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Donor Innovation in Financial System Development: DFID's Design of FinMark Trust in South Africa

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This case study describes how the U.K. Department for International Development (DFID) designed an innovative approach to broaden the outreach of the formal financial system in South Africa.

Overview

How can donors help make financial systems work for poor people? In South Africa, DFID and the Banking Council of South Africa (BCSA) created an independent local organization, FinMark Trust, and gave it the decision-making authority to pursue projects that integrate microfinance into mainstream financial services. FinMark operates primarily as a facilitating organization that has high-level convening power with both the government and the private sector. It also provides technical assistance and finance for strategic projects.

Launched in March 2002, FinMark is a young program and its results cannot yet be fairly assessed. What sets it apart as a significant donor intervention is its structure, flexibility, and staffing. As an independent local organization, FinMark is unrestricted by typical donor pressures: it does not have to meet pre-established disbursement targets, nor must it focus on a narrow set of activities. FinMark has the freedom to choose the projects it will fund (provided they are consistent with its mission) and the agility to respond quickly to opportunities. FinMark identifies projects of mutual interest to government agencies and private financial institutions and facilitates joint support. FinMark has also successfully recruited talented staff and Board members who are well respected in South African financial circles.

Setting the Stage

Although South Africa has a sophisticated financial system, it serves only a minority of the population. Microfinance has largely developed outside the formal financial system and remains limited in scope. Few NGOs have reached significant scale and most remain dependent on donor support.

The public perception of microfinance has been tarnished by payroll-based consumer credit organizations that lend to salaried employees at extremely high interest rates. Known in South Africa as microlenders, these institutions have little in common with microfinance institutions (MFIs) operating in the country and the rest of the world. While most banks have invested in such payroll-based lending businesses, none have invested seriously in uncollateralized microenterprise lending to self-employed people or other financial services for poor people—the type of services that are the foundation of microfinance elsewhere in the world.

However, both the government and private sector have been increasingly focused on improving the reach of South Africa's financial system to cover small and medium enterprises and the un-banked as well as managing the payroll-based microlenders. Self-employed entrepreneurs and poor households in the informal sector have not been the principal focus of their efforts to date, but this is changing.

Changes in Focus at DFID

Two pivotal changes at DFID laid the groundwork for the FinMark project. First, the DFID private sector development team in Southern Africa, led by Hugh Scott, reassessed its approach to promoting microfinance.[1] DFID had promoted business development services in the region since 1994. By 2000, however, the local DFID team recognized that limited access to financial services was one of the principal constraints to enterprise development and poverty reduction. They developed a new approach to microfinance that concentrated on the systemic factors constraining its growth.

[1] DFID defines Southern Africa as the Republic of South Africa, Namibia, Swaziland, Lesotho, and Botswana.

Second, a shift in DFID corporate objectives called for less support of individual projects and more attention to high-level policy engagement. The new policy seeks to address development problems at the sectoral level—including adequate infrastructure, supportive regulation, and local technical capacity. Local ownership of development initiatives became increasingly necessary to encourage national governments and private institutions to tackle major issues of investment, regulation, and policy.

Designing FinMark Trust

Mission. The mission of FinMark is to "make financial markets work for poor people," that is, to ensure that financial markets in South Africa provide demand-driven financial services to poor people on a sustainable basis. The Trust concentrates on attracting private-sector investment into microfinance by strengthening the infrastructure of the financial sector, which it divides into three levels:

a) Institutional infrastructure—policies, laws, and regulations

b) Organizational infrastructure—the institutional capacity of retail financial institutions

c) Support infrastructure—service providers, such as consultants, auditors, information providers, etc.

What distinguishes FinMark's approach is its ability to work at all three levels simultaneously and build on their interdependence.

Funding. The FinMark Trust was established with an initial DFID grant of £5 million (approximately US$ 7.5 million) to be disbursed over five years. Other donors work with FinMark on a project basis, with most projects funded in part by a private-sector partner. The Trust itself is not intended to become self-sufficient, but aims to help establish a sustainable financial services market which services the majority of the population.

Staffing. The ability of DFID to recruit superior local staff for FinMark has been crucial to its success. The Trust is managed by a well-respected CEO, David Porteous, who has an extensive background in promoting financial services for the poor. Established financial leaders were also recruited to the Board of Trustees, which greatly enhanced the credibility and effectiveness of the organization.

Governance. The single most difficult task for DFID was designing a governance structure for FinMark. Rather than fund individual microfinance projects, DFID wanted the program to work with the government and private organizations to resolve the market failures that discouraged private investment in microfinance. This approach required local ownership, technical expertise, and operational flexibility.

> *"If a donor wishes to ensure real local ownership, it must be prepared to lose some direct control."*
>
> Hugh Scott, Senior Private Sector Development Advisor, DFID

The agency sought a structure that would maximize the impact of FinMark activities, minimize direct DFID involvement, safeguard the DFID investment, and avoid unnecessary bureaucracy. After extensive consultations with stakeholders, DFID and the BCSA created FinMark as an independent trust.

The trust structure allows DFID to provide strategic oversight rather than direct management. Led by CEO Porteous, FinMark operations are overseen by a Board of Trustees. The Board establishes strategic direction, approves significant investments, and provides financial oversight. It is comprised of four recognized financial leaders in Southern Africa, plus Porteous. Two senior international microfinance figures (from CGAP and the United Nations Development Programme) and DFID representative Hugh Scott serve as advisors to the Board.

FinMark was originally established as a joint venture with the Banking Council of South Africa. It became independent in 2003 to emphasize its role as an independent, "honest broker" among private-sector and government stakeholders in the financial services market.

> *"It is impossible to underestimate the importance of getting the governance and structure of the FinMark Trust right."*
>
> David Porteous, CEO, FinMark Trust

What Exactly Does FinMark Do?

FinMark can do almost anything it wants in the pursuit of its mission. To date it has convened high level meetings between financial services institutions and government agencies, promoted industrywide communication, and supported regulation and supervision of microfinance. It also funds a range of relatively small

projects and research initiatives. FinMark looks for opportunities to partner with government and private organizations on projects that will increase the provision of sustainable financial services to poor people in South Africa.

FinMark's full-time staff of three (including the CEO) works out of an office in Johannesburg. External consultants are engaged on an as-needed basis. Two of its initiatives are summarized below.

Gauteng Partnership Fund (GPF). Created in 2002, the GPF seeks to attract private investment into the low-income housing sector in the province of Gauteng, South Africa. A technical assistance grant from FinMark of US$ 21,000 was essential to its establishment and helped cover the cost of an initial market assessment.

To date, the GPF has attracted investment from two commercial banks into two low-income housing projects by co-investing in the form of equity and/or partial loan guarantees. These investments have facilitated the construction of 1,200 low-income housing units. GPF is presently planning to develop a database to track the real level of financial risk involved in such housing investments.

Low-income housing project in South Africa. (Photo: Copyright Guy Stubbs, www.guystubbs.co.za).

Micro-Finance Regulatory Council (MFRC). MFRC is a not-for-profit regulatory organization approved by the Ministry of Trade and Industry (DTI) of South Africa. Its mandate is to protect consumers against unfair practices by microlenders while encouraging the development and growth of the microfinance market. FinMark supports a range of projects with the MFRC, including:

- Funding the cost of consumer focus groups as part of a recent MFRC review of consumer credit legislation. In addition to this funding, FinMark

Advice for Donors

1. **Put the right people in place on the ground.** The reputations, expertise, and commitment of the FinMark CEO and Board of Trustees give the organization credibility in the South African financial sector and are thus critical to its success.
2. **Be willing to cede control in appropriate circumstances**, but only if donor and local program staff include individuals with sound technical expertise.
3. **Be clear about program goals.** FinMark's mission of "making markets work for poor people" informs its decision making on all activities.
4. **Be realistic about donor capacity.** DFID created an independent local entity because it wanted to an organization that could both quickly respond to opportunities and credibly influence local government and financial actors as a local player.
5. **Focus on objectives, not expenditure levels.** DFID assesses FinMark primarily on the how well it achieves agreed outcomes, not on its speed of disbursement. Be prepared to adapt the program over time.
6. **Mitigate the risks of local program management** by, for example, naming the lead donor representative an advisor to the Board of Trustees and using standard management procedures (e.g., quarterly disbursements, regular reviews, annual independent audit) to monitor the donor's investment.

CEO Porteous sits on the review panel. The study will be used by DTI to develop a policy paper on "making credit markets work."

- Providing technical assistance (US$180,000) to the National Loans Register, a credit bureau managed by MFRC, to facilitate the register's expansion to cover micro, small and medium enterprise (MSEs) lending. As a result of FinMark technical assistance, the National Loans Register will soon be able to provide credit information on MSE borrowers to registered financial institutions, thereby mitigating some of the perceived risks of lending to this target market.

Initial Conclusions

FinMark is a new program, so it is premature to judge its ultimate success in building financial services for poor people in South Africa. However, several principles have contributed to its emergence as a credible player in the financial sector, giving it an operational flexibility rare among donor programs:

1. **Partner with local institutions.** FinMark is designed to facilitate change in the formal financial system by partnering with government and private sector organizations on projects that encourage both parties to take action.
2. **Focus on good microfinance practice.** DFID staff, FinMark management, and other stakeholders agree that a market-based approach to financial services for poor people is the best way to reach scale on a sustainable basis.
3. **Institute local decision-making.** DFID relinquished direct program management to build local credibility and attract private-sector investment into microfinance. The FinMark Board has the authority to approve projects, allowing the organization to rapidly respond to opportunities as they arise.
4. **Create flexible funding mechanisms.** FinMark can choose from a range of funding mechanisms (grants, loans, equity), but anticipates that the bulk of its financial support will be in the form of technical services.

> *"Donors tend to underestimate the time it takes to develop proposals, and this, combined with often lengthy approval times, makes many project ideas too costly to pursue. In addition, the window of opportunity for an initiative may close if funds cannot be sourced fairly quickly."*
>
> Gabriel Davel, CEO, MFRC

5. **Streamline bureaucracy.** FinMark's funding application process is simple, transparent, and quick, making it an ideal private-sector partner.
6. **Innovate.** FinMark aims to kick-start change and innovation within the sector by supporting unorthodox projects.
7. **Leverage impact.** FinMark understands that large amounts of money are not always required to address market failures, and can in fact be counter-productive. Many FinMark interventions have been low cost but high impact. The ability to undertake very small projects is an enormous source of its strength.
8. **Tap microfinance expertise.** FinMark has made optimal use of local and international technical expertise, developing strategic links with such international microfinance partners as CGAP (a consortium of 28 donors and private foundations that support financial services for the poor worldwide) and *MicroSave-Africa* (a donor-funded service provider specializing in microfinance product development).

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Contacts and Web Sites

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Sarah Barlow is a private sector development consultant on leave of absence from DFID. This case history is based on the cited references as well as input from David Porteus (FinMark), Hugh Scott (DFID), Gabriel Davel (MFRC), and Elize Stroebel (GPF).