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Social Fund Support of Microfinance: A Review of Implementation Experience

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These case studies were developed in order to help Bank task team leaders and their client country counterparts design and support effective microfinance components within social funds. The case studies aim to highlight best practice as well challenges for designing and implementing a microfinance component within a multisectoral project. Based on lessons learned from these case studies, a set of guidelines were developed and is available from the Social Protection Advisory Service or the Social Funds website.

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I. Overview

Objective

As microfinance has become recognized as a valuable tool for increasing the livelihoods and reducing the vulnerability of the poor, many World Bank task managers and project planners have become eager to include microfinance components in social funds and other multisectoral projects. As a result, there has been a growing demand for information on successful approaches to project design and implementation.

In response to this demand, the Social Fund Thematic Group has initiated several activities to support task managers in their work. The first of these activities is this series of case studies that reviews social fund projects with microfinance components. The case studies, which focus on Panama, Yemen, Albania, Bosnia and Herzegovina, and Eritrea, explore a wide range of implementation experiences—both successes and failures. The objective is to identify lessons, best practices, and potential pitfalls. The next step will be to develop practical guidelines for task managers on how to encourage and replicate successful approaches.

Social funds are demand-driven mechanisms that channel resources to the poor and support subprojects that respond directly to the priority needs of the poor. They have been used in a growing number of countries to alleviate the social and economic effects of economic crises, cushion the impact of adjustment programs, generate short-term employment, and finance small-scale investments in poor communities. Since 1987, the World Bank has supported more than 60 social fund programs.

The Social Fund/Microfinance Debate

Despite the attractiveness of microfinance as a tool for poverty reduction, combining social funds—which typically provide grants to community groups, nongovernmental organizations (NGOs), and local governments for community development initiatives—and microfinance is a complex and even controversial undertaking. As these case studies illustrate, social funds are accompanied by a set of constraints that, if not addressed explicitly at the outset, can make adhering to microfinance best practices difficult or impossible. Such constraints vary widely, but commonly include organizational structures that emphasize grants or infrastructure subprojects, budget systems that do not permit rigorous monitoring of microfinance institutions (MFIs), and staff incentives that focus on disbursement of funds rather than sustainability of MFIs. Experience has shown, however, that if a project is designed properly and supported with adequate technical assistance from the outset, microfinance components within social funds can not only respond to a community's demand for financial services, but also provide the nucleus of a country's microfinance industry.

Several options exist for designing projects to support microfinance. For example, microfinance can be part of a financial sector investment loan which has the advantage of introducing general policy and regulatory framework reforms. However, most financial sector operations are aimed at the formal financial sector and larger commercial banks in particular. While this is changing, few address the microfinance niche. Freestanding microfinance projects that focus exclusively on microfinance are also rare. As a result, and because they are more directly linked with community-based demand, social funds and other multisectoral community-level programs have been asked to support microfinance activities as a way of improving incomes and encouraging productive endeavors at the local level.

This study does not seek to answer the broad question of whether social funds are or are not suitable vehicles for microfinance. That would be well beyond the scope of this review. Rather, it takes the approach that, given that social fund projects *do* offer microfinance services, what have been the results? What has worked, what has not, and why? The goal is to identify lessons and best practices from the field, as well as specific obstacles related to implementation that program staff encountered along the way.

New Generation of Social Funds

These case studies focus on a "new generation" of social funds with microfinance components that have been designed and implemented primarily since 1995. It was at that time that a World Bank portfolio review found that, though a small number of social fund programs displayed positive results, the portfolio overall did not generally reflect best practices as characterized by successful microfinance programs worldwide.[1] Performance was satisfactory in terms of targeting, but microfinance programs generally failed to pay

[1] Portfolio Improvement Program—A Review of Social Fund Microfinance Components. World Bank, Financial Sector Development Department, October 1996.

adequate attention to the institutional development and sustainability of their partner financial institutions. This largely reflects the emergency focus of the first generation of social funds. Government policy was oriented more toward creating employment and improving income in response to a crisis than toward longer-term objectives. As such, social fund activities were not geared toward strengthening or reforming the microfinance sector, but rather toward using existing microfinance programs as channels for expanding employment.

This new generation of projects also benefited from developments in the microfinance industry. In 1995, the microfinance industry went through a major transition when the donor community achieved consensus on the broad strategies for the sector and issued *Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries*. The principles have influenced the sector dramatically and point to the critical importance of capacity building for MFIs.

This study suggests that the response of social funds to these industry developments, findings, and recommendations has been positive. What has emerged from the case studies is a picture of a new generation of social fund projects that incorporate microfinance best practices to a greater degree than in the past, in keeping with their evolution toward longer-term objectives. Several of the most successful projects have shifted their focus from reaching disbursement targets to achieving institutional and financial sustainability of MFIs.

The studies show that many projects have adopted a "phasing approach" to institutional development, in which the microfinance program is anchored within the social fund only on an interim basis. During the first phase, the project develops and tests its methodology and trains a core group of staff members. During the second phase, it expands in size and scope, develops new products, and builds staff capacity. During the third phase, it reaches institutional and financial sustainability and is "spun off" from the social fund or removed from government control.

The case studies explore a broad range of implementation experiences. Main lessons are outlined below.

- **Bosnia and Herzegovina:** The Bosnia case illustrates how a "stand-alone" microfinance project can be designed within a social fund and incorporate many of the industry best practices.

- **Albania:** The Albania case illustrates how the "phasing approach" to institutional development works. It demonstrates how a very small pilot project within the social fund can serve as the basis of a country's microfinance industry and lead to a private, self-sustaining MFI. While the Albanian Development Fund provided the institutional backing, space, and flexibility to pilot microfinance, in the long-term the institutional environment was not conducive to fiscal discipline or sustainability.

- **Panama:** An examination of the experience in Panama confirms that social funds can be risky vehicles for microfinance if they do not contain adequate measures for institution building at the outset. As originally planned, the project did not take an industry-wide view nor focus on the institutional development requirements of the partner organizations and, as a result, faced numerous and complex challenges in redesign.

- **Yemen:** The Yemen Social Fund for Development is the first microfinance program in the region to develop a lending methodology based on Islamic banking practices. While the main challenge of the first phase of the project was to establish MFIs where none existed, the challenge of the second phase is to build the capacity of those institutions to provide services on a sustainable basis.

- **Eritrea:** The case of Eritrea shows how a social fund can operate a microfinance program in a post-conflict environment. It is a case in which, given the lack of feasible alternatives or existence of appropriate partner institutions, the social fund engages in direct finance, but does so only as a first step toward developing sustainable financial institutions.

Methodology

The case studies are based on desk reviews of relevant literature, project documents, and operational manuals, as well as on interviews with task team leaders and project staff. The studies have been conducted in collaboration with the Bank's Social Fund Thematic Group, Rural and Small Enterprise Thematic Group, CGAP, and the Financial Sector Development (FSD) Department.

II. Case Study: Bosnia and Herzegovina

Name of project	Local Initiatives Project
Date of appraisal	November 19, 1996
Main components	a) Microcredit Programs, b) Microfinance Capacity Building, c) Project Management
Total project cost	$US18.0 million
Bank loan amount	$US7.0 million
Microfinance component as percentage of Bank loan	100 percent

Introduction

The Local Initiatives (Microfinance) Project (LIP) was designed in the immediate post-conflict context of Bosnia and Herzegovina under the overall framework of the Priority Reconstruction and Economic Recovery Program.[2] Combined with other investments (public works, employment counseling, and retraining) the project aimed at assisting people in making the transition away from unemployment and dependence on humanitarian assistance to active employment and income generation.

Objectives

The project was the first major investment in microfinance in Bosnia and Herzegovina. Although there was a tradition of savings and credit associations, particularly within state-owned companies, there were no microcredit services available for low-income entrepreneurs at project start. The overall aim of the project was *to jumpstart the 5- to 10-year process of establishing a strong microfinance sector* so as to help raise incomes, create jobs, and develop the smallest businesses. This was to be done by contracting selected organizations that met specified eligibility criteria and providing them with the financial and technical support and incentives to develop into high-performing microfinance operations.

Specifically, the project had three objectives:

- To provide access to credit to the economically disadvantaged and war-affected, specifically low-income microentrepreneurs who had no access to credit from the

[2] This case study is an adaptation of the presentation written by Sarah Forster in January 2001, at the Social Fund Thematic Group's series on social funds with microfinance components.

commercial banking sector. A performance target of up to 10,000 loans were to be disbursed.

- To facilitate the development of independent, financially viable MFIs that would continue to provide credit to low-income entrepreneurs over the long-term.
- To create an appropriate legal and regulatory environment for the provision of credit and savings services to low-income entrepreneurs.

Institutional Arrangements

The project is a stand-alone microfinance project, implemented by two specialized agencies—the Local Initiatives Departments—within two government-created, autonomous foundations. These foundations also implement three other projects, including the Public Works and Employment Project, which is based on a social fund model and offers demand-driven, small-scale investments for communities.

The Local Initiatives Departments acted as apex institutions with three main roles:

- To channel loan fund and operating cost support to selected microcredit organizations under performance-based contracts.
- To organize capacity-building support to develop partner institutions as sustainable MFIs.
- To monitor the institutional and financial performance of the partner institutions.

Implementation Experience

The project vastly exceeded its original objectives. As of October 31, 2000, a total of 61,975 loans had been disbursed for a total value of $US83 million-equivalent, with an average loan size disbursed of $US1,450. Repayment rates are extremely high, with less than 1 percent of the outstanding portfolio at risk.

Post-conflict Impact

For many borrowers, the provision of credit targeted toward people such as themselves, without assets or big businesses, has had a positive psychological impact, particularly important in the post-conflict environment.

Seventy-nine (79) percent of the borrowers consider that the loan has significantly improved their economic situation, with increases in monthly household income averaging 26 percent. Thirty (30) percent of businesses stated that they were able to employ one or more additional people after loan disbursement. Forty-nine (49) percent of the borrowers are women, many of them widowed during the war.

Performance Assessments of MFIs

The LIP originally provided financing to 17 selected NGOs. An institutional and performance assessment resulted in withdrawing loan funds from eight organizations and continuing to finance only nine (six local and three international NGOs). The eight organizations ended up merging with those that had continued access to financing, resulting in a welcome consolidation within the microfinance sector.

As of June 30, 2001, these nine MFIs were serving a total of 25,000 active clients (between 1,000 and 4,000 clients each) with outstanding loans worth a total of $US25 million. All nine MFIs are operationally sustainable after less than four years of operation (that is, they are able to cover all their operating costs from the operating income).

Developing a Legal Framework

The process of developing an appropriate legal framework for MFIs is well advanced. A legal and regulatory framework was developed by a working group composed of Ministries of Finance, the Banking Agency, MFIs, the World Bank, and USAID. This framework proposes the creation of four categories of financial institutions based on services provided and public risk. The first step of developing and passing a Law on Microcredit Organizations—such that existing credit-only, non-profit MFIs could register and operate legally—has been achieved.

Financial Sustainability

Partner MFIs received grant support for their start-up fixed and operating costs for the first three years of operations. This support declined from 100 percent of operating costs in year one to 50 percent in year two and to 0 percent in year three.

Operational cost support, referred to as "management fees," totaled $US 4 million, or 18.4 percent of total financing. The nine MFIs currently financed received an average of $US320,000 each in operating subsidy. Today, all MFIs cover their own operating costs from their own operating income and are not dependent on injections of outside funding to continue running.

Second Local Initiatives Project

The success of the LIP has led to the development of a second microfinance project, also funded by the World Bank and other donors. The Second Local Initiatives Project (LIP II) is designed to build on the achievements of LIP I and increase the scale, financial viability, and social impact of microfinance services in BH. LIP II will continue to foster entrepreneurship and promote active employment by providing access to financial services to low-income entrepreneurs who currently have limited access to services from the commercial banking sector. It will also support the development of new products and services and encourage a greater focus on the needs of low-income clients to broaden and deepen financial service delivery to the poor.

The project will continue to take a strategic approach of developing a strong sustainable microfinance industry at a nationwide level. The LIP II has two main differences from its predecessor project:

- LIP II is explicitly designed to ease transition of the microfinance sector from dependence on World Bank and donor financing toward more sustainable sources of financing. Donor grants and concessional funds are limited and not dependable in the long-term. There is a pressing need for MFIs to be able legally to access commercial sources of debt and equity. For some, this includes legally being able to collect savings. LIP II will focus on further developing the legal and regulatory framework for microfinance such that MFIs can expand their sources of capital.

- LIP II will encourage MFIs to pay more attention to client-level information for understanding program impacts and developing new products and services. The aim is to support the shift from a product-oriented approach (focused on developing new types of financial products such as term loans, leasing, savings) to a more client-centered approach (focused on the income impact on clients) This aims to achieve a good balance between social and financial outcomes.

Lessons Learned

NGOs as Implementing Partners

The decision to implement the project by contracting NGOs proved to be appropriate in the particular context of post-conflict Bosnia and Herzegovina. Although other legal entities (commercial banks, private agencies) were also eligible to apply and participate in a competitive selection process, NGOs demonstrated a better understanding of the needs of target borrowers and had other comparative advantages (outreach, reputation in communities, commitment to microcredit, and so forth). However, financial and business skills and management capacity vary across the NGOs. Ultimately, those NGO microcredit organizations that have the best possibility of surviving long-term are those that combine a clear client-driven vision and strategic goals with strong business management capacity.

Institutional Approach

The first project objective of disbursing 7,000–10,000 loans to low-income entrepreneurs was met after only 18 months of project implementation. However, it was agreed that this result would not have a significant impact if it was not linked to the development of institutions that would be able to provide these services over the longer-term and on a sustainable basis. Therefore, particularly during the second half of the project, increased investments were made for technical assistance (TA) and training to strengthen the capacity of partner MFIs in all aspects of microcredit operations. Well-tailored technical assistance also contributed to highly satisfactory performance of partner organizations, all of which have reached operational sustainability.

The TA strategy was to use short-term consultants at the outset rather than long-term advisors. By 1999, partner MFIs were increasingly able to identify their own technical needs, and the TA became more demand-driven to address both common and specific areas of interest for MFI operations. MFIs also paid a portion of the TA costs. In addition to individual training to MFIs, the project organized training courses on topics such as lending methodologies, portfolio management, loan officer training, and financial management.

Performance-Based Financing

Project financing was provided based on the performance of each partner MFI against mutually agreed-upon performance standards related to institutional and financial performance. Furthermore, project financing was tailored "as if" MFIs were borrowing from commercial sources (with cost of capital of 3–5 percent per annum), and reporting requirements were established similar to those of other financial institutions. This approach provided incentives to MFIs to strengthen their institutional and financial performance to meet the standards and develop appropriate internal policies and procedures that have helped them maintain impressively high-quality portfolios.

Consultative Approach

All the key policy decisions related to the Local Initiatives Project were made after consultations with all stakeholders (governments, MFIs, banks, donors, and so forth), which resulted in better understanding of the principles of microfinance. Consequently, MFIs were given an opportunity to work in an environment that was supportive despite the initial skepticism of government officials about the concept of microcredit and loans disbursed by NGOs.

III. Case Study: Albania

Name of project	Microcredit Project
Date of appraisal	May 28, 1999
Main components	a) Rural Credit and Savings Association Network, b) Urban Microcredit, c) Legal and Regulatory Environment, d) Project Management
Total project cost	$US22.8 million
Bank loan amount	$US12 million
Microfinance component amount of bank loan	$US11.2 million
Microfinance component as percentage of bank loan	93 percent
Predecessor projects	a) Rural Poverty Alleviation Pilot Project (1993) b) Rural Development Project (1995) c) Urban Works and Microenterprise Pilot Project (1995)

Introduction

In the early 1990s, Albania faced a serious economic crisis. Having just emerged from more than four decades of communism, it was the poorest country in Europe and only a fledgling democracy. In response to this crisis, in 1993 the government of Albania launched the Rural Poverty Alleviation Pilot Project, to be implemented by the newlycreated Albanian Development Fund (ADF). While the project focused on infrastructure rehabilitation, it included a small microfinance component.

Since that time, microfinance in Albania has evolved dramatically. In 1995, the ADF expanded its microfinance program under two subsequent World Bank-financed projects. In 1999, the microfinance program was spun off into a stand-alone project that focuses on the development of private self-sustaining microcredit institutions. Albania is the only country to date where the microfinance component of a social fund has made this institutional transition. How did this transition take place, and what challenges did the project face along the path of reform?

The experience shows that while the ADF provided the institutional backing, space, and flexibility to pilot microfinance, the institutional environment was not conducive to fiscal discipline or sustainability. It also demonstrates that even a very small microfinance pilot project within a social fund can provide the nucleus of a country's microfinance industry.

Institutional Arrangements

The ADF is an autonomous government agency responsible for both infrastructure and credit activities. It is organized into six different departments: Infrastructure Works; Rural Credit; Microenterprise Support & Rural Activities; Urban Credit; Monitoring, Evaluation and Studies; and Finance and Administration. Policies and objectives are defined and overseen by a Board of Trustees (made up of government representatives) in conjunction with the various donors, primarily the World Bank. Overall management is performed by the Executive Director, a government appointee.

Project planners anchored the microfinance program within the ADF primarily because it lacked alternatives. A stand-alone microfinance project was not feasible in 1993 for several reasons. First, 45 years of isolation and collective production had left most Albanians without the skills and know-how required to engage in market activities.[3] Second, the country had no experience with microfinance, and therefore did not have an established lending methodology to build on. Third, there were no existing institutions or NGOs with the capacity to manage a microfinance program. Finally, the commercial banking system was non-existent. The Albanian state bank—the country's only functioning financial institution—was plagued by corruption and non-performing portfolios.

Implementation Experience

Phase I (1993-1995): Piloting

Under the Rural Poverty Alleviation Pilot Project, the ADF focused on piloting its credit methodology for its microfinance program. Because the ADF's microfinance component was small in relation to other components, it received very little attention when it began. Both the government and the Bank concentrated on the infrastructure side. The result was a rare and valuable opportunity for innovation: The project enjoyed relative freedom and valuable flexibility to test and develop its approaches.

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[3] Case Studies in Microfinance, Legerwood, Joanna, May 1999, p. 7.

The decision to focus on the credit methodology at the outset was critical to the project's success in the later phases. Because the financial products were tailored so closely to local circumstances, when the program expanded, it was able to maintain very high portfolio quality. Specifically, the urban and rural microfinance programs employed separate methodologies.

The rural methodology used group-based lending and was dependent on ownership and management at the village level. Village Credit Funds (VCFs)—revolving fund accounts—were managed by elected Village Credit Committees (VCCs), of which an ADF representative was an ex-officio member. The VCC themselves decided on credit allocations, defined collateral, and controlled the repayment of loans. ADF credit officers provided intensive support to VCCs and information and advice to clients.

The urban methodology was developed beginning in 1994 under a pre-pilot project operating in three cities: Tirana, Shijak, and Shkoder. It was based on individual lending, secured by character assessment, evaluation of client's business, and close monitoring by the loan officer.

Phase II (1995-1999): Expansion

In 1995, after three years of microfinance experience, the ADF substantially expanded its microfinance programs. It supported rural microfinance under the Rural Development Project and urban microfinance under the Urban Works and Microenterprise Pilot Project. Under these projects, the ADF became the only true provider of microfinance services in the country beyond the informal sector.[4]

With this expansion, the microfinance sector entered the next stage of development. The ADF placed a greater emphasis on financial sustainability of the program. The project's orientation shifted from disbursement to developing a credit system that would be financially sustainable and provide microentrepreneurs with access to credit in the long run. The ADF began to closely monitor sustainability and identify operational and social intermediation costs of its credit departments.

[4] Legerwood, p. 10.

Phase III (1999-Present): Exit from the Social Fund

By 1998, ADF's three main programs—infrastructure, rural microcredit, and urban microcredit—were well-developed. Each required its own institution to further expand and reach its full potential. Although the ADF had achieved good results and high repayment rates with its microfinance programs, both the rural and urban programs required subsidies to cover operational costs.[5] It became evident that the ADF was not providing the appropriate institutional environment for the development of sustainable, self-financing credit delivery, primarily because it lacked hard budget constraints and its management did not focus on cost recovery.

As a result, in 1999, staff embarked on the project's most major institutional reform task to date: removing the microfinance program from the ADF. The ADFs microfinance programs were spun off into two separate institutions. The rural credit program was transferred to a new, quasi-governmental Rural Finance Fund. The urban credit program was transferred to the Besa Foundation, a new private microfinance foundation established with the assistance of the Open Society Institute. Both programs are now supported by the Microcredit Project.

Achievements

The rural and urban microfinance programs continue to make strong progress under the Microcredit Project.

- ***Rural Credit:*** Twenty-one Savings and Credit Associations (SCAs) have been created so far under the Rural Finance Fund. Meanwhile, the overall Village Credit Fund portfolio continues to perform at a high level. As of December 2000, there were 156 VCFs in five districts with more than 4,400 active loans amounting to $US2.6 million and only 3.46 percent portfolio at risk (over 60 days).[6]

- ***Urban Credit:*** As of December 2000, the Besa Foundation's urban credit program had more than 2,600 outstanding loans totaling $US4.9 million and a portfolio at risk of 2.1 percent.[7]

[5] PAD, Microcredit Project, May 28, 1999, p. 3.
[6] Albania Microcredit Project, Back to Office Report, April 10, 2001.
[7] Ibid.

Constraints

Following are some constraints created by the ADF's institutional environment that limited the growth and sustainability of the microfinance program.

- ***Soft budget mentality:*** The most important constraint was the ADF's weak emphasis on cost recovery. The ADF's parallel infrastructure program did not face the same cost recovery issues as the microfinance program, and therefore made it difficult for staff to introduce the financial discipline necessary to develop a sustainable MFI.

- ***Joint balance sheets:*** The fact that the accounting and balance sheets for the microfinance and infrastructure components were joined under the ADF also reduced the incentive to keep tight budget controls. If the project had established separate balance sheets originally, it might have been possible to avoid this issue, but the ADF management strongly resisted this change once the program was in operation.

- ***Lack of an exit strategy:*** The removal of the rural and urban microfinance units from the ADF took years of negotiation by Bank staff and required substantial support of microfinance experts. This transition, while critical in moving the program toward institutional sustainability, proved to be one of the most difficult to implement. The government had developed a strong sense of ownership of the program and was reluctant to turn it over to private management. The main lesson is the need to build a clear exit strategy into the project design. If privatization had been articulated as a goal at the outset, it might have been easier to convince the government of its necessity.

Success Factors

Following are some factors that contributed to the success of the project.

- ***Staff training and commitment:*** From the outset, the ADF invested heavily in training the staff of its microfinance unit. This proved critical to the project success, particularly in 1997 when Albania began spiraling into dramatic political and economic crisis.[8] Banks and public buildings were burned, the government was forced to resign, and stocks of arms were looted and seized by the population, then turned against the authorities and businesses.

Under these conditions, no one knew whether the ADF's rural and urban microfinance programs would survive, much less continue to succeed. Against all odds, the ADF carried on its work, maintaining high loan portfolio quality. The ADF's rural credit officers continued to travel to remote villages for loan repayment and disbursement—often

[8] Legerwood, p. 3.

risking their personal safety—in order to preserve the integrity of the VCF system. The urban credit officers continued to collect and disburse loans, even though some cities lacked functioning banks.

- ***Methodology tailored to local context:*** ADF's use of village members in the management of VCFs in its rural credit program resulted in a level of ownership and commitment to success that is not always found in other microfinance organizations.[9] ADF's unusually high repayment rate is evidence of this, as village members have successfully approved and monitored loans within their communities and assisted borrowers who have run into difficulties. Furthermore, the insistence on full loan repayment in order for others to receive loans ensures a commitment on the part of all village members.

- ***Separation of microfinance and infrastructure programs:*** Part of the reason that the program succeeded in the social fund environment was because it separated itself to a large degree from the infrastructure program. The ADF made a deliberate effort to provide microcredit in communities where infrastructure projects had not taken place, and vice versa. While this had the advantage of minimizing confusion between grants and loans, it prevented synergies between the sectors.

- ***Consistent donor support and assistance:*** The World Bank's support of ADF has been consistent since its inception.[10] The Bank's task manager was instrumental in setting up ADF and comanaged the project throughout the first two phases. The continuity provided through frequent field visits and close supervision has led to a good relationship between ADF staff and its donors.

Lessons Learned

While the ADF provided the institutional backing to develop and test the methodology in both urban and rural areas, it did not provide the institutional environment conducive to fiscal discipline or sustainability of a microfinance program. The main lessons learned are:

- The credit delivery mechanisms have to be based on local context and tradition.
- Community-based microfinance can overcome rural finance systemic weaknesses and withstand political and civil crises.
- Early emphasis should be placed on financial sustainability and the institutional environment.[11]

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[9] Legerwood, p. 22.
[10] Legerwood, p. 22
[11] Community-Driven Development in ECA: Experience with Microcredit, BBL, April 10, 2001.

- Microfinance programs should establish a clear exit strategy from the social fund at the outset.

IV. Case Study: Panama

Name of project	Panama Social Investment Fund
Date of appraisal	May 29,1997
Main components	a) Infrastructure (Social and Economic), b) Pilot Projects (school feeding, social services for disadvantaged groups, microenterprise), c) Project Management
Total project cost	$US80 million
Bank loan amount	$US28 million
Microfinance component amount of Bank loan	$US 5.3 million
Microfinance component as percentage of Bank loan	7 percent

Introduction

In 1997, the Government of Panama with support from the World Bank launched the Social Investment Fund Project. The objective of the project is to alleviate poverty by addressing the demands of the poor for priority infrastructure and services and by providing support for productive activities. The project includes a $US5.3 million microfinance pilot program to channel credit to microenterprises through intermediary organizations.

During the first two years of implementation, the microfinance program faced a series of difficulties, many of which derived from the project's focus on disbursement rather than institutional sustainability of MFIs. Project planners did not take into account many of the key design principles that characterize the new generation of microfinance projects—those that focus on institution building, sustainability, and outreach. The lack of attention to such principles created numerous bureaucratic obstacles and resulted in major challenges in redesign. As a result, no loans were disbursed until the fourth year of the project.

Institutional Arrangements

The Fondo de Inversion Social (FIS)[12] implements all subprojects within the Social Investment Fund Project. The staff from the small microfinance unit, Dirección de Credito para Actividades Productivas (DCAP), coordinates the microfinance program, selecting

[12] Until 1999, the FIS was known as the Fondo de Emergencial Social (FES).

intermediary organizations and providing support for training of staff and other institutional development activities in those organizations.

Project Design

Project planners anchored the microfinance component within the social fund largely because they viewed it as a good vehicle for disbursement and a way to channel funds quickly to microbusinesses. The decision was also influenced by the fact that Bank lending to Panama was relatively limited, and while a financial or private sector development project might have been a more appropriate vehicle for microfinance, no such projects were in the pipeline. At the time, the Bank was also widely supporting microfinance components within social funds in other countries in the region, as well as in Africa and South Asia. The Honduras Social Fund model, which included microfinance as a second-tier operation, also heavily influenced project design.

Many of the problems with the project resulted from its original design. At the outset, project planners believed that the FIS offered simple institutional arrangements (the social fund channels resources to several existing and sound MFIs, which would onlend to the target group) and, therefore, did not adequately assess the menu of institutional options available to them. The apex model that was chosen was in fact just one of four options available in Latin America to support microfinance operations. Other options included (i) a federation, (ii) an association of MFIs, and (iii) a private foundation. Although the social fund was probably the easiest vehicle to set up at the beginning, experience has shown it was not the most effective. In addition, a social fund as a second-tier operation assumes that a large number of eligible MFIs will be ready for portfolio expansion. That number of MFIs, however, was at the time and remains small in Panama today.

The other models offered several advantages. First, since the other models were not in the political mainstream like the social fund, they might have been less likely to fall apart with political campaigns and the aftermaths of elections. Second, they probably would have been able to pay higher wages and attract more professional, less political staff with relevant business experience. Third, a private association, because of its membership base, might have been able to represent the industry better in a policy dialogue or respond more effectively to the technical assistance needs of MFIs.

Problems and Constraints

Emphasis on Infrastructure

The social fund's overwhelming emphasis on infrastructure projects created a series of problems for the microfinance program. Neither Bank nor government staff devoted adequate attention to the issues specific to the microfinance sector at the outset, and expected the microfinance component to be implemented largely in the same manner as the other subcomponents. This lack of attention to the requirements of a microfinance program is reflected in the fact that the project preparation team did not include a microfinance expert. As a result, it was not able to build in many of the recent lessons and best practices that have emerged in other parts of the globe. It was not until December 1998, when the Bank recognized it could not manage this component without special assistance, that a microfinance expert became part of the Bank team.

Focus on Disbursement Rather than Sustainability

While the program did not subsidize interest rates, its other design features resembled the previous generation of microfinance projects. Much like infrastructure projects of the 1980s, these microfinance projects focused primarily on disbursement and reaching a target number of "beneficiaries," rather than the sustainability of the MFIs and building credit histories for "clients." This bias left huge gaps in detail, especially on the training and capacity-building side. There were no plans to strengthen the systems and operations of financial intermediaries, so that they could serve an increasing number of low-income microenterprises efficiently and soundly. In addition, the project measured success in terms of number of loans and, therefore, did not set up any processes to monitor the improvements in the institutional capacity of partner institutions. The FIS originally required no reports from partner institutions, no monthly statistics, and no monitoring of staff development or system improvements.

Vague Operational Details

The project appraisal document contained fewer than two pages of details on how the component would operate. While this lack of detail had the advantage of providing a degree of freedom to the financial intermediaries to innovate and develop their own methodologies, products, and services, it caused many difficulties and delays during the first two years of implementation and required serious efforts to correct.

Political Issues

The location of the microfinance program within the social fund has made the program vulnerable to political interference. For example, the change in government following the elections in December 1999 in Panama resulted in almost a complete change in personnel in the microfinance unit, DCAP, and severely disrupted progress. More importantly, disagreements slowed down the government approval process and disbursement, ultimately costing the microfinance program some of its credibility with key actors. Bureaucratic obstacles in combination with design issues meant that the program did not disburse any loans for the first three years.

Implementation Experience

In early 1999, the DCAP team made the tough decision to redesign many of the project's central features. Some of the main issues requiring attention are described below.

Selection of Partner Financial Intermediaries

The original project design set forth no criteria for selecting partner organizations other than that the FIS would lend to two types of financial institutions: "established" intermediary organizations and "emerging" ones. As a result, the staff evaluated loans to financial institutions in the same way they evaluated infrastructure subprojects. They developed a point system to classify the partner as a category 'A' institution (80 to 100), 'B' (65 to 80), or 'C' (below 65). The number of points set the range of potential borrowing from the FIS.

The system suffered from several weaknesses: It was (i) subjective, (ii) not based on a detailed technical review of time series financial statements, and (iii) not uniform across institutions. Past financial performance and systems made up only 35 percent of the score, yet these were decisive for achieving both the scale and sustainability objectives and assuming the soundness of the partners. The definitions were applied inconsistently, and some numbers were clearly not linked to the financial statements. No adjustments were made to the financial statements to recognize the effects of in-kind and other subsidies and grants, making comparisons impossible and the analysis much less valuable. Most importantly, the selection process did not lead to recommendations to the partners on ways that they could improve management systems, products, and services to increase efficiency and reach more low-income microenterprises.

In December 1998, a project supervision mission recommended that the project take several steps to improve the selection of MFIs and streamline the appraisal process. First, it recommended that when evaluating partner institutions, staff should use the financial and poverty indicators developed by the Consultative Group to Assist the Poorest (CGAP). Second, it recommended that Portfolio At Risk (PAR) of 30 days be used as the measurement across institutions, since this is becoming the standard for the microfinance industry (PAR shows the real risk of the portfolio by comparing outstanding loan balances for loans with at least one late payment to the outstanding loan portfolio.) Third, the point system was adjusted to measure the maturity and efficiency of financial systems such as internal audits, external audits, a write-off policy, reserves for bad debts, and delinquency tracking and treatment. Unfortunately, many of these changes were done away with several months later when, as a result of changes after the national election, the entire team was let go by the FIS, leaving little documentation on changes in the process.

Institutional Development Plans

The program's focus on disbursement meant that at the outset the FIS had no strategy for helping partner organizations to improve their operations or build capacity of their staff. Thus, the project introduced the concept of *institutional development plans* for each partner institution, with the goal of improving the long-term sustainability of the microfinance industry in Panama. FIS staff now work with each potential partner institution to develop a plan tailored to the institution's needs. This brief plan includes (i) the institution's development objectives, (ii) the identification of its operational weaknesses, and (iii) a specific plan of technical assistance, training events, and other types of support (such as consultancies) proposed by the MFI and technically verified by the DCAP FIS team to overcome each major weakness.

Contracting Procedures

Some of the Bank's internal contracting procedures also created barriers to implementation of the program. For example, at the outset, the Bank required a no objection to all packages of subloans from the Bank task team leader (TTL). This meant that the TTL had to review a 12-page document for each subloan to a borrower—a requirement developed for infrastructure subloans in the parallel FIS programs, but totally inappropriate for a microfinance program attempting to streamline approval processes. This issue was resolved administratively by the Bank after lengthy discussions.

Lessons Learned

An examination of the experience in Panama with the FIS confirms that social funds can be risky vehicles for microfinance if they do not contain adequate measures for institution building at the outset and are not treated differently from social fund infrastructure activities. In particular:

- A social fund project must take an industry-wide view to be successful, focusing on the institutional building blocks of participating MFIs and sectoral issues, not just on reaching disbursement goals.

- Social fund projects should include microfinance experts as part of the project preparation team in order to ensure that industry best practices are incorporated in project design.

- Project planners should explore the full range of institutional options before including a microfinance project as part of a social fund. This is critical to ensure that the social fund is positioned to support the development of the microfinance sector in the country and that it adds value by encouraging existing MFIs to expand to new regions, serve new types of clients, and develop new financial products for the target group.

V. Case Study: Yemen

Name of project	Second Social Fund for Development Project
Date of appraisal	April 11, 2000
Main components	a) Community Development, b) Microfinance and Income Generation, c) Capacity Building
Total project cost	$US175 million
Bank loan amount	$US75 million
Microfinance component	$US5 million
Microfinance component as percentage of Bank financing	6.7 percent

Introduction

Since 1996, the Yemen Social Fund for Development (SFD) has served as an important vehicle for developing and testing approaches to microfinance tailored to local circumstances. It is the first microfinance program in the region to create and expand a lending program based on Islamic banking practices. While the main challenge of the first phase of development was to establish microfinance institutions where none existed, the challenge of the second phase is to build the capacity of those institutions to provide services on a sustainable basis.

Institutional Arrangements

The SFD was established in September 1997 as an autonomous agency with financial and administrative independence from the government. A Small and Micro-Enterprise Development Unit is responsible for administering the SFD microfinance and income-generating programs through eligible intermediaries. This unit was separated from the other units administering the social fund subprojects.

The unit's main task is to provide technical and financial support to intermediaries using clear and transparent guidelines. Continued support depends upon intermediaries meeting performance standards.

Achievements

The provision of credit to small and microentrepreneurs is a relatively new phenomenon in Yemen. Until the SFD launched a microfinance pilot project, there were no institutions that provided microfinance services to the poor. Now in its second phase, the

SFD has grown to support three microfinance programs and four income-generating programs, all supported by extensive capacity-building programs.

- As of March 2001, SFD had 3,993 outstanding borrowers and 60 savers, with a total outstanding loan amount of $US729,449.[13]
- Since its inception, SFD has supported 11,676 borrowers and 1,500 savers, with a cumulative loan amount of $US2,913,629.[14]

Implementation Experience

Piloting and Selecting Partner Institutions

At the time of the SFD establishment, Yemen had neither the experience nor the institutional capacity to deliver financial services effectively to the poor. The World Bank, with assistance from the EU and the Netherlands, launched pilot projects in two regions: the urban slum areas of Hodeidah city, and the remote areas of the Dhamar Governate. The main objectives were to develop local capacity to build and manage sustainable microfinance programs and to test new delivery mechanisms in a variety of settings.

Selecting partner institutions was considered one of the most difficult tasks, given the goal of identifying partners with the potential to operate financially sustainable microfinance programs. For example, at the start of the project, the SFD identified 10 local NGOs and welfare associations in Hodeidah as potential partners. All had extremely limited capacity. The Hodeidah Women's Union (HWU) was determined to be the most suitable partner for several reasons. First, it had experience in providing a range of "traditional" women's services such as literacy classes and outreach services. It also had an active and committed board and a large network of potential clients, both male and female. The Hodeidah program now operates the largest microfinance program, with 2,072 active borrowers.

The experimentation done under the pilots has proved critical to the success of the project. The pilots explored models for urban and rural areas as well as group and individual lending methodologies that were later replicated and expanded. In addition, the pilot established a few microfinance intermediaries that formed the backbone of the project.

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[13] Funds disbursed in YR, Aide Mémoire, May 2001, p. 2.

[14] Funds disbursed in YR, ibid.

Islamic Banking Practices

One of the main achievements of the program during its first phase was to develop a microfinance methodology closely tailored to local circumstances and based on Islamic banking principles such as Mudaraba, Murabaha, and Musharaka. Islamic banking practices do not use interest rates explicitly because of the strong religious and cultural resistance to them, but instead use fees or profit sharing.

The methodology used under the SFD includes effective interest rates based on fees or profit shares that are high enough to make the program financially sustainable. For example, in programs that offer livestock lending, the participating microfinance institution backs the intermediary by taking a share of the sale as price of repayments. This allowed a relatively high rate of effective interest (40 percent, less 10 percent inflation) without generating public comment or criticism.

Capacity-Building Requirements

The experience in Yemen has demonstrated that the SFD is capable of building MFIs with the potential for sustainability, but the institutions require intensive support from the outset. For example, the most successful microfinance program, operated by the Hodeidah Women's Union, was established as one of the original pilot projects. Although the program has reached operational sustainability, it continues to face major capacity-building issues in order to become institutionally and financially sustainable. Some of the difficulties arose because the microfinance department was separated to a great extent from HWU's other programs. It operated separate bank accounts, had specialized staff training, and implemented its own salary structure. Project planners viewed such autonomy as critical to the program's success at the outset; however, the result was that the program's board of directors was not involved in the program implementation enough to manage it without continuing support from the SFD.[15]

Staff Training

The lack of qualified staff in Yemen has been identified as a primary constraint to expansion of the program.[16] This issue has been and continues to be addressed in several

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[15] Hodeidah Microfinance Program TORs, p. 2.
[16] Mid-term review, p 10

ways including (i) through intensive training and TA for the microfinance unit staff by international microfinance consultants, (ii) through participation of key staff members in training programs internationally (for example, in Boulder, Colorado) and regionally, and (iii) by developing annual training plans. New plans intend to pair a regional MFI with the SFD to support a new program with an Islamic bank in Yemen.

Microfinance vs. Income-Generating Programs

The SFD operates both microfinance programs and income-generating programs (IGPs). Microfinance programs offer credit and savings services. IGPs offer loans to help the poor develop income-generating activities, such as beekeeping and cattle-raising. IGPs have been established in areas where existing demand for microfinance services was high, but where the client base was insufficient to justify large technical and financial investments required to establish an MFI.

Experience from the field reveals important differences in results between the two in terms of outreach and sustainability. Specifically:

- IGPs do not result in large benefits that can always justify the costs involved. The average number of clients for a typical IGP is much less than for microfinance programs.
- With the great majority of their portfolios concentrated in one activity, IGPs are more risky than microfinance programs.
- Problems associated with intermediaries continue to be the major hurdle for this component—generally a major capacity issue hinders working with NGOs, while work with the relatively stronger co-ops is hindered by lack of incentives for these profit-oriented institutions.

Based on this experience, the SFD will be focusing on developing more microfinance programs than IGPs in the future. When IGPs are developed, thorough efforts will be made from the design phase to diversify their portfolios.[17]

Catastrophic Insurance: Responding to a Nationwide Crisis

In 2000 Yemen was hit by Rift Valley Fever and foot and mouth epidemics. The disaster claimed the lives of more than 50 people and thousands of cattle and sheep and had a

[17] This mainly entails longer support to operational cost of programs to allow co-ops to have some financial benefits from income revenues from interest or *murabaha* income during the initial stages. In addition, the SFD Board has decided to allow the intermediaries to keep 50 percent of the net profits after the program reaches a mature state.

very strong negative impact on the portfolio of some of the SFD's microfinance and IGPs. The problems resulted from the loss of sheep and cattle by program clients, the severe drop in the price of meat, and moratoriums on the transport of animals in infected areas. Many programs very quickly depleted their insurance fund resources and faced rapidly deteriorating portfolios.

The SFD played an important role during this nationwide crisis by reducing risk to its borrowers and moved quickly to top the insurance funds of participating MFIs. It also agreed to support affected programs by writing off outstanding loans of clients who had losses of animals, or supporting the insurance funds of those programs that had them. Although the crisis was initially handled with the intermediaries on a case-by-case basis, measures are being implemented to formalize the insurance program in the future, follow international best practices, and ensure equity among programs. The SFD's contracts with MFIs in the future will be revised to include a formal catastrophic insurance clause.

Lessons Learned

Piloting the Methodology

One of the project's main achievements has been to develop a highly innovative lending methodology tailored to local circumstances. This was done primarily during the pilot stage, when the SFD explored a range of socially-adapted mechanisms, including urban programs, rural programs, programs for women, savings programs, and programs based on Islamic banking practices.

Demand for a range of financial services

The microfinance program in Yemen was conceived purely as a microfinance program. However, experience showed that poor clients demand a range of financial products, including savings. The SFD now supports two programs to encourage savings by poor women—one rural and one urban.

Capacity Building

Although the SFD focused on creating sustainable MFIs from the outset, capacity building remains the main implementation challenge. All of the programs continue to need substantial staff training and development to improve efficiency of their operations. To support this effort, the program has developed an improved operational manual based on international best practice standards. The program is also continuing to invest significant resources in training the microfinance unit staff so they can effectively develop and monitor the performance of partner institutions.

VI. Case Study: Eritrea

Name of project	Eritrea Community Development Fund Project
Date of appraisal	January 30, 1996
Main components	a) Social and Economic Infrastructure and Services, b) Pilot Savings and Credit, c) Capacity Building, Training and Research
Total project cost	$US 49.68 million
Bank loan amount	$US17.5 million
Microfinance component	$US3.11 million
Microfinance component as percentage of total financing	6 percent

Introduction

Established in 1996, the Eritrea Community Development Fund (ECDF) was the first program to provide microfinance services to the poor in Eritrea following 30 years of war. The program emerged in response to Eritrea's devastated economy. Enterprises were not operational, the agricultural sector was destroyed, and basic social service facilities had suffered from serious damage and neglect. The disruption of family life resulting from war, displacement, and drought also left thousands of citizens impoverished.

From the start, the government has viewed the ECDF's microfinance program as a first step toward developing and diversifying the financial sector. The program is designed not only to provide financial services to the poorest and most vulnerable groups, but also to encourage the development of sustainable microfinance institutions, particularly in rural areas. This long-term approach and focus on institutional development has influenced the project throughout implementation and contributed to its early achievements.

Institutional Arrangements

ECDF is a semi-autonomous unit operating under the Ministry of Local Government. It was launched in April 1993 as part of the Recovery and Rehabilitation Program for Eritrea. A central Savings and Credit Program (SCP) unit implements the microfinance program. The unit provides overall guidance for the program, carries out program-wide activities such as monitoring, and selects and trains field staff.

Village Administration Committees (VACs) handle credit decisions and lending at the community level. VACs are democratically elected institutions, responsible for promoting the program within the community, orienting "solidarity groups" of borrowers, keeping records on savings and loans, and handling arrears.

The ECDF offers both savings and credit through two types of loans. Tier I clients may borrow up to $US1,000 per group, and Tier II clients up to $US10,000. Groups become eligible for loans only after having successfully accumulated savings for up to three months.

Achievements

The outstanding portfolio currently stands at approximately $US1.4 million, with 87 village banks operating in the country.[18] Portfolio quality has been high, with 0 percent arrears in 1996, 1.15 percent in 1997, 2.04 percent in1998, 7.12 percent in 1999, and 5.96 percent in December 2000. Delinquency increased during 1999 and 2000 as a result of the conflict with Ethiopia.

Individual voluntary and open access savings accounts have proved most successful in attracting savers. Though the microfinance program has been experimenting with compulsory locked-in savings or group accounts, these services have produced lower outreach and slower growth of the deposit base than voluntary deposits.

Project Design: Phasing Approach

While the microfinance program demonstrated immediate success in reaching the target group with financial services, its location as part of the social fund is accompanied by significant risks. In particular, since the program follows the "revolving fund" approach, in which funds are lent to village groups and repaid to the social fund, the ECDF is involved in direct finance. This is a critical issue, because it is generally recognized that donor or government funding will not be large or permanent enough to assure the continuing delivery of microfinance services to the millions of poor or near-poor who need them.[19] Microfinance programs can achieve massive outreach only if they are able to tap into commercial sources of funding, including the deposits of the public.

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[18] ECDF, SCP Evaluation, p. 9.

[19] Levy, Fred D, Apex Institutions in Microfinance, draft, May 1, 2001, p. 2.

The government of Eritrea has addressed this issue by taking a long-term view of the microfinance sector and adopting a phased approach. Although the microfinance program was originally anchored within the ECDF, this arrangement has been viewed from the start as appropriate only for the first phase of development of the sector. From the outset, the project staff have worked with the understanding that the project's main goal is to build institutions that will provide the microentrepreneurs in Eritrea with a range of financial services on a sustainable basis.

Under the Eritrea Emergency Reconstruction Program, which has recently been developed, the microfinance component will be spun off to operate independently from the social fund, but still as a government program within the same ministry. The third phase will focus on building a private financial institution.

Constraints

While the ECDF has provided a valuable vehicle for jumpstarting the microfinance sector in Eritrea, it also created a set of obstacles during project implementation. These distortions were minimized to some degree by the government commitment to the project, but still affected the growth and development of the project. Following is a description of some of the problems the program encountered:

- ***Interest rate rigidities***: One of the program's most difficult problems derived from interest rate caps imposed by the Ministry of Finance. As a result, MFIs were unable to charge the required rates to achieve full financial sustainability. The result has been that the program is covering costs but not financially sustainable. The program charged 16 percent for Tier I clients and 14 percent for Tier II clients, which was relatively higher than other microlending institutions in Eritrea. However, because of inflation, real interest rates have ranged between 0.00 and +0.012 percent.[20]

- ***Salary rigidities***: Because the microfinance program was located within the social fund, the program was unable to raise salaries to the desired level. Salaries were capped to keep in line with salaries of other ECDF staff. As a result, it was difficult to retain qualified and trained staff members.

- ***Incentive structures for loan officers***: Along the same lines as the salary rigidities, incentive structures for loan officers were very difficult to push through and were only approved in 2001.

[20] ECDF, SCP Evaluation, p. 10

Lessons Learned

The factors described below have contributed to the success of ECDF's microfinance program.

- ***Staff development:*** The microfinance program has focused heavily on staff training and development and, as a result, has achieved a very high level of staff commitment. This commitment proved critical to the sustainability of the program itself when fighting broke out in 1999 along the border with Ethiopia. While the portfolio was temporarily frozen, the loans were not written off. Staff continued to monitor the outstanding loans and recover the loans throughout the conflict. Although loan recovery was extremely difficult to implement at the time, it helped the program survive a major nationwide crisis.

- ***Reliance on Microfinance Specialists:*** The program relied heavily on microfinance specialists not only during project design, but also to provide technical assistance and training as the program progressed. This has been considered a key factor in developing the necessary capacity of program staff and ensuring that the program benefits from internationally-recognized best practices in the sector.

- ***Managerial Autonomy:*** Government commitment to the program allowed the microfinance program a critical degree of managerial autonomy. Although the program was located within ECDF, the SCP unit staff was managed separately, with a clear division of responsibility. Political interference was further reduced by the fact that lending decisions were made at the village level.

- ***Piloting Methodology and New Product Development:*** The ECDF developed and tested its methodology during the Pilot Savings and Credit Program. Key elements were flexible loan terms, strong social pressure through the "solidarity group" lending, and incentives of higher loans for repeat clients. The ECDF continues to refine the methodology and develop new products, such as the Tier II loan, which allows higher amounts for small enterprises.

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Summary Findings

These case studies were developed in order to help Bank task team leaders and their client country counterparts design and support effective microfinance components within social funds. The case studies aim to highlight best practice as well challenges for designing and implementing a microfinance component within a multisectoral project. Based on lessons learned from these case studies, a set of guidelines were developed and is available from the Social Protection Advisory Service or the Social Funds website.

HUMAN DEVELOPMENT NETWORK

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