



**COUNTRY-LEVEL
EFFECTIVENESS AND ACCOUNTABILITY REVIEW**



MADAGASCAR

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ACRONYMS AND ABBREVIATIONS

ADEFI	<i>Action pour le Développement et le Financement des Microentreprises</i> (microfinance development and financing agency)
AECA	<i>Association d'Epargne et de Crédit Autogérée</i> (self-managed savings and loan association)
AFD	<i>Agence Française de Développement</i> (French development agency)
AfDB	African Development Bank
AFMIN	Africa Microfinance Network
AGEPMF	<i>Agence d'Exécution du Projet Microfinance</i> (executing agency for microfinance project)
AIM	<i>Association des Institutions de Microfinance non Mutualistes</i> (association of nonmutual microfinance institutions)
APEM	<i>Association pour la Promotion de l'Entreprise à Madagascar</i> (Madagascar enterprise promotion association)
APIFM	<i>Association Professionnelle des Institutions Financières Mutualistes</i> (professional association of cooperative financial institutions)
ARIZ	<i>Assurance pour le Risque des Investissements</i> (investment risk insurance)
BFV	<i>Bankin'ny Fampanandrosoana ny Varotra</i>
BMOI	<i>Banque Malgache de l'Océan Indien</i> (Malagasy bank of the Indian Ocean)
BMZ	<i>Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung</i> (German federal ministry for economic Cooperation and development)
BNI	<i>Banque Nationale pour l'Industrie</i> (national bank for industry)
BOA	Bank of Africa
BTA	<i>Bons du Trésor par Adjudication</i> (treasury bills sold at auction)
BTM	<i>Bankin' Ny Tantsaha Mpamokatra</i>
CNMF	<i>Coordination Nationale de la Microfinance</i> (coordinating office for microfinance)
CAPAF	<i>Programme de Renforcement des Capacités des Institutions de Microfinance en Afrique Francophone</i> (capacity building program for microfinance institutions in French-speaking Africa)
CECAM	<i>Caisse d'Epargne et de Crédit Agricole Mutuelle</i> (cooperative agricultural savings and credit association)

CEFEB	<i>Centre d'Etudes Financières, Economiques et Bancaires</i> (financial, economic, and banking research center)
CEM	<i>Caisse d'Epargne de Madagascar</i> (Madagascar savings bank)
CGAP	Consultative Group to Assist the Poor
CIDR	Center for International Development Research
CLEAR	Country-Level Effectiveness and Accountability Review
CNMF	<i>Coordination Nationale de Microfinance</i> (national coordinating office for microfinance)
CO-SNMF	<i>Comité de Pilotage de la Stratégie Nationale de Microfinance</i> (steering committee for the national microfinance strategy)
CSBF	<i>Commission de Supervision Bancaire et Financière</i> (banking and financial supervision commission)
DFS	Decentralized Financial System
DID	<i>Développement International Desjardins</i> (Desjardins international development)
DIRECT	CGAP Donor Information Resource Center
EC	European Commission
EU	European Union
FERT	<i>Fondation pour l'Epanouissement et le Renouveau de la Terre</i> (French agricultural finance foundation)
FGM	<i>Fonds de Garantie Mutualiste</i> (cooperative guarantee fund)
FIRST	Financial Sector Reform and Strengthening Initiative
GBF	<i>Groupe des Bailleurs de Fonds</i> (donor group)
GEM	<i>Groupement des Entreprises de Madagascar</i> (Madagascar entreprise association)
GRET	<i>Groupe de Recherche et d'Echanges Technologiques</i> (technological research and exchange group)
GTZ	<i>Gesellschaft für Technische Zusammenarbeit</i> (German development agency)
IBS	<i>Impôt sur le Bénéfice des Sociétés</i> (corporate income tax)
ICAR	<i>International de Crédit Agricole et Rural</i> (international agricultural and rural credit agency)
IDA	International Development Association
IFAD	International Fund for Agricultural Development
ILO	International Labour Office

IMF	International Monetary Fund
INSCAE	<i>Institut National des Sciences Comptables et de l'Administration d'Entreprise</i> (national accounting and business administration institute)
INTERCECAM	<i>Centre de Services des Caisses d'Epargne et de Crédit Agricole Mutuelles</i> (services center for cooperative agricultural savings and credit banks)
IRAM	<i>Institut de Recherche et d'Application des Méthodes de Développement</i> (institute for research on and application of development methods)
IS Fund	Information Systems Fund
MAE	<i>Ministère Français des Affaires Etrangères</i> (French ministry of foreign affairs)
MAEP	<i>Ministère de l'Agriculture, de l'Elevage et de la Pêche</i> (ministry of Agriculture, Livestock, and Fisheries)
MCA	Millennium Challenge Account
MEFB	<i>Ministère de l'Economie, des Finances et du Budget</i> (ministry of economy, finance, and budget)
MIS	Management information system
MIX	Microfinance Information eXchange
MFI	Microfinance Institutions
SP	Microfinance Support Project
NGO	Non Governmental Organization
OTIV	<i>Ombona Tahiri Ifampisamborana Vola</i>
PADANE	<i>Projet d'Amélioration et de Développement Agricole dans le Nord-Est</i> (project for agricultural development and improvement in the northeast)
PAIQ	<i>Programme d'Appui aux Initiatives de Quartier</i> (neighborhood initiatives support program)
PAR	Portfolio at Risk
PRBM	<i>Projet de Réhabilitation du Périmètre du Bas-Mangoky</i> (Bas-Mangoky perimeter redevelopment project)
PRSP	Poverty Reduction Strategy Paper
RDSP	Rural Development Support Project
SIDI	<i>Société d'Investissement et de Développement International</i> (investment company for international development)

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MAP OF MADAGASCAR



MADAGASCAR CLEAR—EXECUTIVE SUMMARY

The Madagascar Country-Level Effectiveness and Accountability Review (CLEAR) was conducted in Antananarivo from April 26 to May 17, 2005. The CLEAR analyzes donor effectiveness in microfinance and helps donors better adapt their support for developing financial systems (savings, loans, insurance, transfers, etc.) that benefit the poor. CLEARs are part of the Consultative Group to Assist the Poor (CGAP) Aid Effectiveness Initiative, which was launched in 2002 with a series of 17 Microfinance Donor Peer Reviews. CLEARs help funders adapt their internal systems to design, implement, and monitor better programs. They also help funders identify key gaps in the financial system that inhibit the provision of permanent financial services to poor people. The three levels of the financial system are the *micro* level (e.g., retail institutions), the *meso* level (e.g., apex, technical service providers), and the *macro* level (e.g., regulations and policies). While in Madagascar, the review team consulted over 110 stakeholders, including government officials, practitioners, donor staff, and microfinance clients.

Donors continue to play a key role in the development of microfinance in Madagascar. In 2005, Malagasy microfinance served 70,000 clients for loans and more than 500,000 clients for savings through a large number of points of service. Despite the political and economic crises affecting the island, Malagasy microfinance grew at a remarkable pace between 1999 and 2004, with an increase of 246 percent in the number of members and an increase of over 100 percent in the volume of savings and credit.

Microfinance is developing in Madagascar at all three levels of the financial system (micro, meso, and macro). At the micro level (financial services providers), there are many stakeholders and growing interest from banks and private investors. Microfinance institutions (MFIs)¹, cooperatives and non-cooperatives, play a predominant role, with the Caisse d'Epargne and the postal system also playing a major role. At the meso level (support services suppliers), services such as training or auditing are available. At the macro level (policy, regulatory framework, and supervision), supervision and coordination are in place, and a legal framework specifically for microfinance is being introduced.

However, Malagasy microfinance remains fragile. Malagasy MFIs have structural weaknesses at several levels: governance, portfolio management, internal control, human resources, and lack of financial sustainability. For example, MFIs have, on average, a negative return on assets and portfolios at risk (PAR) in excess of 11 percent. Microfinance support services are rare and of unequal quality. Also, there is a lack of reliable information on financial performance. At the macro level, the supervisory and coordinating bodies have limited resources, and the legal framework is in a state of flux. There is a risk that interest rate subsidies will distort the market; the involvement of the Ministry of Agriculture, Livestock, and Fisheries is not always consistent with the National Microfinance Strategy. Moreover, the legal system is not sufficiently reliable to help further develop the financial sector.

In light of these weaknesses, donors have a fundamental role to play in consolidating the development and guaranteeing the sustainability of microfinance in Madagascar. Pulling back from this role would have negative effects on the country's development.

The CLEAR recommends that, at the micro level, donors help MFIs clean up their portfolios by conducting targeted missions and introducing sound management practices. Donors have access to best practices in microfinance and should be committed to promoting them in Madagascar. Generally, it is essential that donors help well-performing MFIs tailor their services better. The CLEAR also finds that donors should promote the diversification of institutions and approaches in microfinance, for example by creating a microfinance bank.

¹ In Madagascar most MFIs follow the cooperative model and are referred to as systèmes financiers décentralisés (SFD) or decentralized financial systems (DFS).

At the meso level, donors must improve their investment in training by promoting the availability of local training that is clear, accessible, and sustainable. The CLEAR recommends that donors establish multidonor funds that are freely accessible for technical support to the microfinance sector. Donors must take steps to improve governance within MFIs, particularly regarding cooperative institutions. Donors need to encourage the merger of the two professional associations and to support the resulting organization. Finally, the CLEAR recommends that donors promote the emergence of a sustainable system for refinancing MFIs.

At the macro level, donors should help the government maintain an environment conducive to microfinance. Donors need to recognize the risks associated with subsidizing rates and phase out this practice. Donors could help the various microfinance stakeholders clarify their roles. Finally, donors should promote capacity building at the CSBF.

To implement these recommendations, donors must improve their own systems. Donors should ensure that their staff know enough about finance to be able to manage microfinance programs. Donors should disseminate and implement the key principles set forth in the National Microfinance Strategy. They need to strengthen performance-based management programs, especially with service providers. All donor involvement should be aimed at ensuring the sustainability of microfinance, and the tools available to donors must be better adapted to the requirements of microfinance.

Malagasy microfinance needs donor support to:
• Reduce the fragility of the MFIs
• Develop subsidies for training, but not for interest rates
• Establish multidonor funds freely accessible for technical support
• Promote MFI transparency
• Help the government maintain a favorable environment
• Clarify the roles of the various stakeholders
• Build the capacities of the CSBF
Internally, donors need to:
• Ensure that their staff are qualified in finance
• Apply the key principles of the National Microfinance Strategy
• Reinforce performance based management with service providers
• Reactivate their coordination

I. BACKGROUND

In early 2002, the Consultative Group to Assist the Poor (CGAP) and a group of leading donor agencies launched an Aid Effectiveness Initiative, using microfinance as a test case. In its first stage, between April 2002 and November 2003, the initiative sponsored Microfinance Donor Peer Reviews of 17 bilateral and multilateral development agencies. The peer reviews helped donors look themselves in the mirror and focus on what they could most directly influence: their own procedures, processes, practices, and systems. Top management and staff of the participating agencies appreciated the frank and actionable recommendations of the review teams. All agencies are currently implementing recommendations, with promising results.²

The peer review exercise culminated in a high-level meeting in February 2004 called “Leveraging Our Comparative Advantage to Improve Aid Effectiveness.” At that meeting, lessons learned from the reviews were synthesized and steps for further collective action were discussed. Following the meeting, the 17 agencies issued a joint memorandum that endorsed five core elements of donor aid effectiveness in microfinance (the “aid effectiveness star”): (1) strategic clarity, (2) staff capacity, (3) accountability for results, (4) relevant knowledge management, and (5) appropriate instruments. The agencies also committed to a four-step work program, including a mandate to expand the aid effectiveness work to the field.



² For more information on Microfinance Donor Peer Reviews, visit www.cgap.org/projects/donor_peer_reviews.html.

CGAP member agencies jointly designed the Country-level Effectiveness and Accountability Reviews (CLEARs).³ CLEARs focus on strategic issues relevant to donor effectiveness. They are not comprehensive sector studies that deeply analyze financial systems development as do the Financial Sector Assessment Programs. Rather, CLEARs rely on an interview-based methodology and literature review to measure development agency systems and practices against the concrete and specific challenges of building an inclusive financial system in a particular country. CLEARs strive to help funding agencies identify gaps in financial systems and to design interventions that build on their respective comparative advantage. CLEARs also aspire to motivate donors to improve their internal procedures and systems so they can work more effectively with others in the field, thus better contributing to poverty reduction and to the Millennium Development Goals (MDGs).

The vision of an inclusive financial system is client centered. It is based on the assumption that financial services play a critical role in reducing poverty by enabling poor people to accumulate and manage assets, conduct financial transactions, manage cash flows, invest in their businesses, and reduce their vulnerability to external shocks.

Five CLEARs will have been conducted from October 2004 through December 2006. The first CLEARs took place in Cambodia in October 2004,⁴ and in Nicaragua in February 2005.

The third CLEAR was conducted in from April 26 to May 17, 2005. The CLEAR team comprised Eric Duflos, Alexia Latortue, and Jennifer Isern from CGAP; François Lécuyer and Emmanuel Moyart, consultants; and Hubert Rauch from GTZ. The team spent a total of 12 staff weeks in country and consulted over 110 persons representing a broad cross-section of stakeholders, from government officials to

³ Seventeen agencies, including Agence Française de Développement, African Development Bank, Asian Development Bank, the European Commission, Finland, GTZ, ILO, the Netherlands, Sida, and USAID, took part in drafting the Terms of Reference.

⁴ For more information on CLEARs, visit www.cgap.org/clear.

MFI managers and staff to representatives of donor agencies, investors, and microfinance projects. Local interviews were supplemented by the team's exhaustive review of the existing literature on Malagasy microfinance. The team also gathered information through questionnaires followed by telephone interviews of key stakeholders based abroad. Finally, the team presented its initial conclusions to all stakeholders at two wrap-up meetings in Antananarivo on May 17 and at a press conference.

This report is addressed to all funders that support microfinance in Madagascar. It provides examples of good practice from among the different funders in the country, but does not seek to assess the work of individual funding agencies. Instead, the report provides a snapshot of key issues facing the development community

engaged in microfinance and offers concrete recommendations on how to tackle them. Selected funding agencies will receive an individual assessment that focuses on specific issues pertaining to their own effectiveness.

This report begins with a brief overview of microfinance in Madagascar (Section II). Section III presents an analysis of the challenges facing the three levels of the financial system (micro, meso, and macro). For each of these levels, strengths and weaknesses are examined, followed by specific recommendations aimed at bringing donor support more in line with demand and helping them build an inclusive financial system. Section IV delineates the strengths and weaknesses of donor operating systems and makes recommendations aimed at improving their effectiveness in Madagascar.

II OVERVIEW OF MICROFINANCE IN MADAGASCAR

Social, economic, and political context

Madagascar is a large country (587,000 km²), with a low population density (17 million inhabitants). The vast majority of the population is rural (80 percent), and there are many land-locked areas. Poverty affects 70 percent of the population; 85 percent of the poor live in rural areas, according to the 2003 Poverty Reduction Strategy Paper (PRSP). High population growth (2.8 percent annually), a weak education system, and a high illiteracy rate contribute to keeping the poverty level high.

The transition toward a market economy that occurred in 1990–2000 had painful economic repercussions and led to political problems. This difficult period lasted until 2002, when Madagascar experienced a serious political and economic crisis. Although the political situation improved with the election of the president now in office, the economic situation deteriorated in late 2004, with a sharp hike in inflation, a sizable devaluation, and increase in the price of rice—the basic foodstuff for the majority of the population. The lingering effects of the rice crisis are still in the minds of the residents of the capital city who suffered the most from it, and rice prices again began to move upwards beginning in June 2005.

The outlook for 2005 is expected to be more favorable thanks to economic growth and increasing control over the inflation rate. The ongoing reforms, social development, and macroeconomic stabilization efforts enabled Madagascar in October 2004 to reach the “completion point” for the Heavily Indebted Poor Countries (HIPC) Initiative and to obtain substantial external debt cancellations (US\$ 3.4 billion out of a total of US\$ 4.5 billion). According to the OECD’s *African Economic Outlook 2004/2005*, the projected growth rate of Madagascar for 2005 is 6 percent. Notwithstanding the recent progress, there is a sizable infrastructure deficit in both physical terms (e.g., roads and telecommunications) and in legal terms (e.g., land records, enforcement

of the penal code, recovery of guarantees, and the reduction of corruption). The sustainable development of agriculture is yet another major challenge Madagascar will have to meet in the medium term. By way of illustration, agricultural output per hectare is among the lowest in the world.

Financial sector developments

Until the 1990s, the financial sector was largely controlled by the state and reflected dirigist policy approaches. The banking system was made up of sector-specific banks—an agricultural bank, a foreign trade bank, and so forth.

In the late 1980s, the Malagasy economy was exposed to free market principles under the adjustment programs supported by the World Bank and the International Monetary Fund. In the 1990s, the banking system was completely privatized and rehabilitated. The national banks were purchased by major foreign groups (e.g., BTM by BOA, BNI by Crédit Lyonnais, and BFV by Société Générale), and CMB now has a Chinese majority shareholder. Compared with the banking sectors of other developing countries, Madagascar’s banking sector is relatively sound and well capitalized. It includes seven commercial banks, two finance institutions, at least four insurance companies, the Caisse d’Epargne de Madagascar (CEM), and a highly developed network of postal savings banks.

A 1995 banking law made the Central Bank’s Banking and Financial Supervision Commission (CSBF) responsible for banking supervision. The integration of microfinance into the formal financial sector is off to a good start in Madagascar. The traditional banking sector is showing increasing interest in participating in the development of microfinance, which it tends no longer to regard as a fringe activity of the financial sector but rather as a genuine market. Indeed, while the traditional banking sector holds the majority of assets in the financial sector, from the standpoint of the number of borrowers, microfinance is now the main source of financial services for the people of Madagascar.

Major stakeholders in Malagasy microfinance

Microfinance in Madagascar involves a sizable number of stakeholders in various areas of activity.

Microfinance providers. Microfinance supply is covered by many financial services suppliers. There are 477 points of service, a vast majority of which are cooperative financial institutions known as Decentralized Financial Systems (MFIs), but they also include noncooperative financial institutions, joined recently by at least one bank. The first MFIs were established in the early 1990s and achieved formal status shortly thereafter: in 1993 for *Caisses d'Epargne et de Crédit Agricole Mutuelle (CECAMs)* and in 1994 for *Ombona Tahiry Ifampisamborana Vola (OTIVs)*. The Bank of Africa (BOA), formerly *Bankin' Ny Tantsaha Mpamokatra (BTM)*, has a sizable network and contact with the rural population, making it one of the most important stakeholders in microfinance (both for direct distribution of services and for refinancing of networks).

Financial services also are offered through public institutions, such as *Caisse d'Epargne de Madagascar*, which is currently being privatized, and *Paositra Malagasy (Madagascar Post)*.

Professional associations. The Professional Association of Cooperative Financial Institutions (APIFM), founded in 1997, covers all cooperative institutions. Nonmutual institutions are grouped together in the Association of Non-Mutual Microfinance Institutions (AIM), founded in 1999.

The government. The Ministry of Economy, Finance, and Budget (MEFB) is the supervisory ministry for microfinance. Coordination is provided by the government mostly through the National Coordinating Office for Microfinance (CNMF), which reports to the MEFB through the Treasury Directorate. A National Microfinance Strategy (SNMF) was approved by all stakeholders in 2004. Its coordinator is based in MEFB, while a steering committee for SNMF brings together the major stakeholders.

CSBF is responsible for the regulation and supervision of microfinance. Microfinance

activities were structured and organized in the mid-1990s. A banking law was promulgated in 1995. The law on savings and loan cooperatives dates from 1996. The first cooperative institutions were licensed in 1999. A new law on microfinance, covering all MFIs, whether cooperatives or not, has just been adopted.

The Ministry of Agriculture, Livestock, and Fisheries (MAEP), which turned the responsibility for microfinance over to MEFB, still manages several credit components relating to rural development projects.

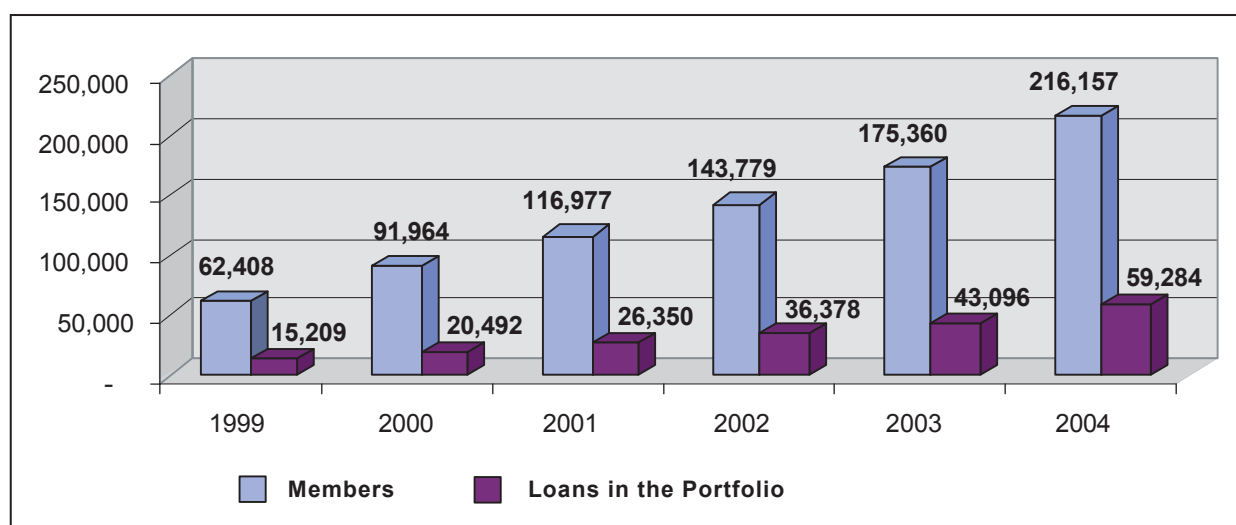
Funders. Most funding is still provided by donors, but the contribution from savings and local banks is increasing. The latter refinance MFIs and take equity positions directly in some MFIs. Some national and international private investors are involved as well. Many of these funders work directly with national and international service suppliers to support financial services providers.

Box 1. Main Microfinance Providers

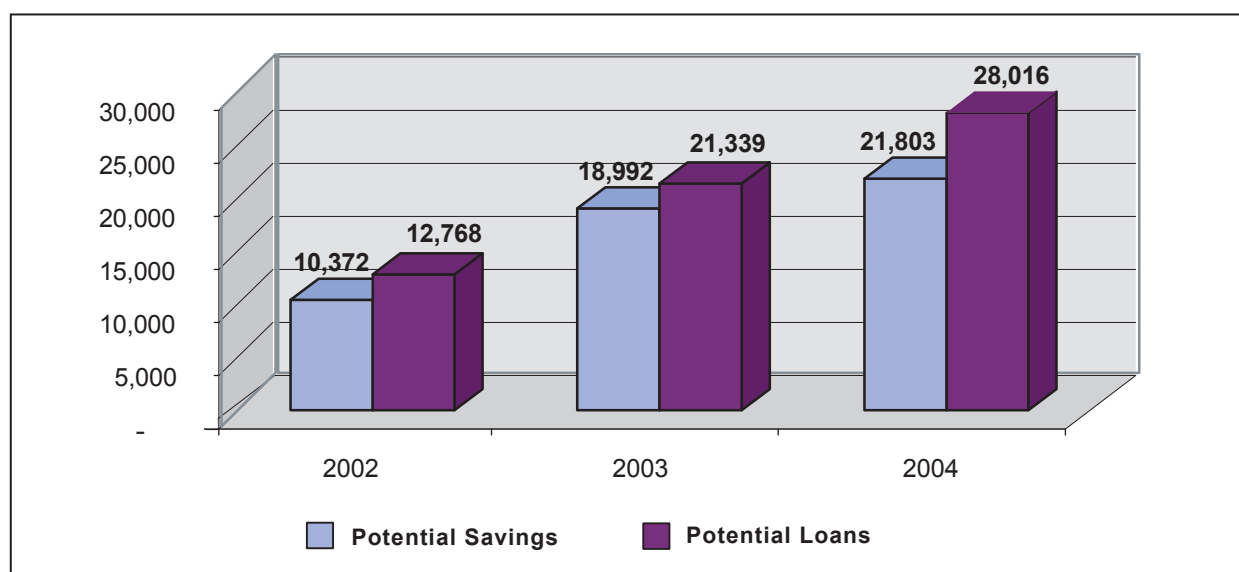
- Cooperative financial institutions that are members of APIFM: **URCECAM, TIAVO, OTIV, AECA, and ADEFI**
- Nonmutual financial institutions that are members of AIM: **SIPEM, Vola Mahaso, APEM/PAIQ, and APEM Farahitso**
- Bank: **BOA**
- **Caisse d'Epargne de Madagascar**
- **Paositra Malagasy**

Customers and recent growth

Microfinance in Madagascar showed significant growth over 1999–2004. The number of members of cooperative institutions increased by 246 percent, and the number of loans in the portfolio rose by 290 percent. This growth continued despite the 2002 crisis. From 2002 to 2004, the number of clients/members grew by 40 percent, savings balances rose by 110 percent, and outstanding loans increased by 119 percent. In 2004, average savings came to MGA 110,000, and average loan volume was MGA 428,000. Exchange rate in 2004 was 1,868.9 Malagasy ariary per US dollar and was of 2,003 Malagasy ariary per US dollar in 2005.

Growth in the Number of Members and Loans in APIFM and AIM Portfolios, 1999–2004

Sources: 1999–2001, APIFM, and 2002–2004, APIFM and AIM.

Growth in Volume of Savings and Lending, APIFM and AIM (in millions of ariary)

Sources: 1999–2001, APIFM, and 2002–2004, APIFM and AIM.

Despite growth in client base, the microfinance penetration rate in Madagascar remains low. Indeed, according to UNDP's Microfinance Support Project (MSP), microfinance has reached only 6 percent of its potential market

and covered only 2 percent of the potential demand for credit. As for savings, the coverage rate is 30 percent when the Caisse d'Epargne de Madagascar (CEM) is included and just 4.4 percent when it is excluded.

III. CHALLENGES FACING THE THREE LEVELS OF FINANCIAL SYSTEMS

Analytical framework

Microfinance is growing rapidly. International development agencies have recently adopted new guidelines on good practice that will be updated regularly to keep pace with innovations.⁵ These guidelines show that the integration of microfinance into the formal financial system enables it to reach a maximum number of clients and have an optimum impact.

The full integration of microfinance into the formal financial sector calls for work at all three levels of the financial system: micro, meso, and macro. Although institutions that offer microfinance services (micro level) constitute the backbone of the financial system, they also need suppliers of support services (meso level) to train their staff, improve their systems, and enhance their transparency. Policies, regulations, and supervision must provide rules of the game that are conducive to the sound and rapid development of the various stakeholders (macro level).

Box 2. Three Levels of the Financial System

Micro: Retail financial service institutions (e.g., NGOs, finance companies, banks, financial cooperatives, and other suppliers, such as moneylenders, agricultural traders, etc.)

Meso: Service providers and industry infrastructure (e.g., networks, trainers, auditors, information technology providers, wholesale financing facilities, credit bureaus)

Macro: policy, laws, and the regulation and supervision framework (e.g., banking regulations and interest rate policy)

Structural fragility of Malagasy microfinance: A recurrent topic

Microfinance in Madagascar is expanding rapidly, but is still structurally fragile. This fragility affects all levels of the financial

system. It includes MFIs in regard to their financial structure and governance. It relates to support services, such as information technology, auditing, and training, which remain difficult to obtain and of mixed quality. It also extends to the regulatory and supervisory area, which is poorly equipped to deal with a growing financial sector. To permit the rapid and sound expansion of microfinance, these fragilities must be reduced considerably.

Donors still have a crucial role to play in consolidating microfinance in Madagascar. This report outlines specific steps donors can take to improve their support, which remains essential for viable microfinance. It builds on the vision of the National Microfinance Strategy aimed at ensuring that Madagascar has a professional, viable, and sustainable microfinance sector that is integrated into the financial sector, diversified, and innovative—one that covers demand to a satisfactory degree and functions within a legal, regulatory, tax, and institutional framework that is appropriate and favorable.⁶

MICRO

MFIs must be structurally strong to offer sustainable and high-quality services to their clients. Despite their significant presence and growth, most MFIs in Madagascar are far from achieving financial and institutional sustainability. Given that the micro level is the backbone of the financial system, this fragility poses risks to the system as a whole.

Micro-level strengths

Growth of inclusive financial services despite recent difficult circumstances. In 2002–2004, all types of MFIs grew despite the serious political crisis of 2002 that paralyzed the country for six months. The survival of these institutions bears witness to their tenacity and commitment.

Large number of points of service. Thanks to the large number of bank branches, savings banks, and post offices, the Malagasy financial infrastructure has immense opportunities for microfinance development. For example, with

⁵ CGAP. “Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance.” Washington, D.C.: CGAP, 2004.

⁶ See the national strategy (SNMF) in the bibliography.

its seven banks and 117 branches, the banking network is relatively extensive compared with other like countries. Fortunately, most of the network was preserved when the banks were privatized. Caisse d'Epargne is solidly established, with 19 branches (created following its separation from the postal system in 1995) and especially its 770,000 passbook savings accounts, of which roughly a third are active. Half of these passbook accounts are held by low-income clients. The postal system is the most extensive network by far, with 230 multi-service offices, 30 rural post offices, 150 postal agencies in the bush, and a project on Postal Service Points with merchants. In February 2005, its clients held 44,000 postal checking accounts and 77,000 passbook accounts.

Sizable presence of MFIs in rural areas. Using the division of the country into 20 agro-ecological regions as defined by MSP (statistics as of 30 June 2003),⁷ only two regions have no point of service (Betsiboka and Melaky). However, several regions have sparse coverage by MFIs extending credit (Atsimo-Andrefana, Mangoro, Tolagnaro, Atsimo-Atsinana, and Horombé), and there are disparities between regions. This relatively good representation in rural areas is essential in view of the high level of rural poverty. Rural finance remains one of the major challenges facing microfinance, and many other countries could draw lessons from the Malagasy experience.

Large number of savers. Often called the “forgotten half of microfinance,” savings are particularly well developed in Madagascar. MSP estimates indicate a 30 percent penetration rate for savings when all accounts with Caisse d'Epargne are considered.

Increasing linkages among the banking sector, private sector, and microfinance. BOA constitutes a good example of the banking sector's growing interest in clients who are less well off. It is already offering microcredit services through its 30 branches to about 6,000 grouped clients. In addition, banks are beginning to invest in the capital of MFIs. The box below provides additional information.

Box 3. Participation of Banking Sector and Private Sector in Microfinance

Banking Sector

- BNI has a 15 percent participation in SIPEM
- BOA, BMOI, and BFV are in competitive bidding for an opening of the capital of ADEFI

Private Sector

- GEM/APEM participation in SIPEM
- SIDI participation in SIPEM

Private Sector (with a focus on investment)

- Crédit Agricole of France (3 regional banks through an investment structure) in Intercecam
- ICAR (Intercecam and new MFIs to be created)
- Aga Khan Group

Note: The banking sector and the MFIs also are linked commercially. The banks can refinance the MFIs, accept deposits from them, guarantee their assets, etc. This aspect is addressed in the section on the meso level.

Desire of some cooperative institutions to adapt their structure to the environment.

Cooperative institutions, such as TIAVO, the OTIVs, or CECAM, have modified their structures and innovated in order to adapt to local circumstances. They have found solutions for improving their profitability while meeting local demand, for example by placing teller windows linked with their branches in remote areas and by grouping certain branches. Another innovation is the creation of apex structures they seek to convert into joint limited companies licensed to function as financial institutions (INTERCECAM authorizations have been obtained for CECAMs).

Micro-level weaknesses

One distinguishing feature of microfinance in Madagascar is the relative fragility of MFIs. This fragility is described below, with particular reference to comparisons with the statistics obtained by the *Micro Banking Bulletin* (MBB), which assembles financial information on MFIs throughout the world.

⁷ This division closely resembles the new administrative division, which features 22 regions.

1. Structural fragility of the MFIs

Governance problems. There is a serious governance problem among cooperative institutions that make up the vast majority of MFIs in Madagascar. The market as a whole is thus made more fragile. Several difficulties are apparent:

- Volunteer work may make some elected heads not as motivated and lead to frequent departures before the end of terms. The need to engage in remunerated activity is not always compatible with their mission.
- Some managers lack the training and skills in management and finance to carry out their duties effectively.
- Some social behaviors are inconsistent with the cooperative principle: favoritism in extending credit, embezzlement, and setting poor examples regarding loan repayment.

The cooperative institutions often are poorly managed as a result. Relationships between salaried technicians and elected officers are sometimes tense, particularly regarding decision making and allocation of work within institutions.

There also are governance problems between apex institutions and cooperative banks. For example, cost allocation policies are not always clear. These issues are important because they can jeopardize the overall financial equilibrium of networks in a context in which subsidies for networks are tending to decline.

Poor portfolio management. According to data gathered as part of a recent study by the MIX and CGAP,⁸ the ratio of PAR for over 30 days at end-2003 is 11.6 percent for the nine major MFIs in the country (ADEFI, 5 OTIVs, SIPEM, TIAVO, and UNICECAM). This ratio is extremely high compared with world averages. It is recommended that PAR > 30 days not exceed 3–5 percent. A sizable PAR poses a cost burden (decreased interest income, increased collection costs, larger reserves provisioning, etc.). The sustainability of these institutions is thus

achieved belatedly, and the additional costs are reflected in the interest rate charged to clients.

Lack of internal systems and controls. In a period of growth, this weakness poses even greater risks, and many of the individuals interviewed referred to many instances of misappropriation. Computerized management information systems (MIS) are still not in widespread use. Even where procedures are in place, it is difficult to monitor activity closely. This lack of technical resources is compounded by the problems of introducing efficient internal controls attributable to insufficient human and financial resources.

Scarcity of human resources. The recruitment and management of human resources are challenges for MFIs in Madagascar, particularly for those established in rural areas. The scarcity of skilled staff leads to sizable recruitment and training costs. It is particularly difficult to find qualified staff in rural areas or to attract such staff from the cities. In addition, there is considerable turnover among staff, who are constantly attracted by new opportunities.

Problems in achieving financial sustainability without subsidies. According to MIX statistics from end-2003, Madagascar's nine major MFIs had a total return on assets of -3.3 percent. Even taking the particularly difficult rural context into account, this figure raises no prospects of financial sustainability in the short term. The figure for return on assets weighted by volume of assets for Madagascar is well below the average returns in Sub-Saharan Africa (1.6 percent). The low productivity of MFIs, with 29 borrowers per staff member as compared with the world average of 139 (MIX data for end-2003), is another drag on achieving sustainability. Finally, relatively high bank rates give MFIs no incentive to seek commercial financing. This engenders a "donor culture" that is contrary to the vision of sustainability.

2. Supply not fully meeting demand

Inadequate supply of credit. The demand for credit is not adequately covered, particularly regarding medium- and long-term credit. MFIs, as a whole, cover only about 70,000 loan customers, with outstanding credit estimated

⁸ "Overview of the Outreach and Financial Performance of Microfinance Institutions in Africa," MIX, April 2005, www.mixmarket.org/medialibrary/mixmarket/Africa_Data_Study.pdf.

at MGA 30 billion at end-2004. There are several reasons for the limited number of borrowers: (i) methodological shortcomings, such as requiring real guarantees that poor clients have difficulty providing; (ii) the attractiveness of placing assets in Treasury bills (BTAs) with rates of about 20 percent as compared to loan portfolios; and (iii) the fact that most deposits are short-term provides no incentive for MFIs to grant medium- and long-term loans.

Micro-level donor recommendations

Although these recommendations are addressed to donors, close cooperation between donors and key stakeholders in microfinance, namely practitioners, the private sector, and government, is required for success.

1. Help MFIs reduce their fragility.

MFIs suffer from structural fragilities. To address this problem, four lines of action growing out of the vision defined by the National Microfinance Strategy are suggested.

Provide MFIs with incentives to improve portfolio quality. Donors could finance technical assistance targeting MFIs to resolve this problem as rapidly as possible: (i) introduce portfolio rehabilitation plans that include special procedures for recovering arrears, the creation of teams devoted to collections, and the establishment of targets and incentives systems for these teams; (ii) finance studies on the causes of the arrears to remedy and prevent them; (iii) promote the adoption of international standards for calculating PAR (that is, monitor the portfolio at 30 days or more and not at 90 days as is often the case in Madagascar) and the dissemination of other quality standards for portfolio management (e.g., provisioning rules).

Finance studies on MFI costs and revenue. Donors could support MFIs in the analysis of their cost and revenue structures. This should enable them to gain better knowledge of and mastery over their expenses and possibly to revise their fees, always with a view to achieving greater efficiency and financial viability.

Encourage MFIs to professionalize their governance. This recommendation requires technical solutions that take into account the special characteristics of the cooperative model. Donors should provide assistance with improving the definition of the allocation of responsibilities among elected officers and technical personnel. This can be done, for example, by drafting terms of reference for the entire staff and through awareness sessions devoted to the various roles. Donors also can support the technical training of elected officers and technical specialists through networks. Finally, emphasis needs to be placed on the importance of generating greater revenue to compensate personnel needed for proper functioning, a question that is linked to the recommendations on cost control and productivity. This enhanced professionalism also can be supported by donors by grouping cooperative institutions, creating points of service, and strengthening apex institutions.

Contribute to the strengthening of human resources. Enhancing human resources in Madagascar is an issue that extends substantially beyond microfinance and has long-term implications. Donors can nevertheless help MFIs acquire and maintain staff they require, by (i) financing activities to enhance the awareness of microfinance of Malagasy students and (ii) financing technical assistance relating to the development of human resources for MFIs. Such assistance could address improving recruitment methods, introducing career and training plans for employees, developing incentive systems, and creating other mechanisms to increase staff motivation and loyalty.

2. Help MFIs better adapt their services.

To improve the linkage between supply and demand, donors can help MFIs improve the analysis of market needs:

Finance market research on demand to better assess clients. Although there are many research and evaluation tools already available (see www.lamicrofinance.org for resources in French, or www.microfinancegateway.org for resources in English),⁹ donors can finance

⁹ Resources can be identified by searching on product development and market research.

research as well. Such studies could be devoted to (i) the client base and its needs; (ii) client satisfaction; (iii) factors behind abandoning efforts; and (iv) the organization of test groups to obtain more hands-on knowledge of the market and how it reacts.

Support the development of new services and/or distribution methods. Donors could finance pilot testing of new products and/or markets. This kind of support could take the form of a fund accessible by all MFIs based on the model of the capacity-building fund referred to below (see meso-level recommendations).

Disseminate the knowledge and know-how already gained in Madagascar and elsewhere. Donors could support the establishment of a database that includes local and international experiences. There are several financial tools and products tailored to rural people already available in Madagascar, and they could be disseminated more widely (e.g., equipment lease with option to purchase).

3. Promote diversification of institutions and approaches.

There is still scope in Madagascar for other methodologies and institutions, especially regarding the supply of credit. To meet this challenge, donors will have to:

Continue enhancing banks' awareness of microfinance. In collaboration with the Professional Banking Association, donors can finance a discussion panel that would enable Malagasy bankers to meet bankers involved in microfinance (e.g., Sogesol in Haiti and Bancosol in Bolivia). Donors might also support the direct activities of banks involved in the sector (in Madagascar, the BOA) and disseminate good microfinance practice information to all banks.¹⁰

Study the establishment of new institutions and partnerships. Through their work in many different countries, donors have gained familiarity with various types of institutions that are

capable of functioning on a large scale. As indicated by a recent study carried out in Madagascar, a local microfinance bank could make it possible to cover certain market segments. It would be beneficial for a donor consortium to consider establishing such an institution (its charter, shareholders, products, etc.). In addition to creating new institutions, donors could also promote ties between MFIs and various types of commercial stakeholders, such as wholesalers of agricultural equipment and inputs, merchants, etc., that can provide services in support of MFIs (e.g., an MFI might use a merchant to open a teller window on market day).

Finance a supplementary study on the potential role in microfinance of Caisse d'Épargne and the postal system. Such studies have been conducted previously, but they need to be updated and supplemented. If the findings indicate these institutions have an important role to play, donors could then participate in the search for technical partners, or in the development of these institutions' microfinance activities.

Subsidize extension of the network of well-performing MFIs. Donors could subsidize the expansion of MFIs according to strict criteria: (i) existence of a business plan that includes expansion-related projections; (ii) achievement of financial and institutional sustainability, as measured by critical international indicators; and (iii) financial contribution to the expansion by the MFI. This subsidy could be used to finance physical infrastructure (branches, teller windows, commercial partnerships), new technologies, or a portion of operating costs for the short term.

MESO

MFIs need support services, such as training, auditing, or private refinancing. The team observed the weakness of this portion of the market, which began to develop only recently. The fragility found at the meso level thus risks broadening, or perpetuating, fragility at the level described above.

Meso-level strengths

Start of microfinance refinancing by the banking sector in Madagascar. The participation of local banks helps promote the sustainability of

¹⁰ Resources can be identified by searching on product develSee the recent CGAP Focus Note on the various models of successful commercial bank involvement in microfinance, at www.cgap.org/docs/FocusNote_28.pdf.

MFIs, their expansion, and their integration into the national financial system. While donors have a role to play when it comes to priming the pump, it is the local financial markets themselves that must carry out the task. Institutions like CECAM, OTIV, Lac Alaotra, ADEFI, or AECA are partially refinanced by BOA, BNI, or BFV. These institutions' outstanding credit to MFIs represents MGA 4 billion–6 billion—about 15 percent of outstanding MFI loans to clients. This is a sizable share, and it is tending to increase.

Existence of professional associations. MFIs are grouped within two professional associations: APIFM for cooperative institutions and AIM for nonmutual MFIs. These associations are financed primarily by their members, although APIFM has received assistance from donors on individual issues. The new law on microfinance requires a microfinance association to have ties to the Professional Banking Association, constituting another step toward integrating microfinance into the formal financial sector. These associations have played an important role in enhancing professionalism and protecting their members' interests in the past and will be called on to continue to do so. They have solid ties with their counterpart organizations abroad, as illustrated by the fact that the annual meeting of the Africa Microfinance Network (AFMIN) was just held in Madagascar.

Initial supply of specialized training. MFIs already have a training base in microfinance, finance, and accounting available in Madagascar and abroad. It includes, for example, “training of trainers” modules (CGAP/CAPAF), operational and financial training modules (seven courses from CGAP/CAPAF with APIFM), “training for technical specialists and elected officers” by AGEPMF (risk management, institutional management, etc.), and the “INSCAE master's” (Master's in Cooperative Financial Institutions and Banking). Other training is offered by the Banking Technical Institute (National Center for Banking Training) and is available abroad, for example at CEFEB (AFD's training center in Marseilles).

Interest shown in microfinance by audit firms and consultants. The most important firms (those affiliated with international firms) are involved in MFI audits. Several firms have received CGAP/CAPAF training on the specifics of microfinance, and some have gone so far as to establish special units for microfinance activities. The fact that MFIs have access to audits on a regular basis enables them to have audited financial statements. This benefits sound management and transparency and eases access to commercial refinancing or participation in their capital by national or international investors.

Meso-level weaknesses

1. Fragility of services provided to MFIs

The services provided to MFIs are still rather scant and depend on outside elements that jeopardize their sustainability.

Inadequate number of skilled national service providers. The small size of the Malagasy market and the lack of trained personnel explain the gap between the supply of and demand for national consultants and service providers. The supply is inadequate for several different types of services, including internal control, management consulting (business plans, for example), MIS, and accounting.

Problems with accessing training. The lack of MFI access to training can be attributed to several factors. First, existing training is poorly promoted and coordinated. There is no centralized information on training, making it difficult to determine who is offering what. Consequently, training sessions are sometimes offered at the same time and topics sometimes overlap. Training can be relatively unpredictable given that it often depends on outside participation.

Finally, training is excessively centralized in Antananarivo. There is genuine demand for training that is more readily accessible by MFIs established in remote areas. Attempts to address this issue are currently being made. For example, AGEPMF has begun to offer training in Diego and Fianarantsoa.

Risk of unfair competition in training and other technical support areas. Subsidies from donor projects sometimes compete with services offered by the private sector. Unfair competition jeopardizes the viability of a private services sector, which is still fragile, thus boosting the fear of a rupture in unsubsidized support services.

Limited transfers of skills. There is a lack of skills transfers under the technical assistance from abroad. Training missions follow one after the other without the training really being incorporated into MFIs operations. References are sometimes made to the sustainability of service providers rather than that of the MFIs. Nonetheless, it is possible that the MFIs do not always do everything they can to view training as an ongoing and essential investment in their sustainability.

Uneven audit quality and perception of high costs. Despite the interest shown in microfinance by audit firms, a majority of them have little training in the special characteristics of microfinance, and audit quality is considered uneven. Some auditors fail to adopt an adequate approach (for example, the loan portfolio audit may be insufficient) and do not probe deeply enough, either because of a lack of financial motivation to do so or because of a lack of knowledge. The findings do not always enable stakeholders (banks, donors, potential investors, and the MFIs themselves) to gain a clear vision of the financial health of MFIs, especially without an in-depth portfolio analysis. Moreover, MFIs consider the service to be costly despite the fact that the firms often offer a 25 percent rebate from the normal rate, while in turn the audit firms do not yet consider this activity to be profitable.

2. Current limitations of the professional associations

Limited clout and visibility. The professional associations appear to lack sufficient clout to defend the interests of the profession. Conversely, the advantages of microfinance and the way it functions are not widely known by the authorities, donors, the public, or sometimes and even the MFIs themselves. This lack of

familiarity may harm the development of microfinance (e.g., through the belief that microcredit is at usurious rates, subsidizing purchase of inputs, or interest rates).

Lack of technical representation at APIFM.

The cooperative institutions are represented in their professional association by elected officers only. The lack of technical specialists limits the potential for technical exchanges of views and leveraging experiences, even though this is one of the main roles of a professional association.

3. Unavailability and unreliability of information

Lack of comprehensive, standardized, and regular statistics. Statistics on MFIs and their activities available from CSBF, the professional associations, CNMF, and some projects are partial and not cross-comparable. For example, to prepare the statistics for this report, the team had to reconcile divergent data from APIFM, AIM, and AGEPMF.

Lack of client information sharing. The lack of information on clients and their financial behavior engenders costs and risks for MFIs. In the absence of a credit information bureau, MFIs make decisions without complete information on the histories of their clients, thereby increasing the risk of default and the risk that clients are borrowing from several MFIs at the same time. However, there are the beginnings of information sharing about delinquent payers under the auspices of APIFM. Furthermore, CSBF, with support from FIRST and MCA, is conducting a study on the feasibility options for a credit information bureau.

Meso-level donor recommendations

1. Improve investment in training.

The training system is still fragile, in terms of structure and availability. Donors must therefore continue to buttress MFIs with training activities, but adopt as a priority the *transfer of skills*—an essential prerequisite for sustainability.

Finance a descriptive inventory of training. There is a sizable supply of available training

(public and private, Malagasy and international). Donors should finance a study on existing training that would gather information on availability, costs, terms of use, assessments, sources of financing, and quality. The conclusions of the recent APIFM study taking stock of MFI training needs in Madagascar could be matched against the inventory to show the gap between training supply and demand. The study should be widely disseminated among MFIs, donors, and any other potential participants (ministries, banks, etc.). The association could subsequently update the information if it so desired.

Streamline and coordinate the financing of training. Generally speaking, it is preferable to subsidize training from the demand side. Regarding subsidizing training from the supply side, donors should make their financing contingent on several criteria, such as:

- Require training to be open to all MFIs that meet a minimum set of criteria (size, transparency, etc.). Offering training to each MFI individually is far too costly and does not always succeed in strengthening the market.
- Promote cofinancing, to ensure clients are motivated. To achieve financial sustainability, donors' subsidies will have to decline over time and ultimately give way to financing assumed by the client in its entirety.
- Ensure information on the training organization is widely disseminated (using the list drawn up with the CLEAR and the one from the APIFM inventory, for example).
- Avoid duplicating training programs, especially when they are available in the private sector.

Make skills transfer sustainable. To encourage the transfer of skills, donors could finance capacity building for national trainings by facilitating “training of trainers” programs, offering “coaching” with international trainers, and preparing and disseminating instructional materials, with particular attention to internal training.

2. Establish multidonor funds that are freely accessible for technical support.

It is essential to create a technical and financial tool base that is accessible to MFIs outside of projects when they have specific needs.

Donors could pool resources available for MFIs when they apply. This fund could, for example, finance scholarships for technical support, audits, MIS, the introduction of a computer system, studies on the implementation of institutional transformation, the development of business plans and action plans, and so forth. This type of multidonor fund already exists in other countries (for example, in Tanzania where it has been created through a DFID initiative). It requires a manager who centralizes resources and transparently performs the following tasks:

- Defines the minimum eligibility criteria for MFIs that will receive financing from the fund, for example the size of the institution or the regularity of the information submitted to CSBF and APIFM;
- Launches requests for proposals and responds to ad hoc requests;
- Defines the selection criteria for proposals and for the use of funds;
- Evaluates applications; and
- Monitors the approved funding.

To ensure system sustainability, eligible institutions will have to cofinance the effort covered by the applications. The partial and declining subsidization makes it possible to gradually integrate training costs into the MFI balance sheets.

3. Promote MFI transparency.

Transparency is essential for all aspects of institutions' lives—not only for the management and supervisory authority, but also for the protection of savers or the search for investors. To ensure MFI transparency, donors should help do the following:

Disseminate standards on good practice for financial disclosure. Donors could finance a seminar on these standards to enhance the awareness of MFIs and encourage them to move

toward harmonization of the indicators used.¹¹ To provide MFIs an incentive to adopt and use these standards, donors, in cooperation with CSBF, could jointly establish a Certificate of Quality Financial Disclosure based on the CGAP Transparency Award. To bring together the DSF databases, donors could provide support to CSBF becoming the depository of an accessible and consistent database on MFI financial information. The professional association could work closely with CSBF to bring together and cross-check data provided by MFIs.

Disseminate the existing information on MIS.

To avoid creating MIS from scratch, donors should ensure that information is disseminated on existing MIS and the terms for using them (by using the resource center on information systems at www.microfinancegateway.org). To help MFIs understand their needs, donors could steer them toward CGAP's IS Fund or turn to the multidonor fund mentioned previously.¹²

Cofinance MFI audits digressively. Because few Malagasy MFIs are sustainable, subsidizing audit costs may be justified. This subsidy should be associated with digressive cofinancing. In all cases, donors should avoid making direct payment for the audits, so that the institutions will become accustomed to paying for their own audits while including the projected costs in their financial plans.

Follow up on the study on the credit information bureau and reach agreement on the response. Donors should work with CSBF to analyze the findings on the feasibility of a credit information bureau. Two options may be considered: expanding the banking risk bureau, or creating a credit information bureau from the ground up. Once a decision is made, donors specialized in this area (e.g., the World Bank) could provide the necessary support (e.g., structuring the credit information bureau and providing support in technology and in training bureau and MFI staff).

¹¹ See the Disclosure Guidelines at www.cgap.org/docs/Guideline_disclosure.pdf and www.cgap.org/docs/Guideline_definitions.pdf.

¹² www.microfinancegateway.org/resource_centers/technology.

4. Encourage and support the merger of the two professional associations.

Donors should support the creation of a new professional association as proposed in the draft law on microfinance. Merging APIFM and AIM will allow a sizable number of stakeholders to speak with one voice and exercise greater influence in the economic, social, and political sphere. Donors should encourage cooperative institutions to include technical specialists in their representation, because these specialists have more comprehensive knowledge of microfinance than the elected officers and could help define the association's priorities. Integrating banks that serve poor people into the professional association would strengthen the insertion of microfinance into the formal financial system.

- Donor support for the new association could take the following forms:
- Preparation of the strategic plan of the association.
- Development of member services.
- Strengthening of advocacy activities: One priority would be training in lobbying and communication and the training of members in the international principles of microfinance. Specifically, donors could finance and train the elected officers of cooperative institutions in sound microfinance policies and conduct pinpoint communications campaigns.

5. Promote a sustainable refinancing system for MFIs.

Donor financing could have a leverage effect to give MFIs access to the capital market. This type of support does not require large subsidies, but does call for in-depth understanding of financial tools and markets. Donors with such knowledge (e.g., IFC, the AFD, and USAID) could do the following:

- Continue to put MFIs in touch with banks, and private investors and then give them sample contracts to help them prepare for negotiations.
- Establish guarantee funds. This often controversial tool will have to be handled prudently and professionally, stressing the

leverage effect, sharing risks, and avoiding potential adverse effects (e.g., negligence in monitoring repayments).

- Help MFIs identify sources of financing in local currency, from local or international institutions, to protect MFIs against exchange rate fluctuations.
- Encourage MFI access to financial ratings and to the training and subsidies of the Rating Fund (www.ratingfund.org) or to the multidonor fund to finance these activities. A rating report brings transparency and constitutes a critical tool for gaining access to private capital from investors and banks.

MACRO

Although it is promising, the policy framework for microfinance is relatively new and fragile. There are still several challenges to be met in the area of supervision, in understanding good practices, and in the conditions necessary for establishing an environment conducive to the development of sustainable institutions.

Macro-level strengths

Positive change in the general environment. Improvements in Madagascar's overall development climate are helping to develop the financial sector. Progress in critical infrastructure, such as roads and telecommunications in particular, is reducing transaction costs for MFIs and their clients. It is not unusual for MFIs to begin operations in a new area once a road is completed.¹³ Another area of progress is the National Land Tenure Program, which will make it possible to secure land tenure and hence production, investment, and the provision of guarantees. Donors are already making a substantial contribution to these efforts. For example, the European Commission is supporting telecoms and roads, and the AFD is supporting the National Land Tenure Program. The strengths of the financial sector are as follows:

¹³ Many regions could benefit from this policy of relieving isolation, which will make it possible to interconnect isolated areas and connect them to the capital (this is true of the Sofia region, for example).

National Microfinance Strategy consistent with good practices. The national strategy statement of aims repeats all 11 key principles of microfinance.¹⁴ These principles were disseminated during the participatory drafting process. The strong involvement of key donors (especially the UNDP) and the government's commitment in this process of drafting the national strategy are positive factors. The strategy clearly establishes the exclusive role of the private sector in the implementation of microcredit. Its Steering Committee (CP-SNMF) is inclusive, with representation from the professional associations, donors, and the government.

Proper assignment of microfinance to MEFB.

While recognizing that microfinance has positive effects in several development areas (e.g., education, health, rural development, etc.), the policy responsibility of MEFB stresses that microfinance is part of the financial system. The National Coordinating Office for Microfinance has thus been in MEFB since 2004.

Existence of a specialized microfinance unit within CSBF. Recognizing the importance and specific nature of microfinance, CSBF created a specialized unit devoted to crafting the new law, studying the establishment of the credit information bureau, and having sole responsibility for supervising MFIs.

Inclusive draft law. The recently approved microfinance law accords priority to an activity rather than to a particular institutional status and allows for better matching of stakeholders with the market. It opens the door to all cooperative and nonmutual institution stakeholders and to new stakeholders, such as joint stock companies. Donors, particularly the World Bank, were deeply involved alongside CSBF in preparing this draft law.

Macro-level weaknesses

Fragilities of the general environment. Despite progress made in key infrastructure, the macro-economic situation remains unstable. This has direct implications for microfinance and the

¹⁴ www.cgap.org/docs/KeyPrincMicrofinance_CG_eng.pdf

financial sector in general through the increase in the banks' leading rates and competition with Treasury bills. MFIs will sometimes invest in BTAs rather than extend credit, while inflation increases MFIs' operating costs. Finally, the devaluation of the ariary exceeding 30 percent in 2004 and 2005 had a negative impact on the repayment of MFI loans contracted in foreign exchange and on the purchase of imported goods necessary for activity (e.g., vehicles, information technology, etc.).

The structural fragility of agriculture is another problem with direct consequences for all microfinance stakeholders. Increasing agricultural output and productivity requires many different interventions. Financial investments are essential, but improvements in agricultural infrastructures and techniques, resolution of the land tenure problem, the organization of the rural world, and the processing, distribution, and marketing of agricultural products are also important to enhancing the productivity of Malagasy agriculture. However, there is a lack of cohesiveness, to which donors contribute, in agriculture financing policy: the need to increase output rapidly exerts pressure on MFIs to lend regardless of the risks and their lack of internal capacity. The need to act rapidly is often used to justify recourse to sub-standard microfinance practices, ultimately jeopardizing the sustainability of MFIs without doing anything to resolve the agriculture problem. By making MFIs more vulnerable, these measures may slow access to financial services by the poor.

Risk of market distortions from subsidies. With all the best intentions, donors use credit—sometimes by encouraging the subsidization of interest rates—out of a sense of urgency and because it seems simple to do so. They call on MFIs and their networks to channel funds directly to the people, in particular to increase agricultural production. Financial services then become tools for distributing subsidies. Unfortunately, the consequences of such operations are not always as positive as expected. Other more direct measures to boost production could have better outcomes (e.g., production techniques, improved seed, irrigation, price supports, etc.). Subsidized rates pose many risks for the Malagasy financial sector, because it

makes both the demand for and supply of credit in rural areas more fragile and also risks increasing inflation. (See the box below for additional details.)

Supervision by CSBF remains weak. The supervisory body is in place, but the team specialized in microfinance is still relatively small and resources are scarce. One consequence of this situation is that the process for examining and issuing licenses is time consuming. The law on microfinance has been approved, but the implementing decrees have yet to be issued. Some of the prudential rules and their application also must be brought in line with international standards. For example, several MFIs monitor their PAR only at the 90-day mark, which is too long to effectively assess the risk of short-term products, such as microcredits.

Questions about the involvement and role of MAEP in the financial sector. Donors are urging MAEP to play a role in providing financial services in rural areas, even though responsibility for microfinance is vested in MEFB. The financing of multisectoral projects through MAEP, though it is becoming less frequent, illustrates this practice. A June 2003 study on rural finance¹⁵ opens the door for MAEP involvement, even though the 2004 five-year plan for rural development does not mention it.

Ineffective legal system. The team was told of many instances of criminal activities (embezzlement) that went lightly punished or not punished at all. The slowness of court proceedings and their high costs (fees for mortgages), particularly regarding collateral collection, undermines the financial equilibrium of MFIs. More generally, the widespread absence of valid ownership deeds and other real guarantees poses a genuine obstacle to microfinance development.

Macro-level donor recommendations

Many donor interventions in areas other than the financial sector have a beneficial impact on microfinance. This is particularly applicable to

¹⁵ “Quelle politique de financement de l’agriculture?” [What is the best agricultural financing policy?], Directorate for Enhancing the Professionalism of Producers, Rural Finance Support Service.

infrastructure investments (e.g., roads, communications, and electricity).¹⁶ Specifically, donors can do the following:

1. Help the government maintain a favorable environment.

Support the government's efforts to maintain macroeconomic stability. The best way for donors to contribute to microfinance at the macro level is to help the government ensure macroeconomic stability. In cooperation with the IMF, donors can finance focused studies illustrating the linkage between economic stability and the development of the financial sector (including microfinance), perhaps making use of the results of the analysis of MFI costs and revenue streams. These studies could show the impact of inflation on MFIs and analyze the implications of a high Treasury bill rate on operations and on the supply of credit.

Support the reform of the legal system. The reform of the land tenure and legal system calls for long-term investments by donors. In addition to providing ongoing support for this reform, donors should devote particular attention to current issues, such as the preliminary draft law on guarantees with respect to collateral security and pledging or the National Land Tenure Plan.

Contribute to analysis of the tax system for the financial sector. Current law provides for sizable tax exemptions for cooperative MFIs¹⁷ that are subject to review under the new draft

law on cooperative and nonmutual institutions. If MEFB wishes to keep the exemptions in place, donors could help the government establish an equitable system adhering to principles such as (i) providing exemptions linked to activities rather than the status of MFIs; (ii) making exemptions transparent; (iii) ensuring exemptions are limited in time and declining; and (iv) clearly indicating that they are incentives. This system should guard against use by organizations that try to benefit from exemptions without providing microfinance services.¹⁸

2. Beware of subsidized rates.

Study and explain the risks of subsidization.

Interest rate rebates, as practiced in Madagascar, are similar to providing an interest rate subsidy to microfinance. It would be worthwhile to examine the results of the tests conducted in Madagascar and to share the lessons learned. The subsidization of client interest rates, even on a temporary basis, has been studied in several countries. Despite its attractiveness at first glance, this practice has often narrowed the microfinance market rather than broadened it, with an undesirable impact on poverty reduction.

Even though many wealthy countries (including France) have used or currently use interest rate subsidies to finance agriculture, the review team has found no examples of successes associated with such practices in developing countries. It is unlikely that the experience of wealthy countries in this area can be used as a model given the economic disparities involved. Donors should be the first to evaluate the risks of credit subsidization if they seek to advocate good practices vis-à-vis the government and MFIs.

More specifically, interest rate subsidization poses the following risks:

- The risk of confusion between credit and subsidy, leading to the likely increase in loan defaults, in particular as from the second cycle

¹⁶ One example is the Lax Alaotra region—one of Madagascar's "rice granaries" near Antananarivo, where two MFIs operate (OTIV and CECAM)—which has extremely poor connections to the capital city. In the dry season, when transport is the most favorable, it still takes three days by road from the Diana OTIV to Antananarivo. Within the regional networks, some offices are difficult to reach, as in the case of CECAM movement throughout Bongolava, Menabé, and Sofia, where that network has established regional unions that are extremely difficult to monitor.

¹⁷ Declining exemption from the business profits tax (IBS), featuring full exemption for five years followed by reductions (for years 5 through 10), exemptions from the professional tax, exemption from the VAT on interest charged on member deposits and loans, and exemptions from taxes and registration fees on asset components related to operation (see Chapter IV of the law on tax provisions).

¹⁸ See page 14 of the "Guiding Principles on Regulation and Supervision of Microfinance," available at www.cgap.org/docs/Guideline_RegSup.pdf.

- Problems with returning to applying market terms once the subsidy period has ended
- A higher risk customer base attracted by the subsidized rates
- Unfair competition with MFIs opting to use a real market rate

While the recovery of operating costs and financial costs needs to be included in the interest

rate, MFIs must increase their productivity and efficiency to improve their cost controls to benefit their clients. Instead of subsidizing interest rates, donors should subsidize the transformation of MFIs into more effective institutions, with more diversified services to better serve the rural population. They should also improve the dissemination of information on interest rates that are intended to cover MFI costs and expansion (see the box below).

Box 4. Subsidized Rates in Madagascar (“Bonification”)

How the mechanism works

The current agricultural investment credit system is subsidized as follows:

- MFIs that so request can offer their clients loans at subsidized rates (1 percent a month instead of the normal 3 percent).
- The subsidy is applied at the end of the loan and is subject to timely repayment and the proven increase in the profitability of the activity.
- The state—sometimes with donor subsidies—pays the difference to the client's account. For the MFI, the operation is transparent, because it collects the customary 3 percent interest.
- Supply is limited over time and intended solely to jump-start the financing of rural investment (e.g., the construction of village-level granaries or agricultural equipment).

Advantages

- Resource transfers to the rural sector
- Subsidization subject to a satisfactory payment history and improved productivity
- No short-term revenue loss for MFIs
- Limited cost to the state, because the offer is temporary (one year)

Drawbacks

- The rebate stemming from the subsidized rate (2 percent on the total loan cost) is negligible in comparison with farmers' total production costs and does nothing to address the fundamental problems of agricultural production.
 - While cost is relatively easy to calculate, benefits are difficult to quantify (initial findings show little evidence of agricultural product growth).
 - Clients forget the true cost of credit (even when informed of the exceptional nature of the subsidy). How will clients react when real rates resume?
 - To the extent that the money is fungible, a portion of the loans is probably used for purposes other than production (“windfall effect”).
 - MFIs that are not or refuse to be subsidized are at a disadvantage when competing with cut-rate prices.
 - There is little likelihood productivity will improve solely because of subsidization for such a short period.
 - Institutions that offer credit at market rates but are competing with artificial prices may be penalized.
 - There is a risk of inappropriate use of subsidies as “gifts,” which may induce favoritism for some clients.
- See the annex for some examples of the negative effects of subsidized rates.

Subsidization is contrary to SNMF

- The principles defined by SNMF (Chapter 5.2) and adopted by all Malagasy stakeholders are undermined by subsidies. In particular, the government's direct involvement in the loan and rate subsidy runs counter to principles of good practice.

3. Clarify the roles of the various stakeholders.

Donors must ensure that the programs they finance have a market orientation and distinguish between the roles of the private and public sectors. To this end, they could do the following:

Finance a seminar on the public sector's role in microfinance. Donors could follow the example of existing training modules on the role of government in microfinance¹⁹ to reaffirm the respective roles of the private sector (operational) and public sector (environment and regulation). This seminar could be used to disseminate the concepts already set forth in the context of SNMF.

Ensure that MEFB plays its proper role as the sole ministry in charge of microfinance. Donors should encourage the government to confirm MEFB's exclusive role in program design and day-to-day management. All microfinance activity, even when its components are part of programs managed by MAEP, should be supervised by MEFB. Moreover, donors should ensure that projects that include a financial component, whether in the urban, agricultural, or rural environment, incorporate the good practices of SNMF. Given the large number of coordination bodies²⁰ involved in microfinance, donors should focus their support on CNMF within MEFB.

Promote the National Coordinating Office as facilitator. Donors should help the National Coordinating Office establish the primacy of its responsibilities, such as adequate coordination and the dissemination of good practices, by

working closely with the steering committee as a whole vis-à-vis the government's decision-making entities, such as the National Assembly and the Senate, the Office of the President, etc. This facilitator role will also enable the private sector to offer financial and support services to MFIs, and CSBF to fully play its supervisory and regulatory role.

4. Build the capacity of CSBF.

Help establish an efficient supervisory organization. Donors should help CSBF improve the organization of its services, for example regarding issuing and examining licenses, centralizing data, training inspectors, and coordinating with the internal control personnel of MFIs and with audit firms. This could involve training, but also equipment, technical support, and so forth.

Support CSBF's human resources. CSBF needs to have an adequate number of trained staff to guarantee efficient supervision of MFIs, whose fragility is already evident, especially regarding governance. In particular, there is a need for a team of inspectors that can have a presence in the field. Donors could second an expert to CSBF to this end.

Support the drafting and dissemination of decrees and instructions on the new law. This urgent task requires focused technical support from donors. With the support of the World Bank, for example, CSBF could continue to take stock of worldwide experience and apply the lessons learned to the situation locally. Donors should encourage the government to adopt the relevant decrees and instructions promptly to avoid a legal vacuum.

¹⁹ Presentation No. 18 at

www.cgap.org/direct/resources/presentations.php.

²⁰ SNMF Steering Committee, National Coordinating Office, MAEP financial group, Rural Credit Support Activities Coordinating Office, Producer Professionalism Support Directorate, and Central Rural Finance Subgroup.

IV DONOR SYSTEMS

Analysis of the strengths and weaknesses at the micro, meso, and macro levels identifies specific recommendations for donor actions at each level of the financial system. Donors themselves have strengths and weaknesses in their operating systems that have an impact on their capacity to address the challenges highlighted in the preceding section.

Disbursements and Commitments of Major Donors in Madagascar		
Donor	Disbursements 2002–2004 (in millions of US\$)	Commitments 2005 (in millions of US\$)
World Bank—IDA	12 ²¹	4
AFD	4,8	?
IFAD	0,8	0,49
UNDP	1,2	0,8
USAID	0,15	0,1
European Commission	4,81	0,55
TOTAL	23,76	5,94

For 1€ = 1,3 US\$

As well as other smaller donors (details in the annex).

Donor System Strengths

1. Solid capacity for collaborative action and mobilization

Commitment to the national strategy. Donors collaborated in SNMF and have adopted it. Donors are active participants in the steering committee, which also includes the private sector and the government (AFD, UNDP, Swiss Cooperation, with USAID, the World Bank, and the EU as alternates), and also take part in the round tables organized by the committee on a regular basis.

Cooperation on joint financing. Donor coordination goes well beyond meetings and strategy agreements. For example, there is parallel European Commission financing for CECAM,

ILO/BMZ financing for the APIFM, Microstart UNDP/AGEPMF financing for TIAVO and the OTIVs, and AFD, EC and UNDP (Microstart) financing for Vola Mahasoia. This kind of cooperation is frequently the best way for donors to make the best of their comparative advantages, as demonstrated by the cooperation between AFD and EC. The sizable financing from EC supplements that of AFD, which has strong internal technical capacities both on site and at its head office.

Cooperation on individual problems. Donors have met to adopt a common stance on questioning the RDSP program, said to compete with MFIs with direct subsidies to the people. This type of cooperation is essential if donors are to respect a code of good practices and steer clear of contradictions between programs, as is the case with RDSP.

2. Movement from a “project” approach toward institution building

Donors tend to support existing MFIs rather than putting projects together from scratch. In addition, fewer and fewer projects have credit components. This has a positive effect on building MFIs, in that such components rarely have suitable technical support and hence have low success rates.

3. Sensitivity to conditions in Madagascar

Donors are trying to understand the special features of the situation in Madagascar and are trying to adapt their interventions to it. Within donor structures themselves, the team noted significant involvement of Malagasy staff, in particular in the representative positions.

Donor system weaknesses

1. Lack of a clear vision

Because of the lack of strategic clarity with regard to the definition of microfinance and related good practices, it is extremely difficult for a development agency to adopt a cohesive approach to microfinance. In Madagascar, despite efforts regarding the national strategy, donor approaches have tended to diverge rather

²¹ Disbursements 2002–2005, not including RDSP.

than complement one another. The absence of a cohesive common vision may be explained by the factors cited below.

Uncertainties regarding donor ownership of the national strategy. There is no clear sense that all donors have assimilated the guiding principles of the National Microfinance Strategy. Notwithstanding the participatory nature of the drafting process, the key messages seem not to have been imparted and are not used as a common starting point. Thus, although the strategy has been adopted, donors do not appear to be working toward implementing an action plan.

The dual approach of financial support for agricultural production and the development of microfinance. The lack of communication between agronomists and financial specialists within donors partly explains this problem, discussed previously in the macro-level section of this report. In addition, there is a shortage of personnel with training or professional experience in finance and economics. The team identified only two individuals with economic or financial training among the donor staff responsible for managing microfinance programs.

Confusion between credit and subsidization. Donors sometimes mix subsidies—which are resource transfers—with loans for clients. The upshot is unfair competition between subsidies and credit in the same areas, sometimes at the initiative of the same donor. For example, the team found that one MFI is proposing loans for inputs that RDSP is distributing free. This confusion extends to the problem of interest rate subsidies, resulting in clients having difficulty distinguishing between what is owed and what has been given to them.

Absence of exit and backup strategies. Donor exit strategies are not always clearly defined. As a result, some donors, such as the World Bank through DID in the context of OTIV support, frequently have been accused of lacking vision on disengagement. Conversely, and with negative consequences, some other donors withdraw prematurely (AECA) and/or on a poorly planned basis (Microstart).

2. Inappropriate selection and management of operators

Operator selection and monitoring are essential to ensure the sustainability of MFIs:

Absence of transparency in contract awards. Some MFIs have observed that competitive bidding procedures and requests for proposals are not open to a sufficient number of candidates and that there is a lack of transparency in the selection process. According to several individuals interviewed, the terms of reference for bidding sometimes appear to have been drafted specifically by and for particular candidates preselected by donors. This practice creates virtual monopolies, with repercussions on the quality of bids and the accountability for results.

Unpredictable use of performance-based contracts. Contracts are often based on a fixed period rather than on the results to be achieved. Contract objectives are not clearly defined (in quantitative and qualitative terms). They do not include incentives for achieving good results, such as improving efficiency or skills transfer. Finally, poor outcomes and failure to achieve objectives are rarely penalized.

Insufficient insistence on skills transfer in contracts. Given the pressing need to ensure the sustainability of Malagasy MFIs, donors are not sufficiently stressing skills transfer in their contracts.

3. Weak knowledge management

When knowledge is properly capitalized and shared, donors can take lessons learned into account when designing new programs.

Insufficient knowledge for managing practitioners and consultants. While many donors work through practitioners, it is the donors who are ultimately responsible for ensuring the quality of services rendered. Management of practitioners requires a minimum amount of technical know-how and knowledge of the situation on the ground. In Madagascar, only rarely do donors have the internal technical capacity in microfinance needed to guide, orient, or take control of their programs. Frequent staff turnover accentuates this problem.

Lack of transparency for properly measuring outcomes. Donors rarely establish clear indicators for evaluating results in their contracts with their partners (i.e., practitioners, executing agencies, and MFIs). Key performance indicators not only make it possible to manage financing in light of outcomes, but also permit internal and external communication on the results of each initiative.

4. Inadequate “loan to government” instrument for microfinance

The financing instruments for microfinance are similar to the instruments needed for the financing of the private sector (e.g., grants in technical assistance, guarantees, and loans). They need to be flexible, adapted to the market, and often relatively small. In Madagascar, the main instrument used by the largest multilateral donors (WB, EU, IFAD, and AfDB) is the loan to the government. This raises several constraints:

Inappropriate cooperation with the government. Passage through the government raises a concern because microfinance is targeted for the private sector. Very few loans to the government are intended exclusively for microfinance or even the financial sector. Consequently, donors incorporate amounts for microfinance in larger projects, as in rural development programs, for example. This practice runs the risk of giving an operational role to the government, which is above all responsible for the policy, economic, and legal framework. Making ministries other than MEFB responsible for executing projects or credit components aggravates this problem.

Pressure to disburse. Donors are often pressured by unrealistic disbursement objectives. Rapid and excessively sizable disbursement is dangerous for the viability of MFIs and the market. When external financing exceeds absorptive capacity, it can pollute the microfinance environment and promote unfortunate practices on the part of clients, or even disrupt the financial market in the long term.

Counterproductive credit components. Donors sometimes build lines of credit into larger

projects through credit components, for example in the rural development programs financed by AfDB, FIDA, or the World Bank. Credit components pose difficulties for sustainability, to the extent that they frequently lack specialized technical assistance or target a population that may not have the capacity to manage a debt. Moreover, the choice of executing agency becomes more sensitive because the credit components may then become the responsibility of officials who have no knowledge of the financial sector.

Cumbersome and slow procedures that penalize MFIs. MFIs are particularly penalized by the failure to observe certain commitments, especially by delays in donor funds disbursement. One can well imagine the disastrous consequences of delayed disbursement for an MFI that is counting on this money to pass on to its clients.

5. Challenges for donor coordination

The word “coordination” comes up often in discussions on aid effectiveness. Coordination refers not to large meetings with many presentations, but rather to the manner in which donor objectives and interventions are aligned to provide maximum support to the country concerned.

Limited representation of donors on the SNMF steering committee. Donors are represented on the steering committee by AFD, UNDP, and Swiss Cooperation. With the exception of AFD, these are not among the largest donors in terms of amounts allocated or experience in the microfinance sector. The World Bank, the EU, and USAID are only alternates. While this structure was established out of a concern for easing the burden, it also creates the danger of lesser involvement on the part of some donors and the risk that a large donor may not be “playing along.”

Lack of a lead donor. While the strong desire of donors to shift the leadership of coordination efforts to the government is understandable, it decreases multidonor cooperation. Donors seem more focused on their individual problems and less disposed to seek a collective approach.

Since the voluntary dissolution of SMB,²² there is no longer an official forum for donors or a single spokesperson, which weakens the message they might convey and the timeliness with which common solutions can be found for improving aid efficiency and resolving their problems.

Donor Systems Recommendations

The fragility of Malagasy microfinance requires prolonged intervention by donors. This support should be reflected not only in new programs, but also in improved management of these programs. To achieve this, donors have to work “differently.” As a consortium of 33 donors, CGAP is available to help its members in Madagascar implement the recommendations.

1. Ensure that staff are qualified in finance

Donors that are heavily engaged in microfinance should have at least one staff member trained in microfinance or finance. A minimum option would be to train the individual with responsibility in this area. A more sustainable and less costly solution would be for donors that wish to remain involved to recruit and train Malagasy personnel. This would also permit greater capitalization and improve knowledge management.

2. Apply the key principles of the national strategy

Prepare a simple listing of key principles. To make the national strategy operational, donors should create a brief document that summarizes the vision of SNMF, its key principles, and the roles of the various stakeholders.

Internalize the key principles. These principles should be disseminated among donors and upheld at all levels. To this end, donor staff could be trained with field visits and periodic presentations on technical topics. Online course

modules for donors (DIRECT)²³ could be used. Donors should ensure the dissemination of the Key Principles of Microfinance summarized in SNMF (p. 35) and the Donor Guidelines on Good Practice in Microfinance recently endorsed by donors.²⁴

Make donors accountable. Donors should establish a system for ensuring that operations conform with the key principles of SNMF. Such a system might include positive incentives (e.g., a prize for the donor who best applies good practices) and should also establish methods for admonishing donors who fail to observe them (a “red card”). This task could be assigned to a subgroup of donors that would submit its project for approval by the steering committee for the national strategy.

3. Steer all interventions toward promoting sustainability.

The role of donors is to stimulate the private sector, not to replace it. Subsidies should not be permanent, and the way they are used should evolve. Experience worldwide shows that MFIs can effectively be made sustainable. Figures from the MIX bear this out: In 2003, 66 of the 124 MFIs registered had attained operational self-sufficiency. To make Malagasy MFIs sustainable, donors should do the following:

- Promote *institutional sustainability* from the outset through a business plan that includes an exit strategy and makes managers accountable. Donors should make their financing conditional on the achievement of the stages of sustainability.
- Maximize *skills transfers*. Such transfers should occur in all technical, commercial, and administrative areas, from the report to clients to the report to the financial system, and including the MIS, the accounting system, and human resources management.
- Give MFIs incentives to make immediate use of market sources of *financing*, using subsidies for leverage and not as the only resource.

²² Donors formed a group in 1997, with an operational arm known as the Multidonor Secretariat (SMB), that held regular meetings and maintained a Web site. In December 2003, the microfinance group of the Donor Group dissolved and integrated the National Coordinating Office for Microfinance (CNMF). Donors are members of the Steering Committee of National Microfinance Strategy (SNMF).

²³ www.cgap.org/direct

²⁴ www.cgap.org/donorguidelines

4. Strengthen performance-based management with service providers.

Give preference to requests for proposals over calls for bids. Requests for proposals define a broad objective and allow candidates to prepare a proposal more freely, whereas a call for bids tends to set rules that adhere to a contract methodology and specific contract objectives, such as to offer credit to a given population group. Requests for proposals allow greater scope for innovation and open the contract to a more diverse range of bids. Requests for proposals also may help prevent instances of terms of reference being tailored specifically for certain practitioners, which restricts the market at the outset.

Allow MFIs to select their own service providers. To enhance transparency and increase the accountability of MFIs and technical services providers, donors could allow MFIs to enter into contracts directly with their technical service providers. Funds could be transferred to MFIs, which would select their technical service provider from a sufficiently broad list pre-approved by the donor. To enhance MFI preparedness, donors could train them in selecting and drawing up contracts with providers.

5. Adapt the tools and interventions systems to the needs of microfinance.

Subsidize good MFIs, not interest rates. When properly managed, direct subsidies to institutions can strengthen their effectiveness and competitiveness. It is important to select MFIs that have the capacity and the will to develop while maintaining efficiency and seeking financial sustainability. These direct subsidies to MFIs must be targeted, declining in amount, limited in time, and performance based. They will exist only as long as there is no reasonable alternative in the private sector and will always entail a strategy for being replaced by loans or equity investments.

To go beyond subsidizing interest rates, which has negative effects for microfinance, donors could promote a reduction in interest rates by promoting competition and by giving MFIs incentives to reduce their operating costs while adopting greater transparency about their interest rates. This said, owing to transaction

costs, the rates charged by MFIs will always be higher than the rates on “traditional” bank loans.

Use MEFB as a conduit in the event of financing through the government. Donors who are obliged to finance all their programs or credit components through the government should work through MEFB.

Avoid pressures to disburse. Budgets should be limited to the absorptive capacity of MFIs, that is, their capacity to develop in a sound manner without jeopardizing their sustainability. If the amounts of funding are too large, donors should reallocate them to other sectors.

6. Reactivate coordination.

Donors have a number of challenges to meet that depend on them alone. For example, most of the recommendations on donor systems do not require government participation.

Enlarge and energize the donor subgroup of the SNMF Steering Committee. Increased donor coordination could be brought about on the basis of the donor subgroup already in place within the committee. It will be necessary to include new arrivals, such as MCA and AfDB.

Ensure that coordination is operational. Create a group of technical specialists or direct managers of microfinance within the subgroup to focus coordination efforts on specific issues, such as the adoption of key performance indicators or the harmonization of disclosure standards. In addition, this subgroup could work in cooperation with agricultural subgroups to discuss agricultural financing. The technical specialists group could also work on follow-up on the CLEAR recommendations and discussions on subsidized rates. Because different donors have varying levels of expertise in microfinance, these meetings will serve as a venue for the exchange of skills. In turn, agency heads could intervene at strategic moments in the decision-making process.

Encourage joint initiatives. Donors should increase focused cooperation efforts in microfinance, taking successful experiences into account. For example, donors could cofinance the multi-donor fund (see the meso-level recommendation) and cofinance MFIs. This should make the most of the comparative advantages of each donor.

Box 5. Factors Behind Good Donor Collaboration

In the course of its experience with donor operations and collaboration, CGAP has updated the essential elements for ensuring success: individuals, the common interest, and instruments (the three “I”s). Donors, of course, do not operate in a vacuum, and collaboration with the government and with practitioners is critical.

The individuals involved

- The involvement of personnel with **technical skills** allows for richer discussion focused on concrete initiatives.
- There must be a **critical mass** of individuals committed to participating collaboratively, which is not always easy for donors that have a sizable number of different projects.
- The **local presence** of donors is essential in order to have frequent and informal contact on site, the core component of vibrant collaboration.
- The **presence of decision-makers at key moments** makes the collaboration functional and more efficient.
- **“Champions”** on each initiative are essential for transforming hopes into realities.

A common interest in collaboration

- **Clarity of the goal** pursued is essential for focusing attention and ensuring the participation of all.
- The **common interest** must be shared, and all must be cognizant of the advantages that can stem from collaboration in the work of their organization.
- **Prior knowledge** of the subject by participants is essential, even if advance training for some may be required.

The Instruments of collaboration

- A **minimum structure** is necessary for sustainable collaboration, though informal contacts continue to be vital.
- Always preserve **transparency** in operations, decision-making, follow-up, and ensuring stakeholder accountability.

ANNEX 1—SUMMARY OF FINANCIAL SYSTEM WEAKNESSES, DONOR RECOMMENDATIONS, AND ESSENTIAL PREREQUISITES

LEVEL	WEAKNESSES	DONOR RECOMMENDATIONS	ESSENTIAL PREREQUISITES FOR EFFECTIVE DONOR ACTION
MICRO	<ul style="list-style-type: none"> Structural fragility of MFIs (governance, portfolio management, internal systems and controls, human resources, financial sustainability) Supply not fully meeting demand 	<ul style="list-style-type: none"> Help the MFIs reduce their fragility Help the MFIs better adapt their services Promote diversification of institutions and approaches 	<ul style="list-style-type: none"> Internal expertise in microfinance Performance-based project management (contracts by objectives, requests for proposals). Vision of sustainability with skills transfers and exit strategies. Transparency in contract awards and delegation of selection to the MFIs. Products and financing suitably adapted (in terms of objectives and amounts).
MESO	<ul style="list-style-type: none"> Fragility of services provided to MFIs •Current limitations of the professional associations •Unavailability and unreliability of information 	<ul style="list-style-type: none"> Improve investment in training Establish multidonor funds that are freely accessible for technical support Promote MFI transparency Encourage and support the merger of the two professional associations Promote a sustainable refinancing system for MFIs 	<ul style="list-style-type: none"> Vision of sustainability through integration of microfinance into the financial sector. Subsidies directly to the private sector for support. Flexibility in the use of products. Capacity to share resources (pooling of tools).
MACRO	<ul style="list-style-type: none"> Fragility of general environment Risk of market distortions because of subsidies Supervision by the CSBF remains weak Questionable involvement of MAEP in microfinance Ineffective legal system 	<ul style="list-style-type: none"> Help the government maintain a favorable environment Beware of subsidized rates Clarify the roles of various stakeholders Build the capacity of the CSBF (staffing, training) 	<ul style="list-style-type: none"> Internalization of the key principles for good practices in the National Strategy. Reopening of a donors' forum. Better representation within the SNMF. Active and operational cooperation between and among donors. Creation of a lead donor status to improve leadership and ensure more effective lobbying.
DONOR SYSTEMS	<ul style="list-style-type: none"> Lack of a clear vision Selection and management of inappropriate operators Inadequate knowledge management Inadequate "loan to government" instrument for microfinance Challenges for donor coordination 	<ul style="list-style-type: none"> Ensure that staff are qualified in microfinance Apply the key principles of good practices from the National Strategy Steer all interventions toward promoting sustainability Strengthen performance-based management with service providers Adapt the tools and interventions systems to the needs of microfinance Reactivate coordination efforts 	

ANNEX 2—THE RISKS OF SUBSIDIES AND SUBSIDIZED INTEREST RATES—some examples

Public authorities often opt to intervene in certain markets by subsidizing or otherwise underwriting lending rates to reach a target group of poor clients or to boost agricultural output. While the objectives pursued are frequently laudable, methods involving rate subsidies entail a high cost for the entities offering the subsidies, even as they have little influence on production, and they often lead to deterioration in the supply of long-term financial services to the targeted groups. The experiences below illustrate several problems that can arise because of these methods and invite the reader to consider the high costs of subsidization in relation to its benefits.

Uganda: Subsidized government programs—the Entandikwa Credit Scheme (ECS) and the Poverty Alleviation Programme (PAP). In Uganda, the government introduced subsidized credit programs focused on the rural poor. The two most developed programs (ECS and PAP) offer credit for rural investment at subsidized rates. The repayment rates range from 20 percent to 80 percent. “Subsidized credit attracts non-poor borrowers and encourages default. [It] should, therefore be [...] avoided.” *Source:* ILO/UNHCR Technical Workshops. See www.ilo.org/public/english/employment/finance/workshop/execsum.htm.

Vietnam: Subsidized rates slow the development of microfinance: Microcredit subsidies have created market distortions. These restrictions on interest rates constrain risk taking in microfinance and cast doubt on the viability of microfinance programs. *Source:* Asian Development Bank, 1999, Gilberto Llanto. See www.adb.org/documents/books/central_banks_microfinance/country_studies/vietnam.pdf.

India: Integrated Rural Development Program (IRDP): In the 1980s, the Indian government introduced a set of targeted subsidized financing programs, including IRDP. The latter experienced the three classic problems of subsidized lending mechanisms: the diversion of funds to benefit those more well off, a low recovery rate, and the impossibility of operating without sizable subsidies. The recovery rate on the amounts lent by IRDP ranges from 10 percent to 55 percent. A 1993 study on rural finance identified widespread embezzlement of loans and a lack of awareness of repayment terms on the part of borrowers. In contrast, the main Indian MFIs (Share and BASIX) have repayment rates approaching 100 percent. The foregoing study also found that the total cost assumed by clients under IRDP ranged from 26 percent to 38 percent when transaction costs (including bribes) are considered. Other studies have shown that IRDP tends to favor rural population groups that are better-off, rather than the poorest groups. *Sources:* Mahajan and Ramola, “Financial Services for the Rural Poor,” World Bank, Microfinance in India; and 2002 data from MIX Market.

Thailand: Loans at preferential rates go to those who know the agricultural extension agents. The case of BAAC in Thailand shows that subsidized credit does not benefit the population groups for which it was intended. A 1996 study by the Thai Development Research Institute shows that such loans instead go to producers who know the agricultural promotion agents or lending representatives. *Source:* GTZ, Marie Louise Haberberger.

Tunisia: In Tunisia, the Banque Tunisienne de Solidarité functions as part of a subsidized mechanism that applies an annual interest rate of 5 percent, a level below that required to ensure cost recovery. Consequently, the bank must systematically turn to the state for subsidies to be able to survive. *Sources:* Interview with Michael Cracknell, CGAP Occasional Paper No. 9, September 2004.

ANNEX 3—DONOR FUNDING ALLOCATED TO MICROFINANCE IN 2002–2004, AND 2005 COMMITMENTS

Estimated amounts in millions of U.S. dollars

Donor	Disbursed 2002–2004	Committed 2005	Planned 2006–2007	Projects 1999–2005
AFD	4.8		1.3	13
European Commission	4.81	0.55	1.3	9.07
WB (excl. RDSP)	12	4		16.4
IFAD	0.8	0.49	1.5	2.5
UNDP	1.2	0.8	2	2.9
USAID	0.15	0.1		3
Japan	0.04			0.03
MCA		2.5	2.6	2.53
Swiss Cooperation	0.03	0.02		
ILO/BMZ				1.25
GTZ				0.39
AfDB				1
Total	23.83	8.46	8.7	52.07

For 1€ = 1.3 US\$

ANNEX 4—DONOR ACTIVITIES

AREAS OF ACTIVITY	AFD	AfDB	WB	IFAD	GTZ	Japan	MCA	Switzerland	UNDP	EC	USAID
MACRO	X		X	X			X		X		
MESO			X	X			X		X		
MICRO	X	X	X	X	X	X	X	X	X	X	X
Institution building	X		X	X			X		X	X	X
Credit funding		X	X	X							
MFIs				X	X	X	X	X	X	X	
Commercial banks									X		
State-owned banks (CEM, postal system)							X				X
Savings and loan cooperatives			X	X	X		X	X	X	X	
Credit component of development projects		X	X	X					X		
Capital subsidies (and investment subsidies)	X	X	X	X					X	X	
Subsidies for technical assistance	X	X	X	X		X	X				X
Portfolio refinancing loans	in euros		X	X					X		
Technical assistance loans	in euros						X				
Lending to the government		X	X	X							
Capital endowments	X										
Bank guarantees, specifying local currency or foreign exchange (for MFI refinancing)	local currency								X		
Other	Subordinated lending					NGO grants				State subsidy on-lent in MFI loans	
Local staff with expertise in microfinance (acc. to donor)	3	0	0	0	0	0	1 to 2 pending	3	3 incl. 2 project	0	1

ANNEX 5—DONOR MICROFINANCE PORTFOLIO

In millions of U.S. dollars

(unless otherwise indicated)

AREAS OF ACTIVITY	AFD	AfDB	ILO/BMZ	WB	IFAD	GTZ	Japan	MCA	Switzerland	UNDP	EC	USAID
Microfinance budgets 1999-2005	10 (euros)	1	1.25	16.4	2.5	0.3 (euros)	0.03 (euros)		0.036 (CHF)	2.9	7 (euros)	3
Microfinance disbursements 2002-2004 (microfinance + credit component of integrated projects)	4 (euros)		1.25	12	0.8		0.03		0.030	1.2	3.7 (euros)	0.15
Integrated projects with credit component (completed or current)		1			4				0.0 15 (CHF)	0.5	0.075 (euros)	0.3
Microfinance commitments 2005 (microfinance + credit component of projects)				3	0.5			2.53	0.021	0.8	0.420 (euros)	0.10
Later planned commitments	1.3			1.3	1.5			5 (*)		2	5 (euros)	

For 1€ = 1.3 US\$

(*) US\$32 million for the financial sector as a whole.

ANNEX 6—SUMMARY OF PROJECTS

MICRO LEVEL

Support for MFIs:

- AFD supported and continues to support 3 MFIs (€10 million): ADEFI Phases 1 and 2 maturing end-2006, CECAM maturing 2005/2006, Vola Mahasoia phases 1 and 2 maturing 2006. Investment and operating subsidies, Credit Fund for professionalization, autonomy building, and institutionalization of networks.
- EU supports or has supported several MFIs (in the amount of about €7 million), principally the CECAM and Vola Mahasoia networks.
- WB/AGEOMF has, since 2000, supported five cooperative networks (OTIV Toamasina, Lac Alaotra, Antananarivo, Diana, and the TIAVO network) in an overall program amounting to US\$ 16.6 million.
- Japanese Cooperation helped create 4 savings and loan banks (Inter-Aides/CEFOR) in poor districts of Antananarivo.
- MCA will be supporting the expansion and development of MFIs in five geographical areas under a program in the amount of US\$ 5 million (CECAM in particular).
- UNDP supported the Microstart program in the amount of US\$ 1.61 million (credit for education savings of poor women to assist with its introduction in several MFIs). It worked with CIDR to help with the start-up of the Ambato Boeni network.

Swiss Cooperation is assisting the SAHA NGO.

- Support for credit components of Integrated Development Projects:
- AfDB is supporting two programs with credit components: Young Rural Entrepreneurs (total program of UA 7,350,000 of which UA 520,000 in credit lines) and the Project to Rehabilitate the Bas Mangoky Perimeter (total commitments: UA 10 million of which UA 290,000 in credit components) conducted with CIDR.
- IFAD is supporting three programs with credit components: Agricultural Improvement and Development Project in the Northeast (PADANE, 1997–2005) entrusted to OTIV SAVA; the Project to Improve the Upper Mandrare Watershed, Phase II (PHBM 2004–2007) with ICAR; and the Program to Promote Rural Incomes (PPRR: 2005–2012).
- UNDP is supporting a microfinance component under RPPMED (poverty reduction program), which provides lines of credit to MFIs (TIAVO, Haingonala, CECAM); UNDP is supporting a Job Creation and Income Boosting Component through a credit fund in the amount of US\$ 500,000.
- EU is supporting food security programs with NGOs, for microcredit of €75,000 (GRET, CARE, ICCO).
- USAID is supporting a credit component of US\$ 300,000 under the BAMEX program.

Support for authorized financial institutions:

- USAID has supported the Caisse d'Epargne de Madagascar (CEM).
- MCA is supporting CEM.

Support to commercial banks

- BOA is involved in direct microfinance with small farmer groups.
- AFD: proposing a guarantee fund (ARIZ) that counter guarantees banks up to 75 percent for the refinancing of MFIs (for example, CECAM by BNI).
- UNDP/UNCDF: Microfinance Support Program (MSP) supported the development of business relations between banks and MFIs with a UNCDF guarantee fund for the refinancing of MFIs (BOA), benefiting five MFIs in the amount of FMG 20 billion (MGA 4 billion).

Support for cooperatives and savings and loan banks

- AFD (CECAM), WB/AGEPMF (4 OTIV and TIAVO networks), FIDA (OTIV SAVA) are supporting networks of cooperative institutions.
- CIDA/DID is supporting OTIV cooperative networks and a project to create a federation of OTIVs.
- GTZ has supported two CECAMs and UNICECAM.
- ILO/BMZ has supported UNICECAM Antsirabe.

Commercial bank investments in MFIs

- BNI is a 15 percent shareholder in SIPEM.
- BOA, BFV, and BMOI are also SIPEM shareholders.
- BNI might invest in the central financial institution for CECAMs.
- BFV, BNI, and BMOI may be interested in investing in the capital of a new ADEFI financial institution.

Investors/shareholders in support of MFIs

- SIDI (international NGO) is a shareholder in SIPEM.
- GEM (Malagasy enterprise group) is a shareholder in SIPEM and APEM, and APEM supports Vola Mahaso.
- Patrice Hoppenot (investor and partner) is a shareholder in ADEFI.
- AFD will provide quasi-capital (subordinated debt) to MFIs in the context of its microfinance “investment facility.”
- An investment company owned by Crédit Agricole France (3 CRCA Reims, La Réunion, Centre Loire) will provide capital to the central financial institution of the CECAMs.
- ICAR is investing in the central financial institution of the CECAMs and is expected to invest in a MFI in the south (PHBM program).
- QMMM (Canadian mines) has been invited to invest in the PHBM program.
- The Aga Khan group is expected to invest in private MFIs to be established (in the West and South of Madagascar).
- Public companies (ARO, CEM) are expected to provide capital to the central financial institution of the CECAMs.

MESO LEVEL***Capacity building: Training (completed or underway)***

- WB (AGEPMF) is disseminating, through local and international consultants, eight major training modules in microfinance for local offices, supervisors, and paid technical specialists of MFIs (microcredit demand analysis, internal audit and control, credit disputes and collection, MFI marketing/development, application of the chart of accounts, personnel management, good governance, management, and administration of microfinance units). The training also applies to senior personnel of cooperative institutions.
- APIFM disseminates seven CAPAF/CGAP course modules via local consultants: training the trainers (basic principles of MFI accounting, quantification and control of arrears/calculation and setting of interest rates, financial analysis, development plan and financial projections with Microfin, management information systems, management of operating risks, and development of new products).
- INSCAE is proposing a master's degree in "Cooperative Financial Institutions and Banking."

Advocates for the sector

- Existence of two professional associations, for cooperative institutions (APIFM) and nonmutual institutions (AIM), that are expected to merge under the new regulations.
- ILO/BMZ has supported the creation and launch of the APIFM.

Refinancing

- Several commercial banks (BOA, BNI, BFV) are refinancing MFIs (CECAM, AECA, ADEFI, OTIV Lac Alaotra) in the amount of MGA 4 billion–6 billion.
- AFD is providing a guarantee (ARIZ guarantee fund) to commercial banks that refinance microfinance.
- UNDP's Microfinance Support Program provided a guarantee fund to commercial banks for refinancing MFIs.
- EU provided a subsidy to the government, which is onlent as a concessional loan (40 year term, 10 year grace period, 1 percent rate).

Accounting reform and audits

- MCA plans to support training programs in accounting and management, the creation of management centers for small entrepreneur capacity building, and to provide small entrepreneurs with access to credit.
- MPA and CGA audit firms are involved in supporting MFIs and creating an offer adapted to this customer base.
- CGAP/CAPAF training of auditors.

MIS

The ORCHID firm is the national software supplier for Vola Mahaso, SIPEM, and TIAVO (under study).

Institutional rating and evaluation

- HORUS has conducted institutional evaluations (OTIV Toamasina and Lac Alaotra, Antananarivo, TIAVO) for AGEPMF.
- UNDP/UNCDF conducted the institutional audit of its four programs in 2002 with HORUS.

Other

- MCA is expected to support the improvement of payment circuits (check encashment, reform of the BTA system for improved access by the public).
- MCA is expected to support the creation of the credit information bureau.
- HORUS developed the strategic plan for CECAMs 2001–2005.

MACRO LEVEL

Regulation and supervision

- AFD: support to the CSBF for improving microfinance regulation in the context of the institutional support program for the CECAM network.
- WB: AGEPMF. Microfinance Project 3217, MAG. Legal and regulatory aspects for micro-finance (strengthening legal framework, strengthening of the CSBF's internal supervision capacity).

Advice on national strategies and policies

- IFAD is supporting the strengthening of the institutions and structures implementing national policies (CNMF, APIFM, CP SNMF); budget of US\$150,000 usable as needs dictate. MCA will support SNMF implementation.
- MCA will support the financial system modernization plan (computerization of land registry) and engage in activities relating to the financial sector (total budget of US\$110 million of which US\$32 million is for the financial sector).
- UNDP will support SNMF implementation (budget of US\$2 million).

ANNEX 7—LIST OF PERSONS CONSULTED

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We apologize for any changes in addresses or titles which may have occurred since the CLEAR.

ANNEX 8—LIST OF DOCUMENTS CONSULTED

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