencies
Support to professional networks and trade associations to build member capacities		X		
Funding of activities and exchange of experiences for MFI networks		X		Including research on innovative technologies or new products and tools
TA to MFI for development of management information and accounting systems, internal control, risk and governance etc.			X	Including product/process innovation with special regard to the creation of savings, payment and insurance schemes, credit scoring etc.
Training of MFI staff			X	
Office and IT equipment for MFI			X	Only in the framework of a wider MFI capacity building, in areas related to hardware, software, and other equipment necessary for efficient functioning of the MFI
Recurrent expenditures (personnel, travel, overhead costs) of MFI			X	Limited to the start-up phase (extension of financial services to rural areas by an existing MFI is considered as a start up phase)

1.3. FINANCING OF CAPITAL FOR ON LENDING

Financing of capital is limited to cases which involve either specialised financial institutions or, exceptionally, specialised NGOs supporting start-up operations of a microfinance institution

Beyond funding for capacity building, the EC may provide grant funding, in special circumstances, to finance capital needs of microfinance institutions if credit facilities are non-existent for the population in the area concerned and if there is a lack of alternative capital resources in that area. Such a situation needs to be clearly and explicitly identified and documented at start of project identification. Two implementation modalities are foreseen for this:

1.3.1 Through specialised financial institutions

The Commission can channel grant funding to finance capital needs of MFIs through established specialised financial institutions (such as the EIB or the DFIs of the EU Member States), which would then, under their own management responsibilities for such funds, use them for on-lending to, equity participation in, or establishing guarantee facilities for local MFIs. The EIB finances such type of operations also on its own resources or on global facilities it manages and which are financed on the EU budget (FEMIP in the case of the Mediterranean region) or the European Development Fund (the ACP Investment Facility). Certain financial institutions in the EU Member States are also strongly active in microfinance. The channelling of grants of capital for further on-lending by the Commission through such financial institutions is to be the preferred implementation mode within the framework of national or regional indicative programmes financed on the EDF or the EU budget. It is equally important to identify the needs for preparatory or accompanying measures to strengthen local capacities in connection with the use of the capital for on-lending, to be financed either by the EC support as well, or through resources managed by the financial institutions themselves.

1.3.2 Through specialised NGOs (following a call for proposals)

In specific exceptional and well-justified cases (i.e. in situations where there are no existing viable microfinance providers – remote or rural areas, post-conflict situations, etc.), the EC may finance capital needs of new ("start-up") microfinance institutions who can fill that gap or of existing MFIs that are extending their operations into rural/remote areas. Grant recipients will have to justify the need for such support (lack of market liquidity, specific constraints to access capital, etc) as well as demonstrate how they meet the criteria listed in Box 6. In order to be eligible for EC financing, funding for start up operations must always be complemented by significant support to relevant capacity development activities.

Some of these criteria relate specifically to the grants of capital for on-lending by MFIs as microcredit. One is the mandatory use of specific performance indicators, already mentioned briefly in section 1.1. They will be discussed in more detail in Part 2 of the present guidelines. Another criterion for the selection of such actions relates to presentation of a strategy for ensuring the project's sustainability.

When providing capital for on-lending with EC support, an appropriate end-of-project (exit) strategy is required in order to ensure continued access to credit on a sustainable basis after the grant ends. The "*End-of-Project Strategies for Revolving Funds Providing Microcredit*" in

Part 3 of the present guidelines provides further elaboration on how to deal with this issue, both for new and ongoing projects. (For ongoing projects where no formal requirement for such a strategy is foreseen, it is nevertheless recommended to follow the guidance in Part 3 in order to reorient the project towards more sustainable end-of–project conditions.)

BOX 6 OVERVIEW OF CRITERIA FOR MICROFINANCE INTERVENTIONS THROUGH SPECIALISED NGOS FOLLOWING A CALL FOR PROPOSAL	
Sector-specific Experience of Grantee	Experience in providing technical support in at least 3 similar initiatives that supported the development of sustainable microfinance in the last three years. OR Experience in providing microfinance services on a sustainable basis (or approaching sustainability) for at least three years preceding the grant application.
Sector-specific Expertise/Capacity of Grantee	Evidence of present in-house technical staff dedicated to microfinance, with sufficient knowledge of microfinance good practice[3] obtained through appropriate training and/or experience (as reflected in organisational charts, number and description of MF-related functions and profiles, CVs).
Sector-specific Expertise/Capacity of Local Partners	Local partner must be either an already established MFI[4] and therefore able to satisfy the criteria for experience and expertise mentioned above. OR Local partner must be capable of providing microfinance services following the necessary strengthening of its capacity through the proposed action.
Funding of Technical Assistance/Capacity Building	Funding can be provided for capacity building to strengthen institutional capacities, such as training, new technologies, management information systems, internal and financial control mechanisms, social performance management system, impact, networking, adapting to government regulations, etc.
Funding of Capital for On-lending	Funding can be provided for support to a start-up local retail MFI or for extension of servicing of existing MFI in rural/remote areas (for example, in the form of seed capital, equity participation, or debt financing) provided that 1. need for start-up is demonstrated by appropriate microfinance market analysis showing the lack of commercial supply of financial services in the areas concerned; and 2. support to start-up through financial input is accompanied by significant support to capacity development. Grant funding available for a start-up not more than 3 years old at the time of the submission of the application (five years for start-ups operating in exceptionally challenging conditions, such as sparsely-populated, remote, disaster or conflict-affected areas). In case of an already existing start-up institution, information about the institution's

[3] As encapsulated in *Good Practice Guidelines for Funders of Microfinance: Microfinance Consensus Guidelines* (CGAP, 2nd edition, October 2006), available at http://www.cgap.org/p/site/c/template.rc/1.9.2746.

[4] The local partner can be an already established MFI operating on a profit-making basis. However, any profits must clearly be used either for investment in further microfinance services or for the strengthening of the MFI's capacities. MFIs are not eligible as local partners should their statutes foresee to use potential profits for any other purpose than those mentioned above (e.g. to share profits amongst owners/shareholders).

	performance to-date (using key performance indicators) should be provided in order to establish a baseline to measure future performance.
Type of Initiative (stand-alone projects vs. components of integrated multi-sector programmes)	Microfinance actions should be operationally and financially autonomous initiatives: either by being entirely dedicated to microfinance (stand-alone) or, where it is a part of a larger integrated development programme, the microfinance initiative needs to be separate and clearly distinguishable (e.g. separate accounting and governance structures, dedicated management etc.) and show clear promises of becoming sustainable on its own, ensuring in particular that a significant focus is placed on institutional development.
Monitoring System and Performance Indicators	Effective monitoring system based on appropriate definition of performance baseline, targets and key financial, social and efficiency indicators. For loan-giving MFIs standard performance indicators should, as a minimum, cover the five core areas of (1) breadth of outreach; (2) depth of outreach; (3) portfolio quality; (4) efficiency; and (5) sustainability.
End-of-project Strategy for Revolving Funds	Proposal of appropriate end-of-project (exit) strategy for initiatives that include revolving funds to ensure that clients who received financial services during the implementation period of the action will continue to have access to these services on a sustainable basis after the grant ends.

PART 2 MEASURING PERFORMANCE IN MICROFINANCE[5]

Experience has shown that funding agencies' microfinance interventions produce better results when design, reporting, and monitoring focus explicitly on key measures of performance. Unfortunately, many projects fail to include such measurement. These guidelines offer some basic tools for measuring performance in five core areas described below, using two sets of performance indicators:

- core performance indicators used for formal microfinance institutions; and
- indicators for community-managed revolving funds and other forms of micro-credit that do not pass through a formal microfinance institution.

2.1 CORE PERFORMANCE INDICATORS FOR FORMAL MICROFINANCE INSTITUTIONS

The five core areas in which performance of a microfinance institution (MFI) is generally measured are:

1. Breadth of outreach—how many clients are being served?
2. Depth of outreach—how poor are the clients?
3. Portfolio quality/Collection performance—how well is the MFI collecting its loans?
4. Efficiency—how well does the MFI control its administrative costs?
5. Sustainability—is the MFI profitable enough to maintain and expand its services without continued injections of subsidized donor funds? The aim is to assess actual net values, removing "masking" effects that inflation and subsidies generally have on assets of institutions operating in high-risk environments

The indicators set out below do not capture all relevant aspects of MFI performance. Some funders, and certainly all MFI managers, will want to monitor a longer list of indicators. And there are important dimensions, such as governance quality, that simply cannot be quantified. The performance areas discussed here represent a minimum that should be (a) treated in all project designs (reporting past performance of institutions that are expected to participate, and ensuring that systems are in place to measure these indicators during the project); (b) monitored and reported during implementation and (c) included in all other appraisals or evaluations of existing institutions during and at the end of a project.

1. Outreach (breadth)

Indicator. The best measurement of outreach is straightforward:

Number of clients or accounts that are active at a given point in time

[5] This part has been adapted from *Core Indicators for Microfinance*, by R. Rosenberg (CGAP, 2007).

This indicator is more useful than the cumulative number of loans made or of clients served during a period. Among other distortions, cumulative numbers make an MFI offering short-term loans look better than one providing longer-term loans. The recommended measure counts active clients rather than "members" in order to reflect actual service delivery: members may be inactive for long periods of time, especially in financial cooperatives.

Interpretation. Expanding the number of clients being served is an ultimate goal of almost all microfinance interventions. But rapid expansion sometimes proves to be unsustainable, especially during an MFI's early years when it needs to design its products and build its systems. It has very seldom been useful for funders to pressure MFIs for rapid expansion.

2. *Outreach (depth)/Client poverty level*

Indicator. Many, though not all, microfinance projects are justified as poverty reduction tools and are thus expected to reach poor clients. For such projects, there are various techniques for measuring client poverty levels, some quite expensive and others simpler, but as yet there is no widespread agreement on any one of them. If the project does not use a more sophisticated indicator, it should at a minimum report the following rough proxy for the poverty level of loan or savings clients at a point in time:

$$\textbf{Avg. Outstanding Balance} = \frac{\textbf{Gross amount of loans or savings outstanding}}{\textbf{Number of active clients or accounts}}$$

This point-of-time number should not be confused with total amounts loaned or deposited during the reporting period, or with the average initial amount of loans in the portfolio. The Average Outstanding Balance includes only loan amounts that clients have not yet repaid, or savings that the clients have not withdrawn. For comparison purposes, it is useful to express this indicator as a percentage of the host country's per capita GDP (atlas method). An average outstanding loan balance below 20% of per capita GDP or $US 150 is regarded by some as a rough indication that clients are very poor.

Interpretation. Average Outstanding Balance is roughly related to client poverty, because better-off clients tend to be uninterested in smaller loans. But the correlation between loan balances and poverty is far from precise. Low loan sizes may be indicative of a poor clientele but not necessarily in all cases. Likewise, growth in average loan size does not necessarily mean that a MFI is suffering "mission drift." As an MFI matures and growth slows, a lower percentage of its clients are first-time borrowers, and average loan sizes will rise even if there has been no shift in the market it is serving.

Funders who want to reach very poor clients should usually look for MFIs that are already committed to a low-end clientele, rather than trying to encourage higher-end MFIs to change their market. Most MFIs that focus on the very poor use established tools to screen potential clients by income level.

3. *Portfolio quality/Collection performance*

Reporting of loan collection is a minefield. Some indicators camouflage rather than clarify the true situation. Moreover, terminology and calculation methods are not always consistent.

Therefore, whenever any measure of loan repayment, delinquency, default, or loss is reported, the numerator and denominator of the ratio should be explained precisely.[6]

MFIs' self-reported collection performance often understates the extent of problems, usually because of information system weaknesses rather than intent to deceive. Collection reporting should be regarded as reliable only if it is verified by a competent independent party.

Indicators. The standard international measure of portfolio quality in banking is **Portfolio at Risk (PAR)** beyond a specified number of days:

$$\textbf{PAR (x days)} = \frac{\textbf{Outstanding principal balance of all loans past due more than x days}}{\textbf{Outstanding principal balance of all loans}}$$

The number of days (x) used for this measurement varies. In microfinance, 30 days is a common breakpoint. If the repayment schedule is other than monthly, then one repayment period (week, fortnight, quarter) could be used as an alternative.

Many young or unsophisticated MFIs do not yet have loan tracking systems strong enough to produce a PAR figure. Most of these, however, should be able to calculate **Loans at Risk (LAR)**, a simpler indicator that counts the number of loans instead of their amounts. As long as repayment is roughly the same for large loans and small loans, LAR will not differ much from PAR.

$$\textbf{LAR (x days)} = \frac{\textbf{number of loans more than x days late}}{\textbf{total number of outstanding loans}}$$

When an MFI "writes off" a loan, that loan disappears from the MFI's books and therefore from the PAR or LAR. Thus, it's useful when reporting these measures to include a description of the MFI's write-off policy. (For instance, "the MFI doesn't write off loans," or "the MFI writes off loan amounts that remain unpaid more than 6 months after the final loan payment was originally due.")

An alternative measure, the **Current Recovery Rate (CRR)**, can be computed by most MFIs, and gives a good picture of repayment performance—but only if it is interpreted very carefully.

$$\textbf{CRR} = \frac{\textbf{cash collected during the period from borrowers}}{\textbf{cash falling due for the first time during the period under the terms of the original loan contract}}$$

This ratio can be calculated using principal payments only, or principal plus interest.

[6] For a list of issues that need to be clarified when interpreting measures of collection, see *Disclosure Guidelines for Financial Reporting by Microfinance Institutions* (CGAP, 2nd edition, July 2003), available at http://www.cgap.org/p/site/c/template.rc/1.9.2785.

CRR and variants of it are often misunderstood. It is tempting, but badly mistaken, to think of the CRR as a complement of an annual loan loss rate. For instance, if the MFI reports a 95% collection rate, one might assume that its annual loan losses are 5% of its portfolio. In fact, if an MFI making 3-month loans with weekly payments has a 95% collection rate, it will lose well over a third of its portfolio every year. *Thus, the CRR indicator should never be used without translating it into an* **Annual Loan-Loss Rate (ALR)**. Here is a simplified formula:

$$\mathbf{ALR} = \frac{\mathbf{1 - CRR}}{\mathbf{T}} \times \mathbf{2}$$

where T is average loan term expressed in years

Variations in late payments and prepayments cause the CRR to jump around over short periods, often registering above 100 percent. Thus, it must be applied to a period long enough to smooth out random or seasonal variations—typically a year.

Interpretation. Repayment of an MFI's loans is a crucial indicator of performance. Poor collection of microloans is almost always traceable to management and systems weaknesses.

The strongest repayment incentive for uncollateralized microloans is probably not peer pressure, but rather the client's desire to preserve her future access to a loan service she finds very useful to her and her family: thus, healthy repayment rates are a strong signal that the loans are of real value to the clients. Finally, high delinquency makes financial sustainability impossible. As a rough rule of thumb when dealing with uncollateralized loans, Portfolio or Loans at Risk (30 days or one payment period) above 10%, or Annual Loan-Loss Rates above 5%, must be reduced quickly or they will spin out of control.

4. *Efficiency*

Indicators: The most commonly used indicator of efficiency expresses non-financial (operating) expenses as a percentage of the gross loan portfolio:

$$\textbf{Operating Expense Ratio} = \frac{\textbf{Personnel and administrative expense}}{\textbf{Period-average gross loan portfolio}^{7}}$$

The Operating Expense Ratio is the most widely used indicator of efficiency, but its substantial drawback is that it will make an MFI making small loans look worse than an MFI making large loans, even if both are efficiently managed. Thus, a preferable alternative is a ratio that is based on clients served, not amounts loaned:

$$\textbf{Cost per Client} = \frac{\textbf{Personnel and administrative expense}}{\textbf{Period-average number of active borrowers}}$$

[x GNI per capita]

[7] "Gross" loan portfolio means the total outstanding (not yet repaid) amounts of all loans. For an MFI that provides voluntary savings, average total assets could be used as the denominator. This ratio is sometimes called "Administrative Expense Ratio" or simply "Efficiency Ratio."

If one wishes to benchmark an MFI's Cost per Client against similar MFIs in other countries, the ratio should be expressed as a percentage of per capita Gross National Income (which is used as a rough proxy for local labour costs).

Interpretation. Measured in terms of costs as a percentage of amounts on loan, tiny loans are more expensive to make than large loans. Only a few extremely efficient MFIs have an Operating Expense Ratio (OER) below 10 percent; commercial banks making larger loans usually have OERs well below 5 percent. The average OER of MFIs reporting to *The MicroBanking Bulletin*[8] is about 30 percent, which probably reflects considerable inefficiency.

As mentioned earlier, the OER tilts the scales against MFIs making smaller loans: six $50 loans cost more to make than one $300 loan. Measured this way, an MFI can become more "efficient" by simply dropping its smaller borrowers, even without making any improvements in operating systems. Cost per Client avoids this perverse result.

When a microfinance market starts to mature and MFIs have to compete for clients, price competition on interest rates will usually push the MFIs to get more efficient. But many MFIs face little real competition. External monitoring of efficiency is especially important in those cases.

Young or fast-growing MFIs will look less efficient by either of these measures, because those MFIs are paying for staff, infrastructure, and overhead that are not yet fully used.

5. Sustainability (Profitability)

Indicators. In banks and other commercial institutions, the commonest measures of profitability are **Return on Equity (ROE)**, which measures the returns produced for the owners, and **Return on Assets (ROA)**, which reflects that organization's ability to use its assets productively.

$$\textbf{ROE} = \frac{\textbf{After-tax profits}}{\textbf{Starting (or period-average) equity}^{9}}$$

$$\textbf{ROA} = \frac{\textbf{After-tax profits}}{\textbf{Starting (or period-average) assets}}$$

These are appropriate indicators for unsubsidized institutions. But donor interventions more typically deal with institutions that receive substantial subsidies, most often in the form of grants or loans at below-market interest rates. In such cases, the critical question is whether the institution will be able to maintain itself and grow when continuing subsidies are no

[8] Issue No. 9, July 2003 — 164 MFIs reporting.

[9] ROE calculations should use starting equity unless there has been a substantial infusion of new equity from an outside source during the reporting period.

longer available. To determine this, normal financial information must be "adjusted" to reflect the impact of the present subsidies. Three subsidy-adjusted indicators are in common use: **Financial Self-Sufficiency (FSS)**, **Adjusted Return on Assets (AROA)**, and the **Subsidy Dependence Index (SDI)**.

Financial Self-Sufficiency (FSS) is a subsidy-adjusted indicator often used by donor-funded microfinance NGOs. It measures the extent to which an MFI's business revenue—mainly interest received—covers the MFI's adjusted costs. If the FSS is below 100%, then the MFI has not yet achieved financial break-even.

$$\textbf{FSS} = \frac{\textbf{Business revenue (excluding grants)}}{\textbf{Total expenses + IA + CFA + ISA}}$$

Adjusted Return on Assets (AROA) measures an MFI's net profit or loss (including adjustments) in relation to the MFI's total assets.

$$\textbf{AROA} = \frac{\textbf{Accounting profit/loss (excluding grants) – IA – CFA – ISA}}{\textbf{Period-average total assets}}$$

An Inflation Adjustment (IA) reflects the loss of real value of an MFI's net monetary assets due to inflation:

IA = (Assets that are denominated in currency amounts[10]
minus Liabilities that are denominated in currency amounts)
times The inflation rate for the period

This adjustment is usually based on net asset values at the beginning of the period, but using period averages may be appropriate for MFIs that receive large grants, or other infusions of equity capital, during the period.

A *Subsidized-Cost-of-Funds Adjustment (CFA)* compensates for the effect of soft loans to the MFI:

CFA = Period-average borrowings by the MFI
times "Market" interest rate
minus Actual amount of interest paid by the MFI during the period

A common benchmark for a market interest rate is the rate that commercial banks pay on 90-day fixed deposits. Arguably a more appropriate rate is a few points above the "prime" rate

[10] For instance cash, investments, or loans; but not buildings or equipment

that banks charge on loans to their best customers, because few MFIs could actually borrow at a lower rate.[11]

The *In-kind Subsidy Adjustment (ISA)* quantifies the benefit an MFI gets when it receives goods or services without paying a market price for them (computers or free services of a manager are common examples).

ISA = Market price an unsubsidized MFI would pay for a good or service
minus Actual price paid by the MFI

The **Subsidy Dependence Index (SDI)** measures how much an MFI would have to increase its lending interest rate in order to cover all of its costs including adjustments.[12] An SDI above zero means that the MFI still needs subsidy to operate—i.e., it has not achieved financial sustainability. A two-stage calculation produces first the amount of annual subsidy and then the index.

$$\text{(1)} \qquad S = A\,(m - c) + [(E * m) - P] + K$$

where:

S = Annual subsidy received by the MFI;

A = MFI concessional borrowed funds outstanding (annual average);

M = Interest rate the MFI would be assumed to pay for borrowed funds if access to borrowed concessional funds were eliminated;

c = Weighted average annual concessional rate of interest actually paid by the MFI on its average annual concessional borrowed funds outstanding;

E = Average annual equity;

P = Reported annual before-tax profit (adjusted, when necessary, for loan loss provisions, inflation, and so on);

K = The sum of all other annual subsidies received by the MFI (such as partial or complete coverage of the MFI's operational costs by the state).

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[11] A more sophisticated benchmark would be based on the probable cost (including interest, administrative expense, and reserve requirements) of the specific form(s) of commercial funding the MFIs is likely to be raising when it moves beyond soft funding sources.

[12] The SDI is framed in terms of increases in an MFI's interest rate on loans, but this is not meant to suggest that raising interest rates is the only path to sustainability. Cutting costs is at least as important.

$$\text{(2)} \quad SDI = \frac{S}{LP * i}$$

where:

SDI = Index of subsidy dependence of MFI;

S = Annual subsidy received by the MFI (see above);

LP = Average annual outstanding loan portfolio of the MFI;

i = Weighted average interest yield earned on the MFI's loan portfolio.

It is important to measure intermediaries' financial sustainability, both to tell whether they're meeting a goal of the project, and to quantify clearly the level of subsidy that is being invested for a particular result.

The fact that an MFI's sustainability indicator improves over a period of years does not necessarily mean that the MFI will reach financial sustainability. Sustainability indicators for MFIs will improve almost automatically in the early years. It takes some sophistication to judge whether an MFI's sustainability is improving fast enough. Most MFIs that have become profitable have done so within 10 years of start-up. However, now that microfinance knowledge and expertise are more widely available, MFIs should usually not take more than 5 years to reach sustainability, with the possible exception of MFIs working in rural areas with very low population density.

One important factor is the pace of growth: rapid growth will temporarily depress an MFI's profitability because such growth requires new investments in staff and facilities that take a period of time to become fully productive. For MFIs that are growing fast, analysis of mature branches and loan officers can often reveal whether the institution is on a trajectory that leads to sustainability.

2.2. PERFORMANCE INDICATORS FOR COMMUNITY-MANAGED REVOLVING LOAN FUNDS FOR OTHER NON-INSTITUTIONAL MICROCREDIT

Some projects provide communities or other social groups with funds to finance loans to their members. When such funds are handled by the community itself rather than by a formal institution, record-keeping may be limited, so that it is often impossible to measure financial sustainability. However, the other three core performance areas can and should be tracked, especially collection performance.

Outreach – Breadth. This is measured the same way for revolving funds as for MFIs: number of clients with active loans.

Outreach – Depth/Client poverty level. The revolving fund records may make it hard to determine the total outstanding balance of the loan portfolio. In such cases where average outstanding balance cannot be determined, an acceptable substitute is average initial loan size, which is more easily determined. This indicator should be expressed as a percentage of per capita GDP.[13]

Portfolio quality/Collection performance. Measuring repayment is crucial for revolving funds, because they are so prone to repayment problems (most revolving funds don't revolve for very long). Even if the purpose of the activity is to get resources into the hands of the community rather than to set up a permanent financial facility, a revolving fund with high default is not a good vehicle for the resource transfer. The distribution of benefit is likely to be inequitable, because the defaulters appropriate most of the value of the fund. Loans that don't have to be repaid are much more likely to be captured by local elites. Furthermore, distributing loans that don't get repaid can do harm by creating a culture of non-payment that makes it difficult for responsible, sustainable lenders to serve the population involved.

For these and other reasons, no revolving funds should be set up without insuring at the very least that there is a system in place to track loan collection performance. Two of the collection measures described above—**Loans at Risk** and **Current Collection Rate**—can be maintained using simple manual systems.

If an existing revolving fund has no system for tracking collection performance, it is usually practical to compute LAR (one repayment period) manually as of the date of the measurement.

A more powerful ex-post approach is to compute an **Annual Loan-Loss Rate (ALR)** as follows. First, compute the Current Value (CV) of the loan portfolio:

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[13] If loans are paid off in instalments whose timing and amount are equal, the relation between average initial loan size and average outstanding balance tends to be as follows:

No. of payments in the whole loan	1	2	3	4	8	12	24 or more
Avg. o/s balance as % of average initial loan amount	100%	75%	67%	63%	56%	54%	near 50%

These percentages will be materially higher if the loan portfolio is growing fast.

CV =

Cash or bank deposits
plus
Total outstanding balance (i.e. amounts not yet repaid in cash) of portfolio
minus
Outstanding balance of all loans whose age since disbursement is more than double the original loan term

Next, calculate the Annual Loss Rate (ALR):

$$ALR = 100\% - \sqrt[t]{\frac{CV}{OV}}$$

where ***t***	=	Time (in years) since the fund started lending
CV	=	Current Value of the fund as computed above
OV	=	Original Value of the fund (total amount disbursed to the fund)

If the project being reviewed has many revolving loan funds and it is not possible to do collection analysis on all of them, then a random sample should be selected for analysis.

PART 3 END-OF-PROJECT STRATEGIES FOR REVOLVING FUNDS PROVIDING MICROCREDIT

In order to assist EC staff with formulating or reviewing end-of-project strategies (also referred to as exit strategies[14]) for projects that include revolving funds – whose purpose is to help entities capable of putting in place microcredit schemes – the following guidance has been prepared. It applies to all projects including revolving funds that are governed by a *Financing Agreement between the EC and the Beneficiary Government* (who in turn can have entered into contractual relations with local financial institutions) or a *Grant Contract between the EC and NGO(s)*. For ongoing projects, where such strategies were not put in place upfront, they need to be designed and introduced.

In principle, exit strategies are to be defined at the conception of projects. Since the December 2005 Call for Proposals for the Co-financing with European Development NGOs – Actions in Developing Countries, applicants responding to the Call have been required to include an exit strategy in their proposal if requesting funds for on-lending. This section should help EC staff and evaluators in assessing the adequacy of the proposed strategies in project proposals and at the end of project implementation.

3.1 DEFINITION OF REVOLVING FUND AND MAIN ISSUES

For the purposes of this document, a revolving fund is defined as a fund whereby money is lent out to clients (poor women and men), collected, and re-lent. As the fund is replenished with loan repayments, money "revolves" so that the fund can continue to serve clients over time. Revolving funds are often also called credit lines or credit components.

Revolving funds have often been part of a larger development project, which may focus on a variety of domains, such as agriculture, community development, infrastructure, irrigation, health, environment, post-conflict rehabilitation, vocational education, and social services. The size of revolving funds (or credit components in multi-sector programmes) varies significantly, but most revolving funds are less than 100,000 euros. In many cases, the credit was targeted to a particular group of people for a specific purpose. For example, a revolving fund targeted small farmers in a specified region for the purchase of certain agricultural inputs. Or, a fund targeted women of a certain age group to change behaviour with regard to family planning.

The following actors are involved in managing and using revolving funds:

Grant Beneficiary: the organization that is the recipient of the grant funding for the revolving fund

Management Agency: the institution that manages the revolving fund and on-lends it to end clients (final beneficiaries). This can be a financial institution (such as a bank or a microfinance institution), an organization with a social mission (such as an association, a local non-government organisation, or a cooperative), a Government agency, or in certain ongoing

[14] This strategy concerns the exit of the EC from the project and not the general disinvestment at the end of the life of the fund.

projects even a Programme Management Unit. The Grant Beneficiary and Management Agency can be the same organisation.

Final Beneficiaries: recipients of loans made from the revolving fund; they are also responsible for repaying the loans.

At the end of a project, as the funds are to continue to be used (re-lent), four main questions generally arise with regard to the necessary transfer and resulting ownership of the assets (revolving funds):

- *What funds* should be included in the transfer of assets?
- To whom should the *ownership* of the fund be transferred?
- Who should *manage* the fund?
- Under what *conditions*?

These questions are relevant because:

- Unlike many other projects, credit lines do not have limited project duration; the instrument involves a grant for loans that are repaid by clients; the credit line is intended to continue to operate with no fixed end date.
- Ownership of these funds at the end of the project is often not clear, and ownership transfer usually has not been not specified in the financing agreement or grant contract.

It is important to address the above questions to ensure the achievement of initial project objectives and the sustainability of financial services delivered to clients in the long run. The growing body of research on the impact of microfinance demonstrates important welfare benefits for clients and their households[15]. The studies tend to find that these benefits are associated with *continuing, long-term access* to credit (and other financial services). One-off loans bring far less benefits, and arguably provide little or no sustainable impact. In addition, a strategy that answers these questions and identifies criteria for appropriate management can help the EC avoid cases of mismanagement involving revolving funds.

3.2 HOW TO FORMULATE AN END-OF-PROJECT STRATEGY?

Specifically, an end-of-project strategy encompasses a stated intention for the use of funds at project end as well as the specific steps planned to ensure a legal and smooth transfer of assets at the end of the project. Therefore, each of the above-mentioned four questions needs to be addressed in the end-of-project strategy:

1. **What funds should be transferred?** All EC funds disbursed to the Grant Beneficiary by the end of the project and effectively used for credit activities become in principle the property of the Grant Beneficiary. EC funds not disbursed to the Grant Beneficiary by the end of project will be de-committed by the EC. Furthermore, the EC will need

[15] See, for instance, Levine, "Finance and Growth: Theory and Evidence"; Beck, Demirguc-Kunt, and Levine, "Finance, Inequality and Poverty"; Honohan, "Financial Development, Growth and Poverty: How Close Are the Links?" and Littlefield, Morduch, and Hashemi, "Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?"

to be reimbursed for EC funds disbursed to the Grant Beneficiary but not yet used by the end of the project, or not used for eligible costs (this reimbursement may, depending on the size of grant amount, include interest generated by the corresponding part of the funds disbursed under the project).

2. **To whom should the ownership be transferred?** This depends on the initial Grant Beneficiary of the funds, which can be a public or a private entity.

- If funds were originally disbursed to a public entity, evaluate if the entity has at present sufficient financial expertise to ensure good oversight of the use of the revolving funds or whether another entity may be better placed to guard the ownership of the funds. In any case, the EC should see to it that the future owner entrusts the management of the revolving funds to a professional and capable institution (see below) and that the latter is either identified in the exit strategy or criteria for the selection of this institution are stipulated in there.[16]

  Where the EC has concluded a Financing Agreement with the government, the government agency should ensure that exit provisions for the EC contribution are accounted for in its contractual relations with local financial institutions.

- If funds were originally disbursed to a private entity, often a European NGO working with a local partner organisation (e.g. a microfinance institution that was established by the project), attention must be paid so that the funds are transferred to an institution that specialises in providing financial services in the local context, and not to an informal group or an organisation that does not specialise in the provision of financial services.

  If during the life of the project the revolving fund is managed not by the Grant Beneficiary itself but by a separate Management Agency – often a local partner organisation of the NGO that has been involved in the project – the funds after the ownership transfer should remain with the Management Agency. In case the local partner is deemed not capable of managing the funds well (i.e., does not meet the "good performance" standards as explained below), the NGO can suggest that the funds be managed by another organisation, in which case a prior EC approval is necessary. If the approval is not granted, the funds will be recovered by the EC.

The specific choice of the institution to which the ownership will be transferred need not be made during project design. This allows for taking into account evolutions that happen in the course of the project. However, clear criteria for selecting the institution with a view to ensuring long term sustainable provision of financial services as well as a timeframe for making the choice should be established upfront.

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[16] In many Latin American countries “fideicomisos” are commonly used to place the funds in.

3. **Who will manage the funds after the transfer?** The Management Agency should be responsible for ensuring that after the transfer the fund is used to serve the poor efficiently and in a sustainable way. To ensure the sustainability of the fund, the Management Agency needs sufficient experience in finance or banking with adequate expertise among the management and staff of the organisation. This experience will ensure that proper lending technologies, adequate loan collection procedures, and sound accounting are in place. Private institutions such as local NGOs that specialize in microfinance, cooperatives, credit unions, finance companies, banks, etc.) usually are more efficient at managing credit than public institutions. Incentives are rarely in place in public institutions to recover costs, and interest rates are often highly subsidized, which in turn de-capitalizes the revolving fund.

4. **What conditions, or measures of performance, should be applied to the transfer?** The end-of-project strategy should foresee that, for the funds to be transferred, the Management Agency needs to meet *minimum performance standards* based on generally accepted microfinance indicators[17]. They correspond to the ones set out in Part 2 of the present guidelines[18]:

   Outreach, or the number of clients served, is usually measured in number of outstanding loans or in number of active clients. Good performance can be measured quantitatively as **breadth of outreach** (e.g., growth in number of clients or low client drop-out rates) and qualitatively as **depth of outreach** (e.g., income levels, gender of clients, or loan size as proportion of Gross National Income per capita).

   Portfolio quality, measured as loan portfolio at risk after 30 days, is usually best maintained at below 5 percent over a consistent period. Portfolio at risk is the most accurate indicator for assessing portfolio quality. It looks not only at the number of clients who are late in paying back, but also at the volume of the debt the institution might not recover from defaulting clients.

   Efficiency in providing financial services (e.g., number of active borrowers per credit officer, cost of one dollar lent to the client, or operating cost per client) is another indicator.

   Sustainability is another important indicator. The organization must demonstrate that it is well on its way to financial self-sufficiency, meaning that revenue from loans fully covers all their costs, including operational costs, inflation, cost of funds, and provisioning costs.

   The performance indicators above should be reported on by the project and monitored by the EC throughout the project. These indicators should be specified in the special conditions of the contract and reported for the entire Management Agency's microfinance portfolio, not just the EC-funded revolving fund. Where a project has already started and this information is not available, it is recommended that performance levels are established by an independent evaluation (or rating where

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17 *Good Practice Guidelines for Funders of Microfinance: Microfinance Consensus Guidelines* (CGAP, 2nd edition, October 2006), Annex 2.

18 For more information on the calculation and interpretation of these indicators see Part 2 "Measuring Performance in Microfinance" of this document.

appropriate)[19] or, if such a review is not possible anymore (i.e., near the project end), at the time of an end-of-project evaluation.

The project evaluation should seek the opinion of a microfinance specialist to ensure the transfer will be done according to good practice standards. The specialist can help project staff draft the conditions in the agreement.

As a result of the evaluation on the basis of the above performance indicators, the management of the revolving fund may be deemed (i) to have performed well, or (ii) to have performed unsatisfactorily.

- **Good Performance.** If the Management Agency has performed well, the EC should transfer the full ownership of the funds at the end of the project. The EC would no longer have a *droit de regard* or any other active or passive role in the management of the funds. This exit provision needs to be clearly stated in contractual arrangements, thus formalizing the final transfer of funds and the total disengagement of the EC from fund management and supervision.

- **Unsatisfactory Performance.** If the Management Agency has not been able to manage the funds well) and there is no realistic potential for improving performance of that Agency over the remaining life of the project, the EC should request the Grant Beneficiary to select another institution that does respond to good performance standards using the appropriate procedures.

  In case the Grant Beneficiary is not prepared to entrust the management of the funds to another management agency, the EC should terminate the project and do the necessary to recover the funds for those parts of the credit line that have not been on-lent to end clients as well as for the amount equal to all funds outstanding on current loans.

3.3 IMPLEMENTING AN APPROPRIATE END OF PROJECT STRATEGY

The contractual arrangements (i.e. grant contract or financing agreement) involving revolving funds financed by the EC need to address several issues. They should set the conditions and the time limit within which ownership of the funds will be transferred to the Grant Beneficiary. Conditions for transferring ownership should include the following:

- A clear vision and reasonable guarantee from the Grant Beneficiary that, after the transfer, the funds will continue to be used for similar objectives as initially foreseen in the project.
- Proof of sufficient management skills of the Management Agency to ensure good performance and long-term sustainability of funds. Technical conditions should include performance indicators, with the objective of monitoring the institutional performance of the Management Agency over time to reflect outreach, portfolio quality, efficiency, and sustainability of the institution.

- Evidence, as reflected in financial projections and the organization's business plan, that the Management Agency is on a path to reach financial self-sufficiency.

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[19] For more information on microfinance ratings, see www.ratingfund.org.

A simplified guidance is provided further below in a checklist for EC staff in Delegations and Headquarters to follow for decisions on end-of-project strategies.

In the case of a grant contract, which contains a provision disallowing "credits to third parties" as eligible costs, this provision needs to be modified. For the current model (2008) of the General Conditions of the standard contract, the provision is Article 14.6 and the modification should be done through Article 7 of the Special Conditions. It is recommended to insert the following text in the Article 7 of the Special Conditions: *"Credits to third parties shall be considered eligible costs under this grant contract."*

EC Delegations should launch a review of existing revolving fund operations to determine whether an end-of-project strategy has been appropriately defined in their contractual documents. If the reviews reveal that no end-of-project strategy exists, an amendment to the contractual document (financing agreement or grant contract) should be negotiated with the Grant Beneficiary. During the review, the EC should verify that principles of good management and good practice are being applied in the EC-funded project. Where these principles are lacking, measures to improve performance should be introduced (see section 3.2 above). To better assess and benchmark performance, the Management Agency may decide to undergo a periodic rating or performance assessment, done by a specialized microfinance rating agency.

All new revolving fund operations should abide by the rules set forth above and should define an appropriate end-of-project strategy. The strategy should foresee the full transfer of EC funds at the end of the project, provided the Grant Beneficiary, or the Management Agency on its behalf, has managed the funds efficiently according to principles of good financial management. The contract should clearly indicate exit options that will apply if these conditions are not met. A detailed implementation of an end-of-project strategy should be prepared and initiated in due time before the end of the project, according to the options set out in the contract (at least one year in advance is advised).

Checklist for Task Managers for Existing Microfinance Projects Involving Revolving Funds

- If the project already has an end-of-project strategy in place, follow the six steps below to check whether all aspects are included.
- If the project does not have an end-of-project strategy yet, draft such a strategy with the grant beneficiary by following the six steps below to ensure that all elements are included.

Step 1: Identify the (type of) entity to which the ownership is likely to be transferred.
Analyse to whom the funds have been disbursed (a public or private entity) and who has managed the funds (on their behalf if not the Grant Beneficiary itself).

Step 2: Make sure that the end-of-project strategy includes:

- Procedures, selection criteria and a time frame for the transfer of the ownership at the end of the project.
- All necessary provisions to clearly limit the extent of the EC's financial liability and responsibility. In particular, they should set the conditions and the time limit within which ownership of the funds will be transferred to the new owner, in any case at the end of the project.
- A clear vision and an indication of the intentions of the Grant Beneficiary institution to the effect that, after the transfer of ownership, the funds will continue to be used for similar objectives as initially foreseen in the project (including description of the intended final beneficiaries, loan sizes, lending criteria, etc).
- Technical conditions demanding sufficient management skills of the Management Agency to ensure good performance in terms of outreach, portfolio quality, efficiency, and long term sustainability of the institution.

Step 3: Analyse the performance of the Management Agency and require regular reporting on standard performance indicators as described in this Note.

If the project is ongoing and reporting on these indicators has not been done, a mid term evaluation should assess the performance. If a mid term evaluation is not possible anymore, a final evaluation should assess the performance.

Step 4: Have an external audit of the fund done and determine what funds should be transferred and their real value:

All funds that have been disbursed to the Grant Beneficiary and effectively used for on-lending will be transferred (including the funds on-lent and repaid by the final beneficiary). Make sure that:

(*a*) EC funds not disbursed to the Grant Beneficiary by the end of project are de-committed;

(*b*) the EC gets reimbursed for EC funds disbursed to the Grant Beneficiary but not yet used by the end of the project (this reimbursement may, depending on the amount size, include interest generated by this part of the funds).

Step 5: Obtain an independent evaluation or rating (whatever is most appropriate) towards or at the end of the project's life in order to assess the performance of the Management Agency.

The microfinance specialist undertaking the evaluation/rating should provide specific advice on the upcoming transfer.

Model Terms of Reference and other advice for such evaluations will be made available on EuropeAid website.

- If the outcome of the evaluation is *positive* and performance is satisfactory, proceed to step 6
- If the outcome is *not satisfactory* and the evaluation shows that the Management Agency has not been able to manage the fund well and there is no realistic potential for improving the Agency's performance over the remaining life of the project, the EC should either

    - request the Grant Beneficiary to select another management agency to entrust the management of the revolving fund to, using the appropriate procedure (in a case where the Grant Beneficiary is a public entity this is likely to be an open tender). Recommendations to this extent can be part of the evaluation,

    or

    - if the Grant Beneficiary is unsuccessful in selecting another management agency, terminate the project and do the necessary to recover the funds. In this latter case, the EC issues a recovery order for those parts of the credit line that have not been on-lent to end clients and for an amount equal to all funds outstanding on current loans.

Step 6: The Grant Beneficiary is to draw up and submit to the EC the transfer document taking into account local administrative requirements for transfer of ownership so that it can be approved by the relevant geographic Directorate at EuropeAid.