

Guidelines for Designing Poverty-focused Projects with Microfinance Components

Developed by the Social Protection Anchor in collaboration with the Consultative Group to Assist the Poorest (CGAP), Financial Sector Development (FSD) and the Rural and Small Enterprise Thematic Group.¹

Background

These guidelines have been developed in order to help Bank task team leaders and their client country counterparts design and support effective microfinance within poverty-focused or multi-sectoral projects such as social funds. The guidelines are not intended to substitute for or replace microfinance industry best practices. Rather, they focus specifically on how to design a microfinance component within a multi-sectoral project in a way that incorporates recognized best practices to the greatest degree possible.

Because poverty-focused, multi-sectoral projects are considered controversial vehicles for microfinance, project managers are strongly encouraged to add to and refine these guidelines as experience grows in this area. They are also encouraged to refer to the *Microfinance Practical Guide* and other resources published by the Consultative Group to Assist the Poorest (CGAP) for more information on best practices (see www.cgap.org).

These guidelines should be read in combination with the case studies of social funds with microfinance components prepared as part of this initiative.² The studies examine in detail the Bank's experience with social fund microfinance programs in Bosnia, Albania, Panama, Yemen and Eritrea and draw lessons from best practices. They also consider less successful approaches and identify common obstacles that Bank task team leaders face during implementation.

Guidelines

Project Design

- **Project designers should explore the full range of institutional options before including a microfinance project as part of a social fund or multi-sectoral project.** Microfinance within a social fund is just one option for how the Bank can support the provision of financial services to the poor in a country. Microfinance can also be delivered as a component of a financial sector loan or a “stand-alone” project. These options may offer greater opportunities to place microfinance within the broader context of financial sector reforms. While these options are not always available in the given country context, it is important that project designers consider

¹ These guidelines have been prepared by Alexandra Gross and Samantha de Silva. For more details and case studies, see also *Social Fund Support of Microfinance: A Review of Implementation Experience*, Alexandra Gross and Samantha de Silva, June 2002. Social Protection Team (HDNSP), The World Bank.

² See footnote above.

various alternatives and have a clear rationale for including microfinance within the social fund. In the past, social funds have been selected when there are no existing microfinance institutions in a country (ie, in Yemen or Bosnia). They have also been selected as a way to encourage existing microfinance institutions to expand to new regions, serve new types of clients, and develop new financial products for the target group (ie Albania).

- **Microfinance components should focus on building sustainable institutions and delivery mechanisms for financial services.** Many social funds, because of their welfare orientation, have tended to focus on disbursement to poor communities, rather than building sustainable institutions. The emphasis on rapid disbursement, rather than loan recovery results in poor portfolio quality and performance, ultimately undermining the program's long term goals.
- **Before including a microfinance component in a social fund, project planners should evaluate the banks, NGOs and other financial institutions that already exist in a country to determine what services are already available and how the social fund would add value to the financial sector.** If no such institutions exist, the evaluation should also identify what institutions have the potential to serve as microfinance institutions (ie, see Yemen case study). Such institutions could range from NGOs that already have experience working with the target group to commercial banks that could be encouraged to lend to micro businesses. Experience has shown that in general it is better to avoid creating new institutions where possible. CGAP provides a methodology for assessing microfinance institutions.
- **Social funds should not provide financial services directly, but work through partner microfinance institutions (MFIs) and support institutions that can provide such services on a sustainable basis.** Since effective microfinance requires a commercial relationship between MFIs and the client, social funds have not been shown to be an appropriate vehicle for direct lending. Rather, lending decisions should be left to MFIs whose performance is evaluated based on specific portfolio size and quality and other measurable performance indicators.
- **Interest rates to the end borrower should not be subsidized.** MFIs should charge interest rates high enough so that the income generated from interest, fees and commissions is sufficient to cover the long term financial and operational costs of doing business. Without this, microfinance institutions cannot become sustainable. Subsidized interest rates only succeed in undermining the development of the industry in a country. In particular, subsidized on-lending rates often result in:
 - Low loan collection rates because clients consider cheap loans as grants that do not have to be repaid
 - Fewer borrowers served as the loan capital shrinks because of bad debt
 - Rationing of loans, which typically favors wealthy and politically connected rent-seekers
 - Institutional corruption and fraud because staff may try to capture the difference in the interest rate by eliciting side payments from clients

- Continued reliance of the MFI on subsidies, because it is unable to reach self sufficiency given that its interest rate margin does not cover its administrative and financial costs over the long term
 - Risk of financial distress for the MFI if the government or donor were to cancel its subsidies.³
- **Governments should not support social fund programs that offer subsidized credit to the final borrowers. Rather, the appropriate role for government subsidies is to build MFI financial management capacity and encourage efficiency and innovation.**⁴ Well designed programs should therefore avoid subsidized lines of credit to microfinance institutions or subsidization of the on-lending interest rate to the final borrowers. Government subsidies should be used to build institutional capacity of MFIs to increase efficiency of service delivery.

Subsidized lines of credit are to be avoided because they create market distortions and can depress savings mobilization by keeping the cost of funds to the MFI artificially low. Loans at subsidized interest rates may be perceived by the final borrower as charity, not to be paid back. In addition, microfinance projects that charge subsidized interest rates cannot cover their costs and have no way of reaching full financial sustainability.

Maximize Autonomy

- **Maximize autonomy for the social fund department that manages the microfinance program.** It is critical that the department within a social fund that manages the microfinance program has maximum autonomy from the rest of the social fund operations. This should include separate management, staff, procedures, budget and goals. Autonomy is required because successful microfinance depends upon an institutional environment focused on cost recovery and portfolio quality—an environment that differs substantially from many social funds with grant-based programs. During the design phase, project planners should separate managerial and administrative aspects of the program to the degree possible. Bosnia provides a good example of this administrative autonomy, as the microfinance program was an autonomous unit anchored within a foundation that handled numerous government development projects. The Albania case reveals how this managerial autonomy grew more important as the microfinance program developed, and eventually required the microfinance program to be spun off entirely from the social fund.
- **Do not mix up grants and loans.** Information and education campaigns and capacity building programs at the community level should distinguish between grants for subprojects and loans issued under microfinance programs. This distinction is critical in order to avoid confusion between what funds must be paid back and preserve portfolio quality. Managerial separation of the project has been shown as one way to

³ Source: Jacob Yaron, McDonald Benjamin and Gerda Pipek. 1997. Rural Finance – Issues, Design and Best Practices, The World Bank.

⁴ Fruman, Cecile and Michael Goldberg, Microfinance Practical Guide, 1997. CGAP

prevent sending mixed messages to communities, who might receive grants for an infrastructure subproject and loans from the microfinance program. Some projects have even gone as far as to operate the microfinance component only in communities where there have been no sub-project grants. While this has the advantage of ensuring that there are no mixed messages, communities do not benefit from the synergies between the various program components.

- **Salaries for employees for the microfinance program should be based on portfolio performance and quality.** Successful microfinance requires a salary structure with incentives for performance. It is important to build in explicit incentives for staff to increase portfolio size and maintain portfolio quality. This may mean that microfinance department staff within a social fund also be judged on the size and quality of the portfolio of the program as a whole, even though they may not be involved directly in lending.

Selection of Partner MFIs

- **Develop rigorous criteria for selecting partner MFIs and closely monitor performance of MFIs that have been selected.** If a social fund is to work with a set of NGOs or institutions involved in microfinance, eligibility criteria must be set, based on past performance and indications that the institutions are heading toward financial sustainability and a subsidy-free status.⁵ Since the goal of supporting microfinance programs is to expand outreach and create sustainable institutions to deliver financial services to the poor, the social fund must work with MFIs that have potential for sustainability, provide technical assistance to build their capacity and monitor their institutional development. Most social funds surveyed have not been selective enough at the outset about what institutions they partner with and have had to go through a consolidation phase.
- **Competitive selection should be introduced from the outset.** Partner MFIs should be informed from the start that only the best institutions will continue to receive funding and support, and even this is limited. In Bosnia, for example, from the outset MFIs were instilled with the concept that they should be looking toward commercial sources of funds.
- **Social funds should establish effective ways to monitor partner MFIs and link continued funding to performance.** To do this properly, monitoring indicators should be clear and transparent and address portfolio quality and operational efficiency. Reporting requirements also must be targeted toward the monitoring indicators (rather than just general, qualitative info only). Mutually-agreed performance standards should be set at the time the partnership is established. CGAP has developed comprehensive standards/guidelines in this area that social funds can draw from.

⁵ Fruman, Cecile and Michael Goldberg, *Microfinance Practical Guide*, 1997. CGAP.

Technical assistance

- **Microfinance experts should be included in the project design team, no matter how small the microfinance component is.** In general, Bank-supported social funds and task leaders have not recognized the intensive technical requirements of microfinance programs and have under performed as a result. Experience points to the need to provide adequate resource to the microfinance component from the beginning. Successful programs require intensive upfront technical assistance and training to build capacity building for both social fund staff in administering the program and for MFI staff in lending methodologies.
- **Include adequate resources for capacity building.** Capacity building has proved to be the most significant challenge for microfinance programs, and successful social funds have required a very high level of additional technical expertise in microfinance. Training in microfinance is necessary for both social fund staff as well as staff of microfinance institutions. For example, the social fund in Yemen devoted substantial resources to training and sent program staff to international courses in microfinance and on study tours to learn from other programs. This help build their capacity and technical skills to monitor the growth of their program and the institutional development of participating MFIs. In Bosnia, the capacity building was targeted toward MFIs directly. By contrast, they delivered a series of courses and training sessions for MFIs on selected technical, financial and managerial issues. Training was conducted by international microfinance practitioners and was partially paid for by MFIs to ensure it was demand-driven. Experience has shown that all successful programs have made institutional development a top priority.

Tailor methodology

- **Tailor the methodology to local circumstances.** There has been tremendous progress over the last decade on developing approaches for delivering financial services to low-income households effectively. MFIs around the world have developed a variety of group-based and individual financial services methodologies. Social funds should encourage the MFIs to adapt these methodologies and develop delivery mechanisms and choice of products (loans, savings, leasing, etc) based on local traditional systems, market research, and pilot testing. Social funds have been shown to be good places to innovate in microfinance (see Albania case study).

Legal and Regulatory Framework

- **Projects should build in mechanisms to allow lessons from the microfinance program to feed into broader financial sector reforms.** Effective MFI programs can be initiated and expanded without changes to the broader financial sector policies and regulations. However, over the long haul, it is important that the lessons from the program contribute to developing a legal and regulatory framework conducive to microfinance (ie one that allows microfinance institutions to operate, does not limit interest rates, secures creditors rights, etc).

- **Microfinance components should take a long term perspective even if they are anchored within a project that has a limited lifespan.** Microfinance programs that have taken this long term perspective from the outset and worked toward the development of the industry as a whole have been the most successful. Albania, for example, established institutional channels to do this from the outset which helped bring about important changes to the legal framework and improvements in the policy environment. These changes enabled the microfinance program eventually to be spun off into a self sustaining microfinance institution.

CGAP Microfinance Tools and Services

Below is a list of tools and services for World Bank task managers and project staff involved in designing and implementing poverty-focused or multi-sectoral projects with microfinance components. A complete list of resources can be found at www.cgap.org.

Reporting and Transparency

Disclosure Guidelines for Financial Reporting by MFIs: CGAP's member donors have agreed on a set of Disclosure Guidelines for Financial Reporting by Microfinance Institutions. This can be downloaded from: http://www.cgap.org/html/p_technifsg.html

Poverty Assessment Tool: This tool was developed by CGAP and IFPRI, and can be used by donors to determine the relative poverty levels of an MFI's clients (its poverty outreach). This can be downloaded from: http://www.cgap.org/html/p_other_documents.html#IFPRI

Handbook for Appraisal of Microfinance Institutions: This format for MFI appraisal includes standard definitions for reporting indicators, and can be downloaded from: http://www.cgap.org/html/p_technical_guides04.html

Microfinance Training

CGAP and UNCDF Donor Training: CGAP and UNCDF/SUM provide periodic training for donor staff either to individual agencies or to groups of agencies.

Donor Training at Boulder: The Microfinance Training Program in Boulder, Colorado, held in July-August each year, has provided high quality and in-depth training to World Bank staff over recent years, as well as to a range of practitioners, donors, and consultants.

For information on microfinance training opportunities, see: http://www.cgap.org/html/ds_staff_training.html

Web-based Resources and Publications

The Microfinance Gateway (www.microfinancegateway.org) is managed by CGAP as an open resource for the microfinance industry, and has extensive resources, including a searchable library of 15,000 microfinance-related documents.

CGAP Publications: The following technical guides and documents can be downloaded from: <http://www.cgap.org/html/publications.html>.

- Focus Notes: A short note series on current topics or trends
- Occasional Papers: An analytical paper series that provides in-depth discussion of technical topics
- Technical guides: Handbooks and guides with software specifically tailored to address gaps in technical know-how for practitioners and donors
- CG Working Group papers: Papers by academic researchers, microfinance practitioners, and donor staff on various topics