CAPITALPLUS

The challenge of development in development finance institutions

A PRACTITIONER PERSPECTIVE

A publication of the
Development Finance Forum

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FOREWORD

"Capital Plus" owes its start to the Ford Foundation. In 1995, as part of its re-visioning as a "global foundation," the Foundation established theme-related staff "affinity groups," including one on development finance. This group's first meeting was held in 1995. Although the meeting was intended primarily for Foundation program staff, a few development finance practitioners were invited, and were also included in subsequent meetings of the group.

In one of the group's meetings, a number of program officers made the point that the practitioners supported by the Ford Foundation had a different perspective from that reflected in the Micro-Credit Summit being planned for Washington, D.C., in February 1997. Based on this discussion, the Foundation selected a group of practitioners to meet in Washington just after the Micro-Credit Summit to explore the idea of developing one or more alternative views about the role of development finance in poverty alleviation.

"Capital Plus" grew out of a Ford Foundation decision to select a group of practitioners to explore the idea of developing one or more alternative views about the role of development finance in poverty alleviation.

What later became the Development Finance Forum (Forum) first met at a restaurant in Washington, D.C., on February 4, 1997.[1] Some of us joked that the meeting was the "Anti-Summit," referring to the just-concluded Micro-Credit Summit, where we had witnessed the promotion of a minimalist microcredit paradigm as a kind of panacea for the poorest of the poor.

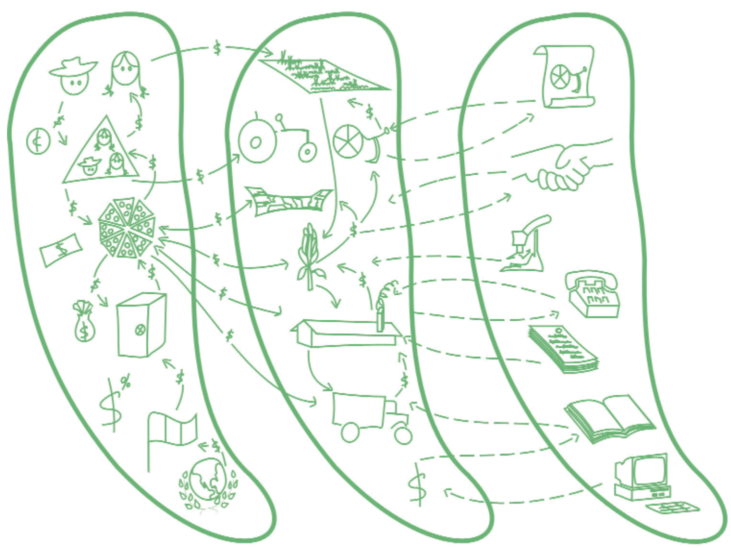
We listed a number of challenges at our initial meeting:

- How do we make development finance work at a significant scale?
- How do we break the orthodoxy of minimalist credit, especially the myth that everybody wants to be self-employed, and how do we tell the truth about the limitations of microcredit, particularly with reference to the poorest?
- How do we apply ourselves to our own institutions while helping build the fledgling field through policy work and sector-level institutions, such as industry associations?

[1] The group was initially called the International Leaders' Forum on Development Finance. At its 2003 meeting, it rechristened itself the Development Finance Forum.

- How do we do all of this while managing the expectations that come with being pioneers in our respective settings, yet remaining acutely conscious of the need to depersonalize the work so that institutions can be built?

The meeting ended with a memorable comment by Alfredo Hubard-Deffis from México: "it was a great opportunity to hear others think." In some ways, this comment set the tone for subsequent Forum meetings. Raúl Hernández-Garciadiego (also from México) summarized the meeting with a picture of three jalapeño peppers, a pungent rejoinder to the minimalist credit paradigm of the Micro-Credit Summit. Later, this was printed on a T-Shirt reflecting the serious debate and fun that were interlaced in the Forum.



The jalapeños depict a three-chain set illustrating the complementary activities of sustainable development. The pepper on the left represents the financial chain (including savings and credit services). It starts at the individual/family level, then is organized into cooperative groups, which join to form group associations; these are then linked with formal financial institutions, with national development funds, and, finally, with international and global funds and institutions.

The jalapeño in the middle depicts the productive rural agro-industrial chain, starting with crop plantations, farm machinery, and ecological regeneration to provide water availability; all of these lead to the harvest, adding value by transforming grain into nutritious products. A subsequent link with the distribution/marketing chain helps deliver these products to market.

The chain on the right shows the professional services needed to support and strengthen these activities and make them competitive. It starts with appropriate technology and moves on through research and development; promotional, educational, and organizational activities; the legal framework necessary to protect rights and responsibilities; and, finally, information dissemination and shared learning.

These three chains are clearly connected at every level, resulting in needs and opportunities for financing flows. The Forum believes that the development finance field must widen its scope, moving beyond its exclusive focus on the left-hand pepper of credit and savings services in recognition of the multiple, complex interconnections involved in addressing poverty.

The Forum began with 12 members from seven countries. Most were “founders” of development finance institutions (DFIs). Two are from the U.S.: Mary Houghton, who co-founded the widely known ShoreBank Corporation, and Jeremy Nowak, a former community organizer who founded and runs The Reinvestment Fund (TRF) in Philadelphia. Two are from México: Raúl Hernández-Garciadiego, who runs Alternativas (an NGO working in the poor arid areas of rural México), and Alfredo Hubard-Deffis of CAME, a micro-credit organization on the outskirts of México City.

Africa is represented by four members. Chief Bisi Ogunleye is the founder of the Country Women’s Association of Nigeria (COWAN), which had over 260,000 members as of 2001. Adeniran Adedoja heads the Farmers’ Development Union (FADU), composed of over 500,000 farmers in northern Nigeria. Aleke Dondo works with the Kenya Rural Enterprise Program (K-REP) and now heads the nonprofit arm of K-REP, which works closely with K-REP Bank (licensed in 1999). Chris Hock founded the Rural Finance Facility and its subsidiary, Rural Housing Finance, a $25 million South African development finance institution that served the poor with microenterprise and housing loans until it closed in mid-2001.

From Asia, there were two initial members: Bambang Ismawan, who founded and runs a 60,000-member association of farmers in Java, Indonesia, known as Yayasan Bina

Swadaya (Movement for Self Help); and Vijay Mahajan, who established the BASIX group of companies in 1996 (by 2001, BASIX was working with 50,000 poor households).

In 2001, Witold Szwajkowski of Poland's Fundusz Mikro joined the Forum at the members' invitation, as did Jennifer Riria of the Kenya Women's Finance Trust. María Otero of ACCION International has also joined the group as an active participant.

Frank DeGiovanni, Director of the Ford Foundation's Economic Development Unit (EDU) and/or Lisa Mensah, formerly Deputy Director, EDU, usually attended our meetings. Adhiambo Odaga, a Ford Program Officer (and the Foundation's Representative for West Africa since 2001), attends as a permanent invitee.

Peggy Clark of the Aspen Institute and Mary Kay Penn acted as facilitators of the early meetings. Thereafter, the Forum established a "secretariat" at TRF, and its sole program staff person, Carla Castillo, has been doing facilitation and inter-meeting linkage work. In 2003, the Forum worked with Tony Sheldon on developing a strategic plan for moving the Forum to a new and broader phase of operations; Tony also served as facilitator of the 2003 meeting.

The Forum usually invites one or two guest speakers to our meetings. For example, John de Wit of the Small Enterprise Foundation was invited to share his experiences on impact assessment at the 1998 Forum meeting in South Africa, while at the 1999 meeting in India, Ela Bhatt of SEWA and Ram Reddy of the Cooperative Development Foundation spoke on "ownership and governance," supplementing a paper on the same topic by a consultant, Tamara Duggleby. A consultant from Seed Capital presented its study on the Challenges of Funding DFIs at the 2000 meeting in México. In Indonesia, three people involved with various funds—Alex D'Silva of ProFund, the world's first microfinance equity fund; Jean-Phillipe de Schrevel of Blue Orchard, a European fund making debt investments in MFIs; and Anantha Nageswaran of the Aavishkaar India Micro Venture Fund—joined us for the portion of the meeting concerned with the theme of "mediating capital markets."

Including field visits, a typical Forum meeting lasts five days, two of which are devoted to a preselected thematic discussion (some of the topics have been "Ownership and Governance of DFIs," "Impact Assessment," and "Capital Plus, or Going Beyond

Microcredit"). Many topics, such as the issue of the tension that exists between the developmental mission and financial demands, have characterized every discussion. The small size of our group (usually no more than 12 to 15, including guests) has created an unparalleled opportunity for us to learn from one another. The Ford Foundation has funded all Forum meetings, initially on an *ad hoc* basis and, since 1999, through a grant to the Forum Secretariat, housed at The Reinvestment Fund.

At our 1999 meeting in India, the Forum developed this mission statement:

> *The Development Finance Forum is an international network of independent practitioners whose purpose is to build the field of development finance. Members of the Forum are dedicated to using capital and other development-oriented tools to create economic opportunity and eliminate poverty. Membership in the Forum implies an interest in professional exchange, a respect for a variety of development finance strategies and approaches, and a commitment to developing the field through disciplined practice and honest reflection.*

As the Forum continued to meet annually, we began to reflect on how we were learning from one another. Borrowing some terms from other fields, we realized that learning was taking place in three ways. First, we engaged in "Single Loop Learning," which means learning about one another's operational details, the products we need to offer, the systems we must improve, and the skills that our staff should have. Secondly, we found that we engaged in "Double Loop Learning," which means learning about reframing familiar problems—in this case, how we can alleviate poverty in a sustainable manner. The exploration of appropriate strategies and institutional designs has been the focus at this level of learning.

Finally, we have connected with one another in "Triple Loop Learning," in which our perspectives, worldviews, and underlying values have been challenged and altered. This "transformational" level of learning, we found, does not come easily. Yet, when such a change does occur, usually in the course of a slow process, the benefits to the practitioner and the organization seem to be enormous.

In our discussions about what later became the "Capital Plus" paper, Frank DeGiovanni noted that the field is dominated by many normative statements, but that they do not come from practitioners. He asked us to come up with our own. These are the seven normative statements we articulated:

- DFIs have a permanent institutional role and should provide financial services to a broad range of low-income clients.
- Access to financial services is necessary but not sufficient to alleviate poverty. Building social capital is a necessary component of poverty alleviation.
- DFIs should be accountable for showing development impact and rigorous financial stewardship.
- Effective DFIs must innovate continually.
- Smart subsidy is good and does not necessarily lead to inefficiency.
- Regulatory change can create wealth. The regulatory environment must be strengthened to enhance the ability of DFIs to alleviate poverty and create wealth.
- Growth of the development finance field requires promotion of social entrepreneurship and appropriate governance systems in order to manage tensions between markets and public purpose in a transparent manner.

In addition to financial capital, the poor need access to other kinds of capital: land, water, and forests; infrastructure, utilities, and housing; education, skills, and training; and functioning institutions. All of these together constitute what we call "Capital Plus."

We feel that the experience of the last few decades has shown that finance (and, especially, microcredit) has been a necessary but not sufficient condition for economic growth and poverty alleviation. In addition to financial capital, the poor need access to other kinds of capital: land, water, and forests; infrastructure, utilities, and housing; education, skills, and training; and functioning institutions (norms, laws, policies, regulations, networks, and markets). All of these together constitute what we call "Capital Plus," and over the last few years we have wrestled with the challenge of developing a broad framework for this constellation of ideas. This paper is one result.

Finally, this account of the origin of the Forum as a learning space for development finance professionals would not be complete if we did not touch on the dimension of personal support. As we got to know each other better, it seemed that almost every one of us was in development work because of strong personal feelings about social justice or an unwillingness to accept the deep inequity in this world. Each of us, we saw, is also a driven person. But driven people can burn out, especially when the work we do is as frustrating and sometimes as lonely as development finance can be. The Forum has, thus, served the unintended purpose of becoming a "mutual support group" for the members. We deeply value the friendships that have been forged through the Forum.

For further information about the Development Finance Forum, please visit our web site at www.dfforum.com.

INTRODUCTION

The Capital Plus Framework

Capital Plus was written by the members of the Development Finance Forum (the Forum), a group of practitioners who have met annually since 1997. The Forum members use the term "development finance institutions" (DFIs) to refer to our diverse institutional forms, customer strategies, and products, which include microcredit, loans to small- and medium-sized businesses, and investments in housing projects and community facilities. The word "practitioner" is the key to our group. While donors, academics, and representatives of multilateral institutions play an important role in building and marketing the development finance field, they have often dominated the way debates and ideas are shaped. We asked ourselves: as practitioners, did we have, or could we develop, a common perspective? Could it shape the debate in a new way? What new ideas could we add?

We asked ourselves: as practitioners, did we have, or could we develop, a common perspective? Could it shape the debate in a new way? What new ideas could we add?

While each of the Forum's week-long annual meetings has had a formal theme, the style of the meetings has been informal, perhaps best described as a free-flowing conversation. Through field visits, the conversation extends to the customers of development finance: rural villagers and the urban poor. Naturally, these connections, practitioner-to-practitioner and practitioner-to-customer, have encouraged the transfer of ideas. But, perhaps more important, the informal style of the dialogue has encouraged the members to challenge their own assumptions and test new viewpoints. *Capital Plus* is an attempt to share a synthesis of the Forum members' thinking, in that same spirit, with fellow practitioners and socially minded investors and donors. Our intention here is to set out, from a practitioner's perspective, some of the pressing issues facing DFIs that choose to have a "double bottom line"—encompassing both profitability and social impact—and to offer our current thinking about how to approach these issues.

We view development finance institutions as financial intermediaries that are also positioned to play critical economic development roles. By **economic development**, we mean a substantive and sustained change in the condition of poor people. Within that perspective, credit appears as only one piece of a much larger and more complex problem. The constraints that keep our customers from building wealth include poor workforce skills and education, substance abuse problems, weak communications infrastructure, ineffective social organization, limited government services, the absence of private-sector investment, healthcare problems, inappropriate government policies, and—sometimes—regressive perspectives and values regarding development and business on the part of donors and investors who are increasingly focused on narrowly defined market outcomes. It is time to reclaim economic development as an intrinsic part of development finance.

Therefore, we view the tool of capital as the glue around which other tools—technical assistance, information services, environmental remediation, sectoral interventions, and more—adhere. Not only are these other tools attracted to capital, they are also made more effective by it. While we are not losing sight of the primary role of credit provision, we are moving toward a broader range of interventions than financial intermediation alone—hence, Capital **Plus**. The additional roles we talk about in this paper are intended to help change the social *position* of the poor as well as their economic condition.

*Capital Plu*s builds on three earlier traditions:

- Publicly funded development banking brought the power of capital to bear on the large problems of development. But, too often, it was marked by political corruption and organizational inefficiency. Moreover, in their early years, the development banks financed large infrastructure projects in the absence of any clear strategy of how best to create opportunity for the poor.

- The NGO sector often sought and still seeks holistic solutions to difficult social problems, but sometimes loses its way because of a lack of discipline and an inability to ground itself in products that have long-term sustainability.

- Finally, *Capital Plus* builds on the three-decade history of microfinance, which has used capital on a considerable scale and with increasing discipline, revolutionizing the way in which major international institutions think about development finance. Although we continue to build on this microfinance tradition, we are now seeking approaches that speak more directly to the broader goals of economic development.

We hope that this paper advances a common vision.

SECTION 1

The personal and the institutional: Pioneering, growing, and other tensions

Development finance institutions have a permanently pioneering institutional role and must be managed accordingly.

The normative drive

DFIs are different from other financial institutions. In a DFI, growth and change occur within the self-consciously normative framework provided by a moral imperative to confront poverty and the social isolation of the poor. Clearly, doing business within such a normative framework is harder than doing business within a standard corporate framework. In the latter situation, the final arbiter for all questions is profit: "if we do this, will it affect our bottom line?" We, too, must answer that question, but we also have another underlying concern to consider: "if we do this, will it improve the well-being of our customers and positively change the context in which they live and work?" In the standard corporate framework, the customer is important in an instrumental way, as a buyer of a product whose purchases help fulfill the *corporation's* goal. In a DFI, the reverse is true: our product is the instrument for fulfilling the *customer's* goals. Our job is to help unleash and expand the financial and social capacity of poor people. It is they (the borrowers, savers, and members) who give life to our work.

Each Forum member has a different story of how and why he or she became involved in this field and in building our institutions. Some of us were influenced by one of the early giants of the field, such as ACCION International, Grameen Bank, or ShoreBank Corporation. For all of us, however, as for these predecessors, the common thread is a commitment to do something about poverty. Nothing else explains the choice to forego other professional and personal opportunities. Over time, that commitment has been translated into a kind of personal equity, be it that of the founders, of the staff and board, or of the early investors and donors. This personal equity is an unsung asset in development finance. Vijay Mahajan of BASIX believes that, because of the inherent value of the

DFIs' social mission, such personal "sweat equity" ought to be viewed by investors and donors in the same way that financial equity is perceived in the commercial world.

On the institutional front, our DFIs' very existence is due to the disconnection between conventional finance and low-income people. For the poor, that disconnection amounts to a credit vacuum, and exists for familiar reasons: the elite culture of traditional financial institutions; perceptions of the poor as high-risk customers; a lack of information and systems for reaching the poor; inadequacies in regulatory and legal systems; and so on.

In bridging the gap between capital markets and low-income borrowers, DFI leaders face a tension between the desire to operate *demonstration institutions* (which lead the way to more mainstream access and forms of commercialization) and the ambition to create *de novo* replacement institutions that will continue to play a capital-access role for clients for a very long time. Can DFIs be both bridges and replacement institutions?

In addition, DFIs have come into being in the context of the political economy of the development industry, where there are many institutions with a poverty-alleviation focus, but relatively few that are also strong and independent. While many governments and NGOs embrace the value of development finance, there are too many examples of short-term capital-access strategies that are likely to have limited impact. In some loan programs (many of them government-run), the political logic of the program dominates product delivery and operating style. Some short-term programs, while focusing intently on the poorest, have very limited impact, resulting, at best, in a temporary improvement in cash flow. Finally, there are operations in which the dominant goal is to show good repayment statistics and high sustainability numbers to donors. Narrowly conceived financial service projects often have limited impact; poorly conceived projects sometimes have a negative effect on borrowers by conveying the wrong messages regarding the cost of capital, the necessity of savings and repayment, and other standards of accountability.

Establishing a stable, long-term institution in the midst of less reliable, short-term-oriented systems creates both financial and political risks. DFI practitioners have all faced such hazards. We sometimes encounter power brokers—in the form of government bureaucrats, entrenched merchants, politicians, and traditional NGOs—who function as the guardians of the *status quo*. The art of building institutional permanence involves not just good performance, but also the ability to operate successfully within a complex political and organizational context that does not always appreciate competent competition.

Four key attributes for DFI impact and growth

Permanently pioneering

Development demands that DFIs have a long-term perspective. In our view, those with that perspective start out with four essential attributes: pioneering leadership, valuable products, a strategy for building sustainability, and social networks that legitimize the work of the institution.

1. **Pioneering leadership:** DFI leaders orchestrate a variety of intangible assets for the benefit of their organizations. They must demonstrate pioneering business and civic leadership in order to garner financial support from diverse investors (including donors), while at the same time having the discipline to manage the deployment of assets and being strategic enough to attract talent and navigate local politics. They must also create systems and relationships, internally and externally, for nurturing the right kinds of future leaders. In addition, leadership goes beyond the institution. By articulating the need for innovations that can reach those not served by established market players, leadership is provided for the development finance field. As others in the market begin to respond to these newly established market niches, DFIs move on to the next frontier.

2. **Valuable products:** A DFI product is valuable when it is relevant to the *business* of the borrowers, expanding their capacity to become fuller participants in the market and in society, or to their broader *livelihood strategies*, which would include financing for housing, health care, school fees, and other fundamental items. Furthermore, for products to be scaleable, they must generate repeat transactions while remaining relevant to new customers. Valuable products also function as filters, focusing technical and financial resources on the best entrepreneurial talent.

3. **Building sustainability:** No DFI can be viable over the long-term if it cannot diminish the need for recurrent subsidies. At the level of a loan transaction, a strategy for sus-

tainability means understanding the cost of transactions (cost of funds, cost of delivery and servicing, and cost of risk) in order to build a pricing model that works for the borrower and the institution. At the level of the organization, a strategy for sustainability means being able to re-create the *business model*—including which products are offered, how markets are identified, how capital is raised, what alliances are formed, how subsidy is used, and how the cost of innovation is managed.

4. **Legitimizing social networks:** Innovative DFIs need more than financial backing. To survive, they must cultivate *a social network that legitimizes the institution* in multiple sectors of society. Both DFIs and conventional finance institutions intermediate both capital and social relationships. The two capacities—civic and financial—reinforce each other. The difference is that DFI networks have an unusually long reach that extends from the poorest people in society to national and international institutions and capital providers. These informal networks allow DFIs to raise funds, solve problems, create an independent business space, and execute transactions under difficult circumstances.

These four characteristics involve quite a few tensions and do not always mesh smoothly. We recognize that our own business growth has been more iterative than linear, defined through interactions with the marketplace of borrowers, investors, and local economic and civic actors. But it is these four attributes—pioneering leadership, valuable products, the building of sustainability, and the legitimizing of networks—that seem to explain our path best.

DFIs require leadership and management that can act and learn, meaning that they can reflect on experience, make pragmatic adjustments, and adapt to market knowledge.

Thinking and Doing

DFIs require leadership and management that can *act* and *learn*, meaning that they can reflect on experience, make pragmatic adjustments, and adapt to market knowledge.

In development finance, the creative tension between thinking and doing can be seen best through four decisions that are always at play: how and whether to expand market share; how to mobilize additional assets; how and where to innovate; and how to manage change and growth. The DFIs we met in the field are alive with questions like the following:

- **On market expansion:** What is the volume of the market that can be penetrated with existing products? Can new techniques expand market volume and new efficiencies? What are the financial risks of new techniques or new lending processes? To expand the market, does a DFI have to expand geographically? If so, what information and infrastructure are required? Will a bigger market help the DFI both to stay on mission and to maintain its sustainability strategy? Do more customers mean more impact, *or* does expansion sometimes prevent us from understanding the critical questions posed by our current portfolio? Alternatively, can scaling up be redefined to mean a deepening of local interactions and expansion of product types rather than reaching more customers with the same product?

- **On capitalization:** What kind of capital structure and capitalization level are required for significant and steady growth? How can a DFI use existing investors or the accumulation of depositors' savings to expand? Are new classes of investors or new systems for liquidity (such as secondary markets) needed in order for the DFI to use its assets more efficiently? To what extent can an institution's solid balance sheet and social networks open up new forms of capital access? How will the cost and nature of new capital opportunities affect the longer-term management and culture of the DFI? Can the wrong form of capitalization affect the ability to control institutional mission and strategy? What are the ways around those mission risks and investor-governance issues?

- **On product innovation:** How can the DFI pay for new product development? Will new products allow market expansion in a qualitatively new way? If they help the DFI grow primarily by offering larger loans with more traditional terms to their best borrowers, does this make sense from the perspective of the DFI's mission? Is it possible to grow by reaching the poorest of the poor with increasingly cost-efficient delivery? How do the two directions (larger borrowers at one end, poorest of the poor at the other) affect the issue of organizational sustainability? When does improving the income of the poorest of the poor have less to do with direct access to capital than with access to other financial products (such as savings accounts and insurance) or to wage-labor interventions? Does product innovation—up-market or down-market—require cross-subsidies from within the DFI or external subsidies, and what should the organizational criteria be for managing such subsidies?

- **On growth management:** Growth in lending volume, capital structure, and product variety requires growth in management depth and systems. How can early-stage managers create systems that accommodate the changing styles and requirements of administration and production? If new lines of business require new infrastructure, systems, talent, and relationships, what business models are best suited to meet these changes? As sophistication in financial modeling and capitalization grows, how can management talent from within be developed and how are the non-technical qualities of leadership best nurtured and utilized?

Action and reflection

A practitioner-to-practitioner forum is valuable because it creates opportunities to share the questions we are all asking rather than the answers we are all declaring. The truth is that growing institutions constantly find themselves at awkward stages, confronting crises and undergoing unexpected transitions. Learning would seem to depend more on understanding failures and wrong turns, doubts and tensions, than on the story-line of success. The strength of a DFI lies in its ability to navigate these sometimes turbulent currents in a disciplined way. It means not just prescribed process and action, but also art, instinct, and reflection.

SECTION 2

Social capital

Development finance must also be defined as building social capital.

Development finance and social capital

Building social capital, the least technical side of our work, is increasingly recognized as central to economic development. Social capital refers to the way that people can secure benefits by virtue of their membership in social networks or other social structures.[2] These "networks" or "structures" need not be formal ones. Two neighbors who help one another are demonstrating (and using) social capital. As with any asset, social capital can be built upon and it can be lost. In order to work, it requires mutual trust.

In places where ineffective or corrupt political and financial systems dominate, these national ills trickle down to the community and the individual. The individual's distrust of public and financial institutions turns inward, leading to local distrust and/or a kind of protective insularity. This is where building transparent, trust-based relationships and organizational systems becomes particularly crucial. When the networks and relationships between our borrowers and the larger economy are reliable, reciprocal, and trustful, the chance of achieving accountable systems *and* economic growth increases.

Social capital refers to the way that people can secure benefits by virtue of their membership in social networks or other social structures.

In part, DFIs help to build and support social capital through example. The qualities of strong development finance institutions—reliability and accountability—support social capital by demonstrating stability and trust through the web of social and economic relationships that they facilitate. If we think about a mature DFI as a hub of civic relationships, capital connections, and information, then the social-capital role can be viewed as a central element.

The basic lender/borrower relationship is the most vital social-capital role that DFIs take on. Particularly dramatic when DFIs are working with very poor borrowers (often making use of group-lending methodologies) is the complex interaction between the provision of

[2] Grootaert, Christiaan, "Social Capital, Household Welfare and Poverty in Indonesia," World Bank, April 1999.

capital and the organization of predictable, trustful inter-group relationships. The two inputs—financial resources and consistent, high-quality organizational processes—form a *virtuous circle*. Capital piques the interest of the poor; the development of trustful relationships with financial institutions then sustains their participation in income-earning activities. In these instances, social-capital formation has the effect of minimizing the transaction cost of credit provision (where voluntary groups become part of the process of capital mobilization and deployment).

We have observed three ways in which many DFIs facilitate building the kind of social capital that has important economic-development consequences:

- By organizing and reinforcing social relationships through group-centered action. An example is Indonesia's Bina Swadaya, which sees development finance as a tool in a broader strategy of group and individual empowerment.
- By facilitating the development of new local institutions. An example is Kenya's K-REP, whose work with village-based Financial Services Associations (FSAs) plays an important role in building social capital by introducing the rural poor to formal banking concepts; by establishing institutional structures in rural areas that previously had none; and, perhaps equally importantly, by introducing and reinforcing the norms of financial institution transparency.
- By identifying social and economic connections for the poor through regional or sectoral economic interventions, as BASIX does in India in its multifaceted sectoral interventions (discussed in Section IV).

Several observations were made as we looked at these examples:

1. **The magnetic role of financial capital:** Capital can attract and sustain participation among the poorest, even when the most critical relationships and interactions may have little to do with financial capital. A portfolio can also attract the attention of other financial and civic institutions important to poor people. As in the case of BASIX, the availability of resources and portfolio gives a DFI the opportunity to enter into institutional relationships that promote poor people's inclusion in wider economic systems (for an example, see Section IV).

2. **DFI as information intermediary:** One of the most important DFI tools for facilitating the creation of social capital is information—on constraints and opportunities that can be identified in the marketplace, on how products link to markets, on production and distribution chains, on how effective institutions operate, and on conventional financial systems. DFIs that play an effective role in social-capital formation also intermediate information, which is used to create or enter market-oriented systems. DFIs must understand these kinds of systems and organizations in order to be able to leverage the information that will have real poverty-alleviation impact.

3. **Managing role diversity:** Non-lending roles are a major part of the strategic focus and effectiveness of many DFIs. The roles of DFI staff are quite varied and unusual. They function as organizers, planners, and trainers as well as acting as lenders and investors. They facilitate group processes and institutional transparency and they provide individuals and groups with the tools needed to use and manage information and relationships effectively. A challenge for DFIs is the management of these diverse and complex roles, including those that may have an appearance of conflict of interest.

A few lessons

Clearly, development finance can facilitate both social participation and income generation. We need more understanding of the role of social capital, however, in order to realize the potential of development finance. The social-capital experiments going on throughout the world of development finance are exciting and often costly, and usually involve a great deal of organizational risk and learning. We can understand our social-capital role and make it more effective, however, without either diminishing the financial services of DFIs or moving back to what some view as the less-disciplined aspects of non-governmental organization (NGO) activity. As always, we need to ask the right questions. For example:

- Should more DFIs be promoting the kind of village-based Financial Services Associations that are emerging in Kenya? Do we know enough about the trade-offs between social impact and financial cost or return? What organizational competencies would be required to train FSA-type managers, and to what extent is the success or failure of this kind of enterprise ultimately dependent on external factors?

- What are the possibilities of the sectoral approach as pursued by BASIX? Should DFIs play a sectoral or regional economic development role? What qualities must they possess to do so? How do we measure the effectiveness of a DFI like BASIX in promoting the broad development of an economic sector and enhancing value for low-income workers and entrepreneurs within that sector?

- Apart from the financial-delivery functions of lending groups, what do we know about the civic impact that they have? Is this important? Can it be measured, and would such measurement be cost-effective or useful? Given the group-formation history of organizations like Bina Swadaya, what is the experience around the world when it comes to building on pre-existing groups versus organizing new groups? What do we know about the comparative productivity of such groups?

While financial performance benchmarks and customer data are the most tangible and, some would say, the most important things to know about a development finance institution, we think it is time to include the role of building social capital in discussions and debates on economic development, impact, and the appropriate use of subsidies. The building of social capital, besides being an axis around which the field can develop, increasingly reflects what we do.

SECTION 3

Accountability and social impact

Development finance institutions should be responsible for maintaining effective financial stewardship and demonstrating social impact.

Accountability and information

Accountability is a fixture in the lexicon of development finance. Besides fiscal responsibility, our work requires that we pay attention to a *double bottom line:* a reasonable financial return for investors *and* demonstrated social impact.

The impetus for this dual accountability is both internal (between DFIs and their clients) and external (for donors and investors). The need for greater accountability to customers, in the form of consumer-protection guidelines and greater transparency in the cost of services, is one important emerging area. Rather than waiting to be regulated, DFIs should set the tone by developing standards for consumer protection and transparency.[3]

Because there are limitations to our traditional capital sources—foundations, governments, and multilateral donors—we need to access capital from a broader group of social investors as well as from commercial sources.

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Apart from the United States, where financial institutions (through regulatory incentives) provide large amounts of capital to development finance institutions, the bulk of DFI capital comes from mission-oriented donors and investors. Few DFIs, including the most mature of us, have gained access to other sources of capital. María Otero of ACCION, for example, finds that the majority of investors in DFIs are still com-

[3] The Consumer Protection Task Force of the Small Enterprise Education and Promotion (SEEP) Network is addressing these kinds of issues. See SEEP's 2003 publication, "Trust Through Transparency: Applicability of Consumer Protection Self-Regulation to Microfinance."

prised of socially responsible institutions with a corresponding mission interest in development finance.[4]

We can attract a broader range of capital sources by increasing the options for investors, thus making DFI investments more commodity-like. We need to increase the number of productive portfolios, create secondary market systems that provide investor liquidity, build insurance pools to mitigate certain investor risks, use tax and other incentives, create more effective wholesaling systems for investors, and so on.

Perhaps the most important key to addressing capital constraints, however, is the provision of adequate information—financial and, particularly, social-impact-related—upon which investors can base their decisions.

Well-functioning markets depend on information that is accurate, reliable, comparable, and quantifiable. The better the information, the easier it is for rating agencies to analyze credit risks and, thus, for potential investors to gauge risk and performance and minimize their transaction costs.

Most established rating agencies are poorly equipped to assess the credit risk of DFIs. As a result, multilateral and bilateral organizations with ties to development finance are developing their own rating systems. Preliminary rating systems have been developed or supported by the Inter-American Development Bank (IDB), the Consultative Group to Assist the Poorest (CGAP), ACCION International, MicroRate, PlaNet Finance, and the World Council of Credit Unions (WOCCU).[5] IDB and CGAP have also approved eight rating agencies and assessors as part of their Microfinance Rating and Assessment Fund initiative.[6]

These systems focus on the financial health of DFIs, a fairly straightforward undertaking. For example, ACCION International's and WOCCU's rating systems, CAMEL and

[4] Interview with María Otero.

[5] According to the Microfinance Rating and Assessment Fund, rating-system development efforts have two long-term goals in common. The first is to stimulate significant improvements in industry-wide levels of financial performance. The second is to increase the flow of private-sector resources to the development finance sector by "improving the quality, availability, and frequency of information on the risk and performance of [DFIs]."

[6] As of late 2003, there was a total of 13 approved raters/assessors, including ACCION International, Clasificadora de Riesgo Pacific Credit Rating of Perú, CRISIL of India, HORUS and PlaNet Finance of France, Microfinanze Ltd. of Italy, and MicroRate and Standard & Poor's of the United States.

PEARLS, rely on traditional financial measurements to arrive at ratings of capital adequacy, asset quality, earnings, and other indicators. These guides allow some DFIs to benchmark themselves against peer groups.

Measuring and rating development—the *social impact* of DFIs—in a cost-effective way is another matter. The challenge is daunting. It requires agreement on what we are measuring, how we will measure it, who will do the measuring, and how it will be used. It means building a level of flexibility into the indicators and finding ways to meet the objectives and interests of a diverse group of stakeholders. Few DFIs have attempted to develop such a system.

The tension between validating impact for donors and for practitioners

Practitioners want impact data that will help them understand their market better. We want to be certain that our program impacts are in line with our mission, but we think about this in a transactional sense. Practitioners receive their validation directly through transactions and customer relationships. Donors, on the other hand, do not get direct validation from the field. They have limited resources to invest or grant when measured against the many demands made on them. They want to understand how best to allocate those resources. Before donors make a choice, they want to know about more than loan-repayment rates, the number of customers served, or the housing units built; they want to know the direct or indirect impact of a DFI loan on poverty alleviation.

Both of these interests are important and require cogent, systematic responses, ideally based on a single set of agreed-upon measures that capture the needs of both perspectives. Two recent initiatives—the USAID-sponsored AIMS Project (Assessing the Impact of Microenterprise Services) and the Ford Foundation supported Imp-Act Project (Improving the Impact of Microfinance on Poverty)—represent promising progress in addressing these issues.[7]

[7] For further information, please refer to the organizations' respective web sites: www.usaidmicro.org/pubs/aims and www.imp-act.org.

Most practitioners understand the complexity involved in collecting social-impact data while running a financial institution. Among the thorny (and potentially quite costly) issues we discussed at our meetings were the following:

- How do we collect impact data from customers without becoming research institutions? If we add too many data-analysis steps to the financial-provision function, we risk losing the transactional integrity of the DFI. Are there social-impact data that would add value to investor decision-making and internal DFI planning, which could also be easily collected and validated by lenders and loan-servicing personnel?

- How do we deal with the complex question of objectivity? Social-impact data do not have the kinds of built-in checks and balances that enable rigorous financial audits.

- How can we (without involving costly control groups) address the complex social science issues of (i) attribution (is impact Y the result of input X?) and (ii) how impacts change over different time periods?

- What is the added value of large-scale, long-term impact studies as opposed to data collection that could be done routinely as part of the process of lending, servicing, and market analysis?

- How will data related to social impact affect our ideas about best practices, scale of production and portfolio, and financial self-sufficiency?

We cannot grapple with all these impact-analysis questions immediately or easily. Instead, we suggest that social impact be a key focus for development finance learning over the next decade and beyond, and that we assume collaborative responsibility for building our knowledge. We need to begin developing:

- A simple, universal system of data collection that can be carried out by DFIs and used as part of a financial/social-impact rating analysis that will be comparative and flexible.

- A collection of deeper and more strategically targeted studies and analyses of the roles and impact of specific institutions and portfolio strategies, carried out by external analysts.

The two efforts should proceed simultaneously. The deeper analyses, which will require longer-term (and costly) studies, can help determine the right standards for practitioner-driven data collection as it develops.

Thoughts on an industry-wide system for data collection

Such standards, based on these deeper analytical studies, will help solve the problem of inadequate proxies for impact (such as repayment ratios and average loan sizes). An industry-wide system for data collection would also be a proactive response (and perhaps an alternative) to the systems that donors already use, and would constitute a response to the growing interest in these issues on the part of governments and central banks. Creating such a system would entail:

1. Developing common indicators acceptable to a wide range of social investors. Though our different funders have separate reporting requirements, most of us have not found this to be a problem with respect to financial requirements, since in all cases these are based on accounting standards. Again, however, social impact is a different matter. There are scores of formats and no standard set of indicators (in fact, different requirements may involve conflicting social goals); these idiosyncrasies mean significant reporting challenges and added costs. We need a common set of development-impact indicators acceptable to as wide a range of investors and donors as possible.

2. Maximizing input from development finance practitioners. The tendency has been for donors, academics, and other non-practitioners to take the lead in determining social-impact collection standards. If all stakeholders are to be included, however, practitioners must have a major voice.

Among the perspectives DFI practitioners bring to this effort is the importance of balancing data collection with the maintenance of good customer relationships. As Mary Houghton from ShoreBank reminds us, her customers think of themselves as do any other bank customers. Because they do not want to be studied and analyzed, ShoreBank minimizes its interference in their private lives.

Also, since our different economic, political, and enabling environments call for different approaches to poverty alleviation, practitioners need a data system that can accommodate different types of portfolios (for example, housing versus small-business loans versus microcredit).

3. Building on existing efforts. We need to build on the momentum of existing efforts at social-impact measurement. The AIMS and Imp-Act tools, as mentioned previously, are major strides forward. Other impact measurements are being developed by investors (Calvert Social Investment Foundation), by governments (the U.S. Treasury Department CDFI program), and by DFIs and their trade groups in response to both external data requests and internal management requirements.

4. Providing incentives for innovation and risk-taking. Since our goal is social impact, we need constant innovation to develop new products, new asset-deployment strategies, and new technology applications to reach those customers who have been least served by financial institutions. We therefore need rating systems that enhance rather than constrain innovation.

5. Recognizing local standards and regional differences. We can learn much from fields where there has been progress both in incorporating various stakeholders in the creation of indicators and in building a system that takes into account differences across regions. The United Nations sponsored Indicators of Sustainable Development (ISD) project was developed through a collaborative process over a period of six years, building on the work of several organizations and countries.[8] The ISD project resulted in the identification of a core set of 134 indicators of social development. It created an important framework for national flexibility and adaptation. DFIs need a development-impact rating system that is similarly sensitive.

6. Providing incentives for data collection that can be integrated into organizational management. Impact data can tell us a lot about the trade-offs between the cost of delivering a financial product and its impact. Impact data can also be used as an

[8] More in-depth information on the Indicators of Sustainable Development Programme can be found at the website of the United Nations' Division for Sustainable Development (UNSD)—www.un.org/esa/sustdev—under Issues of Agenda 21, Indicators.

asset-allocation tool. In short, data collection that can be easily and cheaply integrated into our organizations' management processes is the most useful.

An example of this kind of impact work comes from a South African NGO we visited.[9] The Microcredit Program (MCP) of the Small Enterprise Foundation (SEF) provides micro-loans to existing, but marginal, microenterprises. Its Tshomisano Credit Program (TCP) strictly targets women who live below 50% of the poverty line. Both products are based on Grameen Bank's group-based lending model.

SEF Director John de Wit found traditional impact assessments to be of limited use. The information contained in the reports was dense, provided only a snapshot in time, could not be put into a useful format, and did not enhance staff skills during the process.

Instead, SEF developed a simple and relatively quick customer self-evaluation system that measures changes in customers' life conditions. It has proved to be low-cost and useful, it enables customers to understand the impact of their life choices, and it facilitates adjustments to products and services through ongoing feedback.[10] Among the indicators used are income and business status, meeting attendance, regularity of savings deposits and repayments, education, housing quality, and quantity and quality of food consumed. Information on the indicators is collected in terms of *relative* as opposed to *absolute* values.

For example, SEF personnel ask customers to rate the quality of their housing and food consumption today compared with six months ago.[11] To indicate the change, customers place a stone on the stylized human face that most closely represents their current situation. Field personnel record the customers' responses. At the next interval, staff members again inquire about the same indicators. The method is depicted below for the indicators on food consumption and housing quality.

[9] This section borrows heavily from the meeting notes to the Forum's 1998 meeting in South Africa.

[10] Branch managers use the data collected by staff to assess overall branch performance, identify problems early on, and make recommendations.

[11] SEF's impact-monitoring process actually starts with a public assessment of who is the poorest in the community. This assessment is also done by moving stones on a board, but with the added benefit of the collective knowledge of the village being applied.

Food—quantity and quality of food consumed:

often go hungry	sometimes go hungry	enough food but bad food	enough, OK food	enough and good food
☹	☹	☹☺	☺	☺

Housing—quality of housing:

very poor house	bad house	basic house	better house	good house
☹	☹	☹☺	☺	☺

7. Creating a social return-on-investment model from DFI data. In the spirit of some new thinking within philanthropy, we think social-impact data should feed into a model of "social return on investment." Several Forum members cited the work of the Calvert Social Investment Foundation in the U.S. as a good example of how to begin to develop a new generation of cost-benefit tools that will help to guide the quantification of social benefits so that they can be integrated into return-on-investment calculations.

Calvert's mission is "promoting the consideration of social factors in the investment process and encouraging the flow of investment resources to disadvantaged communities."[12] The Foundation offers investors a variety of investment options, ranging from investments in its general portfolio to investments in specific products. Calvert also offers investors the impact transparency they need to be comfortable with these below-market-rate investments.

To create impact transparency for investors, Calvert developed two innovative web-based features:

- The Community Investment Profile Database provides program information, a brief illustrative story, and an abbreviated balance sheet for a variety of U.S. and international development finance institutions.

[12] The Social Return on Investment Calculator can be found on the website of the Calvert Social Investment Foundation. The website explains the design nuances of the tool: www.calvertfoundation.org/individual/investment/index.html?source=. The Foundation is an independent nonprofit organization associated with the Calvert Group, a for-profit mutual fund company.

- The Social Return on Investment (SROI) Calculator allows a potential investor to enter an investment sum, a preferred term for the investment, a geographic area, and/or an economic sector into the Calculator and then compute the "social return." Thus, a $5,000, five-year investment in the housing sector in Africa, for example, yields a social return of 351 homes built or improved. The same investment in the small-business sector in Africa could finance eight small businesses and create 150 jobs.

Although, as Calvert acknowledges, the SROI Calculator is still inexact, it does provide an approximation of impact; along with Calvert's Database, it has attracted investors to the field.

The role of external, large-scale, strategically targeted studies

Large, research-intensive studies of specific institutions and specific development finance strategies would be very useful. They could help us to develop a richer understanding of the connections between poverty-reduction impacts and various DFI growth strategies. One of the liveliest recurrent controversies at our meetings has had to do with the question of the trade-off between rapid loan growth and the capacity to achieve real impact. We asked if the issue might perhaps be one of cycles rather than of trade-offs: the tendency during a growth spurt to pay little attention to anything but growth, followed later by more careful analysis and renewed focus on impact. In the absence of more careful and comparative analyses, however, we really do not know.

One of the liveliest recurrent controversies at our meetings has had to do with the question of the trade-off between rapid loan growth and the capacity to achieve real impact. In the absence of more careful and comparative analyses, the controversy cannot be resolved.

We also need to understand much more about the long-term impact and cost of indirect as opposed to direct strategies, or wage-labor versus self-employment (entrepreneurship) strategies. Are there instances in which the kind of sectoral logic applied by BASIX (as described in Section IV) has more poverty-reduction impact than direct lending only to the poor? We could not go very far with these questions because of the absence of good comparative data. It is time for all of us to take more responsibility for the collection of the kinds of data that could inform rigorous impact analysis.

Still, large-scale studies come with their own methodological difficulties. An important limitation, from the practitioner perspective, has to do with timing. DFIs should not be subject to major studies too early in their development. It takes time to build the strategies and competencies that generate lasting impacts. In addition, external researchers must be able to work collaboratively with the DFI while being fair and objective. Finally, the cost of these studies will require that they be donor-supported. In any case, large-scale studies are not a substitute for the simple, more universal data collection discussed earlier. Both kinds of efforts are needed.

SECTION 4

Innovation

Development finance institutions must innovate continually in order to stay relevant to mission and market.

Impact, institutional depth, and innovation

While start-up organizations sometimes demonstrate remarkable innovation in design, market, organizational structure, or capitalization—indeed, the very techniques of development finance were innovations pioneered by start-ups—continuous innovation is most commonly found within mature institutions. They have the institutional strength to pursue new markets and products. Innovation is the lifeline of new ways to reach the poor and create new markets. To accomplish these things, a DFI must develop the internal competencies and external relationships that support experimentation and must have sufficient financial resources to bear the transaction costs of new products and methods. Strong institutions can make mistakes and still live to tell the tale. Eight examples from our Forum members illustrate the range of development finance innovation.

Continuous innovation is most commonly found within mature institutions. They have the institutional strength to pursue new markets and products.

ShoreBank Corporation: An innovation in structure

ShoreBank Corporation, a Chicago community-development bank, was created by taking advantage of a change in government regulation and made a structural innovation—the formation of a socially oriented bank holding company—that has been copied around the world.

In 1972, the U.S. Federal Reserve Board reinterpreted a key regulation of the Bank Holding Company Act of 1956, saying that:

> *"Bank holding companies possess a unique combination of financial and managerial resources making them particularly suited for a meaningful and substantial role in remedying our social ills. [This regulation] is intended to provide an opportunity for them to assume such a role."*

ShoreBank co-founders Mary Houghton and Ronald Grzywinski saw the importance of this reinterpretation of federal policy. "If bank holding companies could now own community development corporations," explained Houghton, "then maybe bank holding companies could fulfill the social mission of these nonprofit entities." Houghton and Grzywinski, along with two colleagues, Milton Davis and James Fletcher, established a bank holding company with the mission of restoring the vitality of Chicago's deteriorating South Shore neighborhood, which in the early 1970s was undergoing racial and economic transition. They believed that the holding company structure could make it possible to stimulate markets and leverage a variety of funds in order to reverse the community's decline. The four founders pooled their backgrounds in raising capital, bank operations, social services, and community activism to build a for-profit holding company that meets its social mission through a number of nonprofit and for-profit affiliates.

In 1973, ShoreBank purchased a local bank; in 1978, it capitalized three affiliates. ShoreBank Development Corporation, a for-profit real estate development company, enables ShoreBank to develop residential and commercial real estate.[13] The ShoreBank Neighborhood Institute, its nonprofit arm, offers neighborhood residents services designed to develop their entrepreneurial abilities and obtain employment. The ShoreBank Capital Corporation, a for-profit venture-capital fund, invests equity and subordinated debt in minority-owned companies that have growth potential. The holding company structure has allowed ShoreBank to provide the array of interventions needed to strengthen the neighborhood.

Through its deposit base, ShoreBank's bank operation has been able to leverage ShoreBank's capital 11 times over.[14] The bank's credibility also played a key role in the establishment of the nonprofits, which, in turn, attracted subsidy to fund some of ShoreBank's economic development services. Furthermore, the division of the for-profit and nonprofit activities into their respective entities allowed ShoreBank to provide transparency to different funders. Houghton believes that "ShoreBank's ability to increase

[13] According to the website, since 1978 ShoreBank has developed 2,250 housing units and 129,000 square feet of commercial property in its priority neighborhoods in Chicago.

[14] ShoreBank Corporation has replicated this structure in four other locations: Cleveland, Ohio; Detroit and the Upper Peninsula in Michigan; and the Pacific Northwest.

capital flow to its priority communities has been greatly facilitated by our ability to offer private capital and subsidy providers different companies through which their resources can flow in a transparent manner."

As ShoreBank expanded and created affiliates elsewhere, managing a multi-state corporation with bank and non-bank entities became increasingly complex.[15] There are the expected tensions between centralized strategies and controls and decentralized operations.[16] Despite the challenges, ShoreBank's holding company structure has made it possible for it to invest US$1.5 billion in under-invested communities in the U.S. In 2002, it made $207 million in new development investments in its priority U.S. markets, and it also oversaw the investment of $62 million in small-business loans in eastern Europe.[17] ShoreBank's structural innovation has demonstrated how to integrate the profit motives of a bank and the public purpose of community investment within the same strategic and mission focus.

BASIX: A sub-sectoral approach

Since its founding in 1996 in Hyderabad, India, the mission of BASIX (also a holding company, modeled after ShoreBank) has been to promote sustainable livelihoods for the rural poor. One of BASIX's core strategies is a sub-sectoral approach that integrates analysis, financial services, and technical assistance.

A sub-sectoral approach entails viewing a single commodity (such as milk) as a layered structure of production, processing, and marketing. A commodity sub-sector usually com-

[15] Houghton noted that, to ensure that ShoreBank Corporation's nonprofit entities do not negatively impact the bank, the Federal Reserve required the bank to maintain management control over all subsidiaries. The bank maintains effective control through effective board roles. The nonprofit entities are composed 50% of ShoreBank directors and 50% of external people. Where a ShoreBank director chairs a nonprofit's board, the 50/50 requirement is acceptable to the Federal Reserve without the need for additional ShoreBank board members.

[16] ShoreBank has tried to require its nonprofit affiliates to be fully self-sustaining. It has found, however, that two of its key practices are not self-supporting and have consistently needed subsidies. ShoreBank is currently revisiting the policy that requires its nonprofit affiliates to be fully self-supporting.

[17] Additional information on ShoreBank's accomplishments can be found on the web at www.shorebankcorp.com.

prises different enterprises of varying sizes: producers, sources of credit, support services, marketing channels, etc. The goal of sub-sector analysis is to identify the constraints on low-income players in the sub-sector and to create opportunities for them through credit and technical assistance.

BASIX has found that not all rural poor people want to be self-employed. In fact, most want wage employment offered by farm and non-farm enterprises, which usually are not owned by the poor. To provide such opportunities, BASIX developed a series of networks for input supply, production enhancement, and marketing linkages by collaborating with agro-business companies, small private firms, commodity cooperatives, NGOs, and government agencies that were already extending a variety of technical assistance services to their rural customers. By leveraging these relationships, BASIX increased its own financial sustainability by lowering lending costs, reducing risk, and increasing access to its services.

There are seven sub-sectors in which a large number of BASIX's customers work: ground nut, soybean, cotton, vegetables, lentils, non-timber forest produce, and dairy. BASIX's sub-sector studies identify the interventions that would favor low-income producers, as in the example below from the dairy sub-sector.

In Andhra Pradesh, BASIX used the existing infrastructure of the Andhra Pradesh Dairy Development Cooperative Federation (APDDCF) as a vehicle to promote livelihoods. APDDCF (established by the state government in 1980) has developed a network of milk producers' cooperative societies (MPCS) and milk-chilling plants (MCPs) where milk is brought, chilled, and pasteurized before being shipped to big cities like Hyderabad for further processing and distribution. A number of milk-chilling plants had become nearly defunct because of low milk collection. This led to the break-up of local dairy co-ops and increasingly uncertain marketing for dairy farmers, especially in Mahaboobnagar, a district with low rainfall and high landlessness where dairying is one of the few livelihoods that the poor, particularly women, can practice.

One of the chilling plants (Wanaparthi) in Mahaboobnagar district had never run at more than 30% of capacity. In 1997, its collections and processing were below 5% of capacity and the plant was threatened with closure. Collection was constrained by the lack of production incentives for quality extension activity (resulting in improper vaccination and poor feeding practices) and by the limited availability of credit.

The posting of a dynamic manager to the Wanaparthi plant in 1998 marked the beginning of the plant's turnaround. The productive cattle population had to be increased, and for that the dairy farmers needed loans. Bank loans were not readily available, however, and bank procedures were unfriendly. This was BASIX's entry point. BASIX entered into an agreement with the new manager in which BASIX would provide a large number of loans for farmers to procure buffaloes, while APDDCF, in turn, would revive the dairy cooperatives in the farmers' villages and ensure milk collection, veterinary care, and extension support. BASIX made loans for the purchase of buffaloes to over 600 dairy farmers (of whom 200 were women). Using these loans and their own funds, the borrowers purchased over 800 additional buffaloes. Milk collection increased substantially (almost doubling), as did milk collection from other dairy farmers when they saw the dairy cooperatives steadily buying farmers' milk at a good price. The plant's collections soon went to 60% of capacity and reached 100% in October 2000. This led to the installation of a milk-packaging machine, resulting in the local sale of locally produced milk for the first time since the plant was established in 1981.

BASIX also linked the dairy animal owners with insurance companies that provided insurance covering animals, cattle sheds, and the dairy farmers' lives. In addition, BASIX connected the milk-chilling plant with a software company in Hyderabad, enabling the plant to improve its milk collection efficiency; because producers no longer needed to queue up for hours, they had more time for other productive activities. Milk fat content could easily be checked, facilitating immediate technical assistance to weaker cooperatives. Furthermore, improvements in measurement decreased milk wastage and further increased producer income.

By July 2001, BASIX was working with over a dozen APDDCF chilling plants in seven districts. Since April 1999, BASIX has lent over Rs. (Rupees) 155 million (US$3.2 million) to 14,010 milk producers, leading to the purchase of nearly 20,000 milk animals, 10–20% of which were purchased with borrowers' own money. Additional milk production amounted to about 80,000 litres per day. The estimate for the annual income generated by this initiative is Rs. 240 million (US$6 million).

The sub-sector approach shows how previously unconnected parts in a commodity sector can be linked and then "leveraged" into new connections. In this case, besides the benefits to producers and to APDDCF, BASIX itself benefited: first, from increased loan volume and income due to producers' additional loan requests and second, because loan-repayment risk was reduced by the repayment structure instituted at the Wanaparthi plant, where loan installments were automatically deducted and forwarded to BASIX before village producers were paid for their product.

CAME: Innovation through technology

CAME found that introducing a Palm Pilot system promoted efficiency and educated its borrowers at the same time.

A number of DFIs, especially in Latin America, use Palm Pilot technology.[18] One of these is Centro de Apoyo al Micro-Empresario (Center for Assistance to Micro-Entrepreneurs, or CAME) in México City. CAME became interested in a Palm Pilot system as a result of the limitations of its group-lending model, and found that it promoted efficiency and educated its borrowers at the same time.[19]

Members attending the weekly meetings of their Income Generating Groups (IGGs) found them too time-consuming.[20] The field officers confirmed that the IGGs' manual method of tracking loan information was inefficient. To maintain transactional transparency, the person recording data had to input individual savings and credit data on two documents, one for the group and one for the member. Besides prolonging the meetings, the procedure was prone to mistakes.

[18] ACCION first began testing handheld computer technology in 1999 at Compartamos in México City in order to cut the time and cost of making micro loans. ACCION's Palm Pilots do so by reducing the time needed to collect data in the field and by decreasing the time spent on re-entering data at the head office. "Expansion does pose challenges: because each affiliate uses a lending model that reflects the characteristics of its clientele, the software cannot be generic. Furthermore, widely differing computer standards in Latin America make uniform formatting impossible. At Compartamos, integrating the software with the organization's computer system took months." ACCION's Palm Pilots are used only by loan officers and are not used as an educational tool for borrowers.

[19] Alfredo Hubard-Deffis, President of CAME, explained that, due to a five-fold increase in its membership from 7,000 members in 1999 to over 36,000 members as of December 2002 as well as unforeseen technological difficulties associated with the membership growth, CAME's Palm Pilot system is currently being recalibrated for future reintegration into CAME's lending programs. This description of CAME's experience with the Palm Pilot system is derived from the initial three-year implementation period (1999–2001).

[20] Field officers found that the IGGs' higher-than-desired drop-out rates were caused by concerns over time commitment. Interviews with members who had left IGGs also revealed that familial difficulties often placed significant constraint on members' activities outside the home.

A similar duplication of effort occurred at CAME's head office when the same savings and credit data had to be input into CAME's main database. Data entry errors were frequently made, and the resulting inaccurate information limited CAME's ability to respond to customers' needs and to changing market conditions.

With the introduction of Palm Pilots to IGGs in 1999, savings and credit data were recorded only once, reducing time and errors. Since the Palm Pilot's built-in printer provides transaction reports at the touch of a button, transparency was maintained for IGG members, and the data stored in the Palm Pilots were directly uploaded to CAME's central computer, ensuring data integrity and consistency.

These improvements in accuracy, along with the reduced time commitment for meetings, became a strong marketing point for new and existing IGG members. As they became adept at using the Palm Pilot system, the IGG borrowers' technological sophistication and financial knowledge grew.[21]

Fundusz Mikro: Business education through product innovation

Micro-businesses began operating in Poland in the mid 1990s, a time when domestic demand was high and consumer confidence was strong. As a result, microentrepreneurs did not always develop the business skills needed to weather Poland's subsequent, more challenging economic climate.

Fundusz Mikro (FM), established in 1994 as the first micro-lending institution in Poland, recognized the importance of developing innovative loan products to address these changing economic circumstances.[22]

Fundusz Mikro, the first micro-lending institution in Poland, recognized the importance of developing innovative loan products as the country's economic circumstances became more challenging.

As its former executive director, Witold Szwajkowski, explains, "The market economy is still a new idea in Poland and most micro-business people do not really know how to plan investments and evaluate business risk. [In the strong economic climate of the mid

[21] CAME also envisions a time when the Palm Pilot system will improve its efficiency by reducing labor costs; CAME believes that IGG members will take on full responsibility for inputting transactional information into the Palm Pilots.

[22] In 2000, Fundusz Mikro received an award from the Institute for Financial Services in Germany for its development of products that ensure Polish customers access to financial services.

1990s] they assumed that they didn't have to think about returns or risks. Now … they do not understand that part of their difficulty is because they don't know how to structure their businesses according to the economic environment."

Fundusz Mikro's two innovative products were aimed at building borrower business skills. The first, the micro venture-capital loan, is meant to encourage business growth in Fundusz Mikro's more mature and reliable borrowers.[23] The product mimics an equity-investment model by offering borrowers much-needed quasi-equity capital: while the loan is usually for one year, with monthly payments of interest only at a favorable rate, at the end of the loan term borrowers have the option of renewing the micro venture-capital loan. If the loan is renewed, borrowers bring the interest-paid-to-date up to the commercial rate level and retain Fundusz Mikro's "equity" investment for another term. By continuing this relationship with its "capital investor," the borrower gains access to long-term capital that it cannot access from the formal financial sector, while Fundusz Mikro establishes a long-term, financially beneficial relationship with a mature borrower.[24]

Fundusz Mikro's second product innovation is the two-part partnership finance loan. One of its goals is to educate borrowers in evaluating potential profits, business risk, and

[23] In "The Healthy Core of Entrepreneurship," Witold Szwajkowski defines mature and reliable borrowers as those entrepreneurs "who derive personal satisfaction from running their businesses; plan for the growth of their businesses by defining a vision for their future development and formulating ambitious long-term plans; have considerable business experience; view the future of their businesses optimistically despite the current business slowdown in Poland; cultivate strong business relationships and network effectively with other businesspeople in their communities; care about having a good business reputation and thus meet all contractual obligations, not for fear of legal repercussions but because of their own integrity; treat their customers and clients with respect; and have a sufficiently comfortable financial situation that allows them to view their businesses as a way of life and a means of achieving their professional aspirations rather than as a means of survival."

[24] According to Szwajkowski, Fundusz Mikro chose not to pursue a more formal capital-investor relationship with its customers because of the limitations that Polish commercial law places on the establishment of true partnerships. Although Polish commercial law allows for the legal creation of civil and commercial partnerships, significant hurdles must be overcome. The liability obligations of civil partnerships require that both parties agree to pay each other's business and private obligations. The amount of capital required to set up a commercial partnership is usually three times greater than the loans Fundusz Mikro makes to borrowers.

investment planning in a difficult market climate.[25] An underlying goal is the development of long-term business relationships in which Fundusz Mikro is a partner.

The first part of the partnership finance loan is an origination fee, which is a percentage of the principal borrowed, set at a rate equivalent to the interest rate earned on a bank's savings account.[26] The second part of the loan's cost is termed the partner's return on investment; this is where Fundusz Mikro meets its education and relationship goals. Borrowers must pass two hurdles to proceed to the approval stage. First, they are asked questions designed to gauge their understanding of their businesses' profitability and of the financial advantages they may gain from a "partner's investment" capital. They are also asked to consider the risk that their potential partner, Fundusz Mikro, may take by "investing" in their business. Second, they must present reliable information that details the borrower's expected financial return from Fundusz Mikro's "investment." Thus, besides the standard information on the health of the borrower's business, borrowers must also share their calculations of the expected return and the assumptions on which the calculations were based.[27]

If an otherwise qualified borrower lacks the skill to determine accurately the expected return, a loan officer provides assistance in calculating the projected return. Once the estimated return is properly identified and agreed upon by the loan officer, the loan is committed. The borrower must then determine the portion of his projected return that he

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[25] As part of a market study conducted by an independent institution, Fundusz Mikro learned that its borrower review and unstructured education techniques resulted in borrowers with a substantially better risk-evaluation capacity than a sample group of microentrepreneurs.

[26] The origination fee is collected at disbursement of the loan and is capitalized.

[27] Fundusz Mikro loan officers collect considerable market information from borrowers with whom they have developed strong relationships. This market knowledge enables them to ascertain the reliability of the information provided by new potential borrowers interested in the partnership finance loan. If, for example, the borrower's business information conflicts with the loan officer's knowledge of the market, the loan officer can take two approaches. The loan officer decides which approach to take based on the sense that he or she has developed of the potential borrower over the course of their conversations during the application process. Should the Fundusz Mikro loan officer determine that the borrower does not have the level of integrity or long-term planning ability that Fundusz Mikro is searching for, then the loan officer will direct the borrower to one of Fundusz Mikro's standard loans, in which Fundusz Mikro sets the interest rate. Should a borrower simply not have the complete set of skills needed to determine the financial return, but have the will to enter into a long-term partnership relationship, the loan officer will provide the borrower with the assistance to arrive at an accurate calculation of the expected financial return.

will share with Fundusz Mikro. If the borrower opts for no additional charge, the loan is still disbursed; however, the borrower's chance of obtaining another loan in the future is low. The borrower's real interest in developing a long-term partnership with Fundusz Mikro is tested at the loan's maturity, when it is determined whether the projected financial return was met. If the projected return is not met, Fundusz Mikro returns its portion of the projected profit to the borrower.[28]

Though still fairly new, the two products' initial results are promising.[29] Many new borrowers are attracted to them, repayment rates are strong (averaging 96%), and interest rates on the partnership finance product exceed the standard loan product rate by 5%. Over time, borrowers have come to understand that Fundusz Mikro is not simply an alternative to the financial services provided by a bank, but a financial institution that will actively help them to expand their entrepreneurial capacity.

Alternativas—Innovation through a sustainable productivity chain

Alternativas y Procesos de Participación Social ("Alternatives and Processes for Social Participation," or Alternativas), is a private, nonprofit regional development organization working with the rural poor of México's Mixteca region since 1980.[30] Alternativas' mission is to establish more equal relationships among regions, peoples, families, and sectors such that the quality of life for these groups is improved, especially for the poorest. It approaches its mission through a collaborative search for alternatives and through promotion of social participation processes which lead toward sustainable human development. Alternativas accomplishes its mission by creatively using a variety of funding sources to build a sustainable agricultural productivity chain in a regenerated natural

[28]During the term of the loan, Fundusz Mikro collects its portion of the return identified by the borrower as part of the loan's installment payments.

[29]Micro venture capital loans represent 27% of Fundusz Mikro's loan portfolio, while partnership finance loans represent 10%. The value of Fundusz Mikro's micro venture-capital loans is over US$4 million. Its partnership finance loans are offered to current and new potential borrowers, although the latter, by far, have demonstrated the greatest interest. Fundusz Mikro hopes soon to have data collected on 100 partnership finance loans. The data should provide added insight into the loan product's success. Sixty percent of Fundusz Mikro's portfolio consists of standard loan products.

[30]The Mixteca region includes the southeastern portion of the state of Puebla and the northwestern portion of the state of Oaxaca.

environment. To build this chain, Alternativas combines the regeneration of natural resources with training and education tools, a variety of financial instruments, the development of market access, and community building.

In the early 1980s, Alternativas noted that poverty in the Mixteca region had a number of causes. The more obvious causes were the relatively few linkages that many rural villages had to agro-industrial markets and the unfair exchange conditions between the two. A more in-depth review revealed poor environmental conditions to be one of the endemic causes of rural poverty. Many of Mixteca's rural villages have an unreliable and limited source of water. The water supply to these villages barely supported the villagers' personal needs, let alone the quantities needed for crop irrigation. Alternativas also found villagers' livelihood capacities to be constrained by poor soil quality.

This environmental analysis led Alternativas to address livelihood constraints through a combination of environmental, agricultural, and market development strategies. "If Alternativas had arrived in a region where all the natural resources were there," notes General Director Raúl Hernández-Garciadiego, "we may not have taken this approach. Because we came to a region where environmental degradation was such a concern, we had to start with better utilization of rain and then go to the development of the local market and then the agro-market." Although Alternativas has become known for its environmental work (its staff is referred to as "the water people"), their real measures of success are the production linkages they have helped to create.[31]

Creation of a sustainable productivity chain necessitates the development of three key linkages: agricultural crop production, agro-industrial processing into final consumable products, and development of a distribution network to reach the market. To develop these links, Alternativas employs a set of specialized development finance tools. Examples of such tools include credit and guarantees for income-generation phases, risk sharing co-investment, nonrefundable infrastructure investment, and pools of financing sources.

[31] Alternativas has received numerous national awards for its environmental work. It received its most recent award in 2002 from the Mexican Federal Government, an Honorable Mention in National Ecology Merit for its work in the Mixteca region.

- **Identification and assessment of needs and intervention opportunities:** Alternativas staff must first establish close and strong partnerships with rural villages. Alternativas accomplishes this through group discussions and presentations to village women and men, including the village leaders. The group discussions reveal a village's variety of problems. The problems are organized into "families of related problems" and then analyzed to find the "axis problem"—that is, the principal problem whose resolution would strongly contribute to the solution of other related problems. The problems frequently identified through the group discussions include water scarcity, poor soil quality, low crop production, lack of funds for production efforts, insufficient food, and meager incomes. Water scarcity, however, is most consistently identified as the axis problem that families want to address first. As a result of the attention that Alternativas has had to pay to this problem, it has developed a set of watershed regeneration technologies that combines indigenous approaches with modern possibilities. These technologies have proved effective in recharging groundwater, replenishing springs, and creating ravines out of formerly dry canyons. With the aid of Alternativas engineers, villagers conduct field surveys and learn how to design and manage regeneration projects.[32] These valuable skills offer villagers a broader knowledge base that they can use time and again. Alternativas personnel share their state-of-the-art technology—geographical information systems, satellite images, watershed and soil data—as they work with villagers to identify appropriate projects. Hernández-Garciadiego notes that this ability to link villagers' local knowledge with Alternativas' technological information "helps villagers have a better sense of their region and, ultimately, helps them make better decisions for their permanent development process." By the end of 2002, almost 1,000 waterworks were completed with the participation of 115 villages, improving the lives of 135,000 indigenous people.

- **Finance:** With the village project identified, Alternativas offers the appropriate financing tools applicable for each particular case. Financing can be used for purchasing materials, machinery for building dams, or inputs for agricultural development. "An example of innovation in our finance tools," explains Hernández-Garciadiego, "is a borrower's ability to repay his or her loan with cash, water, crops, or building material retained from water reclamation projects."

[32] Those villages without water constraints may identify different projects, such as improving soil quality or crop production.

- **Agro-industrial and marketing chain:** An example of how Alternativas addresses this crucial link in the sustainable productivity chain is its work through the Quali Cooperative Group, a project initiated in 1983.[33] This project uses amaranth as a nutritional and agro-industrial crop alternative in semi-arid regions.[34] The Quali Cooperative Group currently consists of a total of 1,100 amaranth farmers organized into 60 village-based local cooperatives. The primary purpose of the Quali Cooperative is to connect amaranth farmers with the market for this product. Through their local cooperatives, farmers sell their amaranth crops to the Cooperative Association for a fair price.[35] Quali, as a cooperative group, processes the crop into a number of nutritious, consumable products (for example, cereals, chips, and sweet treats). Quali then distributes the products into the regional market. Quali's amaranth processing plant also provides employment to local people.

Alternativas' methodology has received wide recognition and has enriched the approaches of a number of other projects throughout México.

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The Reinvestment Fund—Innovation through bank partnerships

Based in Philadelphia (USA), The Reinvestment Fund (TRF) is a nonprofit development finance organization that finances small businesses, housing developments, and community facilities such as daycare centers and health clinics. In addition, TRF provides planning, workforce development, and policy analysis throughout its market area.

[33] Hernández-Garciadiego explained how the detrimental impact of the Mexican financial crisis led Alternativas to become the formal capital partner of the Quali Cooperative Group in 1995. During the crisis, Mexican financial laws allowed traditional financial institutions to capitalize the interest due on loans, resulting in a level of debt that borrowers were unable to pay. Borrowers began to default on their loans. Many of Alternativas' borrowers could not understand why they should pay Alternativas if no one was paying the banks. Alternativas addressed this "contagious nonpayment illness" by becoming partners with its amaranth borrowers via the Cooperative. Hernández-Garciadiego notes that "farmers no longer avoided making loan payments because they no longer saw them as creditors but rather as partners walking along with them." Alternativas sits on the board of the Cooperative and attends the monthly meetings.

[34] Once a primary crop of indigenous peoples, amaranth lost favor with the introduction of corn and wheat production. Alternativas has promoted this indigenous crop both for its high protein content and its suitability to the semi-arid conditions of the Mixteca region.

[35] In this structure, Alternativas' loan repayment is netted out of the farmer's proceeds from sale of his crop.

TRF has developed imaginative and varied ways to raise the capital it needs to carry out its lending and investment activities. TRF's social investors (individuals and institutions) choose from three different financial structures: 1) a loan fund capitalized by simple debt instruments for fixed terms and fixed rates; 2) a limited partnership for venture-capital financing; and 3) a consortium for banks and other financial institutions geared toward large construction loans, called The Collaborative Lending Initiative (CLI). Each fund has a distinct capital structure, risk and return profile, and product orientation. The loan fund raises very low-cost debt. The venture fund raises relatively competitive private equity, while the CLI bank consortium pays banks a return at the prime interest rate.

TRF's bank consortium capitalization is perhaps its most interesting innovation. The CLI allows TRF to use bank resources directly without going through the underwriting or servicing processes of the banks. Organized as a subsidiary corporation of TRF, CLI consists of 15 banks that must commit a minimum of US$500,000 each (the actual total is over US$25 million). TRF and the banks agree to underwriting and servicing criteria prior to the bank commitments. In return, TRF incurs the high transaction costs of making labor-intensive construction loans (something that very large financial institutions would rather not do) and gives the banks access to its customer base and deal flow. In addition, this structure provides a 10% credit enhancement or credit insurance on every loan. In five years, more than US$50 million worth of revolving construction credit has been extended, resulting in the construction of more than 2,500 units of housing.

The TRF bank partnership works well for all the parties. TRF gets virtually unlimited capital access for construction lending (the present US$25 million in credit can be increased as needed); the banks have their costs reduced and their credit exposure limited, and receive Community Reinvestment Act credit for the loans; and the borrowers receive easily processed flexible credit.

Bina Swadaya's self-help strategy: Social networks and group formation

Many DFIs play active and complex roles in working with indigenous networks and social groups as part of their financial intermediary role. A particularly rich example comes from Forum member Bambang Ismawan, Chair of Bina Swadaya in Indonesia. Bina Swadaya was established in 1967 with the aim of improving the welfare and self-reliance of the Indonesian poor. The organization works in microfinance, business development, community organization, and education and training. Bina Swadaya views itself as building human and community capacity by undertaking economic activities within a group structure. They see development finance as a tool in a broader strategy of group and individual empowerment.

The self-help group is the key organizational structure used by Bina Swadaya to improve welfare and self-reliance. Bina Swadaya believes that poverty in Indonesia is directly linked to limited human capacity and weak levels of social organization. Supporting group formation and activity is not just a lending methodology, it is a civic organizing process. As Ismawan notes, "The poor are not the have-not, but the have-little. Therefore, if they are assembled into groups and their efforts are facilitated, they will have a capability to overcome the primary problems that constrain the improvement of their social and economic life."

Community groups, including traditional and government extension groups, are quite common in Indonesia. Bina Swadaya uses two approaches to develop self-help groups, either building them from existing groups or facilitating the creation of new groups from the bottom up. Each approach presents its own benefits and challenges and each has financial and organizational issues associated with it.

When working with pre-existing groups, Bina Swadaya preserves and simultaneously reorganizes their infrastructure, often introducing new functions and competencies—credit and savings—into an existing framework. In the absence of existing infrastructure, Bina Swadaya builds new groups. In this case, the facilitator's work involves direct inter-household organizing and instilling the principles of self-empowerment and group economic development.

In spite of the challenges of self-help group formation, the group structure in development finance affords the Indonesian individual and community many benefits. Groups function as the focal points around which personal decisions, capital connections, social solidarities, and new external connections are built. Bina Swadaya not only provides self-help groups with financing and business assistance opportunities, it also helps to link the groups to other financial and service providers outside of Bina Swadaya, including conventional formal sector banking relationships.

Part of Bina Swadaya's overall institutional strategy is to combine high transaction-cost innovation focused on the poorest Indonesians with more profitable business-investment opportunities among less marginalized populations. This creates a pool of internal subsidy that can be used to offset the cost of social innovation. It also increases Bina Swadaya's linkages to institutions, networks, and capital providers that can be mobilized in support of its core mission.

K-REP's Financial Services Associations: building new institutions

Some DFIs are helping to create village-based institutions with their own capital structures and functional independence. Perhaps the best example of this among Forum members exists in Kenya, where the Kenya Rural Enterprise Program (K-REP) is experimenting with the development of small local financial institutions.

K-REP has served the poor in rural and urban areas since 1984. Its threefold mission is to empower low-income people, strengthen microfinance programs and institutions, and increase employment and income opportunities by providing technical assistance and developing the economic activities of the poor. K-REP addresses many of its mission objectives through its Financial Services Associations (FSA) initiative, which is based on a village banking model.

K-REP began its FSA initiative in 1997, primarily in remote rural areas with poor infrastructure, low population density, and limited economic potential. The main purpose of the initiative is to establish a locally accessible, locally owned, and locally operated financial institution. The ultimate objective is to link FSA services to the country's financial system. (Within Kenya's financial system, FSAs are not considered formal financial institutions.) FSAs are shareholding financial enterprises through which rural communities have access to a broad range of financial services.

K-REP's work with FSAs plays an important role in building social capital. Its financial work with villagers and the linkages that it forges with traditional financial institutions have the potential to change the social and financial environment in sections of rural Kenya. K-REP is fostering these changes by introducing the rural poor to formal banking concepts and methods, as well as by aiding in the establishment of institutional structures in rural areas that previously had none. Perhaps most importantly, K-REP's work is cultivating communal norms conducive to a transparent financial infrastructure.

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Villagers' interest in FSAs is evidenced by this initiative's growth: as of December 2002, 63 FSAs had been registered in 18 districts with a membership of 33,340 shareholders. Villagers' interest is also evidenced by their willingness to use a portion of their limited income to purchase membership shares.

The establishment of FSAs involves a three-step process: mobilizing the community, training the FSA team, and providing general oversight of and support for the operating institution. The first two steps involve intensive community work by K-REP's field coordinators. The degree of K-REP involvement in the third step depends largely on the challenges faced by an FSA.

In the mobilization step, field coordinators capitalize heavily on the informal local rules, customs, relationships, local knowledge, and solidarity that exist within a community. They build upon the existing social relationships to generate community interest in the financial institution concept. Field coordinators highlight three key benefits of an FSA for the community: ownership, access to financial services, and income generation.

- **Ownership**—FSAs are owned, financed, and managed by the low-income members of a village, with shareholders electing their representatives.
- **Access to financial services**—FSAs offer savings and credit to villagers without ready access to other financial institutions.
- **Income generation**—Villagers gain income by placing their savings in interest-bearing accounts and qualifying for loans.

K-REP continues its institution-building initiative during the training stage. Training is provided to the three levels of the FSA team: membership, staff, and board. The general membership's training begins with an introduction to the democratic election process in preparation for their election of the FSA's eight Board members. Members also learn of their responsibilities as shareholders and receive an overview on the responsibilities of elected officials and hired staff. Staff training to the FSA's first appointments, the manager and cashier, focuses on the standard functions of each position. Training of the FSA board includes explanation of the Village Banking concept, governance and management, selection of borrowers, and setting of interest rates.

General oversight of and support for the FSA can have many permutations. During this third stage of FSA development, field coordinators provide a wide variety of technical assistance. For example, field coordinators help to link FSAs to the country's banking system. This is an important connection to make because it enables villagers to conduct basic financial transactions, such as money transfers and cashing of governmental checks, in a trusted local institution. Field coordinators also help FSAs identify ways to increase their institution's efficiency, lower lending costs, and maintain professional standards.

Creating an environment that supports DFI innovation

These eight examples of institutions created by Forum members are just a few of dozens from around the world. They are mature organizations that have the financial and portfolio breadth to innovate, using new information technologies and financial mechanisms to reduce barriers to capital access.

Our collective job is to ensure that the environment for development finance maximizes this potential for innovation. We can do this by paying attention to *how we fund*, *how we learn*, and *how we measure*. These three important functions provide the gateway to innovation.

- **Funding:** Donors and social investors must make conscious efforts to finance innovation. This can be accomplished either through grant funds or patient equity investments. Either way, we must remember that innovation requires time and a realistic risk profile and tolerance.

- **Learning:** Real learning networks—as we discovered with the Forum—require both time and personal risk. The learning environment must be safe and constructive. We need to design more systems and opportunities in which practitioners can openly share innovations and engage in constructive discussion and analysis.

- **Measuring:** Our financial and social rating systems must account for our capacity to innovate. Balance sheet ratios are important, but DFIs must be analyzed and rated as both change-agents and asset managers.

SECTION 5

Smart subsidy

The use of smart subsidy is beneficial and does not necessarily lead to inefficiency.

Clarifying the subsidy debate

The heated issue of subsidy for development finance institutions lends itself too easily to oversimplification, as when it becomes a proxy for the broader issue of whether public money should go to economic development at all. The inefficiencies of overly subsidized DFIs can be made to seem similar to the inefficiencies of government investments in the economy, an association that rings particularly true to DFI leaders in societies where the public sector dominates the economy and overly constrains markets. At the same time, we know that in even the most mature market economies, public investments in education, infrastructure, and research and development make a crucial difference.

Too simplistic a view of subsidy tends not only to stunt the debate, but also to create expectations that are difficult for some DFIs to fulfill, particularly those that work to reach the very poorest. A more subtle *theory of subsidy* is needed, specific to development finance, that takes into account the experience of the most self-sufficient (and efficient) DFIs and helps determine when subsidy is valuable ("smart") and how and when it is counter-productive. We hope this section will contribute to such a theory.

A more subtle theory of subsidy is needed that takes into account the experience of DFIs and that asks when subsidy is valuable ("smart"), and how and when it is counter-productive.

Financial self-sufficiency and subsidy

We define financial self-sufficiency as the ability of a DFI to cover the financial and operating costs of its lending and investment operations, including the cost of loan losses, without using external grant funds. We recognize the need for a DFI to be able to increasingly capitalize its lending and investment operations through market-rate investments and to cover the effects of inflation on its equity base. We do not believe, however, that financial self-sufficiency must mean no subsidy for the nonfinancial elements of a DFI's programs.[36] In effect, we feel justified in altering the commercial world's standards to fit us, not because we do not believe in them—*we do*—but because, at the end of the day, we are not exclusively involved in commerce.

Virtually all DFIs are capitalized (at least initially and, to a great extent, on an ongoing basis) by investments that are more patient, more risk-tolerant, and less return-driven than market investments in publicly traded stocks, private equity, or rated bonds. Moreover, economic development functions are often an important part of understanding or creating market demand, and the issue of allocating and covering the costs of those functions is open to debate. Finally, there are situations in which the nature of DFI lending—its risk profile, its market context, or the extreme poverty of its customers—may warrant the continued use of subsidy over a period of time.

At the same time, we believe that rigorous standards must be applied to the use of subsidy. Whenever possible, it is preferable to use the internally generated profits from financial products as the basis for subsidies, thus creating the discipline of managing compensating investments from different parts of the portfolio. DFIs that want to develop products requiring subsidy also need to demonstrate the trade-off between cost and impact. Regardless of where subsidy comes from, DFIs must avoid prolonged or recurrent subsidy and build toward financial self-sufficiency.

This is the case for many reasons. Prolonged subsidy tends to reduce independence, obscure inefficiencies, and create barriers to productivity. Financial self-sufficiency demonstrates the market quality of borrowers, ensures against the political interference that often comes from external donor and government funds, creates a platform for growth, and forces us to create efficient operating and personnel systems.

There may or may not be a direct connection between financial self-sufficiency and poverty-reduction impact. That is something that has yet to be demonstrated. There is, however, a connection between financial self-sufficiency and the operating independence and incentives necessary to ensure long-term development, market expansion, and program innovation.

[36] Ledgerwood, Joanna, Microfinance Handbook, World Bank, Washington, D.C., 1999. p 217.

The roles for smart subsidies and those who provide them

Our conversations identified six costs that are "smart" to subsidize:

- **Start-up costs**, such as grant funds and/or subsidized capital (either long-term debt or very patient equity) to seed new institutions.
- **Research and development costs** for new products or techniques that DFIs cannot easily afford.
- **Costs of high-risk/significant-impact products**, like those targeted to high-risk, very poor customers who might require subsidy beyond the first two or three years of product development.
- **Costs for capacity-building at the field-wide level**, such as training, leadership mentoring, policy development, and advocacy.
- **Costs for building customer capacity**, such as analyses of economic sub-sectors and certain forms of training and technical assistance that are outside the immediate lending processes of DFIs, but which help to stimulate DFI markets.
- **Costs of building capital access**; for instance, developing secondary markets and niche equity funds as part of the creation of a regional or global investment infrastructure to support the field's growth.

Most donors draw rigid boundaries between investments of their core assets, their program-related investments, and their grant funds. A more nuanced approach would be helpful. If donors could see smart subsidy in a commercial way—as an investment despite the lack of a market-rate financial return, as long as the subsidy works for the right institutional benchmarks—then they would be more like equity investors. Good equity investors not only understand the companies they invest in, but also their business models, the general field, and the relevant data. They use their knowledge, capital, and relationships to help the firms they have invested in, are in for the long haul, and are able to remain patient and engaged during periods of business contraction as well as growth.

In all cases, subsidy must be transparent; it should not be provided unless its purpose is clear and the DFI demonstrates the capacity to manage applicable organizational costs. In many cases—particularly for start-ups or innovation—subsidy must be provided with exit strategies clearly laid out beforehand. There has to be agreement on the beginning and the end points of subsidy.

Over and above the use of subsidy for individual DFIs, the same principles of transparency and (sometimes) exit can also be applied to subsidy used strategically to develop the field, although these investments will necessarily have a longer time horizon.

Smart subsidy and economic development

The subsidy debate is important, both in the DFI context and in many others. Many of the comments we make about smart subsidy for DFIs apply, for example, to public investments in the economy. Governments ought to fund costs that the marketplace cannot recover, in ways that maximize the creation of private and social wealth. When the public sector oversteps these roles (for example, by trying to implement ill-conceived loan programs directly) or funds without standards or production expectations, the opportunity for failure increases. If, for example, the government of India subsidizes specialized technical colleges, a vast number of whose graduates leave the country to settle in the U.S., the subsidy would be "dumb" if it can be shown that the investment does not yield positive social or economic returns for India.

In other realms, planting a slow-growing but environmentally useful tree species, bringing up children with adequate nutrition and education, and building democratic institutions are investments that have a positive social return but not necessarily a positive economic or financial rate of return. Yet these are clearly "smart subsidies." Again, the issue is not whether a government ought to fund economic development but what it should fund and how.

At a time of rapid change in social systems, technology, and capital markets, we are all asking ourselves questions about the roles of markets versus government versus civil society. DFIs exhibit both market and civic qualities and functions. This makes it all the more important for the issue of subsidy to be faced and analyzed in a direct and honest way.

SECTION 6

The enabling environment

The right enabling environment creates wealth. Strengthening the enabling environment enhances the ability of DFIs to reach scale and have an impact on poverty.

From transactions to public policy

In one way or another, every nation represented by Forum members has some dysfunctions in its legal and regulatory environment. These include the lack of legal systems for registering property or businesses in a cost- and time-efficient manner; poorly developed banking and non-bank financial regulatory systems; under-developed NGO or civil society regulations; the lack of appropriate anti-corruption measures; the absence of public transparency; limited bridges to connect public, private, and civic institutions; and limited incentives for connecting mainstream finance to the lives of the poor.

These dysfunctions constrain social and capital mobility and limit the long-term effectiveness of DFIs. Thus, we have an additional role to play: helping transform a constraining environment into an enabling one. It is our role as providers of capital that gives us an important platform upon which to build, but to do so we must be aware of the dangers of the political waters in which we navigate.

Dysfunctions in the legal and regulatory environment constrain social and capital mobility, and limit the long-term effectiveness of DFIs. Thus we have an additional role to play: to help transform a constraining environment into an enabling one.

All Forum members recognize the need to maintain the balance between their responsibility for their institutions' well-being and their opportunity to affect broader systems. Forum members know when to advocate strongly for a regulatory change and when not to, when collective action through a network or association will work and when it might not. The capacity to make these judgment calls at the right time is a key characteristic of DFI leadership.

DFI trade associations and networks exist in every country represented by the Forum. Along with capacity-building and capital-access roles, networks almost always play some kind of regulatory advocacy or lobbying role. For example, in Kenya, Aleke Dondo of K-REP is aware that the Kenyan political system is unpredictable and could shut down a

DFI were it to be seen as a political threat. K-REP and others in the microfinance and microenterprise sector have been banding together to influence the central bank's microfinance policy, moving it toward a more coherent, consistent, and reliable set of guidelines.

Regulatory change, NGOs, and formal banking systems

Most DFIs are NGOs and thus exist on the margins of formal banking. Regulatory systems frequently make that position difficult. At the same time, DFIs are often uniquely positioned to advocate for constructive reforms. Examples of the challenges DFIs face in this regard include the following:

Indonesia

Bina Swadaya, working through the Indonesia Microfinance Movement, is working to promote a new law allowing NGOs to become formalized MFIs, enabling them to operate legally as formal financial institutions. The recent financial crisis and global interest in microfinance have greatly influenced the speed with which the Indonesia Microfinance Movement has been able to make progress on this law, since MFIs were the least affected financial institutions during the earlier Indonesian financial crisis of a decade ago.

México

The Mexican government recently enacted legislation that has important implications for DFIs' ability to reach scale and alleviate poverty. DFIs that mobilize and manage customer savings are now required to transform themselves into regulated institutions. Those that do not meet this requirement will not be allowed to borrow from private organizations or investors.

As Alfredo Hubard-Deffis of CAME explains, DFIs that choose to become regulated institutions will need to make dramatic changes. These include hiring new personnel who meet the requirements of the supervising regulatory authority, training staff on their new responsibilities, developing a new management information system, and paying fees for membership in a still-to-be-defined federation of regulated DFIs. Because of the costs

DFIs will have to incur under the new Mexican law, Forum member Raúl Hernández-Garciadiego believes that it will exclude small, local community-based financial institutions from functioning. He thinks that the new law should have different normative requirements for smaller institutions, providing an opportunity for education and capacity-building in these smaller community-based institutions.

Latin America

María Otero from ACCION believes that only by becoming regulated will microfinance institutions reach larger numbers of low-income people and provide larger loans to those with the need and capacity. MiBanco in Peru, for example, became a regulated bank in 1998 and now has approximately 65,000 customers, with 25,000 added in just the last year. Many microfinance institutions that have become regulated have found that they are extending loans to basically the same market and the same customers as they were before. Otero recognizes that the transformation from NGO to regulated financial institution involves fundamental changes in how the DFI does business. She noted two challenges in particular:

- In Latin America, the challenge of moving from the traditional culture of an NGO to that of a for-profit bank often took from one year to 18 months, and required careful training and staff development.

- Even very good institutions had to go through time-consuming and costly changes in systems (including their MIS) if they were to meet the requirements of a supervisory agency.

No matter how regulatory change includes, excludes, or redefines DFIs, the regulators themselves must be trained to understand that they are dealing with a new kind of economic development banking that focuses on the poor. This has been a problem everywhere and Otero sees it in Latin America. Besides training for regulators, she recommends having one supervisory entity specifically for DFIs, using review instruments that are designed for them.

The Latin American context also highlights the need for multiple legal structures and degrees of statutory control to respond to nonprofits not wishing to transform as well as to formalizing DFIs. In general, there needs to be tolerance and support for a range of regulatory systems and policies, from self-regulation to statutory regulation; formal banking supervision generally only needs to become involved with certain types of DFIs.

India

The Government of India's initial refusal to approve BASIX's application to be a rural credit provider with international investors was a reflection of a bureaucracy unable to deal with an unfamiliar entity: it could not put BASIX into any pre-existing category. BASIX's unique activities and structure also prevented it from receiving a rating that accurately reflected its risk profile. Despite the fact that two independent rating companies ranked BASIX's for-profit companies at B+, and despite the fact that BASIX's net return on total assets is better than that of most Indian banks, the rating was downgraded because of BASIX's customer base: the rural poor, who are still perceived as high-risk.

Regulatory reforms that mainstream lending to the poor

The U.S. Community Reinvestment Act (CRA)

Banking regulation can create incentives for existing banks to make loans to poor people. The best known is the 25-year-old Community Reinvestment Act, which has directed billions of dollars of credit to low-income neighborhoods.

ShoreBank helped draft the law and actively advocated for its passage. Mary Houghton believes that the message sent in the U.S. is important for banking institutions worldwide: in exchange for having the privilege of deposit insurance and banking charters, banks must serve all people in their geographic areas of operation. She believes that CRA-type legislation in developing countries could have significant impact if the financial establishment can be convinced of the business logic of making loans to the poor. Houghton suggests that NGOs, such as human rights groups or DFIs, should play the role that U.S. consumer-advocacy groups played in getting the CRA passed. In Nigeria, for example, where CRA-type legislation has been approved (the central bank has asked all banks to allocate 10% of pretax profits to small-business investment) the central bank has had difficulty defining the rules needed for implementation. An advocacy group in this situation could work to mobilize public opinion in favor of the law and make certain that the regulators implement the law in an effective manner.

South Africa's Usury Act Exemption

Forum member Chris Hock from South Africa cites an example of how regulatory change created a flood of new lending for low-income people. That change was closely tied to the end of apartheid. In 1993, the Usury Act Exemption removed interest rate ceilings, giving black communities access to financial markets. In 1996–97, an avalanche of new lending was unleashed, with 1997–98 seeing significant consolidation among lending institutions.

But these were only first steps. Hock notes that DFIs are involved in promoting: revisions to the Banks Act to allow non-bank retail lenders to take wholesale deposits and allow for institutional investors; amendments to the Issues Act to allow loans to be made above the current maximum of Rand$ 10,000 (about US$8,000); and (with the facilitation of the IMF) the Mutual Banks Act, aimed at formalizing financial institutions such as village banks, cooperative banks, self-help institutions, and "burial societies" to enable them to interact effectively with both larger formal financial institutions and government. Such an interface would, in turn, promote the sustainability of these smaller institutions.

SECTION 7

Governance

Growth of the development finance field requires not only social entrepreneurship but also appropriate governance systems in order to manage tensions between markets and public purpose in a transparent manner.

The governance challenge

For DFIs, the governance challenge is not just a matter of better internal systems for financial and impact transparency; governance must also deal with the tension created by the drive to raise capital from traditional markets, while avoiding "mission drift" and a loss of value to low-income clients. No single system or style offers a fail-safe roadmap to resolve these tensions. While the field requires the kinds of governance and leaders capable of managing social and financial returns, the many heated debates the Forum has had on this issue illustrate that "the devil is in the details."

DFI governance must deal with the tension created by the drive to raise capital from traditional markets, while avoiding "mission drift" and a loss of value to low-income clients.

Organizational structure

As noted in the ShoreBank example in Section IV, the holding company structure permits the allocation of internal subsidy from the most profitable enterprises to those with high social value that have greater transaction or innovation costs. It also allows different funds, investors, and organizational cultures to thrive within one overall framework, which acts to ensure the integrity and coherence of the mission.

Forum members who favor the holding company structure believe that it avoids the danger of confusing the profitability goals of the business with its internal or external subsidy requirements. That danger is more real in a single-entity structure that is involved in many different kinds of activities. Nevertheless, some Forum members felt they were able to manage different lines of business and organizational cultures within a single organization.

The single-entity versus holding-company framework conversation was focused largely around the issue of internal management strategies.

Ownership: External investors, internal shareholders

How can we prevent investors that do not share our worldview, whether individual or institutional, from taking too much control of mission and strategy?

Some have resolved this issue by choosing external lead investors who share the mission of the DFI. DFIs based in the U.S. are somewhat better able to pursue this strategy because of the broad interest in the U.S. in social investment, and because of Community Reinvestment Act pressures on banks to function with a social-investor consciousness in certain parts of their portfolios.

Others thought that the issue of choosing investors cannot be separated from the potential governance role of DFI clients themselves. Raúl Hernández-Garciadiego of Alternativas brought up the role of small shareholders and the importance of keeping cooperative systems in mind in discussions about governance structure. Thus, at our meeting in India, we purposely visited two DFIs with similar missions but widely differing governance systems: SEWA Bank, led by Ela Bhatt, uses a credit cooperative governance system; BASIX employs a commercial holding company structure and has chosen lead investors from international social-investment sources.

In SEWA Bank, the board of directors is elected from its customer and shareholder members. Ela Bhatt believes that the poor women of SEWA can do a good job governing the organization. For example, when interest rates were deregulated, SEWA had to decide what interest rate to charge. The board members, who were also the bank's borrowers, had to look at the health of the institution, balancing their differing interests. At the same time, senior management of SEWA provided checks and balances, since management and board must agree on key policies such as pricing. Still, when direct beneficiary interests are at the governance table, conflict of interest remains a danger. Ela Bhatt proposed that perhaps one way out of this complex dilemma was to create a system with different ownership rights for different classes of investors (including, in some cases, direct beneficiaries).

To others, educating "owners" and creating forums for dialogue is a way to mediate the conflict between mission and other interests. Bambang Ismawan, of Bina Swadaya, for example, described how shareholders in one of Bina Swadaya's cooperatives left because they were disappointed that Bina Swadaya would not charge a lower interest rate. The shareholders did not understand the issue of DFI sustainability. Bina Swadaya now conducts information retreats with potential shareholders to help them understand the organization and its policies better.

Vijay Mahajan of BASIX suggested that for the DFI sector to attract capital from mainstream investors, it needs to form technical learning groups combining people from the DFI sector and the mainstream financial sector who can discuss and resolve corporate and financial structure issues.

The board

Forum members noted that the composition and role of nonprofit boards varies significantly, from strong boards that shape policy and engage in long-range planning to relatively weak ones that exert little authority. The different qualities of a board have to do with more than just the people and institutions that compose them. Organizational and capital structure, the position of the organization within its life cycle, the leadership style of the founders and executives, and the experiences of different political and cultural contexts all shape a board's role.

The investor/capital access/governance nexus has been a complex thing to manage in all of the institutions at the Forum, from the smallest and newest to the most mature and best capitalized.

Jennifer Riria of Kenya Women Finance Trust often raises the issue of maintaining local control and ownership. Should DFIs have to give up their vision of becoming locally owned, sustainable institutions in order to attract investment capital from foreign sources? Overseas social investors, including NGOs, inevitably alter the balance of control and ownership, often vesting key decision-making authority in a group with no constituency in or deep understanding of the local population.

ShoreBank's experience led it to two decisions about how to structure its board. First, it decided not to grant automatic board representation to equity investors. Second, it decided to diversify ownership in order to dilute power among shareholders and encourage strong roles for management.

Aleke Dondo of K-REP (Kenya) explained that K-REP Bank initially sought local investors, but had no success. It then sought institutional investors, because K-REP believed they would be more transparent, and developed relevant criteria. The investors must share K-REP's vision and social mission, bring strong financial and commercial discipline to the organization, give K-REP a good image, have resources for future investments, shield K-REP from political interference, have sufficient clout to influence authorities, and be willing to divest from K-REP after five years. K-REP attracted six key investors and ranked them according to how closely their missions aligned with K-REP's, allocating shares accordingly. This ensured commitment to K-REP's mission and a willingness to work with K-REP over the long term.

Board culture

When thinking about board members at ShoreBank, Mary Houghton noted that the ideal board member met a high standard, combining both banking and development expertise. She believes that seeking out such board members works much better than trying to mix various constituencies with radically different technical backgrounds. María Otero, reflecting on the culture clashes between bankers and development people on Banco Sol's board in Bolivia, agreed. She too stressed the importance of finding board members with both sets of knowledge and sympathies.

The issue of board roles and functions was, to many of our members, intimately tied to the issue of organizational ownership and to the form of leadership exerted by key staff. For Alfredo Hubard-Deffis, the key issue is management authority, but it has to be tempered by cooperation and acceptance of outside authority. "To talk about ownership is difficult. There are two dimensions: property and power. As there's no property to speak of, we need to talk about power, and specifically about leadership authority. Who's going to appoint the board? Who's going to establish best practices? We all know that we will try to stay in control of our organizations. But if we are going to create this industry worldwide, we will have to think of ourselves as global institutions or as part of a global network. This surfaces governance and ownership issues because scale and development mean that even the strongest social entrepreneurs must learn to obey the rules of others."

Three additional points worth noting came from our discussions about the role of boards. First, we understand that in places where the regulatory environment is weak, boards must make an extra effort to construct an internal "regulatory" framework that fits both the DFI's mission and high standards of social and financial accountability. Second, there is no single type of board structure that is best suited to the financial and social impacts we seek. Third, there is an important element to board and leadership roles that has to do with the capacity of an organization to understand—in an iterative way—the need for changes in strategy and role definition.

CONCLUSION

At a recent meeting, Elizabeth Littlefield, the CEO of the Consultative Group to Assist the Poorest (CGAP), presented a paper entitled "Water, Water Everywhere, But Not a Drop to Drink." Elizabeth was referring to the paradox of donors' feeling that a lot of funding was pursuing the development finance field, while, on the other hand, DFIs constantly found themselves short of funds. She said that more than 10,000 microfinance institutions (MFIs) worldwide reach only 5% of the potential market, and that only 1% of the MFIs were financially sustainable.

Current donor funding practices tend to focus on a low scale; offer inflexible/inappropriate terms; do not encourage engagement with the public and the private sectors; and lack adequate capacity-building components.

In response to Elizabeth's presentation, Bambang Ismawan commented: "Since ancient civilizations, water was not for everyone; water was for those who were able to control the river … It is clear that, unlike water, which tends to flow towards the lower land, money tends to flow in the opposite direction … Finance can become available to the poor [only] if its proper management is assured." Bambang was saying that building the capacity of financial institutions focused on serving the poor was the key task before DFI leaders; as DFI capacity expands, the supply of funds will follow.

Taking a cue from her trenchant comments, we also added a further diagnosis of this situation. The architecture of the global financial system is like three silos, each standing alone. The first generation of DFIs (National Agriculture and/or Industrial Development Banks) were all set up in the public sector. While they did serve some purpose, they mostly performed badly and are now widely reviled by those in the field. The second silo consists of the "alternative" DFIs, most of which grew out of NGO experiences. They are promising, but generally small and often not financially mature or sustainable. The third silo is composed of the private financial markets, which have huge potential but have, by and large, remained isolated from both the public development banks and the alternative DFIs.

Current donor-funding practices tend to focus on a low scale (compared to the size of the problem); offer inflexible or inappropriate terms; fail to encourage engage-

ment with the public and the private sectors; and lack adequate capacity- building components.

This pattern keeps alternative DFIs in their low-scale, inadequate capacity position, so that resources keep flowing to moribund public-sector DFIs. The public-sector DFIs, in turn, offer "low-cost loans" and soft funds, undermining sustainability for DFIs and, ultimately, the public sector's own developmental goals. Finally, DFIs have not yet been able to encourage private-sector entities to make a significant entry into development finance. Hence, the field remains locked into donor funds, public-sector dominance, low-capacity NGOs, a parallel but seemingly inaccessible universe of private financial markets, and a general malaise.

We believe there is a way to break the cycle and bridge gaps between public-sector DFIs, alternative DFIs, and private financial markets. We see the ideas of *Capital Plus* as a crucial step in that direction.

We believe that there is a way to break this vicious cycle and bridge the three silos. We see the ideas of Capital Plus as a crucial step in that direction. Only through sustainable and effective economic development strategies can the field of development finance hope to gain access to the capital needed to seriously address the needs of the poor.

The demand as well as the supply for new Capital Plus resources can increase significantly if funding is preceded or accompanied by strategies that: foster social entrepreneurship; promote innovation for deepening reach in a sustainable way; build the DFIs' scale, scope, and systems; establish an enabling environment of appropriate laws and policies; and orchestrate, in local contexts, the integrated and imaginative use of public, private, and NGO-sector resources.

There has to be a way to create a virtuous cycle that bridges the three silos in service of the poor. This paper is meant as a step in that direction.

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APPENDIX A

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APPENDIX B

Abbreviations

ACCION	—	ACCION International
Alternativas	—	Alternativas y Procesos de Participación Social A.C.
APDDCF	—	Andhra Pradesh Dairy Development Cooperative Federation
BASIX	—	Bhartiya Samruddhi Investments and Consulting Services, Ltd.
BS	—	Bina Swadaya
CAME	—	Centro de Apoyo al Micro-Empresario
CGAP	—	Consultative Group to Assist the Poorest
CLI	—	Collaborative Lending Initiative
CRA	—	Community Reinvestment Act
DFI	—	Development finance institution
FSA	—	Financial Services Associations
FM	—	Fundusz Mikro Sp. z.o.o.
Forum	—	Development Finance Forum
Ford	—	The Ford Foundation
IDB	—	Inter-American Development Bank
IGG	—	Income Generating Group
IGS	—	Indian Grameen Services
ISD	—	Indicators of Sustainable Development
K-REP	—	Kenya Rural Enterprise Program
KWFT	—	Kenya Women Finance Trust
MCP	—	Microcredit Program
MPCS	—	milk producers' cooperative societies
NGO	—	non-governmental organization
SEF	—	Small Enterprise Foundation
ShoreBank	—	ShoreBank Corporation
SROI	—	Social Return on Investment Calculator
TRF	—	The Reinvestment Fund
TCP	—	Tshomisano Credit Program
WOCCU	—	World Council of Credit Unions

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