

TOWARDS GOOD PRACTICE PRINCIPLES FOR MICROFINANCE IN WAR-AFFECTED CONTEXTS

This discussion document is intended to contribute to debate among donors, NGOs, MFIs and microfinance clients on a common standard for microfinance in war-affected contexts. Even in war-affected contexts, both clients and MFIs can benefit from microfinance providers conforming to the *Donor Guidelines for Microfinance International Best Practice*, developed in 1995. Indeed, a small but growing list of MFIsⁱⁱ are now demonstrating that following these best practice principles can contribute to outreach and viability. However, the conditions peculiar to war-affected contexts and the situation of the clients necessitates additional good practice standards. This document suggests standards, which it is hoped can be further discussed in order to reach widespread agreement.

An MFI is considered to be operating in a war-affected context (and affected by armed conflict) if one or more of the following have an impact on clients:

- Economic activities are affected by on-going armed conflict, or the on-going threat of armed conflict.
- Health or wellbeing is affected by interaction with armed combatants.
- Displacement as a result of armed conflict or substantial effects from past displacement.
- The local infrastructure or natural resource used by clients are increasingly degraded, the damage caused by civilians or combatants reacting to current or past armed combat.

These situations prevail during armed conflict and for varying lengths after a peace accord has been signed. For the purposes of this document, microfinance is defined as any financial service targeted at low income people (credit, savings, money transfer, insurance and currency exchange) including services provided by community managed groups, NGOs, commercial banks, individual moneylenders and collectors. The term Microfinance Institution (MFI) is used to capture the broad range of providers described above that provide microfinance services. 'Client' encompasses both the members of user-managed organisations and the customers of externally managed organisations.

Historically some microfinance projects affected by armed conflict have failed to comply with microfinance best practice principles. A large proportion have subsequently failed leaving a legacy of repayment indiscipline, creating distrust toward financial service providers and making the development of a thriving microfinance market more costly and time consuming to achieve.

Furthermore, complete peace rarely follows civil war so relief and development activities often need to be implemented side by side, but in different proportions depending upon the severity of past and present conflicts. During a severe conflict, more relief interventions are required but as the armed conflict subsides, a greater proportion of development activities are appropriate. The foundation of an intervention in the microfinance market may be laid during a period of conflict, but could potentially flourish once conflict subsides. Given that microfinance projects not adhering to best practice principles often fail, and that there is no cut-off point between relief and development, the principles governing microfinance in war-free areas must also govern microfinance in war-affected contexts.

In the next section of this document standards for MFIs are presented relating to a) Institutional Strengths, b) Quality of Services and Outreach and c) Financial Performance. In the final section for donors, standards are presented relating to a) Appropriate Uses of Grants, b) Appropriate Uses of Loans, c) Commercial Sourcing of Funds and d) Coherence of Donor Policies.

I. INSTITUTIONAL PERFORMANCE STANDARDS AND PLANS

Intermediaries should demonstrate the following characteristics, either in current operations or through credible plans.

A. Institutional Strengths

1. Security of staff and clients is the highest organisational priority, as indicated by total adherence to a staff security handbook. This should be written in the local language, based on international guidelines (e.g. Save the Children's book, 'Safety First') and frequently updated to reflect the local context. Product design and organisational procedures promote risk-minimising behaviour (e.g. travel restrictions during times of day known to be dangerous, varying days of the week for loan disbursement and repayment, not allowing loan officers or individual clients to carry large amounts of cash).

2. Service delivery to a significant and growing number of clients with the intention of sustained financial service provision when the country is no longer considered war-affected.

3. Substantial investment in staff and client capacities to compensate for the loss of educated and skilled people during war through death, disablement or displacement.

4. A philosophy of remaining, or becoming, independent of NGOs and donors to prevent donor-dependency, common after conflict; a strong sense of independence.

5. Accurate management information systems that are actively used in day-to-day and strategic management and which can withstand the resurgence of conflict (e.g. procedures in place to respond to the destruction of offices, the total loss of the main MIS and loss of electricity supply).

6. Simple efficient operations that can be learned easily by staff. Operational efficiency will inevitably be affected by lack of experienced personnel, higher costs and losses caused by resurgence of conflict. Higher costs are caused by specifically, staff salaries inflated by competition between relief agencies, high security costs and the need to maintain a large amount of cash in the branches in case of a run on savings. The last provision is both risky and inefficient.

7. Contingency plans to enable the MFI to cope with resurgence of short-term and long-term conflict. These might include plans for i) rapid withdrawal from an area in case of renewed violence, ii) temporary relocation of the branch to the nearest area unaffected by conflict (may be the capital city or provincial town), iii) transfer to manual systems, using backups and iv) ethical, market-friendly closure in case of long-term armed conflict.

8. Transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately. The launch and continuation of microfinance operations dependent upon securing and retaining competent finance staff with the skills appropriate for the complexity of the MFI's finances and its financial reporting requirements.

B. Quality of Services and Outreach

1. The establishment of strong repayment discipline is a clear priority in war-affected situations. This will ensure a strong foundation for future growth. Motivating staff towards this objective through incentives based on portfolio quality is key. Growth plans must ensure that the foundations of repayment discipline are effectively replicated to new areas and new clients. This may require careful adaptation to new areas that might have been differently affected by the conflict.

2. A client targeting strategy which defines the segments of the population that will (and will not) be targeted. Wide-ranging experience suggests that demobilised soldiers have poor repayment records, especially when targeted exclusively. It may of course be dangerous to ignore them. Successes in targeting female and child-headed households, displaced people and those living with HIV/AIDS can be lessons for the future.

3. Total clarity among staff and clients on the differences between grant giving and the range of financial services encapsulated under the term '*microfinance*'. Non-microfinance services, such as grants, business advisory services and education provided by another organisation. Where they must co-exist, concrete plans to phase out grants in favour of financial services as the situation improves.

4. Market research at the outset to establish whether or not an intervention in the microfinance market is appropriate (most important factors are demand for services and security). Also assessment of the products in demand. Thereafter, frequent market research to monitor client satisfaction, competition and the rapidly changing environment.

5. Generally smaller loans for shorter terms (even one day) with more frequent flexible repayment plans after armed conflict. Loan size and term that can be gradually increased as stability returns. Use of collateral substitutes (preferably group guarantee) accompanied by intensified work in group development, closer supervision and understanding of intra-group dynamics.

6. Thorough analysis of the risks, costs and benefits inherent in mobilising savings. Adherence to international standards in deposit taking where there is no national regulation to ensure that savings are protected. The increased costs and risks of managing savings in war-affected contexts may be very

high – especially if the risks of recurring conflict are significant.

C. Financial Performance

1. A pricing policy that acknowledges the higher market rates of interest on loans in war-affected contexts. Rates should also be sufficient to cover the costs of lending and deposit taking, once clients are no longer defined as war-affected. Competitors' services must not be undermined by MFIs offering services below cost or in ways that cannot be sustained.

2. Establishing and maintaining excellent portfolio quality (PAR <5%) through conservative plans for growth, effective screening of loan applications, tight delinquency management and effective marketing of the organisation as a serious financial services provider is an important priority. The past or present influence of less conscientious credit providers can negatively affect the performance of serious providers.

3. Profitability or self sufficiency will inevitably be affected by the risks of resurgent armed conflict, its intensity and proximity to the MFI. It should however be planned for using realistic financial projections and achieved in incremental steps. In war-free countries, five to ten years is the norm but more time may be required in war-affected contexts.

4. Support from funders that recognise the need for long-term support to match the MFI's long-term liabilities.

5. The lack of appropriate staff, difficulties in developing functioning MIS, lack of repayment discipline, the perception by clients and some staff of donor money being free money can increase the risk of the theft of funds. Strong internal control systems, including regular spot checks, and plans for annual external audit. Ground work to ensure that careful mobilisation occurs.

II. STRATEGIES FOR DONOR SUPPORT

Short-term microfinance services, those without a sound competence in microfinance and those without a firm long term commitment should not be funded. Brief injections of donor funds appear to distort the microfinance market by changing client motivation and expectation and also changing competitor behaviour. Funders should work together to ensure that their support encourages the recovery of a microfinance market that is, as much as possible, in equilibrium (i.e. all actors are responding to market stimuli rather than to subsidies). There should be a preference for organisations established with the sole purpose of providing financial services as these are normally the most efficient and effective.

A. Appropriate Uses for Grants.

1. A flexible approach to the kinds of institution that can be supported since conflict creates opportunities for a range of microfinance providers including moneylenders, traders and RoSCAs. It may be more appropriate to work with these groups as they are indigenous and support/development strategies may be easier to manage. Thorough assessment to check that intermediaries have the ability to provide professional support and that MFIs have the capacity, structures and systems in place to function effectively. Donors should recognise the importance of commitment to a long term funding arrangement in war-affected contexts to support the development of a viable operator and sector and reflect the difficult conditions.

2. Capitalisation, or grants for equity are of strategic importance in enabling organisations to build a capital base. However grants to increase the size of the portfolio can be absorbed by MFIs more slowly than in war-free areas, since loans are smaller and loan terms shorter. Similarly savings are usually mobilised at a slower rate than in war-free contexts. In war-affected contexts, capitalisation should be used to help MFIs to prove viability, prior to attempting to achieve a mix of grant funds and commercial sources, but too much, too quickly can be damaging.

3. Operating losses are likely to be incurred for longer in war-affected contexts and are heavily dependent upon the nature of conflict that has been experienced and on the perceived threat of future conflict. It may be appropriate in some cases to modify performance standards (e.g. *Performance Indicators for Microfinance Institutions: Technical Guide, Microrate and Inter-American Development Bank, 2002*).

4. Donors may wish to support the purchase of fixed assets. However in war-affected situations care should be taken to balance the benefits and the costs: Highly visible new assets such as vehicles, buildings and computers increase the perceived reliability of the MFI and ensure that staff work in a safe environment. But they can also give the impression to clients that the MFI has too much donor money, which is benefiting staff more than poor people. Donors should therefore consider the simplest asset possible.

B. Appropriate Uses of Loans.

Donor support, through loans to the MFI, is appropriate for lending-based institutions that meet performance standards. Care should be taken to ensure that the value of the portfolio is not eroded either by inflation or by devaluation, which usually occur during conflict and may not abate for some time after a peace agreement has been signed. This can be achieved by monitoring the national consumer price index, or if this does not exist, the price of a fixed basket of goods. Changes in the value of money should be reflected in the wholesale interest rate (from donor to MFI) and retail interest rate (from MFI to client).

C. Commercial Sourcing of Funds.

Donors can act as catalysts to effect transition to fully commercial sources of funding. However, the high risk of retail lending and the harsh business environment, as well as (in some cases) the short history of microfinance makes it more difficult to find satisfactory commercial sources of funding for MFIs in war-affected contexts. In some harsh contexts, donors should concentrate on supporting MFIs to become profitable, stable businesses before offering incentives to source commercial funds when the situation has stabilised.

D. Coherence of Donor Policies.

Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. Donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied.

Through their funding decisions, donors can play an important role in positively influencing the behaviour of microfinance retailers, government and Central Banks. To achieve positive influence on a national scale requires effective co-ordination of donors and the

production of clear guidelines on the kinds of project that will be supported. Such guidelines need to emphasise that any intervention in the microfinance market must lead to long term, sustainable development, rather than short-term gains.

Within each donor office, microfinance specialists need to communicate and co-ordinate with colleagues in other professional areas such as health, agriculture and education which may fund projects with an element of credit e.g. medicine revolving funds, revolving cow banks, credit for teachers or other carers. Such projects rarely conform to microfinance good practices and thus damage the microfinance market.

ⁱ The Donor Guidelines should be read in their entirety and are available at http://www.undp.org/sum/sum_reports/donor_guidelines.html

ⁱⁱ A small, but growing list of promising MFIs following best practice principles includes Finance Salone, Sierra Leone with 7,250 clients and PAR less than 1%. Other suggestions (supported by stats) welcome.