

**UNCDF Strategy for**

# **POLICY IMPACT AND REPLICATION**

**in Local Governance and Microfinance**



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# FOREWORD

As a small-scale investment organization, our direct impact on poverty reduction is a must. However, even under the best circumstances, this would be far from sufficient for us to claim success. Our *raison d'être* will largely depend on the extent to which our pilot operations in the areas of local governance and microfinance can exert wider influence and leverage – in other words, on the extent to which they can impact policy and provide a viable, tried and tested model for replication by national governments and other development-assistance organizations.

In this context, national and local ownership combined with quality of the results produced on the ground are indispensable. The critical importance of policy impact and replication (PI&R) is addressed prominently in the 2001/2002 UNCDF Business Plan.

This paper, which represents the UNCDF corporate strategy for achieving this wider leverage, is thus an important document for us. It develops an overall analytic framework for looking at the twin objectives of policy impact and replication, at the mechanisms and instruments to achieve these, and at the likely conditions of success. Building on this framework, it then sets out specific strategies for PI&R in both local governance and microfinance.

This document should also be of wider interest within the UN Development Programme, given the focus on A2 P2 (advocacy, advice, pilots, & partnerships) announced by the UNDP Administrator.

I would like to recognize the work and contributions of my colleagues in UNCDF for the time and dedication that went into producing this publication, especially that of Heather Clark and Roger Shotton, who worked tirelessly coordinating inputs and refining content.

I expect that this paper will guide UNCDF operations in our two areas of focus. But beyond that, I also expect that this paper will help stimulate, within the international development community at large, an action-oriented exchange and debate on this important issue.



Normand Lauzon  
Executive Secretary

# 1 AIM AND OVERVIEW OF THIS STRATEGY PAPER

The 1999 external evaluation of the United Nations Capital Development Fund (UNCDF) reported significant accomplishments in Policy Impact (PI) and Replication (R) but recommended that UNCDF develop a strategy to “achieve impact on national Government policy and to encourage replication by other multilateral and bilateral donors”<sup>1</sup>. To address this need Action Plan Team 2 under the leadership of Roger Shotton and Heather Clark, collectively drafted this Strategy Paper. The material below is presented in two sections: 2.0 introduces the paper, explains why PI&R are important for UNCDF, illustrates achievements to date, and defines terms. 3.0 presents PI&R strategies for the Local Governance Unit (LGU) and for the Special Unit for Microfinance (SUM).

Action Plan Team 2 leaders were Heather Clark & Roger Shotton. The members of the group were Angelo Bonfiglioli, Kiendel Burritt, Sophie de Caen, Bettina Fuhrmann, Cyril Guillot, Yee Woo Guo, Albéric Kacou, Hitomi Komatsu, Amal Medani, Stefan Rummel-Shapiro, Kristin Wambold-Liebling, Jo Woodfin.

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<sup>1</sup> The Synthesis Report of the external evaluation of UNCDF, and all other reports and studies mentioned in this publication, are available online at <http://www.uncdf.org>.

# 2 INTRODUCTION AND GENERAL CONSIDERATIONS

## 2.1 Background

### 2.1.1 The Importance of Policy Impact and Replication for UNCDF

The Administrator of the United Nations Development Programme (UNDP) has called for a change process through which UNDP will punch above its weight and exert leverage beyond the modest resources it manages directly, to exploit fully its comparative advantage as a neutral ally and honest broker, and to assume a more substantial role as advocate and adviser to help improve governance policies and broaden institutional development in its programme countries<sup>2</sup>. This approach is even more critical for UNCDF. The Fund disburses annually some \$40 million – less than 1/1000th of global ODA flow<sup>3</sup>. While UNCDF assistance plays important roles in its programme countries, the Fund is nevertheless dwarfed by the major multilateral and bilateral agencies<sup>4</sup>. This reality is unlikely to change.

To permit UNCDF to aim beyond direct poverty impact – as critical as that is – the 1995 Policy Paper<sup>5</sup> argued for UNCDF to structure all future programming as pilot operations. Building on the Fund’s comparative advantages<sup>6</sup>, initiatives would be designed to yield policy-relevant lessons for use “upstream”, thereby effecting wider UNCDF leverage. This corporate focus evolved further in the 1999 Policy Papers on Local Governance (“Taking Risks”) and on Microfinance, summarized in “Investing with the Poor”, UNCDF’s corporate policy statement. The 1999 external evaluation strongly endorsed this corporate policy niche but called for a more explicit, comprehensive and consistent strategy to achieve it.

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<sup>2</sup> For example, the Administrator’s statement to the UNDP Executive Board meeting in Geneva, June 2000, highlighted the corporate focus to be given to “A2 P2”: advocacy, advice, pilots and partnerships.

<sup>3</sup> Total annual ODA flow fluctuates around the \$50 billion level.

<sup>4</sup> Uganda, a UNCDF focus country, received some \$ 3 million in 1998 from UNCDF, equiv. to only 0.6% of the total ODA flow of approx. \$500 million.

<sup>5</sup> “Poverty Reduction, Participation & Local Governance: the Role for UNCDF”, 1995.

<sup>6</sup> Small-scale allowing greater flexibility and responsiveness, grant-funding better able to promote riskier and more innovative approaches especially at the local level, mandate to marry capital and technical assistance allowing for “real time” capacity building and institutional development.

### **2.1.2 Illustrations of PI&R Achievements**

A few examples illustrate what we mean by PI&R, and describe the flavour and range of UNCDF's PI&R achievements:

#### ***A. Local Governance***

##### *Cambodia*

Through support to CARERE and the Government SEILA initiative, UNCDF has since 1995:

- Re-oriented CARERE activities from post-conflict rehabilitation to longer-term institutional development, preparing for decentralization and the establishment of elected local government;
- Encouraged CARERE replication of UNCDF-designed local planning and financing procedures in all six provinces thus far targeted, and secured commitments by Government and donors to replicate these procedures in other provinces;
- Informed the 1999 policy and legislation on establishment of new commune authorities, *and*
- Influenced the national debate on devolution and fiscal decentralization.

##### *Malawi*

UNCDF and UNDP have supported decentralization and local governance in Malawi since 1994, when multi-party Government was restored. This programme has:

- Demonstrated the key role of district and local institutions in planning and managing development activities and encouraging participation;
- Piloted local planning and financing procedures now adopted as national standards;
- Supported Government in formulating and approving a progressive decentralization policy favouring devolution (rather than consolidating deconcentration) and drafting legislation to enshrine this policy;
- Provided direct input to Government policy on fiscal decentralization, *and*
- Rallied major donors to replicate, or at least borrow, key elements from the programme.

##### *Uganda*

UNCDF, with UNDP and the World Bank, has supported decentralization policy in Uganda since 1997 through the District Development Project (DDP), explicitly acknowledged to be a "policy-relevant pilot" project. This programme has:

- Demonstrated the role of districts, sub-counties and local bodies in planning and managing development activities;
- Promoted innovations in local governance and central-local relations – which the Government has adopted as policy -- and amended the legislative and regulatory frameworks;
- Led to design and funding of a major World Bank project which replicates these innovations nationally and which Government has designated as a model for all donor support to decentralization;
- Encouraged donors to change programme strategy and adopt key DDP elements, and
- Inspired a performance-based funding approach that has been imitated by the Poverty Action Fund, the principal Government and donor vehicle for financing poverty reduction activities.

### *Mozambique*

UNCDF-supported activities in the Nampula Province have:

- Stimulated donors (Dutch, EU and the World Bank) to fund projects based on the same planning and financing model;
- Helped develop national legislation incorporating institutional innovations (notably the District Consultative Councils) piloted in Nampula, and
- Encouraged national adoption by Government of local planning procedures initially developed in Nampula.

### *World Bank -- Social Fund Policies*

- UNCDF and the Bank co-sponsored a joint review of social funds and decentralization which recommended that future Bank activities follow UNCDF Local Development Programme principles more closely. UNCDF has already influenced the Bank's design of the next phase of the Zambia Social Fund (ZAMSIF 2).

## **B. Microfinance**

### *MicroStart Mongolia*

MicroStart Mongolia began operations in July 1998 despite constraints in policy and the enabling environment: Several laws effectively prohibited micro-lending activities; Government, donors and implementing agencies in general misunderstood microfinance due to a series of poorly-designed and -implemented interventions. The prevailing attitude held that microcredit did not and could not work in Mongolia. MicroStart Mongolia activities motivated the public, Government and donors to create an enabling environment. By con-

centrating on building experience, rather than advocating abstract policy, MicroStart Mongolia became the country's first legally-licensed microfinance institution and its first finance company -- MicroStart-XAC. The IFC, CGAP / World Bank, UNDP, and Triodos Bank now recognize MicroStart-XAC as an institution that employs microfinance best practices.

### *ACLEDA*

On October 7, 2000, ACLEDA – an MFI supported jointly by a UNDP, IFC and USAID transformation project – received a banking license under the new National Bank of Cambodia (NBC) law. The law incorporated several enabling provisions for the operation of microfinance institutions. Over a five-year period ACLEDA, together with other microfinance institutions operating in Cambodia, sponsored seminars to exchange information among MFIs and Government. To address growing interest in microfinance in Cambodia – where many MFIs serve well over 10,000 clients – the NBC sought MFI participation in drafting specific bank regulations conducive to microfinance.

### *MicroSave Africa*

MicroSave Africa – a joint UNDP-DfIF research initiative in savings and new product development – assisted the Bank of Uganda when it considered a Microfinance Act and specific regulations for microfinance deposit-taking institutions. The microfinance market in Uganda is competitive, with several well-established institutions, including commercial banks. The Bank of Uganda and the Ministry of Finance, seeking to establish and maintain a sound, stable financial sector to protect depositors' funds, pursued a consultative process with MFIs. The process involved dedicated workshops with all stakeholders to develop basic laws and performance standards governing the MFIs. Key provisions of the legislation addressed deposit-taking institutions, as distinguished from credit-only institutions that use mandatory savings to guarantee loans. The consultative process also allowed small, user-owned and -managed organizations to remain under adequate, existing legislation. The new regulations considered the percentage of capital on reserve for deposits and the risk-weighting of unsecured portfolios.

### *MicroStart Morocco*

In Morocco MicroStart established a solid reputation for technical quality and support to growing MFIs. The active involvement by important financial sector actors on the MicroStart Advisory Committee promoted better understanding of microfinance operations and improved Government attitude toward interest rates. As a result, the Government is establishing a second-tier organization to provide financial services to MFIs, enabling them to scale-up and deepen outreach.

With UNCDF funding and technical assistance, the Guichet helped ACEP, a leading MFI in Sénégal, to introduce new methodology and product to serve a new market – group lending to women in rural areas. Success of this intervention encouraged other MFIs to replicate the product and expand service to additional rural communities. It also sparked donor interest in supporting pro-poor initiatives by showing that deep outreach and sustainability can be achieved by well-run microfinance institutions.

## **2.2 Clarifying Terms**

The examples above demonstrate that many issues cluster under the broad headings of PI&R. Before exploring the specific challenges facing UNCDF in Local Governance and Microfinance, we must define the broad terms "policy impact" and "replication" to ensure clarity and consistency.

The distinction between PI and R is not always obvious; they can overlap, they are closely inter-related, and people use the terms differently. In this paper, we adhere to the ITAD Recommendation whereby "policy impact" refers primarily to actions by national authorities and "replication" to actions by donors. Thus when Government and other national institutions imitate UNCDF procedures nation-wide it is "policy impact" (not replication); and where UNCDF influences donor strategy it is "replication" (not donor policy impact).

Furthermore, in the longer term replication may become subsumed by policy impact. Donors are gradually shifting away from direct project support and toward broad budget and thematic support. National Governments are increasingly determining the frameworks within which donor resources are pooled and used. At some point donor "decision to replicate" will become moot..

### **2.2.1 Policy Impact**

#### **Dictionary Definitions of "Policy"**

**Webster:** "a governing principle, plan or course of action."

**Oxford English Dictionary:** "a course of action adopted and pursued by a government, party, ruler, statesman, etc.; any course of action adopted as advantageous or expedient".

Clearly these definitions, and the samples of UNCDF "policy impact" achievements highlighted further above under A., suggest a wide range of possible objects of attention falling under the one heading of "policy". Consequently, we need to be clear as to the various sorts of "policy issue" which may be appropriate targets for UNCDF impact or influence.

Schematically we may posit four domains of “national policy” – applying both to local governance and to microfinance – on descending levels, from “macro-policy” to micro-policy”:

***(a) The national political stance and broad policy direction (macro-policy).***

This level has to do with the broad political options and direction being taken by national political authorities - as regards decentralisation & local governance, or microfinance - and is often tied to the wider debate (if debate there is) within political fora and to pressure from parties, civil society, advocacy groups and the media (and to some extent from donors).

The sum of the positions taken (or not taken) on these options will comprise the national political stance and will determine the overall enabling context for local governance or microfinance. With respect to microfinance the broad policy direction or macro policy will include a range of financial sector policies, such as inflationary controls, interest rate policies, monetary policy and financial sector reforms. Policy at this level may be consistent, well articulated and documented (in Cabinet papers, White papers, Presidential statements, party resolutions or manifestos, etc.) or it may not, and different national authorities may also hold different views.

***(b) Legislation and the statutory framework.***

National political direction is – sooner or later - further articulated and implemented through legislation. This legislation will spell out in more detail, and in a manner which allows for state enforcement, government position on the various options highlighted above under (a). Draft legislation – e.g. a Local Government or Decentralisation Bill, or a Banking/Finance Sector Bill, or subsidiary Bills – is usually prepared, debated, reviewed and approved by government, then submitted to national parliament for further scrutiny, debate and final approval.

The principles and statutory provisions expressed in such legislation (vague or detailed, expressly designed or carelessly drafted or even neglected, consistent or inconsistent with other standing Acts as they may be) come themselves to constitute the legally sanctioned instrument of national policy, until they are amended by subsequent statutes. Again, such legislation may be more or less detailed, consistent and implementable, and may be more or less favorable to good local governance and microfinance.

***(c) The regulatory framework.***

To be implemented, many aspects of the legal framework require further translation into more detailed Ministerial decrees, directives, regulations and circulars – e.g., on the functioning of local government councils and the committee system, arrangements for local government financial management and accounting, or on the prescribed modus operandi for banks and microfinance institutions, such as the minimum capital requirements, reserve rates or the allowable percentage of unsecured portfolio.

This body of formal, detailed directives constitutes the regulatory framework. This framework is often imperfectly developed and lagging behind the development of policy and legislation, and may even be partly inconsistent with it.

***(d) Norms: Systems, procedures, guidelines and practices (micro-policy).***

Finally, national policy is also expressed in less formal Norms: i.e. systems, procedures, guidelines and practices which are officially accepted and even promoted, though they may not be adopted uniformly nationwide – e.g. local government planning guidelines, training manuals, communication and monitoring arrangements, etc., or microfinance institutional procedures and practices such as application of GAAP, external audits, financial disclosure guidelines and reporting, ownership structures and procedures related to service delivery methodologies and products.

These sets of norms may be more or less consistent with broad national political direction and legislation, may or may not be codified and have formal endorsement, and may vary substantially between parts of the country and microfinance institutions.

### **2.2.2 Replication**

#### **Dictionary Definitions of "Replication"**

**Webster:** "Imitation, copying ..."

**Oxford English Dictionary:** "A copy, reproduction. Also, the action of reproducing."

There are different meanings of "replication" as applied to UNCDF programming. UNCDF separates replication occurring at the global or industry level or within the wider development community, from replication occurring at country-level. And UNCDF also distinguishes between the various operational forms of replication at country-level.

#### **A. Country-Level Replication**

Other partners may replicate UNCDF-supported country programmes in several ways, according to the degree of strategic or programmatic collaboration and sequencing. Country-level replication can take the form of co-programming agreements, sequential upscaling, ad hoc imitation or design modification by donors (with no explicit agreement involved) and, in MF, through the adoption of microfinance operations by the formal commercial banking sector.

##### *i. Expanding a Programme by Co-financing*

The most direct and immediate replication occurs when donors commit to expand the scale, scope, or intensity (usually geographic) of a UNCDF-supported programme through co-financing, more or less contemporaneously with that programme:

- Co-financing arrangements. These may take several forms, from trust fund or co-funding for the same project, to parallel funding for a similar project.
- Mode of influence and fidelity of replication. This may range from exact replication, where the partner simply co-funds with UNCDF a project designed by UNCDF, to where a "replicated" project is designed separately, with varying degrees of involvement by UNCDF (and Government) in the process.

*ii. Upscaling a Programme Sequentially*

Another mode of replication is the sequential expansion of programme activities by a donor during or after UNCDF programme implementation. Again, the form such upscaling takes may vary:

- Purposiveness and prior agreement. Sometimes a clear agreement is made during the UNCDF programming process with Government and/or another partner to undertake upscaling, once UNCDF operations generate positive results; in other cases a decision to scale-up may be made later, and be more spontaneous. Such cases may give no formal recognition of UNCDF involvement with the model being replicated – and the very fact of replication may go unnoticed.
- Mode of influence and fidelity of replication. This, too, may vary depending on the involvement of UNCDF (and Government) in the process.
- Scale. The upscaling may be national or more limited.

*iii. Ad Hoc Influence and Inspiration*

Replication at country-level may take place in a partial or ad hoc manner. Other partners may simply adopt or follow aspects of UNCDF programme design or strategy, often without formally acknowledging the source of their inspiration.

*iv. Private sector replication.*

Lastly, there is a form of replication specific to Microfinance: Private banking institutions may develop financing relations with MFIs, or adopt practices advocated by UNCDF, thus effectively scaling-up UNCDF-type interventions to cover a much greater number of MF clients and deepening de facto UNCDF influence on the national financial system.

***B. Replication in the Wider Development Community***

Replication can also occur beyond country-level within the wider development community of multilateral and bilateral donors, and amongst research, training and advocacy institutions in both North and South.

*i. Donors*

Replication may occur when UNCDF influences the broader corporate policies and strategies of the donor community through joint activities, study or research, workshops, or simply effective communication, advocacy and networking.

*ii. Research, Training and Advocacy Institutions*

Replication may also take place by influencing the agenda, content, or activities of research, training and advocacy institutions.

*iii. Networks of Practitioners*

Replication can occur – internationally and at the country-level – when networks of microfinance practitioners share information on UNCDF practices, performance and innovations. (These bodies also play a key role in policy impact.)

Influencing the broader corporate policies of donors at the global level also influences replication at country-level. And, donor consortia, such as CGAP or the Donor working groups on financial sector reform and small enterprise development, play an important role in this process.

***C. Linkages between Replication and Policy Impact***

Finally, we note:

*i. Government Actions*

In local governance, it is tempting to consider Government adoption or imitation of UNCDF systems, procedures, practices, etc., to be a form of replication. However, to be consistent, this outcome will be treated as policy impact [see 2.2]. We consider the formal banking sector adoption of UNCDF microfinance systems, procedures and practices to be replication.

*ii. Chain Reactions*

Although Government adoption or imitation of UNCDF systems, procedures, or practices are not forms of replication, such policy impact can lead to increasing pressure by national authorities on donors to replicate.



# 3 PI&R IN LOCAL GOVERNANCE AND MICROFINANCE: SETTING THE STAGE

We now build on the definitions outlined above and describe possible UNCDF PI&R targets. We shall discuss the mechanisms UNCDF can use to achieve PI&R – both instruments and channels of influence. We look at factors which shape the use of these mechanisms, and at various lessons from past UNCDF successes and failures in PI&R. Then we discuss proposed strategies for Local Governance and Microfinance based on these considerations.

## 3.1 Building Blocks of the Strategy

### 3.1.1 The Meaning of Policy Impact and Replication

#### A. *Policy Impact*

The Illustrative Policy Issues Matrix (*see page 14*) presents the kinds of impact UNCDF might try to achieve in the four Local Governance and Microfinance policy domains. These policy objectives range from the highly ambitious to the much more modest. UNCDF strategy must select targets appropriate to its resources, comparative advantages and limitations.

#### i. *Policy Evolution*

Many of us view national policy development in Local Governance and Microfinance as a gradual, linear progression “rightward” from policy domain (A) through (D). This opinion has some validity. Thus, for example, without national political commitment to devolution and local government – or legislation supporting these objectives – discussions of detailed, local governance regulations or procedures are premature. Similarly, in micro finance, if national inflation or interest rate policy preclude microfinance viability, then establishing microfinance regulatory frameworks to govern reserve requirements or liquidity ratios will be academic.

But there are also progressions “leftward” through the policy domains, and micro-policy impact under (D) can influence items in policy domains (A), (B), or (C). For example:

**Table I: Illustrative Policy Issues Matrix**

a. Broad Policy Direction	b. Statutory & Legal Framework	c. Regulatory Framework	d. Norms: prescribed systems, procedures, guidelines, practices
<p><i>Official positions and statements (eg Cabinet papers) on such options as:</i></p> <p><b>Local Governance</b></p> <ul style="list-style-type: none"> <li>▶ Whether to constitute elected local authorities at all (ie. Devoln vs deconc.);</li> <li>▶ how many tiers;</li> <li>▶ what urban/rural distinctions;</li> <li>▶ the nature of local political representation;</li> <li>▶ what role local authorities are to play;</li> <li>▶ role of sector ministries vs area authorities;</li> <li>▶ what powers, staff and fiscal resources to entrust to them and how;</li> <li>▶ how they should relate to parliament, to central government, to civil society, &amp; to traditional authorities;</li> <li>▶ what autonomy they should enjoy;</li> <li>▶ what institutional arrangements to support them;</li> <li>▶ how policy debate to be managed; etc.</li> </ul> <p><b>Microfinance</b></p> <ul style="list-style-type: none"> <li>▶ Financial Sector Policy</li> <li>▶ Monetary policy</li> <li>▶ Inflation control</li> <li>▶ Financial repression particularly targeted to sectors or through specific institutions</li> <li>▶ Interest rate controls and ceilings</li> </ul>	<p><i>Constitutional and legal provisions – their adequacy, clarity, consistency with broad policy, existing laws, internal consistency, on such issues as:</i></p> <p><b>Local Governance</b></p> <ul style="list-style-type: none"> <li>▶ The role, functions and powers of local governments;</li> <li>▶ Make up of representative councils and their internal constitution;</li> <li>▶ Relations between local legislature, executive, and central government;</li> <li>▶ Relationship with the public, civil society and traditional authorities;</li> <li>▶ Relationship with other tiers;</li> <li>▶ Relations with civil servants;</li> <li>▶ Fiscal powers and transfer arrangements; etc.</li> </ul> <p><b>Microfinance</b></p> <ul style="list-style-type: none"> <li>▶ Legality of microfinance</li> <li>▶ Organizational forms that can legally lend, mobilize savings or handle other financial transactions</li> <li>▶ Banking Acts, Cooperative and Society legislation, special Microfinance Acts</li> <li>▶ Statutes set out for ownership</li> </ul>	<p><i>Ministerial regulations, directives, circulars, - their adequacy, clarity, consistency with nat. policy &amp; with legislation, internal consistency, on such issues as:</i></p> <p><b>Local Governance</b></p> <ul style="list-style-type: none"> <li>▶ Channeling of funds to local government;</li> <li>▶ Management &amp; acctng of local government finances;</li> <li>▶ local taxes collection;</li> <li>▶ preparation of local government plans and budgets;</li> <li>▶ procurement procedures &amp; limits;</li> <li>▶ staff hiring and management;</li> <li>▶ role of local committees and how they are constituted and run;</li> <li>▶ council business, minutes, communications, etc.</li> </ul> <p><b>Microfinance</b></p> <p>The range of banking regulations, for example:</p> <ul style="list-style-type: none"> <li>▶ Minimum capital requirements</li> <li>▶ Initial capital requirements</li> <li>▶ Capital adequacy</li> <li>▶ Reserve requirements</li> <li>▶ Liquidity requirements</li> <li>▶ Asset quality</li> <li>▶ Portfolio diversification</li> <li>▶ The range of products &amp; services permitted, e.g. savings, wire transfers, checking accounts, FOREX, etc.</li> </ul> <p>Designation of supervisory authority &amp; reporting requirements</p> <p>Use of rating agencies</p>	<p><i>Officially endorsed or accepted systems, procedures, guidelines and practices – their consistency with a., b. &amp; c., effectiveness, efficiency, fairness, transparency, reflection of best practices, on such issues as:</i></p> <p><b>Local Governance</b></p> <ul style="list-style-type: none"> <li>▶ How to undertake local consultation, plan preparation and budgeting;</li> <li>▶ Implementing investments;</li> <li>▶ Organizing community self-help;</li> <li>▶ Dealing with the private sector or NGOs;</li> <li>▶ Training and capacity building;</li> <li>▶ Monitoring;</li> <li>▶ Communications; etc.</li> </ul> <p><b>Microfinance</b></p> <ul style="list-style-type: none"> <li>▶ Institutional procedures &amp; practices</li> <li>▶ Governance &amp; management practices</li> <li>▶ Portfolio quality &amp; measures to control delinquency</li> <li>▶ Building local capacity, staff training</li> <li>▶ Customer outreach &amp; market responsiveness</li> <li>▶ Product design &amp; quality of service</li> <li>▶ Financial and institutional viability</li> <li>▶ Meaningful &amp; timely information for decision making</li> <li>▶ Management systems</li> </ul>

- Successful testing of local planning and financing norms, systems and procedures (on a limited scale) can fuel debate on national policy by showing that “things can work” at the local level, thereby strengthening the advocates of decentralization.
- Likewise, successes in implementing specific participatory planning guidelines or micro-finance operations may then be adopted in the stronger policy form of regulation, or even amended legislation.

The dynamic indeed lies at the heart of pilot programme rationale [see 3.1.2]. Influence flows in both directions across the spectrum of policy domains.

Local governance policy generally develops in an ongoing process, with decisions that either advance local authority or reverse it, even in countries where devolution is well-accepted and where local governance laws, regulations and systems are in place:

- Periodic rekindling of interest and debate over certain aspects of local governance (e.g. increasing the functions or resources of local authorities), may in turn have legislative and regulatory consequences;
- Conversely, a change in government, a national political or economic crisis, or pressure from donors (intentional or otherwise) may reverse previous policy, with positive or negative effects.

## *ii. Variations Between Countries and Over Time*

Clearly, the importance of the policy domains can vary greatly between countries. In a country yet to adopt a national policy favouring decentralization, or where microfinance operations lack institutional strength or have not developed as a broader industry, the major issues for debate are the broad national policy options; it would be premature to discuss legislative or regulatory issues – although it might be worthwhile to test systems and procedures. An exception here is where microfinance or lending outside the formal banking system is illegal, as in many former socialist countries. In such cases focus would tend toward policy domains (A) and (D).

Conversely, in a country with a clear and well-articulated national decentralization policy and legal framework and a well-developed, mature microfinance industry, the discussion will more likely concentrate on the detailed regulations and procedures required to ensure implementation. Focus would thus be on policy domains (B), (C) and (D).

Cambodia and Uganda offer good examples of extremely different approaches to local governance interventions. Until 1998, democratic decentralization was barely on Cambodia’s national political agenda; therefore UNCDF supported the arguments for decentralization by demonstrating what could be achieved through local pilots. In contrast, Uganda had a well-considered decentralization policy and detailed legislation on local government; there, UNCDF tested systems and procedures for adoption nationwide.

### *iii. Illustrative Policy Issues*

These last examples demonstrate that policy issues shift over time within a country. Thus in local governance efforts in Cambodia, the early focus was on bringing decentralization into the national agenda. After the 1998 national policy commitment to establish elected local government, focus switched to helping develop the legislative and regulatory framework. Microfinance in Mongolia provides a similar example of policy shifts over time. Once Mongolia established the category of non-bank financial intermediary, focus turned to gaining experience in its operation, not rushing to develop regulatory requirements that might have been inappropriate for the environment.

In local governance, pre-1998 Cambodia and Uganda are extreme cases; most countries are “in the middle”. For example, Zambia, Senegal and Bangladesh all have in place longstanding, detailed, legal and regulatory frameworks for decentralization. In such environments the challenge is to revitalize local governance by focusing in parallel on piloting innovative systems [micro-policy – policy domain (D)], while encouraging a wider national debate on policy options [macro-policy – policy domain (A)]. In many ways this is more difficult to do than in a country like Cambodia, since these activities must take careful account of the status quo: a large body of often outmoded laws, regulations and practices, and of vested interests.

Mongolia and Uganda present useful examples of approaches to microfinance. Until 1998, lending outside Mongolia’s banking system was illegal and microfinance operations were non-existent. MicroStart Mongolia therefore worked with parliament and the Central Bank to permit financial operations through a non-bank financial intermediary. In Uganda a variety of microfinance institutions – microfinance operations in banks and community-based operations, practitioners and research initiatives, such as MicroSave Africa – worked with Government to discuss microfinance policy and legislation. With several years of experience, a thriving industry, and market research in hand, the dialogue could focus on more specific regulatory requirements.

### *iv. One Country’s “Policy Domain (B)” issue is Another’s “Policy Domain (D)” issue*

Finally, policy positions on the same issues might be more formalized and mandatory in some countries than in others. For example, central-local fiscal transfer arrangements might be prescribed by law (indeed, even by the Constitution) in some countries, while elsewhere they might take effect through de facto practices in systems and procedures. Similarly, procedures and timetables for undertaking local planning might be directed by ministerial instructions in some countries, while in others they might simply be recommended in guidelines.

This framework of “Policy Domains” is therefore to be used flexibly – the same policy impact achievement in one country may require changes to the regulatory or even the legal framework, while in another country only require changes to prescribed systems and procedures.

**Table 2: Replication**

COUNTRY LEVEL			GLOBAL OR REGIONAL LEVEL
a. Expanding Same Programme thro' co-financing	b. Upscaling Programme sequentially	c. Influence or Inspiration	
<p>Co-financing arrangement with other donors whereby latter expand scope of UNCDF-designed LDP or microfinance through:</p> <ul style="list-style-type: none"> <li>▶ Trust fund</li> <li>▶ Cost sharing</li> <li>▶ Parallel financing</li> </ul> <p>Design of other programmes influenced through participation in parallel programming activities of other donors.</p>	<p>Agreements with other donors and/or governments to endure longer term national scale funding of UNCDF LDP activities.</p> <p>MFI's expand branch networks to scale up through private sector investment and links to the formal financial system</p>	<p>Aspects of UNCDF programme strategy or design adopted by other partners</p> <p>Donor's policy focuses on supporting sustainable microfinance</p>	<p>Other donors adopt part/all of LDP strategy principles.</p> <p>Other donors participate in joint LDP &amp; microfinance learning exercises &amp; best practices workshops with UNCDF.</p> <p>Research/advocacy agencies adopt local governance and microfinance agendas and concerns.</p> <p>Industry wide reporting, disclosure &amp; performance standards are established</p>
		<div style="border: 1px solid black; padding: 5px;"> <p>MF networks in-country or internationally disseminate practices based on successful experience for the benefit of other MFIs.</p> </div>	

*The ease of achieving these forms of replication may vary and will depend on country context. UNCDF strategy must take this into account.*

**B. Replication**

*3.1.2 Mechanisms for Achieving PI&R*

*A. The Need for a Process View*

A simplistic view might suggest that to achieve influence on policy or replication simply entails identification of the appropriate (government or donor) “decision maker” and providing him/her with convincing evidence of the costs, benefits and rationale for adopting the proposed policy or strategy change. Many donor policy-advisory programmes have been rooted in this model, and have generally failed.

Clearly neither national policy nor donor strategy decisions are usually the outcome of such a techno-rational process<sup>7</sup>. Instead, in the making of these decisions:

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<sup>7</sup> This view was widely expressed not so long ago by systems theory analysts and some of the rational choice school of political economists. For a typical expression of this economic-technocratic model of decision making see “A Primer for Policy Analysis”, Stokey and Zeckhauser, 1978.

- (a) political/policy agendas must often first be changed, sensitised or even established before the issue can be addressed at all;
- (b) many different individuals and agencies may be involved in the process, and must feel part of the process, which is rarely linear but usually iterative;
- (c) a forum where these individuals and agencies can interact, determine the policy agenda, discuss and agree, or at least make compromise, is often required;
- (d) somewhat counter to conventional wisdom, the availability of incontrovertible or even convincing evidence to justify change will not always be necessary for the change to be made (though, sooner or later, will be necessary to sustain the policy position), and is almost never sufficient; *and*
- (e) conversely, credibility and skills of advocacy and persuasion to bring issues on to the agenda, and to influence members of the “policy community”, and the techniques of communication of whatever evidence is available, are often necessary to achieving any impact<sup>8</sup>.

All of these have clear implications for UNCDF strategy in achieving PI&R. Specifically, they suggest that even the best M&E mechanisms for reporting lessons of pilot operations will be insufficient, on their own, to achieve PI&R. Such mechanisms must be complemented by proactive Advocacy and Advisory (A&A) activities [see below].

## ***B. The Audience***

The persons or institutions to be influenced will vary according to the type of PI&R sought. Many institutions can be concerned in policy decisions:

### *i. Country-Level*

- Ministers, senior officials and key advisers from ministries of Local Government or Territorial Administration, Finance, Planning, Rural Development, etc. or for Microfinance, the Ministry of Finance, and the Central Bank;
- Chairpersons and key members of interdepartmental decentralization or rural development committees, public sector / expenditure / fiscal reform, or similar policymaking bodies, and advisors to these bodies;
- Key parliamentarians, e.g. members of parliamentary committees on decentralization or local government, or on public sector / expenditure / fiscal reform or involved in financial sector reform, banking committees, etc.;
- Party leaders and members of party policymaking bodies;

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<sup>8</sup> A much more politically realistic and process-oriented view of policy decision making is detailed in “Evidence, Argument & Persuasion in the Policy Process”, Giandomenico Majone, YUP, 1989.

- Local government associations and other prominent local government leaders;
- Leading national research / advocacy bodies and NGOs;
- National and international media representatives;
- Leading donor representatives (UNDP, World Bank, IMF, key bilaterals) and donor working groups on local governance, etc.; and
- Educators and Clergy.

*ii. Local Level*

- Local government representatives and civil servants;
- Central Government representatives;
- Community leaders;
- Community organization members;
- Credit unions, MFIs, cooperatives, banks and finance companies;
- NGOs and social activists;
- Local educators;
- Local clergy;
- Local media representatives;
- Local programme beneficiaries, and
- Staff from other development projects.

*iii. Understanding the Audience*

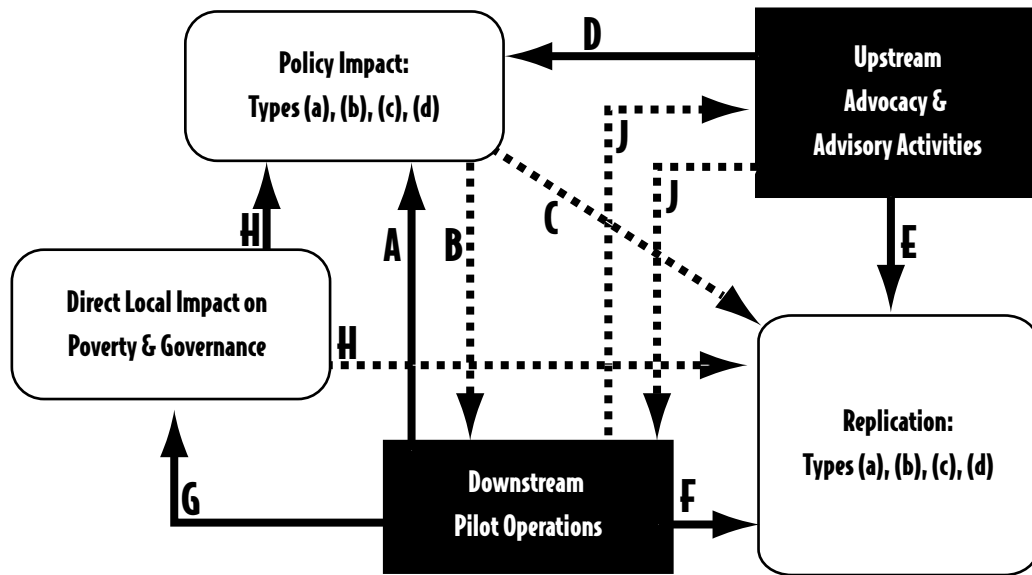
Clearly, each set of actors and institutions identified above has its own objectives, agenda, constraints, etc., which will limit impact and determine appropriate modes of influence.

**C. Achieving Influence**

*i. Schematic Overview*

The following diagram depicts the relationships between UNCDF corporate objectives, its instruments and avenues of influence.

**Chart I. Objectives, Instruments and Influence**



**Legend**

- UNCDF corporate objectives in the area of LG operations: Policy Impact and Replication, and also Direct Poverty & Local Governance Impact.
- Instruments of UNCDF influence on these objectives.
- Sets of “mechanisms for influence”.
- Feedback effects.

*ii. Mechanisms of Influence*

UNCDF mechanisms of influence on PI&R can be divided between:

- **Downstream Pilot Operations.** These are the classic UNCDF activities (LDP or MF projects), with more or less predetermined objectives, outputs, activities, workplan and budget; *and*
- **Upstream Advocacy or Advisory Activities.** This refers to a range of possible activities (advocacy, policy-relevant studies, workshops, fielding of advisors, etc.) which may be less predictable, more spontaneous and which will react to evolving context and opportunities; note that there are important differences between advocacy and advisory activities [see below]. These activities have not been traditional UNCDF undertakings and they may be provided and financed by various sources: From within the same project delivering the Downstream Pilot Operations, from budget lines which may be UNCDF- or UNDP-financed; from core activities and missions of UNCDF staff (Technical Advisers and RTAs, Programme Managers, Programme Officers) or senior management, and by international microfinance technical service providers with successful track records.

Although, as noted, both Downstream and Upstream instruments have usually been financed from the same project budget, these instruments have distinct scope and limits:

*(a.) Pilot Operations (Downstream work)*

These aim basically to test innovations, to generate information and lessons, and to provide demonstrations, thereby influencing policy and donor strategies and programmes – Arrows A and F. Clearly, the effectiveness of this mechanism will vary according to the type of PI&R and depend on certain conditions. [See 3.2.1 below]

Where PI leads to policies more conducive for LG or MF operations, pilots themselves can be more effective (feedback Arrow B), creating a virtuous circle.

Of course pilot operations also seek direct local impact (on poverty, institution-building, local governance, etc.) through the activities, goods and services delivered along Arrow G. Note that a direct impact strategy may, at times, conflict with PI&R strategies – and there may thus be tension and tradeoffs between G, A and F. For example, a local governance financing mechanism to channel funds to local authorities might be designed to bypass Government procedures – for more rapid poverty impact – or, instead, to work, more slowly through them – to mimic standard procedure and reform it from within. Or an MFI might be concerned with direct outreach, placing lower priority on institutional performance and linkages with the formal financial system; but here, by focusing on immediate delivery for poverty reduction, long term policy impact is unlikely to result.

Feedback Arrows H suggest that manifestly positive, direct, local impact enhances UNCDF credibility and interest in a pilot, thus indirectly favouring UNCDF influence on PI&R.

*(b.) A&A: Advocacy and Advisory Activities (Upstream work)*

These may aim to raise awareness of policy issues, to influence policy agendas, to support informed analysis of policy options, to support revision of the legislative or regulatory frameworks, to rally interest by donors, to influence donor programme strategies or design, etc. Such objectives are achieved along Arrows D and E. Again, the effectiveness of this mechanism will vary according to the type of PI&R and depend on certain conditions. [See 3.2.1 below]

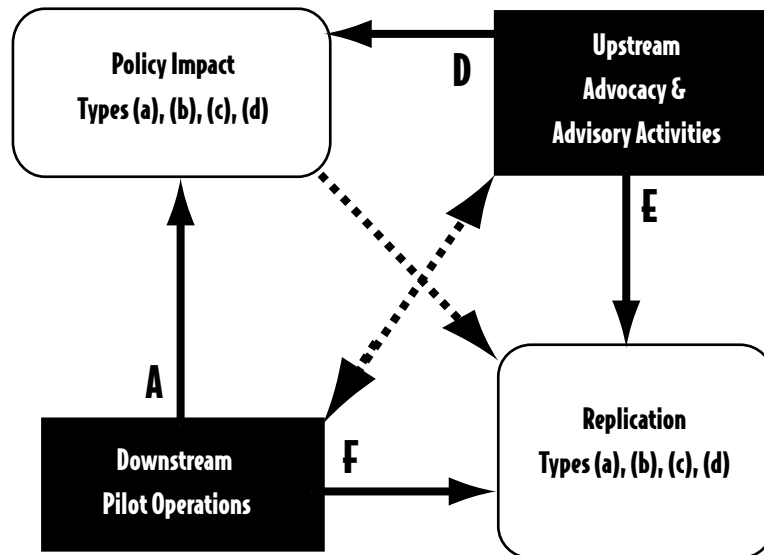
Where PI results in Government pressure on donors to modify their programme strategies accordingly, then indirect influence on replication is achieved through feedback Arrow C. For instance, if Government is encouraged to require that all rural road funding be channeled through local authorities, and in turn instructs or exhorts donors to comply with this approach, replication is an indirect effect. In the microfinance context, when Government eliminates subsidized lending operations and instructs donors to follow suit, the same effect is achieved.

Finally, note that the two instruments themselves are (or should be) interdependent. That is, UNCDF-sponsored pilot operations and A&A feed one another, and the latter should be grounded in the former. This relationship – shown by feedback Arrows J – helps maintain the policy-relevancy of pilot operations and, especially, provides empirical backing and credibility to UNCDF A&A.

### 3.2 Factors Bearing on UNCDF Strategy

It is useful to recall the main relationships between the UNCDF corporate objectives and instruments which concern us, taken from the previous diagram:

Chart 2. Objectives, Instruments and Influence



*For legend, please see page 20.*

#### 3.2.1 Conditions for Effectiveness of UNCDF Instruments

Section 3.1 outlined possible PI&R objectives, UNCDF instruments, and avenues by which these might achieve their objectives. This section outlines certain factors that influence the effectiveness of these two sets of instruments in local governance and microfinance:

##### A. Pilot Operations (Downstream work)

This instrument can show national policymakers and other development partners that change in broad LG or MF policies is feasible (e.g. that local institutions can manage their affairs and therefore decentralization is warranted, or that only sustainable microfinance is likely to provide long-term development and therefore eliminating interest rate ceilings is warranted). Or it can prompt them to develop systems, procedures and guidelines which may be adopted officially by national authorities, private institutions, or development partners.

##### i. Effectiveness

Whether the target audience learns and applies the lessons generated by pilot operations will depend upon several factors:

- Technical relevance, soundness and coherence of the lessons for the audience, in light of national policy concerns or donor interests;
- Accessibility and timeliness of the lessons;
- Prior audience commitment to view the operations as a lesson-generating pilot; *and*
- Attractiveness and novelty of these lessons compared to current practice and state of the art, and in the context of audience agenda and interest.

## ii. Implications

Effectiveness is contingent upon:

- Sound prior analysis of “policy impact” domain issues;
- Identification of “policy audience” members and assessment of their concerns and agendas;
- Involvement of key stakeholders in designing the pilot operation;
- Design of the pilot to “mimic” policy-relevant conditions, institutionalize procedures, and avoid “parallel structures”;
- Design of the pilot to promote innovation and best practice;
- Government ownership of local government design and monitoring processes; and, MFI ownership of microfinance design and monitoring processes;
- Monitoring with policy lessons in mind;
- Quality substantiation and communication of lessons; *and*
- Support to fora where lessons can be debated.

## B. *Advocacy and Advisory Activities (Upstream work)*

The various activities within this instrument aim to influence broad policy direction, inform policy debate, illuminate policy options, advise on legislative or regulatory reform, rally donor support, influence donor programme strategies and design, etc.

### i. Effectiveness

The influence of A&A will depend upon:

- Technical credibility of UNCDF as an advocate or adviser;
- Participation by UNCDF at policy debate fora;
- Consistency of UNCDF's advocacy or advice with that offered by other partners;
- Relevance and soundness of the A&A, in light of audience agendas and concerns; *and*
- Timeliness of the advocacy or advice, given that policy debates can evolve quickly and unpredictably.

ii. Implications

Effectiveness will depend on:

- UNCDF reputation for achievements – in-country or elsewhere – and successful, downstream pilot operations that consistently apply good practices;
- UNCDF local representation on – or access to – policy fora, directly or through alliances with other partners;
- Dialogue with partners to encourage a common stance;
- Monitoring the nature and evolution of policy concerns and debates to ensure timely and relevant responses, and
- Technically-sound advice and linkage with downstream pilot operations.

**3.2.2 Lessons from Experience**

The considerations outlined above are somewhat a priori. Actual UNCDF experience highlights critical factors that can influence PI&R success or failure. These factors, which partly overlap those above, can be summarized generally – in no particular order – as follows:

A. *General*

- Many scattered instances of PI&R occur without being registered in any systematic fashion; UNCDF only learns of them by chance; *and*
- Many PI&R successes attribute no role to UNCDF, despite important contributions made by the Fund.

B. *Pilot Operations (Downstream work)*

- Project design must be linked to the relevant national policy concerns, and include explicit hypotheses which can be tested;
- Project design must be undertaken in close collaboration with national / local stakeholders to encourage them to view the operation as a lesson-learning experience;
- Project design may need to evolve as the policy context itself evolves, and so operations should be flexible;
- Policy lesson-learning requires an interlocutor agency, or a network of practitioners at country-level which is involved in national policymaking debates and fora;
- To avoid confusing roles, a single agency should not be burdened with both implementation and national policy development; for example, in MF the most effective policy advocacy work is done by MFIs working together with enlightened policy-makers; *and*
- Policy lessons must be well-substantiated and communicated, but this is not always a prerequisite for influencing change.

*C. Advocacy and Advisory Activities (Upstream work)*

- Prior and ongoing analyzes of policy issues, and the impediments to promoting LG, are needed to identify opportunities;
- Evolving policy issues must be monitored to ensure that response / support evolves accordingly;
- Policy allies must be identified and supported;
- The arguments of policy opponents must be understood;
- Opportunities for wider advocacy amongst the potential policy audience should be seized;
- Opportunities for influencing donor strategies and programmes should be sought;
- Policy advocacy will tend to precede policy advisory activities;
- Policy advocacy activities can be critical but are rarely requested by the target audience;
- Policy advisory activities are only useful when they respond to a request from national authorities or organizations implementing microfinance operations;
- Such requests often come at short notice and are easily missed;
- Policy advisory support may take the form of indirect support to national capacity-building (policymaking or coordinating bodies, their technical secretariats, or networks of MFIs, etc.);
- This support is most effectively provided in alliance with other, like-minded development partners;
- UNCDF should maintain linkages with the A&A staff of other development partners, both HQ-based and country-based;
- The UNDP / UNCDF partnership can be most effective, but this is not universal and UNCDF participation has not always been easy;
- Staff / advisers deployed at country / regional level can play critical roles in many of the above activities, but their relationship with UNDP must be clearly defined; *and*
- High-level advocacy by UNCDF senior management on mission can be significant vis-à-vis Government and other development partners.

***3.2.3 Broader Issues and Emerging Challenges***

To complete the backdrop against which UNCDF PI&R strategy must be built, it is important to highlight other, broader issues which must shape UNCDF strategy:

*A. Potential Demand*

The potential sphere of PI&R activities is growing, due to the increasing attention paid local governance and microfinance issues by both policymakers and donors:

- Governance is becoming the dominant framework for discussing and addressing development and poverty issues within the development community, hence local governance issues are growing prominent;
- Government policies more and more reflect decentralization (in some cases due partly to UNCDF efforts) and policymakers are increasingly addressing the complexities of legislative, regulatory, systems development and procedural implications;
- National Governments are paying more attention to microfinance as experience is gained in their countries and internationally and as MFIs begin to assert considerable outreach and transform into licensed financial institutions;
- UNDP's policy focus tempts involvement in microfinance regulation, when microfinance is undeveloped or the dynamics and consequences of the regulatory frameworks are poorly understood; *and*
- Other donors are, consequently, growing more interested in developing programmes in these areas.

Given UNCDF's limited resources – in funds and technical staff – we must focus and set priorities both within and between countries, and among the types of policy initiatives UNCDF can reasonably manage. As other development partners increase their roles in Local Governance, UNCDF will need to refine further its LG niche. In microfinance, UNCDF must remain focused on its defined niche and pursue policy actions within and supportive of that niche.

#### *B. Pilot Project Operations (Downstream work)*

These represent a critical element in UNCDF's comparative advantage, not only by directly generating lessons, but also by keeping us in touch with reality and lending credibility to our A&A. Nevertheless, certain challenges and questions are emerging:

- Trade-offs between objectives need corporate recognition. For example, local involvement in process-driven project formulation (required to ensure national buy-in to the pilot) may prevent timely approval and delivery of commitments. Or in microfinance, the over-involvement of Government executing agencies often conflicts with what is essentially a private sector initiative;
- In some countries the effectiveness of pilot operation lessons is undermined by UNCDF's unclear relationship with UNDP (co-funding uncertainties and cutbacks, differing views of execution and financial management arrangements, etc.);
- In "mature" programme countries, where pilot operations have run for some time and some PI&R has already occurred, UNCDF must decide whether to continue and consolidate learning on the same themes, diversify into new themes, or simply exit from direct funding;
- When SUM provides technical advisory services to UNDP in countries where

UNCDF does not operate, or in the UNDP-managed MicroStart programme, UNCDF faces the challenge of integrating experience into corporate policy;

- Where donor funding assures sequential replication, or as Government adopts funding mechanisms for LG pilot initiatives, or as MFIs transform into private shareholder companies, UNCDF must decide its role in relation to the project or the institution after direct funding ends; *and*
- Maintaining a technical and innovative edge in designing and implementing these operations will require greater UNCDF technical knowledge – and higher corporate regard for such knowledge – and greater efforts to promote experience exchange between programmes, especially as competitors increasingly enter “the local governance market”.

*C. Advocacy and Advisory Activities (Upstream work)*

It is clear that downstream pilot operations may not suffice for achieving PI&R due to the unpredictable and diffuse nature of the issues addressed. More ad hoc technical support and facilitation are required to identify and address problems and opportunities as they arise. However:

- Relations with UNDP. Undertaking such activities on a wider and more sustained basis requires that UNCDF, sooner or later, clarify its role in relation to both UNDP HQ and individual Country Offices in promoting LG. At country-level, identification of PI&R problems and opportunities should be the role of UNDP Country Office – yet relying on the UNDP partnership in both LG and MF is problematic in several key countries; the PO is also often ill-equipped to undertake this;
- Relations with Other Partners. In LG and MF, UNCDF must collaborate with donors because they are more influential and/or because they can (intentionally or not) undermine progress. This requires identifying and maintaining close links with individuals in partner organizations and building credibility with them;
- Mode of Operations. UNCDF’s operational procedures (for proposing, approving, and managing assistance) are geared to the project mode. While appropriate for downstream pilot operations, they are not always appropriate for upstream A&A work, *and*
- A&A Risks. UNCDF should be careful to assess the merits and risks of A&A activities not somehow linked to pilot operations, and should determine the proper balance between them in allocating budget and staff resources.



# 4 PROPOSED UNCDF STRATEGY AND OPERATIONAL IMPLICATIONS FOR POLICY IMPACT AND REPLICATION

## 4.1 Local Governance

We now pull together the various arguments and lessons outlined above to construct the operational implications of a PI&R strategy for Local Governance.

### 4.1.1 *Country Programme Level*

#### A. *Country Strategies – General*

##### i. Country Record of PI&R Achievements

PI&R achievements are often inadequately recorded or reported, hence incompletely shared within UNCDF, let alone communicated to the outside world. LGU should prepare and update annually a report of PI&R achievements to date, according to the one-page format presented on the next page. These reports should feed into LGU reports to UNCDF management, and into the annual ROAR.

##### ii. Preparing and Adjusting Country PI&R Strategies

Based on a review of policy context, opportunities, challenges and constraints, Country Strategies for PI&R should be prepared annually – and reviewed and adjusted periodically – as part of the broader LGU Country Programme Strategy exercise.

Country strategies should identify the specific policy challenges to be addressed, and the instruments for achieving influence or impact. An illustrative framework for this is provided at the bottom of the next page.

**Country PI&R Report**

**Country** \_\_\_\_\_.

**Policy Impact**

Macro policy	Legal framework	Regulatory framework	Norms: Systems, procedures, practices adopted nationally
Eg. Malawi (support to political move to devolution, fiscal decentralization)	Eg Cambodia, Uganda, (Commune laws, input to redrafting LG Act)	Eg Uganda (revisions to Financial Regulations)	Eg Mozambique, Mali, Vietnam, Cambodia, Uganda (adoption of planning and/or financial allocation procedures)

**Replication – also indicate \$ value of programmes “influenced” if possible**

Co-financing (various types)	Sequential scale-up	Influence
Eg Mozambique (Dutch Trust Fund), Malawi (ADB ..) or government \$ ..	Eg Uganda (WB), Palestine (EU) \$ ...	Eg Zambia (ZAMSIF II) \$ ..

**Total Value of other donor resources “influenced”:** \$ \_\_\_\_\_

**Strategy: Policy domain where change to be affected**

Local Governance Policy: Area of Policy Challenge / Focus	Broad Policy Stance	Legal and Regulatory Framework	Norms: Systems, Procedures, Practices
Listing of key areas to be targeted, e.g.:  Fiscal Decentralization Policy: I. Service Delivery Planning & Implementation (i.e. expenditure assignment issues) II. Local Revenue Mobilization III. Inter-Governmental Fiscal Transfers	Develop strategies for:  Advocacy & support to debate and discussion venues; analytical work on policy options; feedback from pilots	Develop strategies for:  Advocacy & advisory work on legal & regulatory texts; feedback from pilots	Develop strategies for:  Local pilot operations testing innovative approaches; clear hypotheses & lessons monitored

The Country PI&R Strategy reports presented on the preceding page should thus contain the following elements:

- Key, feasible, short- and medium-term PI&R objectives and activities based on analysis of country context (using the definitions given earlier, and the framework outlined above);
- The respective roles of UNCDF and UNDP in PI&R [see below];
- Other partnerships [see also below];
- Types of lessons to be generated by pilot operations;
- Key A&A activities, to the extent they are “plannable” ;
- A defined role for RTA (if appropriate), and
- The resources available (project budgets, project staff, others).

### iii. Country Compacts with UNDP

Experience clearly suggests that the UNCDF-UNDP relationship is a key factor in the success of PI&R activities. Specific sections within proposed UNCDF / UNDP Country Compacts (currently under consideration by UNCDF management as a follow-on to the MOUs) should clarify roles and expectations in PI&R and upstream A&A work, and the roles of UNCDF staff (Programme Officers, Regional Technical Advisers, HQ staff on mission) in dealing with Government staff, at donor meetings on local governance, etc.

### iv. Partnerships

UNCDF's experience to date underscores the importance of working with national partners, donors or development agencies. It is therefore important that we:

- Identify country-specific partners – allies in Government and civil society, donors and NGOs, and advocacy agencies [see country strategy above];
- Send partners appropriate information about UNCDF, its policy and operational strategies, and its country programmes; and
- Have HQ and POs maintain active links with donors (country and HQ staff) and identify opportunities for influence and joint activities (workshops, missions, etc.).

## B. *Downstream Instruments: Pilot LDP Operations*

### i. Programming and Project Preparation

A number of principles should be followed to encourage PI&R:

- Programming activities should only be undertaken where the national context is favourable for PI&R – analysis of these possibilities should be included in the Country Strategy;

- Key PI&R partners should be associated with programme development and project preparation (to be invited on missions, at workshops and meetings; to comment on draft documents; etc);
- Documentation (CSP, Concept Paper, Prodoc) should clearly indicate specific PI&R aims and strategies, and
- Prodoc budgets and activities should be flexible enough to permit ad hoc A&A [see below], which are often inherently difficult to specify or plan at the outset.

ii. MIS, M&E Systems and Communications

A well-functioning system for recording, reporting and communicating information on the activities, achievements and policy-relevant lessons of downstream LDP pilot operations is essential for formulating useful and credible inputs to upstream A&A.

More than this, quite apart from the validity of the lessons themselves, the existence of documented downstream operations strengthens the legitimacy and credibility of UNCDF as a participant in upstream A&A.

It is therefore critical that all country LDP operations set up such systems, in keeping with the recommendations of Action Plan Team 8. However, while we should standardize as far as possible the structure of MIS and M&E systems, the specific sorts of policy-relevant information and lessons needed will vary between countries.

*C. Upstream Instruments: Advocacy and Advisory activities*

i. Upgrade Importance of A&A

Information and lessons generated by pilot LDP operations are necessary to effect PI&R – but are usually insufficient alone to achieve influence. Proactive and opportunistic A&A are generally needed and more consistent attention must be devoted to them, consistent with UNCDF staff and resource constraints. Consequently:

- POs should maintain regular contact with key partners (national and donors) and should report on plans, concerns, and issues under debate;
- HQ staff and management should ensure regular outreach and advocacy with key partners and should identify A&A opportunities on missions;
- Country-specific “hot topic” policy issues (e.g. the relative costs of infrastructure delivery through LGs vs. Social Funds) should be routinely identified;
- Project-focused research should be sponsored and its results disseminated for debate; *and*
- In general, LGU should become more "opportunistic" regarding A&A, standing ready to support ad hoc workshops, advisory missions, and study tours by maintaining flexible project budget lines.

ii. Expanding A&A Roles for UNCDF

Expanded A&A roles for UNCDF will depend upon three factors:

(a.) Downstream / Upstream Synergies

The essential role played by pilot LDP operations in creating legitimacy and credibility for UNCDF A&A has been cited above. This implies that UNCDF should only rarely embark on upstream A&A alone – with no “supporting” downstream LDP – and only in countries where:

- Either UNCDF has already acquired legitimacy and credibility through past LDP activities which may have phased out; *or*
- UNCDF is clearly invited – by Government, UNDP and/or by donors – to support some aspect of PI&R.

(b.) In-house Technical Capacity

Overall, since A&A rely especially on credible LGU technical competencies in local governance and decentralization, the growth of A&A opportunities will parallel growth in technical capacities at UNCDF HQ, regional and country-levels.

(c.) Deployment of Outposted Regional Technical Staff

Following point (b.), experience suggests that deploying Regional UNCDF technical staff can play an important role in PI&R, primarily through A&A with Government and other partners. An important part of strategy should therefore be to:

- Select focus countries where opportunities permit Regional staff to play this role effectively;
- Ensure that staff so deployed are technically competent to fulfill an A&A role, are fully briefed on LGU activities and LDP strategies, and that there are regular exchanges among outposted staff, and between them and LGU staff at UNCDF HQ; *and*
- Ensure that the A&A role and accountability of these outposted staff are accepted by UNDP Country Office staff and by Government partners.

**4.1.2 Global and Regional Levels**

PI&R also calls for concerted action with development partners at regional and global levels:

A. *Outreach to Key Multilateral and Bilateral Agencies*

Successful replication requires more than contact with donors at country-level; this must be matched by outreach to the corporate managers of these donors at HQ level. UNCDF management and staff should thus ensure regular outreach (through visits, telephone, email) to

HQ staff of selected multilateral and bilateral agencies with corporate interest and involvement in governance, decentralization and rural development. This outreach should:

- Communicate programming strategy and the status of country programmes;
- Identify possibilities for programme collaboration and replication; *and*
- Identify common research and advocacy concerns and possible joint activities (workshops, studies, etc.) in local governance-related areas.

Some specific initiatives toward this end include:

i. World Bank

- LGU should catalogue its collaboration with the World Bank from Country PI&R reports [see above];
- UNCDF Senior Management should periodically brief high-level World Bank staff (Vice President and/or Country Director);
- LGU staff should contact selected Task Managers and others to develop country-specific strategies; *and*
- LGU staff should contact World Bank thematic learning groups (Rural Infrastructure, Decentralization, etc.) and the World Bank Institute to identify potential for collaboration in learning agenda [see below].

ii. European Union, AfDB, AsDB

UNCDF Senior Management should periodically brief these institutions – and cultivate other informal contacts – to identify “pockets of interest” within these institutions, with appropriate LGU follow-up visits to HQs.

iii. Key Bilaterals: Danida, Netherlands, SIDA, Norad, France, Belgium, Japan, DfID, et al.

- UNCDF Senior Management should make periodic briefing visits to donor HQs;
- LGU HQ staff should maintain regular contact and information flow with counterparts at donor HQs, and make occasional stopover visits; *and*
- UNCDF should invite key donor HQ or regional staff to participate in UNCDF events (workshops, missions, etc.).

*B. Global / Regional Research, Training and Advocacy Institutions*

In order to ensure Policy Impact UNCDF must also develop further its network of credible and competent technical research, training and advocacy institutions in the fields of decentralization and local governance. To this end:

- UNCDF should identify selected, prospective regional / global research, advisory, training institutions;

- UNCDF staff should make exploratory contacts to assess the feasibility and merits of partnership;
- Where promising, UNCDF should establish a partnership agreement specifying the collaboration in advocacy and policy development in local governance; *and*
- Partners should undertake joint, policy-relevant research, dissemination, and advocacy for local governance.

#### ***4.1.3 Some Corporate Implications***

To ensure that PI&R activities receive due attention and are not sidelined by other routine activities, UNCDF should:

##### *A. Internalize PI&R Planning and Monitoring*

- PI&R issues should feature regularly on the UNCDF Management Meeting agenda and in periodic LGU planning / review meetings, and
- PI&R achievements should be reflected in the ROAR.

##### *B. Clarify UNCDF / UNDP Relations*

To prevent lingering uncertainties about the roles of UNCDF and UNDP from leading to inertia, UNCDF and BDP / MDGD, etc. should establish and agree on their respective roles in Local Governance PI&R.

##### *C. Programme and Project Procedures*

New formats and procedures (project concept paper, etc.) should reflect corporate PI&R concerns.

##### *D. LGU Management Plan, Staff Roles and Responsibilities*

- LGU Planning should identify specific Results and Activities aimed to achieve and measure PI&R;
- PI&R-related performance expected of HQ and PO staff should be clarified, through RCA and possible modifications to Job Descriptions; *and*
- New LGU staff and field staff (POs, RTAs, et al.) selection should weigh competency for PI&R-related activities, and new staff should be briefed on the importance of these activities and the need to report on them systematically.

## 4.2 Microfinance

Here we present a policy impact matrix for microfinance. We explore the four types of issues presented above [2.2.1], analyze how factors in each generally influence microfinance, and set guidelines for UNCDF / SUM PI&R.

### 4.2.1 Policy Impact Matrix

Microfinance services have nearly universal viability. MFIs have survived and grown in quite different regions of the world, and in a wide variety of social, political and economic environments. However, certain environmental factors can promote or hinder the emergence and growth of sustainable MFIs that reach the poor. UNCDF / SUM PI&R therefore should consider critical factors that will influence the policy context, and thus any impact, as detailed in Annex A of this report.

### 4.2.2 Policy Impact: Strategy and Operational Implications

The strategy for advancing a microfinance policy agenda differs markedly from the strategy used for local governance agenda. A key reason is that microfinance is not generally implemented directly with Government partners (where this has occurred, such efforts have been reformulated to follow UNCDF's policy framework for support of microfinance). Secondly, "pilot activities" in microfinance differ from those of local governance projects. While UNCDF Local Governance Unit operations seek to mainstream pilot efforts through Government, most investments in microfinance are directly with MFIs. The objective of these investments is to build sustainable institutions, enable an MFI to unlock barriers that prevent it from reaching scale, or to develop new products and services that reach a different market.

#### A. Country Strategy – General

The policy agenda can focus on:

- Identifying the most immediate and harmful policy threats to building sustainable institutions within the countries where UNCDF operates and where UNDP is engaged in the sector;
- Observing the norms, procedures and practices component of the policy impact matrix; *and*
- Working elsewhere in the policy matrix only when there are "downstream" activities, and then only in areas within UNCDF's grasp given its size, niche, expertise and the presence of other actors with greater policy influence at the macro level (e.g. World Bank, regional development banks, bilateral agencies with policy initiatives).

## *B. Upstream: Advocacy and Advisory*

### i. Macro-Policy and Statutory and Legal Frameworks

The guiding principles above limit UNCDF's influence on microfinance macro-policy to three specific types of advocacy:

- For the repeal of usury laws;
- For expansive, rather than exclusionary, legislation regarding organizational form; *and*
- For Government and donors to close programmes and projects that distort the micro-finance landscape – i.e. subsidized programmes that cannot operate viably over time without donor resources.

### ii. The Regulatory Framework

Within the regulatory arena [3.4.1 C] policy action initiatives require careful thought and utmost caution. The record here is mixed – regulatory frameworks have been premature and indifferent to on-the-ground experience, implementing institutions and analysis of how the framework will affect long-term availability of services. The most effective policy actions have several characteristics in common which should be incorporated in any UNCDF work in this area:

- They are practitioner-led (including networks);
- They tap on-the-ground experience and expertise working with MFIs in-country;
- They are complemented, not led, by experienced international experts;
- They involve policymakers in a long-term process linked with on-the-ground micro-finance activities and the people who implement them;
- They do not appear overnight and cannot be held to artificial timeframes; in fact the reverse appears true – pressure to deliver causes mistakes not easily remedied;
- They have not grown out of “policy action projects”, but by building institutions with established reputations for delivering high-quality services in ways that ensure institutional permanence (financial and institutional viability) and with commitments to serve the poor; *and*
- They require concerted effort by local MFIs, international experts and networks experienced in other countries, and Government officials – particularly those within the Central Bank and Ministry of Finance – who understand how microfinance works.

Work in this area requires UNDP and UNCDF decisionmakers who understand how key elements of policy action either support an enabling environment for microfinance or hinder development of sustainable microfinance.

### iii. Operational Implications and Prerequisites for Work in Regulation

Our work on regulatory frameworks over the past two years has attempted to prevent premature legislation and regulation that would effectively limit the growth of sustainable microfinance. Prerequisite to future work, UNCDF and UNDP must:

- Learn more about policy impact in the legislative and regulatory arena;
- Recognize that technical advice in this specific area is scarce due to lack of experience globally;
- Identify and hire consultants with proven track records in regulatory reform in countries where that reform has benefitted the industry;
- Accept that the long-term effects of microfinance regulatory frameworks are best understood by studying countries that developed a framework based on microfinance industry experience, and examining how, over time, the regulatory framework has affected operations; *and*
- Allocate sufficient budget and staff to support this effort, either directly or by establishing formal linkages with organizations that have developed expertise in this area.

iv. Actions to Support a Regulatory Strategy

Gaining expertise about microfinance regulation can be accomplished by:

- Working with international networks, such as Accion / Calmeadow, and experienced partners, such as the Central Bank advisors in Cambodia and Mongolia, to share their experience;
- Incorporating relevant Central Bank staff experience and expertise in workshops and seminars at the country-level;
- Arranging study tours to countries that have successfully established enabling legislation, and preventing the use of UNCDF resources on study tours to countries that have not; *and*
- Training in microfinance principles and practices at recognized institutions.

C. *Norms: Systems, Procedures and Practices*

Experience suggests that a UNCDF policy action agenda for microfinance should focus on norms [3.4.1 D], with only the few exceptions mentioned above. Many countries are vulnerable to policies that prohibit microfinance or make it unsustainable, and effective policy advocacy requires on-the-ground experience with sustainable and profitable microfinance operations that have reached scale and are ready to enter the formal financial system. Otherwise, policy advocacy can backfire by creating an environment less favorable to sustainable microfinance.

i. Operational Implications and Prerequisites

We must ensure that our own operations support microfinance initiatives firmly committed

to best practices and that can become significant players in their markets – those with the potential to achieve financial and institutional viability.

Due to UNDP 's new policy action wave, SUM staff must redouble its commitment and efforts to explain the value of an operational approach to microfinance. In-country POs and technical staff must be able to articulate this value and encourage this approach.

Maintaining relationships with agencies that work on the policy environment, such as the World Bank and regional development banks, will become more important. So will participating in country, regional and international fora. This will require increasing the budget support for attending these events.

## ii. Actions to Support the Strategy

The most important contribution UNCDF and UNDP can make in microfinance at the country-level is to support sustainable microfinance operations that have transparent track records, and that are financially and institutionally sound. This implies critical review of all microfinance activities and re-orientation or closure of projects that do not fall within this main principle of UNCDF's work in microfinance.

- Policy actions should complement UNCDF on-the-ground support to microfinance institutions and should correct inappropriate legislative and regulatory initiatives. (For example, in Laos and Myanmar where UNCDF and UNDP are major microfinance donors and have established credibility and experience in microfinance.)
- Country strategies should elaborate the financial sector policies critical to microfinance, including prohibitive policies such as usury laws or laws that effectively make microfinance illegal.
- Project documents for microfinance should cite the legal framework under which the operation will fall, and the major policy issues it is likely to confront while developing a sustainable operation that reaches scale.
- Any microfinance project document with a policy action component unrelated to implementation or not soundly rooted in the norms dimension of the policy impact matrix should be examined critically. The burden of proof should focus on why a policy action component is necessary, what other actors are involved in policy, and how UNDP and UNCDF can reasonably contribute to these efforts given their niches, resources and access to expertise.
- UNCDF should ensure Government partners are well-grounded in microfinance best practices and understand how the policy and regulatory environments influence operations. This is most easily accomplished by encouraging partners to attend regional and international workshops and courses run by training institutes on microfinance best practice.
- UNCDF should hold informative seminars with UNDP Regional Bureaux and Country Office staff on the value of policy action tied to on-the-ground activities.

### **4.2.3 Replication: Strategy and Operational Implications**

A strategy for replication is conceptually quite simple – technical excellence breeds success; success attracts others. We can see how this works by referring to the examples given at the beginning of this paper:

- MicroStart Mongolia illustrated the ability to scale-up and build a solid institution within a relatively short time. The effort attracted co-financing early, sparked donor interest in the second stage, and attracted institutional equity investors and loan funds in the third stage of its institutional evolution.
- UNCDF's experience with ACEP in Sénégal showed how the success of a new product and methodology led to replication by other MFIs. The effort expanded and attracted follow-on funding.
- In Cambodia the successful scale-up and solid institutional structure of ACLEDA relied on co-financing by several key donors. Follow-on funding for transformation, and brokering the interest of institutional equity participation and international lenders, led to successful transformation of a specialized microfinance NGO into a commercial bank.
- MicroStart Morocco's technical excellence strengthened several MFIs that were then able to scale-up, attract follow-on funding and the interest of the Government of Morocco in establishing a national, second-tier, financing institution.
- MicroSave Africa was established predominately with UNDP funding and a small co-funding agreement with DfID. In the second phase, due to recognition of its contribution to microfinance in Africa, DfID has provided the majority of financial support and another donor has provided core funding.

These examples demonstrate:

- No clear sequence of “steps” ensures replication, no modality appears more effective than another. What is clear is that success breeds success;
- Some examples of successful replication involved initial support by others. For example, support by the Finnish Government helped the MicroStart Global programme leverage additional follow-on support, and a small co-funding agreement with DfID for MicroSave Africa is being leveraged to larger programme support and attracting another donor;
- In most instances, the institution's reputation attracts “replicators” in the marketplace as well as additional donor financing; *and*
- Additional financing is not automatic; the MFIs, UNDP Country Offices and SUM staff must actively broker it. This type of replication requires the time to build a reputation for supporting quality work, and to build relationships with donor agencies.

## A. *Operational Implications and Prerequisites*

Successful, on-the-ground activities – those resulting in sustainable operations or perceived by donors as valuable contributions – drive donor interest and willingness to fund UNDP- and UNCDF-initiated efforts.

### i. Focus Corporate Vision

UNCDF's corporate vision should recognize that "replication" in microfinance implies independence from donor resources as the operations become profitable, rather than greater donor resources. This will require UNCDF/SUM to:

- Strengthen linkages to private sources of finance, such as equity funds, and understand how these sources affect the ownership structure and operations of MFIs;
- Learn about savings mobilization, reserve requirements and costs of mobilizing deposits, and existing regulations applicable to deposit-taking institutions, and
- Learn about "disposition of assets" and an appropriate structure that can maintain an MFI's strong asset base and good governance.

UNCDF's corporate vision must look beyond LDCs and focus countries to UNCDF / SUM activities elsewhere, such as in Mongolia, Kenya, Guatemala, Egypt, Mexico etc.

SUM should broker donor involvement and equity participation in growing and transforming MFIs.

### ii. Timing and Documentation

- A successful operation needs time to develop. This implies resisting the temptation to document lessons before adequate time has passed – early success may later confront institutional growing pains that effect operations.
- M&E is important. In the initial stages, monitoring focuses on key performance indicators, the development process, the appropriateness of technical assistance, and the reliability of financial information and reporting systems.
- In the later stages, M&E must sharpen focus, and become more of an institutional appraisal that is meaningful to private sector investors, quasi-private equity funds and lenders.

### iii. Outreach and Communication

Many of these actions are similar to those articulated in the Local Governance section of this paper [3.3]. More detail may be found in SUM's management plan for 2001, and each yearly management plan should incorporate particular actions to support a strategy dictated more by current operations than general practice. Such general practice actions include:

- Working with key bilateral organizations – both in-country and at global HQ offices specialising in microfinance. A good joint investment in one country can leverage support in another (SUM already works with key bilateral donors, including CIDA, SIDA, Norad, USAID, DfID);
- Participating in CGAP, IDB, AfDB, ADB and ERBD meetings and events;
- Learning about the operations of equity funds and lenders, including AFRICAP, FMO, DEG, Triodos Bank, South Shore Bank, IFC, etc.;
- Visiting key microfinance donors in-country while on mission;
- Debriefing key donors and UNDP at the end of a mission; *and*
- Participating in training events and seminars.

# ANNEX A: MICROFINANCE POLICY FACTORS AND HOW THEY AFFECT MICROFINANCE

The four domains presented on the policy impact matrix for microfinance (2.2.1) are discussed in more detailed with respect to how these factors generally influence microfinance, and a proposed set guidelines for UNCDF / SUM PI&R.

## A. Economic, Political and Social Policy Environments

### i. Inflation

In countries where inflation is under control and interest rates are unrestricted, the general economic environment is conducive for microfinance. Analysis of top-performing microfinance institutions revealed that only the macroeconomic conditions of hyperinflation and rigorously enforced interest rate controls could prohibit MFI development (Christen, Rhyne and Vogel). Inflation generates real costs to MFIs (and their clients) that must be covered by the interest on loans:

- If MFIs borrow funds in currencies other than their own, inflation can cause foreign exchange losses;
- If interest rates do not cover the cost of inflation, the MFI's equity-funded portfolio will lose value; *and*
- If inflation is too high for an operation to guarantee a positive return to clients, mobilizing local currency savings becomes costly to the saver.

Nevertheless, good MFIs have survived moderately high inflation by adjusting interest rates, where the inflation rate has not fluctuated wildly. Where inflation is high and fluctuating, interest rates can be pegged to an inflation index, rather than fixed for the period of the loan. Alternatively, loans can be denominated in a more stable currency, or loan terms can be kept short and capital can be re-lent at inflation-adjusted rates

### ii. Economic Stability

Volatility can limit the number of financial institutions and microenterprises in a given economy. Conversely, economic stability\* – in particular, effective control over inflation – encour-

ages microfinance viability. \*[footnote: A country's annual GDP growth indicates that country's economic stability and future growth prospects.] Stability affects MFIs in a number of ways:

- In times of economic growth, micro and small enterprises tend to expand; expanded economic activity in turn stimulates demand for financial services, and
- Even stagnant economies can be potential markets for microfinance services if unemployment increases and more people become self-employed; but stagnant or falling GDP levels also result in lower incomes and less demand for products and services.

### **iii. Interest Rate Ceilings**

Given the cost structure of microfinance, interest rate ceilings and restrictive usury laws can undermine MFI efficiency, competitiveness, and viability. To cover their costs, efficient MFIs must charge higher interest rates than conventional banks. If enforced, legal limits on loan interest rates often prevent MFIs from operating on a commercially viable basis. Typically, such restrictions on interest rates fail to protect the most vulnerable populations; generally, poor borrowers do not benefit from intended low-cost services and small loans, because they are more expensive to deliver and manage, or are simply unavailable in the marketplace

### **iv. Financial Repression**

Government-run operations that support certain sectors of the economy or particular institutions through subsidized interest rates and directed credit can also discourage the emergence of viable banking institutions

### **v. Poverty Levels, Markets and a Cash Economy**

The degree of poverty in a country or region and the balance between subsistence and cash economies influence the size and demand for microfinance services in a potential market: Markets where goods can be bought and sold, where transportation and communications infrastructure provide sufficient access to markets, and where the cash economy enables people to develop profitable, small-scale economic activities, will have some cash surplus and a need for financial services

### **vi. Political Unrest**

Conflict or political unrest that undermines existing systems and social networks pose extra concerns for MFIs. During severe unrest, MFI activities may decrease or cease altogether, especially if unrest threatens the safety of staff and clients. Because microfinance is a cash-based business, it is particularly vulnerable.

## **vii. Population Density**

Microfinance programs now flourish in both urban and rural areas. Outside major cities, microfinance is easier to deliver in areas of moderate-to-high population density and adequate transportation, communications and infrastructure. However, inroads are even being made in sparsely populated areas by institutions finding creative ways to use times and places where people gather. Often it makes sense for MFIs to establish services in “easier” areas, such as major population centers, and gradually extend them to smaller market towns and rural areas. In sparsely populated areas, mobile units – such as loan officers handling all transactions on periodic visits – may be more financially viable than a branch office. In areas with poor infrastructure, part-time, makeshift branches staffed locally may be more feasible than one branch serving the same large area

## **viii. Literacy**

While literacy is an enabling environmental feature, MFIs can successfully employ many techniques to reach people with limited literacy.

## **ix. Attitudes Toward Interest**

Cultural, political or religious attitudes against charging or paying sustainable interest rates can be overcome, but they challenge microfinance operations. While other institutions can charge administrative fees that cover the full cost of services, MFIs must rely on loan interest alone. Nevertheless, microfinance institutions that have demonstrated the value of their services to the poor and maintained efficient operations have encouraged revisions of usury laws.

# **B. Statutory and Legal Frameworks**

## **i. Legal Organizational Forms**

Existing, legal forms in the financial, cooperative and non-profit sectors are rarely well-suited to microfinance operations. MFIs differ from cooperatives in their ownership structure and their non-member customer base. They differ from NGOs by virtue of their specialization in finance and their developmental – as opposed to philanthropic – objectives. A body of law that permits expansive, rather than exclusionary, organizational forms can encourage microfinance institutions suited to the environment. But premature legislation may fail to anticipate how MFIs will evolve in a particular country. Several countries have favoured microfinance regulations based solely on credit cooperative characteristics. Such moves have impeded the growth of other institutions, including NGOs, non-bank financial intermediaries, specialized agencies and shareholder-owned institutions. The restrictive nature of the PARMEC law in West Africa, which limits both legal form and establishes interest rate ceilings, shows how legal organizational forms can block microfinance operations.

## **ii. Usury Laws**

Usury laws, discussed above [3.4.1 A.iii.], are particularly prohibitive for sustainable microfinance operations that seek to reach large numbers of poor people.

## **iii. Illegal Microfinance**

In some environments, especially former socialist countries, lending outside the banking structure is illegal. MicroStart Mongolia addressed this by working with Government authorities and parliament to create an enabling environment for microfinance.

## **iv. Restrictive Tax Laws**

Tax laws can hinder a microfinance operation. Examples include:

- Taxing borrower savings accounts;
- Taxing MFI-required savings received as collateral; *or*
- Taxing net profit under a more liberal provisioning policy, when a more conservative policy is recommended for short-term unsecured loans.

## **v. Legal Framework for Enforcing Contracts**

A legal framework for enforcing repayment is helpful, though not essential, for a successful microfinance operation. However, well-defined property rights and good contract law can minimize costs of legal proceedings. In many cases, legal recourse is valuable as a credible threat, even when not employed by the MFI.

# **C. The Regulatory Framework**

## **i. Financial Regulation and Supervision**

Financial regulation refers to the principles, rules, standards and compliance procedures that apply to financial institutions. Financial supervision involves the examination and monitoring of organizations for compliance with financial regulation. Prudential regulation and supervision are designed to:

- Avoid a banking crisis and maintain integrity of the payments system;
- Protect depositors; *and*
- Encourage financial sector competition and efficiency.

The existing conventional banking sector regulatory framework rarely accommodates microfinance operations. Most MFIs differ from commercial banks in institutional structure and the manner in which they secure their loans through peer group guarantees and non-traditional collateral.

## **ii. Avoiding the “Rush to Regulate”<sup>8</sup>**

Because of gaps in their regulatory frameworks, many Governments have been keen to develop appropriate MFI regulations. The “rush to regulate” the industry to promote or control its development may undermine the potential of these emerging institutions:

- A regulatory framework based on limited, national experience can be premature;
- A regulatory framework does not foster the growth of microfinance; in fact, it often hinders it;
- The temptation to create regulations for the “orderly development” of microfinance can lead to overcontrol; *and*
- Regulations intended to be light, such as special registration requirements, can easily become bureaucratic bottlenecks, particularly if supervisory capacity is in short supply.

At the early stages of microfinance industry development, it is probably best to permit institutions to operate under existing legal frameworks where possible, and allow some experiments to push the edges of those frameworks.

## **iii. Whom to Regulate and Why**

Analysts generally agree it is unnecessary to regulate organizations that lend but do not take savings. A lending organization that fails does no harm to clients (other than by discontinuing services). It is widely accepted that many institutions – including associations, foundations, and cooperatives – may safely lend. The UNDP-supported MicroSave Africa has provided much research on this topic.

The benefits of regulating microcredit operations – ostensibly to improve their quality by applying performance standards – are unlikely to outweigh the potential disadvantages, such as discouraging new entrants. High-quality microfinance services depend on high-quality microfinance institutions, not on standards applied by a regulatory authority.

Institutions that mobilize public savings require regulation. The failure of a savings-based institution harms its depositors, and may damage other institutions by undermining confidence in financial institutions and the financial system. It is particularly dangerous to broaden the range of institutions allowed to take savings from the public, where a capable supervisory structure for those institutions is lacking. It is seldom wise to allow NGOs to accept

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<sup>8</sup> c.f. Christen and Rosenberg, “The Rush to Regulate”

deposits (other than forced savings that are part of a loan contract). MicroSave Africa demonstrates that small organizations in isolated rural areas, although risky, may be safer than alternatives.

**iv. When to Establish Regulations.**

When MFIs reach critical mass and begin to operate as financial intermediaries, work on the regulatory level begins to make more sense. Such work will benefit from a body of experienced practitioners who can work with Government to ensure that new regulations match on-the-ground operations. As Governments take more active roles in regulating microfinance, they will need to increase their investment in specialized, supervisory capacity. The time, commitment, costs and trade-offs of pursuing this course of action must be thoroughly examined.

**D. Norms: Systems, Procedures and Practice**

Microfinance Best Practices have been well-documented. Several principles identified here are particularly relevant to UNCDF's scope of influence and level of operations. UNCDF should support efforts to:

- Create viable, permanent institutions that seek to provide access to services (financially viable, institutionally robust, and commitment to scale within market);
- Listen to customers and commit to serving them (product development, depth of outreach, quality of services);
- Charge interest rates on loans that enable the lender to cover costs;
- Control delinquency and default;
- Invest in technical assistance for institution-building (human dimension) and capitalisation (access to commercial finance);
- Remain methodology neutral.
- Resist the temptation to diversify too quickly, but avoid the temptation to remain complacent in the marketplace;
- Foster competition that improves efficiency and quality of services;
- Establish and promote effective governance;
- Promote learning institutions that can manage risk, examine success and explore failure;
- Develop good MIS that produces timely, accurate and meaningful information;
- Ensure financial and institutional disclosure, i.e. transparency, and
- Encourage Government to play an effective role by supporting a macroeconomic enabling environment (particularly controlling inflation), not by implementing microfinance programmes.