CGAP

FOCUS NOTE

A New Look at Microfinance Apexes

This paper reviews recent experience with apex facilities (defined in Box 1) that support institutions delivering retail financial services to poor and low-income clients.[1] CGAP published its first study of such apexes 10 years ago (Levy 2002a and 2002b). That study did not reach categorical conclusions about apex effectiveness, but it did raise some serious concerns about the extent to which apexes supported the development of sustainable microfinance.

Box 1. What is an apex?

An apex is a second-tier (or "wholesale") fund that channels public resources to multiple retail financial providers—typically lenders—in a single country. Apexes provide mainly local currency loans, but may also offer loan guarantees, equity investment, grants for operational cost support, and technical assistance.

An apex is not always a standalone institution. It may be housed within a larger organization, such as a development bank.

Since then, the number of apexes and their total funding have grown a great deal. Apex facilities have become increasingly popular with host-country governments, as well as with development finance institutions (DFIs) and multilateral agencies, such as the European Commission (EC), the Inter-American Development Bank (IDB), the International Fund for Agricultural Development (IFAD), Germany's Kreditanstalt für Wiederaufbau (KfW), and the World Bank. A 2008 CGAP mapping exercise identified 76 apexes in 46 countries. In 2009 the largest 15 of these disbursed US$1.5 billion. By comparison, total disbursements of all cross-border funders (including bilateral and multilateral donors, DFIs, and microfinance investment vehicles [MIVs]) are roughly US$3 billion annually (El-Zoghbi, Gähwiler, and Lauer 2011). Not only has the number of apexes grown, but more individual apexes have accumulated enough years of experience to permit some assessment of their usefulness.

Clearly, it is time for a fresh look.

Terminology

This paper uses the shorthand term "microfinance" to refer to financial services for low-income people.[2] Apex facilities exist for other sectors besides microfinance—for instance, lending to exporters or small and medium enterprises (SMEs). However, since this paper is limited to microfinance; "apex" here generally refers only to microfinance apexes.

This paper does not cover federations of retail cooperatives or credit unions, even though they sometimes play a refinancing role. Such federations often provide management or supervision in addition to finance and, therefore, tend to involve distinctive operational issues. Finally, some people call associations of microfinance retailers "apexes," but these have no refinancing role and thus fall outside the scope of this paper.

Principal Sources

Data collection for this paper involved four efforts:

- The 2008 **mapping** referred to above, which identified 76 microfinance apexes.
- A **literature review**, including both global and country-specific studies, as well as reports from apex institutions themselves (see Annex 4, Bibliography).
- A 2010 **quantitative survey** of 23 apexes, representing about 90 percent of all apex funding

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1 These "microfinance institutions" assume a variety of organizational forms, including, for instance, not-for-profit nongovernment organizations, commercial banks, finance companies, postal savings banks, and financial cooperatives.

2 The financial services used by low-income people include credit, savings, transfers, and insurance. Today, many prefer to refer to such services in terms of "inclusive finance" or "access to finance" rather than the more common "microfinance," arguing that the latter term has tended to connote microcredit rather than a full range of services, and specialized microfinance institutions rather than the full range of financial providers. Nevertheless, this paper uses "microfinance" for the sake of conciseness. Note that microfinance apexes have focused much more on supporting credit than on supporting other financial services, and that most institutions receiving apex funding specialize in microcredit.

in terms of their loan portfolios. This survey collected information about the apex's mission, portfolio size, performance management, funding sources, and other characteristics using a questionnaire and follow-up telephone calls.

- **Case study analysis** of six apexes representing different regions and institutional forms (see Table 1). These six apexes represent about 60 percent of the total global apex portfolio surveyed. They were judged to offer lessons of global relevance, but the sample is not representative: it is biased toward larger apexes and those more able to provide information. The research team conducted interviews with 73 stakeholders, including apex management, microfinance institutions (MFIs), donors, and investors, as well as analysis of apex and Microfinance Information Exchange (MIX) data on the performance of the MFIs funded. The research team also conducted field visits to study the operations of Bancoldex, Palli Karma-Sahayak Foundation (PKSF), Social Fund for Development (SFD), and Small Industries Development Bank of India (SIDBI). A list of those interviewed, which includes apex managers, MFIs, and donors, is provided in Annex 1.

At the outset of the project, CGAP members who fund apexes or have an interest in them formed a working group that provided early input into the research design. In March 2011, this group, along with managers from MISFA and SIDBI, reviewed the initial findings at a one-day workshop and provided useful inputs for this report.[3]

Structure of This Paper

This paper is organized into three parts:

- The first section offers a global picture of microfinance apex operations, including their size, trends, and characteristics. It draws primarily on the 2010 survey of 23 major apexes, but also includes some results from the broader mapping done in 2008.
- The second section highlights key issues from across the six case studies.
- The third section offers conclusions and recommendations about maximizing the chances for apex success. It draws not only from the specific research conducted for this paper, but also from CGAP's 17 years of experience with (and publications regarding) the operations of development funding agencies.

Like CGAP's previous study of apexes, this report does not attempt to produce categorical conclusions about the usefulness of microfinance apexes worldwide. There is great diversity of experience among the 76 apexes we identified, and few of them make enough information public to support judgments about their success or failure. Rather, this paper tries to distil lessons about how to improve apex performance.

Table 1. Six case-study apexes

Name of Apex	Country	Gross Loan Portfolio 2009 (USD million)	Active MFI Clients 2009*
Small Industries Development Bank of India (SIDBI)	India	847	19,620,000
Bancoldex	Colombia	462	278,000
Palli Karma-Sahayak Foundation (PKSF)	Bangladesh	430	8,260,000
Microfinance Investment Support Facility for Afghanistan (MISFA)	Afghanistan	69	250,000
Social Fund for Development (SFD)	Egypt	68	218,000
Banque Malienne de Solidarité (BMS)	Mali	12	190,000

*Active clients of investee institutions, without implying that the apex is financing all of these clients.

3 The workshop was attended by AFD, AsDB, DFID, EC, GiZ, IFAD, IFC, KfW, UNCDF, and the World Bank as well as managers from SIDBI and MISFA.

Table 2. Top 15 apexes 2009, by outstanding portfolio

SIDBI	India	$847,080,000
Nafinsa	Mexico	$491,195,601
Bancoldex	Colombia	$462,000,000
PKSF	Bangladesh	$429,601,508
PPAF	Pakistan	$137,705,613
BTS	Tunisia	$117,908,000
Fedecredito	El Salvador	$102,215,808
PCFC	Philippines	$74,743,843
MISFA	Afghanistan	$69,348,000
SFD Egypt	Egypt	$67,889,186
FFSA	Kazakhstan	$66,344,711
JAIDA	Morocco	$47,500,000
Funda-Pro	Bolivia	$39,610,405
RMDC	Nepal	$27,523,071
BfP (FNI)	Nicaragua	$24,404,795
		$3,005,070,541

Source: CGAP 2010 survey.

1. The Global Landscape: Apex Characteristics and Trends

CGAP's 2008 mapping identified 76 microfinance apexes. A 2010 survey collected information from 23 of the largest of these, representing the vast majority of apex portfolio and disbursements worldwide. Numerical analysis in this section is based mainly on the 15 largest apexes.

Globally, apex funding is significant, growing, and concentrated. The largest 15 apexes had a total gross loan portfolio (GLP) of over US$3 billion in 2009. Although apexes exist in all regions, they are most prevalent in Latin America and South Asia (Duflos and El-Zoghbi 2010).

These apexes disbursed close to US$1.5 billion to MFIs in 2009, an increase of 25 percent over 2008. Three quarters of the total portfolio was held by the four largest apexes. Almost three quarters of total disbursements came from three apexes: SIDBI, Bancoldex, and PKSF, which are discussed in this paper as case studies.

Apexes use a wide variety of organizational forms, ranging from small divisions of government development banks to large standalone foundations. Bancoldex, BMS, and SIDBI are all specialist units within development banks that have a broader focus on SMEs and industrial development. PKSF was established as a foundation specializing in microcredit, though it is now supporting wider livelihoods efforts. SFD is a foundation that funds community-level infrastructure projects as well as microfinance and small enterprise development. MISFA began as part of a government ministry, but always had operational independence and a nongovernment board majority. Table 3 illustrates the range of institutional types with examples from around the world

Table 3. Institutional Type

Type	Ownership	Examples
Development Bank	Government	SIDBI (India), Bancoldex (Colombia), RDB (Cambodia), CFN (Ecuador)
Commercial Bank	Private	BMS (Mali), Bank Andara (Indonesia)
Standalone Fund *(could be legally constituted as a nonprofit foundation or a company)*	Government	PCFC (Philippines), DAMU (Kazakhstan), PKSF (Bangladesh), NAFINSA (Mexico), SFD (Yemen), PPAF (Pakistan)
	Quasi-government	MISFA (Afghanistan), SFD (Egypt)
	Private	Jaida (Morocco), Funda-Pro (Bolivia), MITAF (Sierra Leone), MDF (Mongolia), FFSA (Kazakhstan), RMDC (Nepal)
Donor Project Implementing Unit	Government	LID (Bosnia) and MISFA (Afghanistan) were initially donor projects before legal entities were created

Table 4. Instruments by active portfolio (15 largest apexes)

Instrument	USD million (2009)	Percentage
Debt	2,894	97
Equity	49	2
Guarantees	18	1
Grants	16	1
Total	2,980	100

Source: CGAP survey 2010. (Percentages do not add to 100 percent because of rounding.)

There tends to be some correlation between an apex's institutional form and its culture. For example, apexes housed within development banks often take a closer-to-commercial approach (e.g., Bancoldex will lend to MFIs only if they are profitable). They may have in-house staff with the financial expertise and skills to carry out financial due diligence and monitoring. They also have the financial strength that comes from the capitalization of the bank. Nonbank apexes typically take a more holistic, socially oriented approach. They are more likely to have a broader social mission and to fund higher risk, small, unregulated nongovernment organizations (NGOs) or community-based MFIs. Different apex types may appeal to different funders' missions and priorities.

Apexes mostly provide local currency loans. Among the 15 largest apexes, almost all disbursements were loans, and over 90 percent of these loans were in local currency. A few apexes, such as SIDBI and SFD in Yemen, also provided quasi-equity and equity funding to MFIs. The average loan maturity ranged between one-and-a-half and four years, with an average of three years. In 2009 the interest rate of apex loans to MFIs ranged from 0 percent to 12 percent per annum, with an average of 8.1 percent (unweighted).

Capacity-building grants represent a minor share of the disbursements of apex institutions. Only six of the 23 apexes surveyed provide grant funding for operational support and technical assistance for MFIs. Although such grants represent less than 1 percent of total funding, the case study apexes and experiences elsewhere suggest that they can have a significant return in terms of strengthened MFI capacity, particularly in early stage markets (see Section 3).

Apexes lend to a large number of diverse institutions. The 15 largest apexes were lending to 1,650 retail microfinance providers in 2009, across a wide variety of institutional types, including NGOs, cooperatives, microfinance banks, and commercial finance companies. Among these are very large institutions (e.g., Bandhan, with nearly 3.5 million borrowers, funded by SIDBI in India) and very small institutions (e.g., the portfolio of SFD in Egypt).

Apexes' microfinance operations are overwhelmingly focused on MFIs' credit services. Although apexes fund a diverse range of institutions, they usually finance the expansion of access to credit for microentrepreneurs. Apexes' founding policy objectives have typically included poverty alleviation, enterprise development, and job creation, all of which microcredit was expected to help support.[4] Until recently, policy makers have focused little attention on possible apex roles with regard to other financial services. To expand their lending, MFIs need major funding, which matches well with the debt finance that apexes offer. Savings, insurance, and transfers do not imply a similar funding need, though some grant funding can be useful in the development of these services.

Some apexes are beginning to focus on the broader financial inclusion agenda. For instance, Bancoldex (Colombia) administers Banca de las Oportunidades (BdO), which provides subsidies for new product development and new business models, including savings and branchless banking. MISFA is supporting development of microsavings in Afghanistan.

Apexes assess the performance of their client MFIs. All the surveyed apexes report ongoing measurement of their client MFIs' portfolio quality; 89 percent measure their client MFIs' operational sustainability, and 84 percent measure operating efficiency. Some apexes use CAMEL (Capital adequacy, Asset quality, Management quality, Earnings, Liquidity management) performance standards.

4 For more recent assessments of the impact of microcredit, see Roodman (2012), Rosenberg (2009), and Bauchet et al. (2011).

Table 5. Number of MFIs served by 15 apexes with largest portfolios, 2009

	Apex	No. of MFIs
1	SIDBI	146
2	Nafinsa	24
3	Bancoldex	79
4	PKSF	192
5	PPAF	N/A
6	BTS	288
7	Fedecredito	55
8	PCFC	156
9	MISFA	16
10	SFD Egypt	446
11	FFSA	N/A
12	JAIDA	5
13	Funda-Pro	28
14	RMDC	208
15	BfP (FNI)	7
	TOTAL	**1650**

Source: CGAP 2010 survey.

Anecdotal observations suggest that the quality and effectiveness of this monitoring vary widely.

At a time of increasing concern about the social performance of MFIs, some apexes are emphasizing measurement of social bottom line. For example, two-thirds of apexes track rural outreach and the percentage of female clients, and some have commissioned impact studies.

Public funding is the main source of apex resources. Typically, domestic finance ministries are the main source of host government funding, and international multilateral agencies (e.g., World Bank, Asian Development Bank, European Commission, Inter-American Development Bank), bilateral donors (e.g., DFID, USAID), and DFIs (e.g., KfW, IFC) are the main sources of international funds. Two-thirds of apexes are funded by a mix of domestic and international public agencies. About a quarter of them are financed exclusively by international agencies. In some exceptional cases, apexes are funded by commercial banks or by NGOs and private investors. Bank Andara (Indonesia) has a consortium of investors led by Mercy Corps; Jaida (Morocco) has a mix of public and private investors.

Some apexes, particularly those that are subsidiaries of banks or those that are registered as banks in their own right, borrow from banks. BMS, for example, borrows from Banque Ouest Africaine de Développement, the regional development bank for West Africa. As apexes grow their lending operations, retained earnings become an increasingly important source of funds.

Most apexes are funded with subsidized resources (grants, or loans at well below market interest rates). At the same time, apexes are typically expected to fund their operations by earnings from lending out or investing these resources.

Apexes strive for their own sustainability. Twenty out of the 23 apexes say they regard their own financial sustainability as a goal, but the levels of current sustainability probably vary widely.[5] Even though apexes are usually set up to address a temporary shortage of funding for a nascent microfinance sector, apexes are no different from any public organization in that incumbent staff have a strong incentive to maintain their jobs. In the course of its research, CGAP did not learn of any active apex that was contemplating a wrap-up of its operations.[6] Some microfinance apexes eventually shift their operations toward other objectives.

2. Highlights from Case Studies

This section reports observations based on the six apexes CGAP studied in detail in 2010–11:[7]

- Bancoldex (Colombia)
- Banque Malienne de Solidarité (BMS) (Mali)
- Microfinance Investment Support Facility for Afghanistan (MISFA)

5 Reliable information on apex financial performance is often difficult to obtain.
6 LID in Bosnia–Herzegovina wrapped up its operations in 2007.
7 For most of the case study apexes, microfinance is only a part of their activities. Microfinance is not the primary activity of Bancoldex, BMS, SIDBI, or SFD. PKSF has been focused on microfinance, but that is changing, and the apex is now working on flood restoration and recovery, health services, an ultra-poor program, and various micro- and small enterprise programs, as part of a more holistic, community-based development approach. MISFA is now looking at lines of credit for SMEs.

- Palli-Kharma-Sahayak Foundation (PKSF) (Bangladesh)
- Small Industries Development Bank of India (SIDBI)
- Social Fund for Development (SFD) (Egypt)

Some characteristics of these apexes are presented in Annex 2. In addition to the six case study apexes, this section draws on the experience of the local initiatives departments (LID) apex in Bosnia–Herzegovina.

The case study apexes operate in a range of diverse countries, some with dynamically shifting microfinance contexts. At the time of this writing, important events continued to unfold in India following a microfinance crisis in the State of Andhra Pradesh. Because the impacts of this crisis continue to reverberate across Indian microfinance, it may be too soon to be definitive about what the apex there might do differently. And in Afghanistan, the sector is retrenching after earlier growth, due partly to internal weaknesses of many MFIs there, but perhaps most influenced by a deteriorating security situation. Such situations underscore the uniqueness of different contexts and also caution against generalizing too much about apexes.

Apexes operate at different market stages. Apexes have been established in both early stage and more advanced markets. In all market contexts, there needs to be a clear underlying demand for microfinance from low-income people. However, the stage of MFI development and the level of MFI demand for wholesale finance can vary widely.

At the time of MISFA's creation, there were only a few multisectoral NGOs running small microcredit schemes in Afghanistan. MISFA was created to jump-start the development of microfinance by investing in start-up MFIs, including NGOs, credit unions, and a microfinance bank. LID in Bosnia–Herzegovina was another apex focused on start-ups in a country with very little pre-existing microfinance. PKSF, by contrast, was created in 1990, when Bangladesh already had well-established MFIs, such as Grameen and BRAC.[8] Most of PKSF's funding supported the expansion of established MFIs, though the apex also funded selected early stage MFIs.

The 2002 CGAP apex study suggested that apexes were unlikely to be successful in countries that did not already have a critical mass of competent existing MFIs. The experiences of LID and possibly MISFA provide counter-examples that argue otherwise. Both of these apexes have catalyzed the development of MFIs in a previously undeveloped market, in particular by bringing in external expertise. LID wrapped up operations in 2007, by which time it had supported the development of eight strong, profitable MFIs in Bosnia–Herzegovina that were able to attract private, commercial funding from both local banks and MIVs as well as from the DFI-backed European Fund for South East Europe (EFSE). Arguably, these MFIs ended up attracting too much funding, to the point of generating an over-lending crisis. SFD, on the other hand, has not played much of a role in catalyzing development of sustainable MFIs in Egypt.

Apexes supporting start-up or young MFIs in undeveloped markets will need a different strategy than apexes operating in mature markets with established profitable MFIs. Early stage MFIs are more likely to require intensive supervision and hand-holding, so it may be best for an apex in a start-up market to invest in a relatively small number of MFIs, and to be prepared to deploy extensive technical assistance to help build institutional capacity. Such apexes should expect to encounter significant MFI performance problems, and they need to be disciplined in ending support to nonperforming MFIs unless there are strong reasons to expect a turnaround.

In some cases, apexes have been established immediately after a conflict amid wider national reconstruction efforts. These apexes typically need

8 PKSF did not fund Grameen Bank.

to build a microfinance sector from scratch, as was the case with MISFA. At the same time, such apexes are also often faced with lingering uncertainties about security. In such circumstances, the need for sustainable MFIs and good risk management is no less important, but at the same time certain contingencies or buffers may need to be considered in advance. For the apex and the MFI, this may require holding greater reserves and more soft funding as a cushion against rapid shifts in the security situation.

In more mature markets, the focus will be more on meeting the external financing needs of growing, creditworthy MFIs in a way that does not crowd out private investment. This may include structuring subordinated loans or equity investments to leverage other sources of funding, such as deposits and local commercial bank loans. Apexes in mature markets have the option to deploy most of their portfolio with relatively low-risk MFIs. Bancoldex, for example, lends only to profitable MFIs. PKSF financed quite a few small and start-up MFIs, but given the large number of MFIs in Bangladesh, it was able to be very selective—for a while the apex was accepting only one out of every 10 applications it received. Most of SIDBI's funding goes to larger MFIs, but it also has a portfolio of smaller, early stage partners and sees part of its role as expanding the frontiers of microfinance by taking more risk than commercial banks. An important question these apexes regularly confront is how to reposition what they do when markets are better developed—though this is not always easy for large, well-funded organizations to do.

Most of the case study apexes have accelerated the growth of sustainable microfinance. PKSF, LID, SIDBI, and Bancoldex have funded sustainable MFIs that significantly expanded outreach in their respective markets. In all four cases, other funding sources were severely limited, especially during the early years of operation. Of course, other factors contributed to growth as well, but interviewees (including MFI managers) were nearly unanimous that these apexes played an important role in accelerating the growth of sustainable microfinance in the countries concerned.

BMS has contributed to the sector's development in Mali, but its track record is mixed. A considerable amount of its support went to organizations that proved to have management problems or that did not stand up well in the face of problems in the cotton industry.

In Afghanistan, it is too early to appraise MISFA's success. It was successful in jump starting microfinance quickly post-conflict in 2003–2005, but more recently most of its initial investees have run into trouble, due to security problems and internal weaknesses. It did fund one MFI (BRAC/Afghanistan) that achieved wide outreach early on and First Microfinance Bank Afghanistan, which has performed well financially.

SFD has funded over 500 Egyptian MFIs, most of them community-based NGOs. However, very few of SFD's investees have achieved strong, sustainable growth. With the support from the World Bank, SFD has now shifted its policy to concentrate on 10–15 high-potential MFIs.

The experiences of SFD, BMS to an extent, and perhaps the early stage of MISFA raise the question of whether good results are less likely when the apex focuses too much on disbursement and early outreach, rather than on the quality of partner MFIs. The apex's funders can be a source of undue disbursement pressure. Current MISFA management estimates that over-rapid disbursement, combined with insufficient focus on capacity building, resulted in large losses in defaulted portfolio and shutdown costs, as well as grants to institutions that didn't survive.

As maturing markets grow, the importance of the apexes' lending as a source of funds for microfinance development tends to decline—which is, of course, a desirable outcome. SIDBI has seen very strong growth by its top MFIs, which include large, high-growth MFIs, such as Bandhan, Equitas, and Ujjivan. According to SIDBI's management, its share of debt funding for the largest MFIs and for the sector as a whole has declined from nearly 100 percent of lending in its initial years of operations to 10 percent by early 2010, as these profitable

MFIs gained access to commercial bank loans.[9] In Bangladesh, too, the largest, most mature MFIs, such as ASA and BRAC, have increased their commercial funding, including deposits, so that by 2009 PKSF was financing only about 11 percent of microcredit in Bangladesh (Sinha 2011).

Have the case study apexes crowded out commercial funding? The case for apexes is strongest in environments where other funding is in short supply—for instance, where commercial banks do not yet have confidence in MFIs' creditworthiness, or where an unfavorable regulatory environment keeps MFIs from taking deposits or foreign investment. But what happens when those funding sources start to become available?

A common critique is that publically funded apexes crowd out private finance, as their subsidized money reduces MFIs' motivation to go after deposits, bank loans, private equity, and other nonsubsidized funds. However, some of the case study experiences suggest that this need not always be the case.

Four of the case study apexes are now charging rates comparable to what MFIs are paying commercial banks.[10] In the case of MISFA, there is virtually no commercial bank lending available to MFIs. Only PKSF is charging rates well below a demonstrable commercial market.

However, the pricing of apex loans is an imperfect indicator of whether the apex is crowding out commercial funding. Even where an apex charges commercial interest rates, it may still offer an advantage over bank loans, in terms of longer loans or lower collateral requirements. That said, some apexes have an explicit objective of promoting commercial funding. SIDBI has a policy of providing no more than 15–20 percent of larger MFIs' funding needs. To facilitate commercial funding, it has created a Lender's Forum, with over 40 domestic banks. SIDBI management says that it shares information on MFI performance with these banks, including SIDBI's own credit ratings. Furthermore, SIDBI structures some of its own finance to fill critical gaps in equity and subordinated quasi-equity loans, which facilitates bank lending to the MFI.[11] Bancoldex has a similar policy, with apex investment capped at 40 percent of an MFI's portfolio. Recently, PKSF has started to help more of its small partners build relationships with commercial banks.

Table 6. Interest rates and loan terms of apexes

	Interest rates charged to MFIs (2009) (%)		Average loan term (2009)	
Apex name (Country)	**Apex**	**Commercial Banks**	**Apex**	**Commercial Banks**
PKSF (Bangladesh)	7.0*	12.2	3	2.5
SIDBI (India)	12.0*	12.0	4	2.8
BMS (Mali)	8.1	8.4	3	2.5
Bancoldex (Colombia)	7.9	9.7	3	2.8
MISFA (Afghanistan)	5.0	n/a	10	n/a
SFD (Egypt)	10.0	10.8	4	2.5

Source: CGAP Apex Survey 2010, MIX Market
*PKSF charges a lower interest rate of 4.5 percent to its small partner organizations, defined as those with fewer than 100,000 active clients. SIDBI charges lower rates to some MFIs working in remote areas.

9 The commercial banks—most of them government owned—were willing to lend to MFIs mainly because such lending satisfied the banks' priority-sector lending obligations. In the wake of the crisis in Andhra Pradesh, bank loans have become harder to obtain.

10 In SIDBI's early years its loans were well below market cost, but it has moved to market pricing more recently. Other apexes as well have subsidized rates in early years, on the grounds that (1) commercial borrowing is simply unavailable to MFIs, so there is no market to distort, and (2) MFIs' early stage operating losses need to be financed.

11 External factors have also driven bank lending to MFIs in India. The government's Priority Sector Lending policy sets targets that banks can partly meet by lending to MFIs. SIDBI has helped facilitate the market entry of banks but it cannot be said to have caused this trend.

In terms of actual results, unsubsidized commercial funding has become predominant in India and Bosnia–Herzegovina, making it hard to see a serious crowding-out problem with those apexes.[12] In Bangladesh, although some MFIs still choose lower cost PKSF money instead of available commercial sources, the sector as a whole has moved heavily toward unsubsidized funding. Some of the largest MFIs view the conditions of PKSF's loans as overly restrictive, especially PKSF's interest rate cap. So large MFIs in Bangladesh have avoided apex loans even though the interest rates are low. In Mali, the microfinance sector still depends on subsidies, but regular commercial banks are increasingly lending to some MFIs, based on those MFIs' track records in paying their loans from BMS.[13] MFI managers in Colombia and India cite a similar demonstration effect: commercial lenders become more interested after they see an MFI successfully repaying its apex loans.

As with other observations about the case study MFIs, their performance with respect to commercial funding cannot be taken as representative of apexes worldwide. But the experiences of some of them demonstrate clearly that it is possible to have a vigorous apex without precluding an eventual shift to unsubsidized resources. Obviously, the availability of large apex funding can have a tendency to delay that shift, especially if the apex's terms are more favorable than what the commercial market offers. At the same time, apexes that step in and take early stage risks can create a demonstration effect that accelerates the entry of private capital.

As markets have matured, overheating is a serious risk. When markets for any form of retail credit—not just microcredit—become saturated, problems with over-indebtedness are likely.[14] With rapid growth in Bosnia–Herzegovina and in the regional market of Andhra Pradesh in India, supply expanded very quickly, contributing to a rapid push by lenders to make many loans in a short time span, often without care for consumer needs or interests. Such overheating can occur without apexes present, and in Bosnia–Herzegovina the overheating happened well after LID's exit. Nevertheless, apexes are usually recipients of subsidized funds, and therefore, they bear a significant leadership responsibility for the microfinance sector they fund. Apexes ought to be especially attuned to the risks of overheating, and they should even take measures to raise awareness as these risks intensify. At the same time, it is important to acknowledge that apexes that support the entry of private commercial funders over time see their relative influence over the microfinance industry decline. This perhaps highlights the importance of the role of apexes and others to promote industry infrastructure, such as credit bureaus, earlier on before markets mature or become overheated.[15]

Some of the case study apexes are trying to foster "responsible" finance. Many apexes are starting to measure the social performance of their MFIs. All the case study apexes monitor basic social performance indicators, such as the number of clients reached and percentage of female borrowers, but they are increasingly going further. MISFA is currently developing indicators for client poverty as well as for changes in poverty and well-being. BMS has funded a workshop on social performance measurement methods and indicators for its partner MFIs.

Especially after the Andhra Pradesh crisis, SIDBI is raising the importance of responsible finance. It now requires all partner MFIs to implement a code of conduct that lays out a set of core values for microfinance, including ethical behavior, avoidance of over-indebtedness, transparency, and promotion of financial literacy. This commitment has been written into SIDBI's loan agreements, which require all MFIs to undergo an independent assessment of adherence to the Code of Conduct as well as other measures to ensure transparency and ethical behavior (see Annex 3, SIDBI and Responsible Finance). Both SIDBI and LID also commissioned independent research into the impact of microcredit on borrowers.

12 In Bosnia–Herzegovina, it could be argued that the EU- and DFI-funded EFSE has competed with, if not crowded out, private funding.

13 BMS is itself a commercial bank, though its shareholders are MFIs.

14 See Schicks and Rosenberg (2011) for a discussion of this dynamic as well as of other issues associated with microcredit over-indebtedness.

15 Bangladesh microcredit as a whole has not yet encountered an obvious over-indebtedness crisis, but because the market appears to be close to saturation and delinquency is high by world standards, there is reasonable cause for concern (Sinha 2011).

Most of the case study apexes have provided capacity-building support. The main activity of an apex is to provide wholesale finance to retail MFIs; however, apexes that have an objective of developing the institutional capacity of early stage MFIs also provide grants. For example, MISFA, PKSF, SIDBI, BMS, and LID have provided time-bound grants that help young MFIs with training and technical assistance, fixed assets, and operating deficits. Such grant funding is typically a small percentage of portfolio (see Table 3), but funders and apex managers regard it as an important activity.[16]

SIDBI is recognized as having made a significant contribution to the institutional development of the microfinance sector in India through a sector-wide strategy for capacity-building. During its first phase (1999–2005), SIDBI provided a comprehensive package of support to partner MFIs based on an annual Capacity Building Needs Assessment funded by DFID and IFAD. SIDBI has helped start a generation of young and promising MFIs across India. According to management, it has also instituted innovative capacity-building programs, such as the Young Professionals program and support to the Institute of Management to develop microfinance modules. In Bosnia–Herzegovina, MFI managers and World Bank staff say that LID technical assistance was crucial to the development of the sector.

The case study apexes have not done much to spur innovation. Not surprisingly, it is individual MFIs rather than the apexes that have historically driven development of new products and systems. More recently, some of the case study apexes are trying to provide more support for innovation. Bancoldex, for example, now administers BdO, which is the Colombian government's policy to promote access to financial services by, for example, subsidizing the development of new products (e.g., microinsurance and savings for recipients of conditional cash transfers) and extending the reach of the financial sector (including MFIs) by subsidizing the opening of new branches and "corresponsales no bancarios" (branchless banking agents). PKSF and SIDBI are now supporting new product development, including SME loans, agricultural lending, and insurance products.

Most of the apexes have not done much to support development of market infrastructure—for instance, consulting capacity, credit bureaus, rating agencies, or trade associations. SIDBI is an exception. It has helped finance trade associations, commissioned M-CRIL to undertake MFI ratings (before the ratings market was well-developed),[17] trained auditors and technical support providers, and most recently promoted the development of a client protection Code of Conduct assessment tool by a private company. Additionally, SIDBI is supporting the establishment of a platform to consolidate MFI performance reporting at the national level.

The case study apexes have sometimes influenced policies and regulation. Apexes often have the advantage of having one foot in the practice of microfinance through the MFIs they fund and one foot in the policy sphere through their governance. The apexes studied have all participated in the development of microfinance policy, law, and regulation. SFD was a key player in the development of Egypt's Microfinance Strategy. SIDBI provided input into the Microfinance Bill, and it has been consulted as the Indian government shapes its response to the crisis triggered by events in Andhra Pradesh. MISFA is advising the Afghan Central Bank on how to monitor and supervise MFIs, and it contributed to a draft law for deposit-taking MFIs. LID also lobbied—unsuccessfully—for MFI deposit-taking regulation in Bosnia–Herzegovina.

Given some recent crises in microcredit and the prevailing political economy of many countries, interest rate caps are on the agenda of many governments. Apex institutions can sometimes affect policy in this area. Bancoldex was influential in encouraging the Government of Colombia to

16 Sometimes the apex finances third-party technical assistance through a grant or a contract. Alternatively, the apex's staff may provide the assistance. Either way, such technical support represents a nonreimbursable contribution.

17 M-CRIL subsequently developed its rating work more widely and became the largest specialized microfinance rating firm in the world.

increase an interest rate cap. PKSF, on the other hand, has a cap on final borrowing rates for its partner MFIs of 12.5 percent flat and has influenced the government to set a general cap of 27 percent effective.[18]

In some countries (e.g., Bangladesh), questions have been raised as to whether apexes can play a role in supervising MFIs as they transition to formal, regulated institutions. If an apex were to prudentially supervise MFIs it has invested in, there could be a conflict between the supervisor's duty to protect the public and the investor's desire to collect on its investment.[19] But apexes can certainly encourage transparency and prepare MFIs to become licensed institutions subject to government supervision. They can, for example, teach MFIs to track and report on indicators required by supervisory authorities. They can also advise central banks on the characteristics of MFIs and appropriate supervision regimes, as MISFA is doing in Afghanistan.

Donor coordination is a challenge. Apexes and their funders could do more to pursue consistency of policy, coordination of funding, and uniformity in performance standards and reporting requirements. Funders are more effective when they share information and collaborate on (rather than duplicate) programs.[20]

When an apex is receiving funds from multiple donors, there is a tendency to design and maintain separate programs. SFD has found it difficult to coordinate its multiple donors, which included the World Bank, UNDP, EC, the Kuwait Government, and the Japanese development agency JICA. One donor required highly subsidized loans. Another insisted that MFIs could receive second loans only after those applying for a first loan were served. Through inconsistent policies and funding requirements, some donors pushed SFD toward good practice microfinance, while others pulled it back. Unfortunately, donors sometimes treat apexes as their own project implementation units rather than independent microfinance wholesale institutions in need of investment to deliver on a unified strategy.

3. Recommendations for Apexes and Their Funders

Before offering specific recommendations, two general notes are in order. First, the evidence base for this third section is broader than the evidence base for the first two. Apexes are funding agencies that support microfinance. The same is true for the international development agencies who are members of the CGAP consortium. Apexes work in a single country, while CGAP's members work in multiple countries, but many of the same issues and lessons learned apply equally to both types of funding operations. Accordingly, this section draws not only on the apex research conducted for this paper but also on CGAP's 17 years of experience around issues of funder effectiveness. One useful summary of that experience is the "Pink Book" (CGAP 2006); but many other CGAP publications address issues that apex managers confront regularly.

Second, this paper does not offer conclusions about whether setting up an apex is likely to be a useful tool in any given market. As mentioned earlier, CGAP research does not support general conclusions about how often apexes are likely to succeed. Rather, the recommendations address situations where an apex already exists, or the decision to create one has already been taken. This section offers suggestions about how to make those apexes as effective as possible.

3.1. Apex Setup

Begin with a thorough market study. Apex managers and their funders need to have a thorough understanding of the microfinance marketplace. In some circumstances it may be appropriate to begin by assessing the demand for microfinance among

18 For a discussion of concerns about interest rate caps, see Helms and Reille (2004).

19 For instance, the public interest might call for closure of a troubled deposit-taking MFI, but a supervising apex might be reluctant to take this step if the MFI could repay its loan from the apex only by continued operations. There would be less of a conflict if the apex provides nonprudential supervision (e.g., consumer protection).

20 CGAP 2005–2007 (Country-Level Effectiveness and Accountability Reviews). The cases of Sri Lanka, Nicaragua, and to some extent Pakistan show how little coordination took place among funders in supporting an apex and the negative market consequences.

Box 2. Donor coordination issues in MISFA

MISFA has played an effective role in coordinating donor support for microfinance in Afghanistan, though challenges remain. MISFA was created following a war for control of Afghanistan, and as donors funded the post-conflict reconstruction efforts, individual countries' donor agencies tended to want to allocate their funding to areas where their national forces were deployed, or to promote alternative livelihoods to opium production, or a myriad other individual donor priorities. These varied needs made it challenging to pursue a coherent national policy.

MISFA was successful, however, in persuading a range of funders to channel most of their microfinance resources into a World-Bank-administered trust fund, which was then programmed into MISFA with a more coherent single strategy. This not only permitted a single national strategy, but it also meant that managers of MISFA and their investee MFIs faced a single set of conditions and reporting requirements. Had this not been the case, MISFA management thinks it would have had to spend much more time on donor requirements and much less on its main task of promoting microfinance.

Donors have sometimes insisted, with MISFA's acquiescence, that contributions be earmarked for specific activities rather than be used to support MISFA's core fund. These projects in general have been difficult to administer and have often been unsustainable.

Source: Communication from Dale Lampe, MISFA director of operations.

low-income households, but this has seldom proved a limiting factor for microfinance development, given the large unmet demand for financial services in most countries. Typically, the most important element of a market study is assessment of the existing microfinance providers that are candidates to receive funding from the apex. Apex designers have often omitted this step, but it need not be particularly burdensome. In a day or two spent with an MFI, a first-rate microfinance operations expert can usually get a meaningful impression of the quality of management and operations, and the probability that the MFI will be able to reach sustainable scale. In an early stage market where start-up of new MFIs will be needed, the study should look at whether there are realistic prospects to recruit the foreign or domestic managers, investors, and technical support that start-ups will require.

The study should also assess which other sources of local and international funding are available to MFIs, including commercial funding, to verify the nature of the funding gap the apex is aiming to address. Such a study might also include an overview of the policy and regulatory environment for microfinance and what work is needed in this domain. Ideally, the study would be carried out as a joint exercise between the apex and all interested funders.[21]

Protect political independence. Promising MFI partners are often scarcer than originally expected, and building a portfolio of such partners can be hindered if funding decisions are distorted by extraneous political considerations. Political independence should be bolstered, not just by expressions of intent, but by governance structures built into the apex's constitutive documents. In MISFA, for example, it was agreed that a majority of the board would be independent persons who have no formal role in the Afghan government. In Indonesia, Bank Andara has been set up as a fully private apex with the backing of Mercy Corps, IFC, KfW, Hivos-Triodos Fund, and Cordaid.

Name a qualified board. Typically, the majority of the directors should be independent, and the board should have expertise in areas such as banking and finance, law, accounting, economic development, and ideally the needs of end clients. It may be useful to structure an independent investment committee reporting to the board, to further insulate funding decisions from political considerations.

Be clear that the apex's objective is to support development of sustainable retailers. Retailers become "sustainable" when they can collect their loans effectively and they are profitable enough to continue expanding their operations without further subsidies, by drawing on commercial bank loans, foreign and domestic investment, deposits, and other sources of market funding.

21 For examples, see CGAP Country Level Effectiveness and Accountability Reviews (2005–2007).

For most microfinance apexes, financial services are seen as serving the ultimate policy goal of income generation and poverty alleviation. The apex wants to see quality services extended to as many low-income people as possible. But in the short to medium term, the focus should be on building sustainable retailers, more than on numbers of clients. If retailers are sustainable, expansion of outreach has a high probability of eventually taking care of itself. Conversely, expansion without sustainability is likely to be only temporary.

Build in leverage of commercial finance as a stated objective, making it clear that the apex's role is to substitute for commercial finance when it's not available, and not to crowd out commercial finance once it does become available.

Don't create large disbursement pressure in early years—especially in early stage markets. It takes time for apex staff to learn the business and to assemble a portfolio of strong partners. The partners themselves are often well advised to concentrate on piloting and refining their systems, rather than expanding rapidly in their first few years. If an apex has too much money that it has to disburse, it may be forced into funding unpromising MFIs or pressuring its partners for inappropriate growth. It may be better to fund the apex in stages, starting out small and adding resources as they become necessary.

Establish regular, transparent public reporting on the performance of the apex and its investee MFIs. Most people agree that when MFIs regularly disclose their financial and social results, it not only serves the interests of their funders, but also tends to improve the performance of the reporting MFIs. The same principle applies to the apex. The financial reports of both the apex and its partner investees should comply with generally accepted accounting principles as codified in the country or—even better—with International Financial Reporting Standards. MIX can help develop reporting systems for the MFIs.

Establish clear expectations about the apex's financial performance. There is considerable discussion about whether apexes should or can be sustainable. The answer will depend on one's definition of sustainability. If "sustainable" means "unsubsidized," the proposition that apexes should be sustainable becomes an odd one. It is hard to see how they can fill a gap in the commercial market—i.e., finance retailers whose risk is too high or whose return is too low for commercial lenders—without using subsidized resources, whether grants or soft loans.

If, on the other hand, "sustainable" means "able to operate without continuing infusions of subsidy," then any apex, no matter how inefficient, can be made sustainable with a big enough initial subsidy. In practice, many apexes can generate surpluses, covering their administrative costs with the interest rate differential between the low cost of their funds and the interest income from lending out or investing those funds. Of course, this will depend on the apex being able to collect a high percentage of its loans to MFIs.

Some apexes are financed by continuing fiscal infusions from the government. When this happens, it is usually not the result of the initial plan, but rather because the apex is lending a lot of money to institutions that fail to repay.

Plan for what will happen to the apex once "success" has been achieved—that is, once the country has a good supply of strong retailers with adequate commercial funding available. Should the apex close operations at that point, or shift to other work? If the latter, what work? Without this sort of explicit planning, the apex's evolution at that point is more likely to be driven by the staff's incentive to maintain their positions, rather than by pure development objectives.

3.2. Early Stage Markets[22]

Expect to have to do a lot of hand-holding and capacity building. In markets where the MFIs are

22 While this section focuses on early stage microfinance markets, the recommendations are also relevant for apexes supporting start-ups in more advanced markets.

mainly new and/or weak, there will be performance problems. In such settings, the expertise of apex management and staff is particularly important. If it is not possible to recruit people who already have experience in microfinance operations, then apex personnel should receive intensive training and technical assistance in the early years and be supported by international experts, if need be. (This does not imply that staff expertise is unimportant in later stage markets with more advanced MFIs.)

The apex should have appropriate instruments (typically grants), as well as adequate resources and staffing to provide high-quality capacity-building support to partner MFIs. In early years, apex staff are relatively inexperienced and less likely to be able to provide strong technical assistance, so the focus should be on recruiting third-party experts, relying as much as possible on those who have a demonstrated track record of producing sustainable microfinance, whether locally or in a foreign setting.

Managing an effective capacity-building program is a resource-intensive undertaking, whether done by apexes or independently, and it requires dedicated staff and resources. First, apexes should separate its capacity building and grants function from its wholesale lending. This kind of firewall lowers the risk that the apex will be liable for the performance of the MFI. Second, technical assistance will obviously be more effective when it is demand-driven, when it is based on specific issues identified through an assessment of the MFI's needs, and when the source of technical assistance is not tied by the funder. MISFA, LID, and SIDBI have conducted on-site institutional assessments with their MFIs. Third, it may be necessary to develop the firms and technical assistance providers as part of the institution-building process. For example, SIDBI supported the growth of microfinance consulting firms and rating agencies in India by contracting them for specific assignments.

Box 3. An apex that liquidated itself

The World Bank-funded LID project in Bosnia–Herzegovina is the only apex known to CGAP that planned an exit strategy early on. MFIs understood clearly that the project would end, and that they needed to become financially sustainable and seek other funding sources. Apex and World Bank staff assisted this process by introducing MFIs to investors, such as Triodos and Blue Orchard, and facilitating relationships with local commercial banks. The portion of the original loan capital that had been funded by bilateral donors was converted into capital grants for MFIs once they met strict standards related to management capability, governance, outreach, and financial sustainability. These grants gave the MFIs a capital base with which to leverage commercial funding. The remaining outstanding loans were transferred from the apex to the Ministry of Finance, and the apex's lending ceased. At the end of eight years of apex operations, there were eight profitable MFIs with outreach across the country.

Consider time-limited grants to retailers to cover start-up losses. As experience with microcredit grows, young MFIs are reaching profitability more quickly than used to be the case (Gonzalez and Rosenberg 2006). Still, new MFIs typically need a few years before income catches up with costs and the resulting losses need to be financed. Some apexes have provided operating grants to cover these losses in the early years.

Other apexes have chosen to finance start-up costs by initially lending to new MFIs at subsidized rates. This is a reasonable approach. Some would argue, though, that it is better to use grants (an equity infusion) in combination with full-price loans. This latter approach defrays the start-up losses, but it also ensures that an MFI from the very beginning gets used to liabilities at the cost that it will face as it funds its long-term expansion.

When an apex finances start-up or young MFIs, it should be ready to take risks. But two qualifications are called for (1) no investee partner should be selected without a thorough appraisal by a microfinance operations expert, and (2) the apex must be willing and able to drop partners who do not perform. Both of these points are discussed further in Section 3.4.

Prioritize building early market infrastructure and reporting. One of the benefits of having apexes coordinate a small growing industry is that much can be done to structure the industry early on. This may involve establishing standards around reporting and definitional issues. It may be useful to establish standards for audits and governance. It might be too early for a credit bureau to be useful or viable, but it can be important nevertheless to begin planning for a credit bureau in preparation for the later time when it will be needed. Credit bureaus often take several years to build. As a major source of funds, apexes in such industries may have the clout to ensure that this infrastructure gets attended to early on.

3.3. Advanced Markets

Actively leverage commercial finance. Advanced markets typically have a critical mass of strong, profitable MFIs that can be creditworthy borrowers from commercial banks, or candidates for other commercial investment or a deposit-taking license. Apexes in these markets should consider the following steps:

- Setting an upper limit on the percentage of a large MFI's assets that can be financed by the apex.
- Making the raising of unsubsidized commercial resources a performance target in the apex's agreement with advanced MFIs.
- Offering equity, quasi-equity, or other subordinated lending to MFIs. This kind of instrument allows another creditor—for instance, a bank—to collect its loan before the apex collects (such subordination encourages commercial lending to the MFI by making it safer).[23] More generally, apexes should focus on offering funding that is not available from other sources.
- Requiring MFIs to report their financial performance using formats and standards that are familiar and credible to commercial lenders.
- Organizing a lenders' forum or some other mechanism to share the apex's knowledge of its investees with potential commercial investors.

Be alert for over-indebtedness as the microcredit market approaches saturation. The demand for microcredit is not infinite. Effective demand is often lower than many people expect (Anand and Rosenberg 2008). When competitive markets approach saturation—that is, when supply begins to catch up with demand—problems with client over-indebtedness are almost inevitable. Apexes need to be alert for this dynamic, and should consider collaborating with MFIs and regulators to develop an early warning system and encourage responsible practices.[24]

Consider providing more support in the form of equity or quasi-equity. A more advanced microfinance market implies stronger retailers who are becoming able to borrow from commercial sources. An MFI's ability to take advantage of this opportunity is limited by the strength of its equity base. If an apex injects equity capital or makes quasi-equity subordinated loans, the MFI can borrow more.

Consider supporting development of savings services, other new products, and market infrastructure. Low-income clients' need for financial services goes far beyond traditional microcredit products. These clients need deposit facilities, fund transfers, and insurance, as well as a wider range of credit products. An apex could provide financial support for such efforts (e.g., by funding technical assistance), and could also work with regulators to help develop an appropriate licensing regime for depository microfinance.

Development of a sound microfinance industry requires the evolution of market infrastructure, including audit, consulting, and training capacity; industry networks; and eventually credit bureaus. Apexes can play a role in supporting such infrastructure.

Consider other roles. Eventually, advanced microfinance providers will be able to access commercial sources for most or all of their funding needs. At this point, the apex may need to reconsider its mission. As a practical matter, few apexes will choose to terminate their operations (whether or

23 Use of these financial instruments may require augmenting the apex's staff expertise.
24 For a full discussion of microcredit over-indebtedness and possible ways to deal with it, see Schicks and Rosenberg (2011).

not this would be a desirable outcome). An apex that has been funding mainly large, advanced MFIs might refocus its support on younger, smaller MFIs operating in more difficult environments that are judged to be risky by private funders. An apex might take on the role of "lender of last resort," providing emergency liquidity in times of crisis. Or the apex might take on other development activities besides microfinance. Many of those other activities tend to need grants rather than loans; in such cases, the apex might face a sustainability problem when it no longer has interest income flowing in from loans to MFIs.

3.4. Selection and supervision of MFIs

Be selective in picking retailers, based on the likelihood that the investee will become sustainable. For an apex that aims at developing a sustainable microfinance industry, the central question in choosing investee partners should be, "Is this MFI sustainable in terms of profitability and loan collection, and if not, how high is the probability that it will become so?" Evaluating the prospects of a young or start-up MFI is as much an art as a science. The evaluation is based on both current performance and the quality of management. Current performance can be quantified, for the most part. Appraising the quality of management, on the other hand, is more complex, and often comes down to judgement. Such an appraisal should be conducted by an expert who has extensive experience working with strong MFI managers. There are useful guides for evaluating MFIs (e.g., Isern, Abrams, and Brown [2008]), but they cannot substitute for the experienced judgement of someone who knows the business well.

Use performance-based contracts that focus on key performance indicators. If the apex's investment is premised on the expectation that the MFI will move toward, or maintain, sustainability, then this expectation should be quantified and incorporated into the loan or grant agreement, in the form of minimum performance thresholds for key indicators.[25] A short list of performance indicators is more likely to be effective than a long list. At a minimum, the list should include cost recovery (profitability) and loan collection. Core financial and outreach indicators are discussed in Rosenberg (2009).[26]

Some apexes may wish to contractually enforce performance against one or more social indicators. In this case, care should be taken to select an indicator that is both meaningful in terms of social outcomes and unambiguously measurable.

Consequences for failure to meet a minimum threshold should be spelled out, probably including the apex's right to suspend or cancel future disbursements. Performance-based contracts of this sort will not be credible unless the apex demonstrates that it is willing to enforce them. Sometimes there will be extenuating circumstances for a missed threshold. But when an MFI fails to perform, the apex should not continue funding the MFI unless the MFI demonstrates a clear, specific, and credible plan to remedy the problem. In any event, the apex—like any other development funder—should not continue supporting an MFI that repeatedly fails to meet defined minimum performance standards.

Focus supervision on the overall institutional performance of the investee, not just on some component of its operations funded by the apex. If the apex's objective is to develop a sustainable microfinance market that provides high-quality services, achievement of that objective will depend on how every retail institution as a whole performs. Unless the institution as a whole is sustainable, whatever specific activities may be earmarked for apex funding are unlikely to continue and expand over the long term.

Independently evaluate MFIs' loan collection performance, using specialized testing. Loan

25 A minimum performance threshold is different from a planned target. The latter represents the performance that the MFI expects to achieve. By contrast, a minimum threshold represents the lowest acceptable performance; in other words, the apex is saying that it won't think its investment has been justified if the MFI doesn't reach this level.

26 The recommendation here is that there should be only a very few contractually required minimum performance thresholds. The list of indicators that the apex monitors (as opposed to contractually enforces) will be longer.

Box 4. Core performance indicators

Most funders will want reports on a wide range of outreach and financial measurements, but there is a small set that most analysts would regard as core indicators.

1. Breadth of outreach—number of active clients served
2. Loan repayment—percentage of portfolio that is late, or written off
3. Financial sustainability—net profit as a percentage of equity or assets
4. Efficiency—administrative cost per dollar of loans outstanding or per active client

In recent years there has been increasing emphasis on reporting social performance, not just financial performance. MIX has adopted a set of 11 social performance indicators developed by the Social Performance Task Force, including measures such as client poverty levels, client retention rate, client protection policies, and the range of products and services.*

*See http://www.themix.org/social-performance/Indicators

collection is the biggest business risk facing providers of microloans, and a vast majority of MFI failures are attributable to collection problems. Furthermore, the loan portfolio is the element of MFI financial statements that is most commonly subject to material misstatement.

Accordingly, keeping track of an investee's loan portfolio quality is the apex's most important risk-control challenge. Unfortunately, normal audit procedures provide little assurance as to portfolio quality.[27] Meaningful assessment of loan quality requires specialized testing above and beyond a regular audit, whether this testing is performed by the external auditor, by apex staff, or by some other expert evaluator. Suggested portfolio testing processes can be found in Christen and Flaming (2009). MicroSave provides training in another portfolio audit tool.[28]

Most apexes (and MFIs) do not do this kind of portfolio testing. Even though it adds to the cost of auditing, periodic independent portfolio testing is strongly recommended. It probably would have identified the problems brewing in overheating markets well before they exploded.

Require investees to adopt and implement codes of responsible finance and consumer protection. The SMART Campaign (www.smartcampaign.org) has developed a global set of client protection principles, along with tools and resources to implement them. The Social Performance Task Force (2011) has developed a set of standards for social performance management.

Conduct regular reviews of the performance of all apex investees. At least twice a year apex management should conduct a portfolio-wide review looking at the performance of each partner MFI against key performance indicators. LID in Bosnia–Herzegovina shared key performance indicators among all of its investees and found that the practice stimulated healthy competition among the MFIs.

Invest heavily in apex staff capacity, through recruitment and training. It is axiomatic that an apex's effectiveness in selecting and supervising partner MFIs depends on the skill and experience of its staff and management. This is often a challenge for new apexes, which tend to be created in environments where there are not many experienced microfinance specialists available for recruitment. If possible, the apex should recruit microfinance experience, even if that means hiring some foreign personnel at the beginning. In any event, the apex should have a substantial training budget and use it. It would be penny-wise and pound-foolish to skimp on staff training because people are too busy carrying on the apex's day-to-day work. Apexes do not necessarily need large numbers of staff, but they are well served by having a highly capable team of top managers who know the microfinance business well.

3.5. Structuring funding to be useful to retailers

Try to structure some lending as working capital loans. Some apexes require full repayment of an MFIs' loan before the MFI can borrow again. This kind of lending may be suitable for fixed-asset acquisitions, but it does not match well against the

27 For suggestions on MFI audits, see CGAP (1998).
28 http://www.microsave.org/sites/default/files/toolkits/toolkits/Loan_Portfolio_Audit_Toolkit_Summary.pdf

ongoing working capital needs of a loan portfolio. Low-income borrowers' willingness to repay depends on the MFI offering prompt follow-on loans when these clients' previous loans are paid off. This implies a fairly steady funding requirement, which would be better served by a line of credit, or an overlapping series of concurrent loans, rather than by a single large loan that has to be paid down to zero before further borrowing. On longer term loans, it may be useful to build in a grace period during which the MFI does not have to amortize capital.

Ensure that disbursements are timely and reliable. If the MFI does not have dependable liquidity to fund follow-on loans, it will quickly run into repayment problems. Liquidity management is more crucial for microlenders than for normal collateralized lenders.

Keep red tape to a minimum and reporting requirements reasonable. MFIs' most common complaints about apexes are that apex loans are encumbered with unnecessary requirements and that the transaction costs of dealing with apexes are high. Even after taking into account the MFIs' natural bias (everyone would like money with no strings attached) it seems that there is some merit to this complaint. All development funders, not just apexes, have to work hard against their natural inclination to proliferate requirements.

As a general rule, it is preferable to allow the apex's investment to be used as core funding for the MFI, rather than to tie it to particular loans or activities. In particular, apexes should usually avoid making MFIs report on individual subloans funded with the apex's money. Money is fungible, and it makes little difference in terms of development objectives which of the MFI's funding sources are allocated to a given loan, at least in an MFI whose credit all goes to a microclientele. The apex should be concerned with seeing that the MFIs' total microloan portfolio increases by a given amount, rather than with identifying particular borrowers with the apex's resources. Reporting on sub-borrowers increases the cost of lending, which usually gets passed on to borrowers in the form of higher interest rates.

An apex should usually avoid requiring MFIs to report on job or enterprise creation as a result of their loans. It is very difficult to get reliable information about these variables and to determine whether they are attributable to the loan.

More generally, any reporting requirement that goes beyond standard financial reporting should be justified by a specific need to know, and a clear notion of what decisions will be affected by such reporting.

Be cautious about restrictions on product terms, lending methodologies, and target markets. As a general matter, retailers tend to be better situated than wholesale funders when it comes to figuring out what services clients want, how to deliver them at low cost, and which markets are practical to serve.

Apexes sometimes tie funding to particular geographical areas or particular clients. This may occasionally be appropriate—the argument being made here is only that such requirements should be scrutinized carefully. When funders have wanted to provide direct support to a specific area or clientele, they have had better results when they find a retailer who already wants to serve that market, rather than twisting the arm of a retailer whose basic interests lie in other directions.

Some apexes cap the interest rate that partner MFIs can charge to the ultimate borrowers. This practice is controversial. It has the effect of discouraging service to some clients who are more expensive to reach, for instance because of small loan size, remote location, or low population density. Before adopting such a policy, the apex should carefully weigh the perceived benefits of the measure against the outreach limitations it may entail.[29]

29 See Helms and Reille (2004).

Lend at commercial interest rates. Most apexes' resources come from grants or well-below-market-rate loans. It would often be possible for them to lend to retailers at below-market rates, and still to have enough of an interest margin to fund their administrative costs.

However, the countries where microcredit is available to most of the qualified customers who want it are almost always countries where the retailers have been able to tap commercial resources, including bank loans and deposits. Young MFIs need to build business models capable of absorbing the full cost of such resources. When apexes lend at less-than-commercial rates, they risk lowering the retailers' incentive to move on to commercial borrowing, and to mobilize deposits (which not only fund microloans but also are a valued client service in and of themselves).[30]

Sometimes, as in the case of SIDBI, charging commercial rates to retailers results in large profits for the apex. Some argue that these profits should be passed on to the retailers in the form of lower rates. The question here is who should capture the subsidy. For the reasons indicated above, the best solution is usually to leave the profit in the apex, where it can be used for other public-benefit purposes.

Where possible, pursue donor harmonization, including unified reporting requirements. In many microfinance markets, resources are wasted due to lack of strategic coordination among development funders and administrative burden on MFIs because of conflicting reporting requirements. Sometimes apexes can help to reduce this problem.

In the first place, if multiple international donors channel their resources through an apex, some strategic coordination results, at least if the donors don't attach idiosyncratic objectives and restrictions to their contributions. Of course, this decision rests ultimately with the donors, but an apex's board and management may be able to encourage coordination.

Second, even when the donors channel their funds directly rather than through the apex, there is room for harmonization of reporting requirements, so that an MFI with three funders does not have to prepare three separate reports. Funders tend to underestimate the time and resources tied up in MFI reporting. Arguably, a domestic apex with strong leadership might be in a good position to enlist international donors in working out a unified reporting scheme.

Microfinance apexes are a major source of funding for low-income financial services, and they are likely to remain so for some time. They face most of the same challenges that other donors and development agencies have faced for decades. Supporting financial access for the poor is a difficult business. Apexes that pay attention to the lessons of international experience are much more likely to be effective at that business.

30 The rationale for limited-term subsidized lending to new MFIs was discussed above in Section 3.2.

Annex 1: List of Interviews for Case Study Apexes

	Type of case study)	Number of interviews conducted	Key interviewees
Bancoldex (Colombia)	Field visit	11	**Bancoldex:** CEO, CFO, Head of MF, Head of BdO **MFIs:** WWB Cali, Finamérica, Contactar, Bancamía, Emprender **Others:** MF Network, Planet Finance
BMS (Mali)	Phone interviews	13	**BMS:** CEO, Head of MF department **MFIs:** Kafo Jiginew, Nyesigiso, Demesow, FADEL SA, Jigiyaso Ba, Soro Yiriwaso, Misileni **Others:** BIDC, Oikocredit, Grameen Foundation, Sidi
MISFA (Afghanistan)	Phone interviews	4	**MISFA**: Managing director **MFIs:** BRAC, FMFB **Donors:** DFID, WB
PKSF (Bangladesh)	Field visit	18	**PKSF:** Chairman, management team **MFIs:** BRAC, Shayida Foundation, Padakhep, POPI, CCDA, Uddipan, Buro **Donors:** DFID, WB
SFD (Egypt)	Field visit	11	**SFD:** Director of MF sector and his deputy **MFIs:** SBACD, DBACD, Lead, Tadamun, Mubadara, Matareyyah, Shabab Misr **Donors:** AfDB, JAICA
SIDBI (India)	Field visit	16	**SIDBI:** Chairman, management team in both Lucknow (HQ) and Kolkata branch **MFIs:** ASA, Bhandan **Donors:** DFID, KfW, WB **Other:** Sa-Dhan, MFIN, M-CRIL

Annex 2: Self-Reported Characteristics of Case Study Apexes

Institutional Form and Governance

Apex	Institutional Form	MF is primary activity	Board Members (No. of members)
Bancoldex	Division of a government-owned development bank	No	Government, member appointed by the Shareholders General Meeting, member appointed by the Exporters Association Guild Council (5)
BMS	Division of a private commercial bank with majority MFI ownership	No	Representatives of the Government, Para public organizations, one social investor, MFIs (12)
MISFA	Not-for-profit, limited liability, joint stock company (nondividend disbursing), government owned	Yes	Members representing the government of Afghanistan (Ministry of Finance and Rural Rehabilitation and Development), donors, private sector, and academia (7)
PKSF	Government-established not-for-profit association	Yes, but may change	MD of PKSF, representatives of Bangladesh Economic Association, academia, award-winning social worker, Prof. Muhammad Yunus (7)
SIDBI	Division of government-owned development bank	No	Government, State Bank of India, Bank of India, West Bengal Financial Corporation, IDBI Bank Ltd., Life Insurance Corporation of India (11)
SFD	Semi/quasi-governmental organization	Yes	Representatives of the government and private sector headed by the prime minister

Performance monitoring tools

	Performance measurement tools	Frequency	Financial Indicators
Bancoldex	Portfolio reports, financial statements	Quarterly	CAMEL (capital adequacy, asset quality, management quality, earnings, liquidity management)
BMS	Financial statements	Quarterly	Prudential ratios reported to central bank (capital adequacy, liquidity management, risk limitation, legal reserves)
MISFA	Portfolio reports, financial statements, institutional development action plans	Monthly	22 performance standards, including financial and nonfinancial indicators (e.g., strategic and business planning, capitalization, accounting treatment of nonperforming loans and write offs, etc.)
PKSF	Portfolio reports, financial statements	Monthly	Financial performance indicators (e.g., debt-to-equity, capital adequacy, debt service coverage, liquidity, return on capital, adequacy of provisions)
SFD	Portfolio reports, financial statements, simplified GIRAFE* tool	Monthly	E.g., number of loans disbursed, number of active borrowers, portfolio and repayment rate, OSS, etc.
SIDBI	Institutional assessment, external rating, portfolio reports, financial statements	Monthly	Credit score approach (e.g., profitability, capital adequacy, debt-service coverage, liquidity, PAR, loan loss provisions)

*An evaluation tool, similar to CAMEL, developed by Planet Finance.

Capacity-building activities of apexes

Bancoldex	Client-level capacity building (Programa EOCM Especial: credit linked to TA), TA for 6 MFIs, incentives to MFIs to open new branches
BMS	No large-scale capacity-building programs but has provided in-house TA to 7 small MFIs
MISFA	Intensive TA to turn around poor performing institutions
PKSF	Institutional development fund used to provide training and capacity-building support to all MFIs. Provides training both directly (in-house) and out sources to qualified consultants.
SFD	In the past, TA was provided particularly during the first 1–2 years of funding an NGO-MFI; however, SFD currently does not have funding for capacity-building support and is relying on other donors to fund this.
SIDBI	Capacity-building support to MFIs; support to MFI associations, rating agencies, auditors, technical consulting firms, training of trainers program, Young Professionals program, support to Institute of Management to develop microfinance modules

Annex 3: SIDBI and Responsible Finance

SIDBI Lenders' Forum—Additional Terms of Sanction (March 2011)

The borrower shall agree:

(a) to furnish financial and operational data in the specified format to the India Microfinance Platform (IMFP) within reasonable timelines and with accuracy.

(b) to undergo a third party Code of Conduct Assessment with a view to assessing the degree of adherence to the voluntary microfinance Code of Conduct through accredited agencies for the purpose.

(c) to undergo a Systems and Portfolio Audit involving detailed examination of operational systems and procedures, funds utilization, assessment of loan portfolio in respect of the risk parameters, finance as well as planning and control etc. by an external agency.

(d) to ensure transparency and uniformity in calculating and reporting (to clients and in the public domain) the effective cost (on reducing balance basis) being charged to the ultimate beneficiaries.

(e) to prepare a Board approved note on recovery practices that would be displayed in local language at each branch and to give an undertaking to take steps to ensure responsible and non-coercive loan recovery practices at the field level

(f) to develop a Board approved strategy to check multiple lending/over-indebtedness amongst clients by December 31, 2010 and implement it thereafter and also obtain annual affirmation of the strategy by its Board.

(g) to put in place an effective grievance redressal mechanism by December 31, 2010 – to be placed in the website of MFI and also displayed in the branch offices.

(h) to take steps to ensure that some acceptable form of electronic, written or printed acknowledgement of financial transactions is left with the individual borrower or the group/its representative.

(i) to furnish regularly, accurate and comprehensive data to Credit Bureaus like CIBIL and High Mark Credit with regard to beneficiaries.

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