

**MICRO AND SMALL ENTERPRISE FINANCE:
GUIDING PRINCIPLES FOR SELECTING
AND SUPPORTING INTERMEDIARIES**

**COMMITTEE OF DONOR AGENCIES FOR
SMALL ENTERPRISE DEVELOPMENT**

**DONORS' WORKING GROUP ON
FINANCIAL SECTOR DEVELOPMENT**

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This document is a joint product of the Donors' Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. It was inspired by and is largely consistent with the recommended standards for support set out by a UN expert group of leading small and microenterprise practitioners convened by Women's World Banking in January 1994. The donor committees adopted the principles in their current form in June 1995, following consultations with key donor agencies involved in small and microfinance. This document is intended for use by project officers in donor and implementing organizations, managers, and policy makers.

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MICRO AND SMALL ENTERPRISE FINANCE: GUIDING PRINCIPLES FOR SELECTING AND SUPPORTING INTERMEDIARIES

The purpose of these principles is to establish common standards for donor agencies to apply in supporting broader access to financial services for micro and small enterprises.¹ Such enterprises have historically lacked access to the formal financial system, but the growing success of many institutions provides confidence that access can be provided sustainably in many settings. It has now become possible to identify and agree upon the basic principles that support successful micro-level finance, so that donors can work in concert to ensure that lessons of success are translated to the institutions they support.

The framework for donor support to micro and small enterprise finance centers on two equally important and complementary objectives. First, **outreach** embodies the aim of expanding access to increasing numbers of low-income clients. Second, **sustainability** provides the means to expand and maintain outreach. These concepts underpin the guiding principles described here.

Different types of micro and small enterprise clients have different characteristics and demand different services. Hence it is desirable to encourage a range of institutions that use specialized methods to serve their particular market niches. These can include commercial and development banks, credit unions, mutual or community banks, non-governmental organizations (NGOs), finance companies, cooperatives, savings and credit associations, and other specialized intermediaries. At the same time, however, this document is based on the premise that fundamental principles of finance apply widely and must be observed by all institutions if they are to succeed. Moreover, donors must design their support mechanisms in ways that are consistent with best international practices and long-run development of a sound financial system.

This statement of guiding principles first identifies characteristics donors should seek in selecting institutions to support. It then describes appropriate forms of donor support. An annex lists reporting standards on outreach and financial performance.

¹ Included in the term micro and small enterprises are a wide range of enterprises (industry, transport, commerce, services, agriculture, etc.) ranging in size from part time, seasonal activities of a single person to small, formal enterprises employing several non-family members.

I. INSTITUTIONAL PERFORMANCE STANDARDS AND PLANS

Intermediaries seeking support should be able to demonstrate the following characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions.

A. Institutional Strengths

1. **Institutional culture, structures, capacities, and operating systems** that can support sustained service delivery to a significant and growing number of low income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership, and accountability.
2. **Accurate management information systems** that are actively used to make decisions, motivate performance and provide accountability for funds. Such systems are essential for effective and efficient management.
3. **Operations that manage small transactions efficiently**, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).
4. **Meaningful, transparent financial reporting** that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data listed in the Annex should be reported, and institutions should regularly monitor financial condition using appropriate financial ratios derived from such data.

B. Quality of Services and Outreach

1. **Focus on the poor:** evidence of service to low-income clients, women and men, especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.
2. **Client-appropriate lending:** for example, quick, simple and convenient access to small loans, often short-term, that are renewed or increased based on excellent repayments. Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cashflow and project appraisal for larger and longer term loans.
3. **Savings services:** savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds—either independently or with another institution.

4. **Growth of outreach:** significant progress in expanding client reach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

C. Financial Performance

1. **Appropriate pricing policies:** offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity.²
2. **Portfolio quality:** maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days below 10 percent of loans outstanding and annual loan losses under 4 percent of loans outstanding satisfy this condition.
3. **Self-sufficiency:** steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency [defined as covering all administrative costs and loan losses with client revenues] within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and financial self-sufficiency [defined as covering all administrative costs, loan losses, and financing costs at non-subsidized rates from client revenues] within five to ten years.
4. **Movement toward financial independence:** building a solid and growing funding base with clear business plans, backed by operational capacities, that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programs also provide non-financial services, such as business advisory services, health, or education, they should account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this document.

II. STRATEGIES FOR DONOR SUPPORT

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programs have drained resources without becoming sustainable, and have contributed to the mistaken notion that the poor are unbankable. Funders should provide financial and other support in such a way to ensure the quality of services provided and the widest outreach, as well as to foster the

² It should be understood that the costs of non-financial assistance provided to entrepreneurs may continue to be subsidized. However, it is crucial that these costs be separated from the costs of lending operations, so that the financial viability of lending operations can be assessed.

movement to scale, financial self-sufficiency, and independence from donor support, taking into account the particular characteristics of different types of institutions. Donors should ensure that institutions, in their effort to become sustainable, maintain a focus on offering appropriate services to the poor.

A. Appropriate Uses for Grants

1. **Institutional development.** Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective, as institutions become able to meet more of their organizational development needs from within. It should also become more specialized, as institutions tackle more difficult problems.
2. **Capitalization.** Grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. Externally-financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.
3. **Operating losses.** Donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business every program will take some time to reach a break even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.
4. **Fixed assets.** Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

B. Appropriate Uses of Loans

Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings-based institutions, such as savings and credit associations, by making loans available to them below the cost of mobilizing funds locally.

C. Commercial Sourcing of Funds

The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as:

1. **Investor equity**, from both official and private sources. Donor support can help leverage private investment.
2. **Second-tier operations**, which raise funds from commercial sources and on-lend to microenterprise finance institutions.
3. **Partial guarantees** of loans made by commercial banks to NGOs.

D. Coherence of Donor Policies

Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to small and microenterprise institutions, donors should ensure that they coordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied. Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

ANNEX: MINIMUM REPORTING INFORMATION³

Donors should require regular reporting on institutional performance and should base funding decisions on achievement of performance targets. The following tables cover the **minimum raw data** that should be reported, but do not include analytic indicators, such as financial ratios or adjustments for subsidy or inflation. The intent is to ensure the quality and comparability of data so that financial analysis can be conducted in a way that both donors and programs can interpret. Meaningful analysis requires a firm base of data. These indicators are intended to furnish such a base.

Portfolio and Outreach

1. Number and amount of loans outstanding at beginning and end of reporting period	
2. Number and amount of loans disbursed during reporting period.	
3. Number and amount of small saver deposit accounts at beginning and end of reporting period. Show compulsory and voluntary savings separately. ⁴	
4. Arrears (on a loans outstanding basis). Unpaid balance of loans with payments overdue more than 30 days. There should also be an aging of arrears report, covering, for example, 60 and 90 days and one year.	
5. Percentage of female clients.	
6. Number of staff (only those involved with savings and credit activities).	

Interest Rate Policy

7. Effective annual interest rate paid by clients (incorporating all required fees, and calculated on a declining balance basis), both nominal and real. Effective rate paid to savers.	
8. Local annualized interbank lending rate and 90-day CD rate.	
9. Local annual inflation rate (give source).	

³ For institutions that offer a full spectrum of financial services, information should apply only to that portion of the institution's activities and overheads focused on small and microenterprises.

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

Income and Expense Information

Income	
10. Interest and fee income from loans (excluding accrued uncollected interest on non-performing loans)	
11. Income from investments	
12. Other operating income from financial services	
13. Total income	
Expenses	
14. Staff expenses (salaries and benefits) ⁵	
15. Other administrative expenses (includes depreciation)	
16. Loan losses. All loans over one year in arrears should be written off, as far as local rules permit. Institutions should describe their criteria in recording loan losses.	
17. Interest and fee expenses (itemized by source of funds)	
18. Total expenses	
19. Net operating profit	
Other Income and Expenses	
20. Non-operating income (if any)	
21. Non-operating expenses (if any)	
22. Donations:	
22a. For operating expenses	
22b. Capital contribution (identify purpose, e.g., loan fund, equity, fixed assets)	

⁵ 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.

Balance Sheet Information

Assets	
23. Cash on hand and in banks	
24. Mandatory reserves	
25. Short term investments	
26. Loans outstanding (must match indicator 1, above)	
27. Less: Loan loss provisions	
28. Net portfolio outstanding	
29. Long term investments	
30. Fixed assets (after depreciation)	
31. Other assets	
32. Total Assets	
Liabilities	
33. Savings and time deposits from target group clients	
34. Other deposits	
35. Loans from central bank	
36. Loans from other banks	
37. Other short term liabilities	
38. Other long term liabilities	
Equity	
39. Paid-in equity (shareholders)	
40. Donated equity	
41. Retained earnings	
42. Other capital accounts	
43. Current year profit or loss	
44. Total Liabilities and Equity	

Analytic Performance Indicators

The items listed here provide information in a raw form. In order to evaluate and compare performance, the raw data will have to be analyzed, through computation of ratios and other indicators. Informed opinions differ on which indicators are most important. Therefore, this document makes no attempt to specify those indicators. Rather, it provides for an information base to allow the calculation of a range of key ratios. Examples include: net profit, average loan and savings account size, adjustments for subsidy and inflation, operational and full self-sufficiency, return on assets and equity, administrative costs as a percentage of portfolio (required spread), portfolio yield, and staff productivity.

It is expected that every institution—and the donors that support it—will actively use such analytic indicators to monitor the institution's financial condition.