POLICY FOR FINANCIAL SECTOR DEVELOPMENT

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CONTENT

SUMMARY

FINANCIAL SECTOR: FUNCTION AND RELEVANCE

The financial sector of a country comprises all individual and institutional players in the financial market, both on the supply and on the demand side, along with the market's legislative and regulatory framework. Well-functioning financial markets are an essential factor facilitating the generation of income, employment and asset building by small enterprises, farmers and poor households (notably women). Such financial markets can contribute to SDC's efforts to alleviate poverty effectively, provided that SDC's target groups are also able to access essential 'non-financial' services like education, health, physical infrastructure, market information, etc. Still, only a small proportion of the economically active, yet poor population in developing countries has access to formal financial services. The key development role of the international community is therefore to facilitate the rapid outreach of institutional financial services to large numbers of poor people.

SDC FINANCIAL SECTOR POLICY: RATIONALE, GOAL AND STRATEGIC ORIENTATION

The policy offers strategic guidance to SDC decision-makers at head office and the cooperation offices, executing Swiss, international and national agencies, and consultants so as to ensure coherent and effective financial sector development (FSD) projects. It also guides SDC positions in multilateral organisations. Guidelines, tools and other instruments supplement it.

SDC supports its partners in their development, while aiming at sustainability and maximum depth and breath of outreach (access), by strengthening financial sectors at four levels:

- **Demand side:** helping clients in strengthening their social capital and financial literacy, and thus their bargaining position, so as to facilitate their access to institutional financial services.

- **Supply side:** supporting financial institutions that have the potential to significantly expand their services to SDC's target groups on a cost-covering basis and share the development vision in becoming viable institutions to maximise their breath and depth of outreach.

- **Infrastructure:** supporting networks and associations of financial institutions, training institutions, rating agencies, credit bureaus, auditors, transfer and payment systems, information-technology and technical-assistance providers, etc., so as to strengthen FSD.

- **Policy, regulatory, and supervisory framework:** supporting regulatory and supervisory institutions and financial sector reform where framework conditions impede FSD.

SDC gives priority to rural areas and to capacity development in its FSD projects, and intervenes particularly at the first three levels mentioned above.

SDC FINANCIAL SECTOR POLICY: OPERATIONAL PRINCIPLES AND INSTRUMENTS

Demand-side measures

- SDC does not intervene directly on behalf of its target groups, but through dedicated and skilled support organizations (e.g. member-based associations, self-help groups) that help the target groups to empower themselves through the choice and effective use of diverse, client-friendly and reliable financial services.

- Realizing synergies with other development programmes, notably in the fields of small enterprise development and rural development. Very poor people in particular can only use financial services effectively in combination with access to essential 'non-financial' services.

Supply-side measures

- Support is provided to financial institutions with a clear vision of providing SDC's target groups with lasting access to financial services that are financially and institutionally viable or have a clear plan to reach such status. Revolving credit funds should thus generally be avoided, as they tend to fail to cover costs, have a limited client outreach, and face a trade-off in pursuing a mix of a wide range of social, economic and project-specific objectives.

SUMMARY

• Application of "good practice" management and a "client first" attitude that appropriately addresses the needs of the clients. Particular attention is paid to savings mobilization as a client service and with respect to a healthy liability structure including savings deposits.

• Considering the lack of banks catering to poor rural clients, the **'up-scaling'** approach is still very relevant in the South. Microfinance service providers with a vision and potential for economic viability and large-scale outreach are strengthened, thereby leading to their potential transformation into regulated institutions. SDC may offer them capacity development, technical assistance, risk capital instruments (e.g. grants or guarantees) and facilitated access to domestic capital markets or to international social investors so as to improve their governance and financial leverage.

• This **'linkage'** approach of bringing self-help groups, their associations, or other types of semi-formal financial service providers together with formal financial institutions (strategic alliances) helps reduce both risks and financial transaction costs. SDC may facilitate linkage processes through institution building of self-help groups and their associations on the one side, and that of financial institutions on the other side. It may underwrite risks by guaranteeing the financial institutions a percentage of their loan portfolio.

• The **'greenfield'** approach of creating new financial institutions is only justified where no institutions are present or existing ones are not willing to extend their services to SDC's target groups in a financially and institutionally sustainable manner. It normally requires long-term support and high capital outlays. SDC may cover part of the start-up costs and facilitate the access to (social) investors.

• The **'down-scaling'** approach can be a promising strategy, particularly in small enterprise finance and in more mature financial markets where significant bank branch networks exist (e.g. in Eastern Europe). The commitment and strategies of banks to target small enterprises and/or poorer market segments is essential for down-scaling. Support to fully operational banks to deepen outreach to SDC's target groups on a long-term, profitable basis may cover technical assistance, training and access to long-term refinancing sources.

• In the course of financial sector deregulation of former socialist systems, SDC may assist in the restructuring of development and agricultural banks and apex institutions, if they assume strategic roles vis-à-vis retail financial institutions serving SDC's target groups in terms of refinancing, guarantees, equity participation, securitization, etc.

SUMMARY

SUPPORT OF THE INFRASTRUCTURE OF A FINANCIAL SECTOR

Financial sector infrastructure support includes improving the quality and flow of information between financial institutions, their clients, investors and the general public. SDC may provide support with technical assistance, the organization and (co-)financing of national and international partnerships, exchange visits, traineeships, quality analytical work, seminars and conferences.

HOW TO SUPPORT THE POLICY AND REGULATORY FRAMEWORK OF A FINANCIAL SECTOR

Financial sector reforms for greater breadth and depth are needed to create more competition for improved services at lower costs. This requires not only banking laws conducive to development of financial institutions, but also efficient, non-bureaucratic supervisory mechanisms. SDC may engage in policy dialogue and in innovation and reform processes of the regulatory and supervisory environment, in close coordination with other bilateral and multilateral donors.

GENERAL OPERATIONAL PRINCIPLES AND PRIORITIES

SDC's interventions comply with the following main operational principles and priorities:

- Based on a sector-wide analysis, country-specific strategies are designed to take into consideration local priorities, partnerships, and SDC's comparative advantages.
- SDC aims at capitalising potential synergies in its FSD operations with interventions in agriculture, small enterprise development, (functional) literacy and integrated approaches, without compromising the need to institutionally separate financial and non-financial services.
- Capacity development is essential at all levels for the strengthening of financial sectors. An institutional perspective and joint planning of capacity development measures enhance ownership and integration into the partners' own strategies and resource plans.
- Recognition of the strategic importance of savings mobilisation, as savings promotes the autonomy of the target groups, the financial institutions and the national economy.
- SDC supports the development, testing and dissemination of innovative banking technologies adapted to local conditions that help rural financial institutions to reduce the relatively high transaction costs and risks associated with services to the agricultural sector.
- Importance is given to the capitalisation, exchange and dissemination of practical experiences and good practices.
- The quality of the planning, monitoring, and evaluation practices and the «accountability for results» in SDC's financial sector operations will be enhanced, building on internationally recognised methods, indicators, and in-depth institutional dialogue with SDC's partners. Importance will be given to both financial and social (development) performance.

SDC'S MAIN COMPARATIVE ADVANTAGES IN FSD

SDC sees its main comparative advantages as follows:

- Rural finance, capitalising on synergies with complementary rural development activities.
- Proximity to partners and understanding of local contexts.
- Ability to work in multi-partner arrangements at retail, infrastructure, and policy levels.
- Ability to take risk and to engage early or to stay on in an institution's development process.
- Supporting innovation and experimentation.
- Development cooperation with a long-term perspective.
- Diversity of instruments that can be used flexibly according to local needs and conditions.
- Capacity development at all levels.

1.

DEFINITION AND FUNCTION OF THE FINANCIAL SECTOR

The financial sector of a country comprises all individual and institutional players in the financial market, both on the supply and on the demand side, along with the market's legislative and regulatory framework. The financial sector comprises all banking activities as well as other asset-building activities such as insurance, leasing, factoring, pension funds, lotteries, and so forth. Microfinance constitutes an integral part of the financial sector that targets, in particular, poor households and small enterprises as clientele who have no or only limited access to formal financial services.

The main suppliers of financial services include commercial, co-operative, development, and postal banks (private and public ownership alike), as well as regulated microfinance institutions, insurance companies, trading companies and other financial institutions in the formal sector. The informal sector includes not only village savings groups, self-help groups, development funds, financial NGOs and temporary projects, but also moneylenders, traders, traditional savings and credit groups (rotating savings and credit associations, savings clubs, etc.), as well as friends and relatives. Many co-operative savings and/or credit institutions, associations and financial NGOs are registered, but not regulated, and fall into the semi-formal sector.

The policy and regulatory framework of the financial sector encompasses policies, laws, and regulations on (1) banks and their registration and supervisory regulations, (2) the banking and insurance supervisory authorities, (3) the central bank, and (4) monetary and foreign exchange policy. In some countries, the legislative and regulatory framework of the financial sector also covers insurance companies.

A national financial sector can function quite differently in selected regions/localities depending on its overall level of maturity, the geographical, socio-cultural, economic, political and historic features of the regions/localities, and the level of socio-economic infrastructure. At the same time, a national financial sector is embedded into regional and international financial markets.

The financial sector is vital to national socio-economic development because of its intermediation function of mobilising savings and channelling them to investments. Well-functioning financial markets are an essential factor facilitating the generation of income and employment as well as the building of assets by small enterprises, farmers and households. Financial institutions offer the following main services:

- Savings products (including deposits on current accounts and term deposits);
- Loans, not only for working capital and investments, but also for consumption and emergency purposes;
- Domestic and international payment transactions;
- Insurance products for risk-mitigation purposes.

2. RELEVANCE OF THE FINANCIAL SECTOR

Still, only a small proportion of the economically active, yet poor population in developing countries has access to formal financial services (notably savings and credit products). The vast majority continues to turn to the semi-formal and informal sectors, including relatives and moneylenders. Usurious interest rates charged by moneylenders often lead to increased indebtedness and dependence. Informal savings are very insecure as the poor may lose them through theft, fraud, fire, etc. The key development role of the international community is therefore to assist in facilitating the rapid outreach of institutional financial services to large numbers of poor people.

The situation is somewhat different in transition economies where substantial branch networks often exist. But many people still hesitate to entrust their savings to banks due to their recent experience of high inflation and bank failures in the wake of economic transition. And all transition economies, including countries in Southeast Europe, share the same challenge as developing countries with respect to the very limited access to credit – if at all – for most farmers and small enterprises (in 2004, the general level of credit penetration in Southeast European countries was a third of that in the Euro area).

The financial sector in the South and the East fulfils a specific development function when it mobilizes what are often substantial, locally available funds and encourages their reinvestment in the local economy. In this context, a properly functioning financial sector is a precondition for the creation and growth of small enterprises and the related generation of jobs and income for a large proportion of the population, thereby representing an instrument for effective poverty alleviation. Access to financial services helps households to better manage their cash flow, thus helping them to mitigate risks and vulnerability.

The infrastructure supporting a financial sector comprises various types of service providers (training institutions, organisational advisors, auditors, technology firms, raters, etc.), credit bureaus, associations, and so forth.

An empirically verified, positive correlation exists between the overall level of financial sector development and economic growth and pro-poor growth, respectively. The development role of the financial sector in its own right has been acknowledged internationally since the 1989 World Development Report. The UN Millennium Declaration in 2000 underlined the importance of the financial sector in achieving prosperity and peace. The UN Monterrey Conference in 2002 called for financial sector strengthening as a priority development task. The donor guidelines on good practice in microfinance developed by the CGAP (Consultative Group to Assist the Poor) in 2006 call for the building of inclusive financial sectors, and the United Nations launched the Blue-Book on microfinance in late 2005 to underline the significant role of lasting and cost-covering financial services for poverty reduction.

However, financial services can only help poor households and small enterprises to increase and/or diversify their entrepreneurial activities provided that they are also able to access the required know-how, socio-economic infrastructural services, and markets where they can sell their products and services. The better both the enabling macro-economic and business environment existing, and the law and order situation prevailing, the more efficiently financial institutions will be able to operate.

3. RATIONALE FOR A FINANCIAL SECTOR POLICY

The Swiss Agency for Development and Cooperation (SDC) developed its Financial Sector Policy (FSP) to offer strategic guidance to the decision-makers at SDC Headquarters and in SDC cooperation offices, to project executing agencies, and to specialist consultants in order to ensure coherent and effective cooperation programmes and projects in the SDC's partner countries in the South and East. Equally, the FSP serves as strategic guidance for those Swiss and international organizations whose financial sector development projects are fully or partially funded by the SDC. The positions of the SDC on financial sector development in multilateral organisations are guided by this policy, too.

The FSP is periodically reviewed in the light of SDC experiences and international 'best-practices' to ensure its continued validity and, if necessary, its adaptation and further development. It is supplemented by guidelines, tools and other instruments to facilitate implementation.

The financial sector is a core sector for sustainable economic development, in which the SDC has a long history and broad experience. The FSP is based on the Federal Law of 1976 on International Development Cooperation and Humanitarian Aid, the Federal Law of 2007 on Cooperation with the Countries of Eastern Europe, the SDC Guidelines and its Strategy 2010, and the Medium-Term Strategy 2008-2011of the Employment and Income Division. Important complementarities exist with small enterprise development, agriculture, and rural development. Successful projects and programmes in these areas depend on a well functioning financial system.

As the SDC and SECO both operate in the financial sector, their actions in this field are closely coordinated. The SDC also aims at co-ordinating with other donors, the private sector, and civil society in order to maximise development impact.

4. GOAL OF THE SDC IN PROVIDING FINANCIAL SECTOR SUPPORT

The SDC employs the FSP as one of its strategies in the fight against poverty. It supports financial sector development in selected partner countries with the goal of promoting income and employment, as well as fostering asset building by poor households, individuals (notably women), small farms, and small enterprises by means of reliable and long-lasting access to demand-oriented, diverse financial services. Financial sector development contributes – directly and indirectly – to pro-poor growth and reduced vulnerabilities of poor people.

The SDC aims at strengthening financial sectors in partner countries at four levels:

- The clients: by helping them in strengthening their bargaining position together with their financial and other management skills so as to become more bankable.

- The financial institutions: by supporting them in becoming viable institutions that can maximise their breath and depth of outreach to the SDC's target groups.

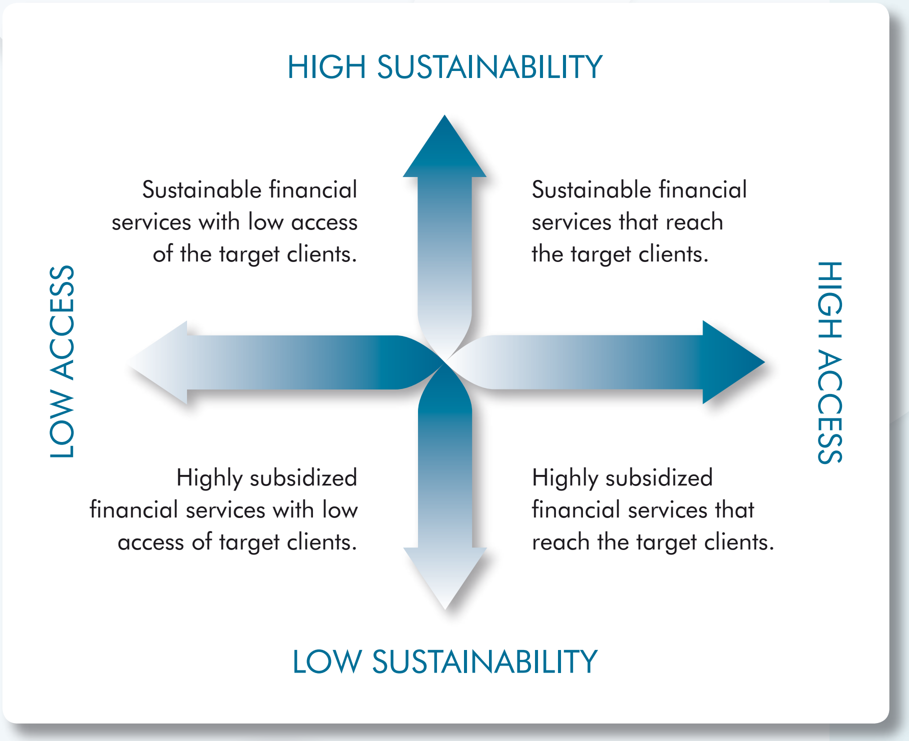
- The support infrastructure (such as microfinance networks and associations, auditors, rating agencies, credit bureaus, training institutions, IT providers, and so forth): by assisting them in improving the quality of the services they provide to the financial institutions.

- The regulatory and supervisory institutions, and governments: by advising them in creating an enabling legislative and regulatory framework for the financial sector.

Country-specific strategies define the levels of cooperation and the roles, specific instruments and areas of expertise the SDC intends to employ in coordination with local partners and other donors, based on comparative advantages.

5. STRATEGIC ORIENTATION OF THE FINANCIAL SECTOR POLICY

The SDC's strategy is to support its partners in their development, while aiming at sustainability and maximum depth and breath of outreach (access), i.e. moving towards or staying in the upper right quadrant of the diagram. A diversity of financial and non-financial (e.g. personnel and organisational development) instruments can be used for this purpose, depending on local needs and circumstances.



In pursuing its above-mentioned goal and strategy, the SDC supports its partner countries with measures targeting:

A) the demand side: by strengthening the social capital and the financial literacy of poor house-holds and individuals (notably women), small farms, and small enterprises so as to facilitate their access to financial services. Social capital comprises the organizational and knowledge-based capacity of a group to mobilise resources from the outside and from among its members and to employ them for the common benefit of the group, i.e., to build assets, to enhance bargaining power, to proactively change, or to influence local factors impacting on their livelihoods.

The SDC does not intervene directly on behalf of its target groups, but through relevant support organizations (e.g. member-based associations, self-help groups) that help the target groups to empower themselves through the choice and effective use of appropriate financial services. Only then can the target groups gain social and economic advancement through the access to institutional financial services. Most often, this will also require access to non-financial services and access to markets. The SDC therefore also supports better access of its target groups to non-financial services, such as functional literacy, business development services, plus social and infrastructural services. Delivery of non-financial services, however, must be organised separately from financial services.

The SDC pays attention to environmental laws and regulations so as to contribute to the environmentally sustainable business operations of its target groups. The sustainable use of natural resources determines the quality and long-term productivity of the livelihood systems of the SDC target groups.

B) the supply side: by supporting only financial institutions that (1) have the potential to significantly expand their services to the SDC's target groups on a cost-covering basis within the given market and legal framework conditions, and that (2) share a development vision with the SDC and commit themselves to implementing it within a specific time frame based on the following principles:

- «Client-first» attitude and client-oriented financial products that appropriately address the needs of the SDC's target groups. A particular focus is given to safe and accessible savings products for the lower strata of the poor population.

- "Best-practice" management to maintain or aim at institutional and financial sustainability. This requires openness for developing, testing, introducing and adapting innovative banking technologies that help reduce transaction costs and risks associated with the services to the target groups.

- Particular attention is paid to savings mobilisation as a client service (as mentioned above) and with respect to a healthy liability structure including savings deposits.

- The early development of internal controlling systems, transparent performance evaluation, and reporting on a regular basis.

- Good governance practices and importance given to personnel and leadership development.

C) the infrastructure of the financial system: by supporting networks and associations of financial institutions, training institutions, rating agencies, credit bureaus, auditors, transfer and payment systems, information-technology and technical-assistance providers, and so forth. Support is particularly required and can have substantial leverage in those partner countries where the poor quality level of such institutions constitutes a serious bottleneck for financial sector development.

D) the policy, regulatory, and supervisory framework of the financial sector: by supporting regulatory and supervisory institutions and financial sector reform in coordination and collaboration with the World Bank, the International Monetary Fund, and other donors in partner countries where framework conditions impede financial sector development.

Overall, the **SDC gives priority to** rural areas and to capacity development in its financial sector development programme. Furthermore, focus is given to the following levels of intervention: support to target groups (the demand side), selected («strategic») financial institutions, and the strengthening of the financial sector infrastructure. In its most important partner countries and based on country-specific strategies, the SDC can also contribute to the development of more favourable regulatory and supervisory framework conditions, particularly in collaboration with other bilateral and multilateral donors. In such cases it is important that the SDC is able to put its experience to effective use and that relevant know-how can be successfully mobilised for the benefit of the local partners or for sharing on an international level.

6. OPERATIONAL PRINCIPLES OF THE FINANCIAL SECTOR POLICY

The operational principles of the financial sector policy are outlined below according to intervention levels and the key actors which the SDC supports in strengthening the financial sectors of its partner countries.

How to support poor households and small enterprises in accessing financial services. (demand-side measures)

The FSP's key operational principles to support potential and current clients are:

- Target group orientation in compliance with the SDC's overarching goal of poverty reduction by focussing on poor households and individuals, small farms and small enterprises in all sectors of the economy. Special attention is paid to rural areas and women by considering their particular socio-cultural and economic situation.

- Strengthening the human and social capital of these target groups through dedicated and skilled support organisations. The «bankability» of poor people is important for them to be able to access diverse, client-friendly and reliable financial services.

- The SDC aims at realizing synergies with other development programmes, notably in the fields of small enterprise development and rural development (linking with business, extension and infrastructural services like education, transportation, etc.). Very poor people in particular can only use financial services effectively in combination with access to certain non-financial services (e.g. functional literacy).

- Customer protection that can take the form of financial literacy training, along with disclosure of lending terms and conditions, etc. Potentially effective measures are efficiency improvements in financial institutions and the development of a policy framework facilitating competition so as to bring down interest rates.

How to support financial institu tions in targeting poor house-holds, small farms, and small enterprises as strategic clientele (supply-side measures)

The FSP's key operational princi-ples to support **financial institutions** that target or would like to target poor households, small farms, and small enterprises as strategic clientele are:

• Support is provided only to insti-tutions with a clear vision of provi-ding SDC's target groups with lasting access to financial services. Such institutions are either already finan-cially and institutionally viable or have a clear plan to reach such status.

Therefore, revolving credit funds are generally avoided, as they tend to be run by staff without the required technical qualification, particularly as components of non-financial development programmes and projects. They tend to fail to cover costs, have a limited client outreach, and face a trade-off in pursuing a mix of a wide range of social, economic and project-specific objectives. However, in exceptional cases, in the absence of any other viable options and, if well designed and managed professio-nally, such funds can be used as an action research activity for inno-vative financial service activities.

However, funds should be institutio-nalised as soon as feasible, and the ownership must be clear.

• New financial institutions are sup-ported only where no institutions are present and where existing ones are not willing to move or extend their services to the SDC's target groups in a financially and institutio nally sustainable manner. The 'green field' approach normally requires long-term support and high capital outlays during ten or more years for the new institution to mature into an economically viable operation. The time needed to reach financial and institutional sustainability can be significantly reduced, however, if established financial institutions are prepared to bring in their human resources and proven management know-how and systems. In such situations, the SDC may cover part of start-up costs and facilitate the access to (social) investors.

• The SDC may forge links between existing or newly created self-help groups, their associations, NGOs or other types of semi-formal finan-cial service providers on the one side, and formal financial institutions on the other side (strategic alliances).

This 'linkage' approach helps reduce both risks (through «social colla-teral») and financial transaction costs (with client groups assuming selected tasks in the delivery of services).

The SDC can facilitate the linkage process through (1) institution buil-ding of self-help groups to increase their social capital, notably their finan-cial literacy, asset building capacity, organizational strength and bargai-ning power; (2) institution building of NGOs, associations etc. on the one side, *and* financial institutions on the other by training staff; (3) identifica-tion of linkage partners and support in negotiating 'linkage' contracts; and (4) underwriting risks by guaranteeing the financial institutions a certain percen-tage of their loan portfolio with self-help groups or other linkage partners.

• The SDC endeavours to facilitate lasting access to financial services in the most efficient manner. There fore, the 'down-scaling' approach may be a promising strategy, particu-larly in small enterprise finance and in more mature financial markets where significant bank branch networks exist (e.g. in certain coun-tries in Eastern Europe). The commit-ment and strategies of banks to target small enterprises and/or poorer market segments is essential for down-scaling. Support to fully opera-tional banks to deepen outreach to the SDC's target groups on a long-term, profitable basis may cover technical assistance and trai-ning in areas such as product deve-lopment, costing and marketing, the adjustment of management infor-mation systems (MIS), customer rela-tions with the new clientele, etc.

• Considering the lack of banks that are interested in serving poor rural clients, the 'up-scaling' approach is still very relevant in the South. Microfinance service providers with a vision and potential for economic viability and large-scale outreach are strengthened, thereby leading to their potential transformation into regulated institutions. The SDC may provide support for capacity development and technical assistance, and facilitate access to domestic capital markets or - where this is not possible or not the most favourable option - to regional or inter-national microfinance funds and private investors as early as feasible. This contributes to improve governance, strategic guidance, and financial leverage.

• In the course of both financial sector deregulation and the transformation of former socialist financial sectors, the SDC may also assist in the restructuring of development and agricultural banks and apex institutions. A precondition for SDC support is that these institutions assume strategic roles vis-à-vis retail financial institutions serving the SDC's target groups. Such a role may include refinancing, guarantees, equity participation, securitization, and other services. The SDC's assistance would be dependent on sound equity structures and governance, professional management, and the absence of political interference.

What the operational instruments are for supporting financial institutions

The SDC can apply (combinations of) the following operational instruments in its cooperation with financial institutions, depending on needs and local circumstances:

• Institution building through organizational and human resource development. This may encompass strategic planning and financial forecasting, organisational change processes, the introduction and development of key management systems (e.g. MIS, internal control and audit, risk management, liquidity/treasury management, and so forth), as well as product development and marketing etc., involving both technical assistance and training.

• Financial instruments depending on the development stage of the institutions concerned:

- Grants for co-financing start-up and expansion costs may be required and justified temporarily at gradually decreasing levels.
- Loans may be needed for refinancing purposes as long as access to credit and equity on the national and international markets is not possible.
- Guarantees or other instruments may be needed to facilitate the development of local refinancing markets for the sustained growth of pro-poor financial institutions.
- Equity or quasi equity in specific cases, following separate SDC guidelines. However, SECO, social and commercial microfinance funds, international financing institutions and other specialised intermediaries have comparative advantages in enhancing important dimensions of good governance and in financial leveraging.

• Risk capital instruments (basically grants or guarantees) to share risks that financial institutions take when developing and testing new products and innovations with a potential to reduce transaction costs and deepen outreach towards poorer clients and rural areas.

How to support the infrastructure of a financial sector

The SDC may support the creation and institutional strengthening of microfinance networks and associations, training organizations, credit bureaus, rating agencies and apex organisations, and the development of markets for essential services to financial institutions, i.e., services for auditing, information technology, human resource development, etc. The more qualified the services of these organizations are, the better they enable the financial institutions to improve their services to the SDC's target groups.

A wide variety of instruments are available to strengthen the infrastructure of a financial sector. These include technical assistance, the organization and (co-)financing of national and international partnerships, exchange visits, traineeships, quality analytical work, seminars and conferences. Improving the quality and flow of information between financial institutions, their clients, investors and the general public may be an effective intervention, too.

The SDC may also support such improvements of the legal framework for financial transactions as have an important impact on the operations of financial institutions and their clients, such as general contract and property laws and collateral laws. The latter depend on the status of the cadastre system, the regulations for mortgages and foreclosure, as well as the quality of the judiciary system.

How to support the policy and regulatory framework of a financial sector

Financial sector reforms for greater breadth and depth are needed in many partner countries to create more competition for improved services at lower costs. This requires not only the banking laws conducive to development of financial institutions, but also efficient, non-bureaucratic supervisory mechanisms.

Financial institutions must be able to determine cost-covering interest rates based on their management strategies. Government interest rate caps generally prevent financial institutions from serving poor clients. An environment fostering competition, together with measures to facilitate the lowering of transaction costs prove more effective in bringing down interest rates.

In countries where the SDC has substantial financial sector programmes and experience, and if the necessary expertise can be mobilised locally or internationally, the SDC may engage in policy dialogue and in innovation and reform processes of the regulatory and supervisory environment, in close co-ordination with other bilateral and multilateral donors. Given their important role in rural areas, the regulation of savings and credit co-operatives are of specific interest to the SDC.

Introducing or extending regulatory functions to microfinance institutions requires utmost caution so as not to constrain the growth of semi-formal institutions. It also requires the early development of specialised supervisory capacity.

Instruments to support the development of a conducive policy and regulatory framework include quality analytical work, exchange visits and seminars, technical assistance and capacity development of regulatory and supervisory authorities.

What general operational principles and priorities have been set by the SDC in financial sector development

• The SDC's main *comparative advantages* in financial sector development are:

- Rural finance, capitalising on synergies with complementary rural development activities
- Proximity to partners and understanding of local contexts
- The ability to work in multi-partner arrangements at retail, infrastructure, and policy levels
- The ability to take risk and to engage early or to stay on in an institution's development process
- Supporting innovation and experimentation
- Development cooperation with a long-term perspective
- Diversity of instruments that can be used flexibly according to local needs and conditions
- Capacity development at all levels.

• Based on a *sector-wide analysis, country-specific strategies* are designed taking into consideration local priorities, partnerships, and the SDC's comparative advantages. The SDC focuses its interventions on geographical areas and activities where it can best mobilise expertise and capitalise its experience. This is the basis for the SDC to *harmonise and align* its contributions a) to the development of local financial markets serving poor house-holds, small farms and small enterprises, b) to the support of local poverty reduction strategies, and c) to the achievement of the Millennium Development Goals (MDGs).

• The SDC aims at capitalising potential synergies in its operations in the field of financial sector development, *agriculture, small enterprise development, (functional) literacy and integrated approaches* (such as local economic development-LED), without compromising the need to institutionally separate financial and non-financial services.

• *Capacity development* is essential at all levels for the strengthening of financial sectors. Support in this field needs to be adapted to the resources available to partners and may, over time, become highly selective and limited in duration. An institutional perspective and joint planning of capacity development measures enhance ownership and integration into the partners' own strategies and resource plans.

- Recognition of the strategic importance of *savings* mobilisation, as savings promote the autonomy of the target groups, the financial institutions and the national economy. Institutions that mobilise savings should be regulated in order to protect savings deposits. Small co-operatives and other member-based institutions might mobilise deposits without formal supervision, as their internal social control mechanisms may compensate for the lack of external control and external supervision may be too costly.

- Special consideration is given to risks associated with agricultural credit caused by climatic factors, natural disasters and unpredictable price changes. New solutions and mechanisms are needed to cover *agricultural risks*. Therefore, the SDC is particularly committed to supporting the development, testing and dissemination of innovative banking technologies adapted to local conditions that help *rural financial institutions* to reduce the relatively high transaction costs and risks associated with services to the agricultural sector.

Apart from strengthening the social capital and financial literacy of its target groups in rural areas, the SDC may technically and financially support such measures as the deve-lopment and testing of new products, service-delivery methodologies and local risk-sharing schemes.

- Importance is given to the capitalisation, exchange and dissemination of *practical experiences and good practices*. The SDC therefore supports national, regional and international networks and conferences, and actively participates in international committees and global initiatives such as the CGAP. Attention is given to supporting and facilitating the application of sector knowledge and good practices within the SDC and its partnerships.

- The quality of the *planning, monitoring, and evaluation practices* and the «accountability for results» in the SDC's financial sector operations will be enhanced, building on internationally recognised methods, indicators and, in-depth institutional dialogue with the SDC's partners. Importance will be given to both financial and social (development) performance, and evaluations will be used systematically to compile lessons at the institutional level and to improve the SDC's financial sector development policy and practice.

7. CHALLENGES AHEAD

During the coming years, the international community and the SDC face several challenges in implementing financial sector policies that promote access of poor households, small farms and small enterprises to financial services:

- Cutting poverty in half by 2015 to reach the first Millennium Development Goal requires the strengthening of the *economic* basis for development. Financial sectors are of strategic importance in this process. Developing and transition countries face formidable tasks in building *inclusive financial systems* that offer a range of appropriate financial services on a commercially viable basis to their poor population majorities. They need to increase their financial sector penetration many times over, notably in Sub-Saharan Africa and in selected Asian and Latin American countries. Apart from improvements in the general business environment, the regulatory framework, and in the financial infrastructure, *capacity-building* at the retail level remains the main constraint for reaching poor clients on a massive scale.

- The *role of donors* is changing with the proliferation of international micro-finance funds and the entry of private investors into the loan and equity market. *Donor co-ordination* is also becoming more demanding because an increasing number of development organizations are entering the field of micro-finance due to its appeal as a successful tool for poverty reduction. The SDC faces the continuing challenge of identifying its optimal role vis-à-vis private actors and in multi-donor programmes (donor *harmonisation* and alignment).

- The financial volume of the SDC's engagement in financial sector development is modest compared to that of the International Finance Institutions or major bilateral donors. The SDC must therefore focus on where it can *add value*, on longer-term perspectives, quality, innovation, strategic (local) partners and the capitalisation of its experiences and synergies with like minded partners.

- Banking to serve *rural areas, small farmers, and small enterprises* in rural and semi-urban areas continues to require a good deal of attention and innovation (to reduce transaction costs and cope with risks; to capitalise on synergies with extension, literacy, and business-service providers; to tap the potential of remittances from urban areas and abroad; to cooperate and build strategic alliances with commercial banks; and to strengthen the management and governance of savings and cooperative systems, etc.).

- *Savings* mobilisation is particularly important for poor clients and the long-term funding needs of financial institutions. It needs to be promoted at all levels of a financial sector. Decentralised financial systems based on local savings have also proven to be stable in the face of major national and international economic shocks (Ecuador, Indonesia, etc.) and have helped poor households in coping with the fallout of these shocks and vulnerabilities in general.

- Banking with poor clients and small enterprises requires *development know-how* and commitment as well as *banking know-how*. Understanding the specific challenges of development finance, and the application and continuing development of good practices (knowledge mana-gement) in this field, will go a long way in harnessing the potential of sustainable financial services for the population majorities in developing and in transition countries.

ANNEX 1
THE ELEVEN KEY PRINCIPLES OF MICROFINANCE (CGAP, 2004)

The following Eleven Key Principles of Microfinance were prepared by the CGAP and its members. They were endorsed by the G8 in 2004. The references in parentheses help to highlight or better clarify selected issues.

1. Poor people need a variety of financial service, not just loans, but also savings, insurance and money transfer services.

2. Microfinance is (no panacea, but rather) a powerful tool in fighting poverty. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.

3. Microfinance means building financial systems for the poor. It will reach its full potential only if is integrated into a country's mainstream financial system.

4. Microfinance can pay for itself, and must do so, if it is to reach very large numbers of poor people. Unless microfinance providers charge sufficient to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.

5. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.

6. Micro credit is not always the answer. Other kinds of support (i.e. grants, as well as convenient voluntary savings services) may work better for people who are so destitute that they are without income or means of repayment.

7. Interest rate ceilings (and interest rate subsidies) hurt poor people by making it harder for them to get credit, as they prevent microfinance providers from covering their costs.

8. The role of government is to enable financial services (by creating a supportive legislative, regulatory, and supervisory framework), and not to provide them directly.

9. Donor funds should complement private capital, not compete with it. Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap pri-vate funding sources, such as deposits.

10. The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on capacity building.

11. Microfinance works best when it measures and discloses its performance. Microfinance providers need to produce accurate and comparable reporting on financial and social (development) performance.

ANNEX 2
SELECTED READINGS AND LINKS

The following annotated bibliography contains a small selection of published and unpublished literature relating to the financial sector which focuses on lessons learned from experience and good practices. The list is in no way exhaustive.

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  Download at: www.intercooperation.ch/finance/download

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  Download at www.intercooperation.ch/finance/download

WEB LINKS

- BSM Finance: www.intercooperation.ch/finance
  (Financial sector website Intercooperation on behalf of SDC)

- Cerise: www.cerise-microfinance.org
  for social performance: www.cerise-microfinance.org/publication/impact.htm

- Consultative Group to Assist the Poor (CGAP): www.cgap.org

- Mix Market: www.mixmarket.org

- Ohio State University Rural Finance Program:
  http://aede.ag.ohio-state.edu/programs/ruralfinance

- Portail Microfinance: www.lamicrofinance.org in French
  for rural finance: www.lamicrofinance.org/resource_centers/finrur

- Swiss Development Cooperation: www.deza.admin.ch/ei

- The MicroBanking Bulletin: www.mixmbb.org

- The Microfinance Gateway: www.microfinancegateway.org
  for savings: www.microfinancegateway.org/resource_centers/savings and
  for social performance:
  www.microfinancegateway.org/resource_centers/socialperformance
  for savings: www.microfinancegateway.org/resource_centers/savings
  and for social performance:
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