DONOR BRIEF
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Helping to Improve Donor Effectiveness in Microfinance

MICROFINANCE DONOR PROJECTS: 12 QUESTIONS ABOUT SOUND PRACTICE

***Background**: "Microfinance" means financial services for the poor. Most donor support goes to lending ("microcredit"). However, services such as savings and insurance are also important to the poor. Their demand for financial services vastly exceeds the present supply.*

Sustainability is a cornerstone of sound microfinance. This term refers to the ability of a microfinance institution (MFI) to cover all of its costs through interest and other income paid by its clients. Financially sustainable MFIs can become a permanent part of the financial system: they can continue to operate even after grants or soft loans are no longer available. Donors have nowhere near enough funds to meet the global demand for microfinance. But when an MFI becomes sustainable, it is no longer limited to donor funding. It can draw on commercial funding sources to finance massive expansion of its outreach to poor people. Experience proves that microfinance can be done sustainably, even with very poor clients.

Most donor microfinance projects fall into one of four types, depending on whether the funds are disbursed to:

- *A retail MFI that provides direct services to poor clients (for instance, a state-owned bank);*
- *A wholesale "apex" fund that finances various retail MFIs, such as NGOs or private commercial banks;*
- *A component of a social fund or community development project that provides revolving credit funds for local community organizations; or*
- *A technical implementer, such as an international NGO or consulting firm, that conducts institutional capacity-building, industry infrastructure, and policy work.*

Unless otherwise noted, the questions below are relevant to all four types of projects.

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1. Is there a credit component in this project? Microcredit is often buried in large multi-activity projects, especially community development or social fund projects.

2. Is credit appropriate for the target clients? Vulnerable groups like HIV/AIDS or post-conflict victims may have great difficulty repaying loans, in which case credit may only burden them with inappropriate debt. Grants might be a better tool to help such groups. Generally, microcredit is appropriate for households that *already* have the cash flow to repay a loan. Lending to someone who won't be able to repay the loan unless her investment of the loan proceeds proves successful is simply too risky, both for the client and for the MFI. Diversified rural microcredit can be sustainable, but microcredit programs that finance only agriculture have almost always failed.

3. How poor are the clients being served? Some microfinance projects characterize themselves as poverty-focused even though the actual poverty level of the clients and their households has not been seriously examined. Microfinance helps not just the very poor, but the less poor as well. Whatever the poverty level of the clientele, there should be truth in advertising. If reaching a particular poverty level (e.g., the bottom 25%) is critical to a project's rationale, then the project should use available tools to test client poverty.

4. Were microfinance specialists involved in project design? Most microfinance projects announce sustainability as a goal, but fail to achieve it. Involving experts greatly improves the chances for success, especially when they participate from the very earliest stages of project conceptualization.

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5. Are retail-level financial services provided by specialized institutions? Sound microfinance is seldom produced by government agencies, multi-service community organizations, or other entities whose mission and expertise are not focused squarely on retail credit and/or savings.

6. Is the project supporting development of sustainable retail-level microfinance institutions? One-off credit lines for specific target groups seldom produce lasting benefit. Projects should focus on the development of sustainable retail MFIs. One way to build sustainable institutions is to enforce financial performance requirements with teeth (see #8 below). Another is to provide money for building institutional capacity, not just funds for on-lending. Capacity-building support should promote the development of local markets for training and technical assistance services where possible, rather than "helicoptering in" external service providers.

7. Does the project's design create disbursement pressure? Large microfinance projects are often based on an assumption that funding is the key bottleneck holding back microfinance in the country. This assumption is usually wrong. In most countries, the binding constraint is the scarcity of sound retail MFIs. Projects often allocate more funding than can be absorbed by sound MFIs, and there is frequently political pressure for large and quick disbursements. The overhang of large amounts requiring disbursement can lead to the selection of weak MFIs or inappropriate borrowers. Wherever possible, it's much better to start with modest amounts and increase funding in stages, based on demonstrated demand from MFIs with viable lending capacity.

8. Are there sustainability-related criteria for selecting retail MFIs and tracking their performance, especially profitability and loan collection? These are the most critical indicators of financial sustainability, but some projects fail to require this information. Many projects fail to include a means of credibly verifying the results being reported by MFIs.

9. If the project involves a second-tier apex (wholesale) fund, does the project design justify the apex by demonstrating that a sufficient number of strong retail MFIs can absorb the funding? Apex funding and technical assistance can help good MFIs, but usually cannot create good MFIs or turn bad MFIs into good ones. Apex project designers seldom do a careful study of the capacity of existing MFIs, and almost always overestimate such capacity.

10. If the project involves an apex fund, has it been protected from political pressure and interference? Most apex projects have not been very successful in contributing to the development of sustainable MFIs. Successful apexes usually have management and an oversight board where the government has little or no representation, or where the government's influence is outweighed by the presence of powerful private sector, non-partisan individuals on the board. Most apex project documents assert that the apex will be independent of political interference. This assertion has little value unless that independence is built into the structure of apex governance.

11. Is the national government's interest rate policy conducive to sustainable microfinance? It costs much more to make a thousand $200 loans than to make one $200,000 loan. To be sustainable, MFIs must charge high interest rates. Clients willingly pay these rates because they value the service so highly. When governments enforce interest rate caps, MFIs can't charge enough to be sustainable.

12. If the project involves a special licensing window for MFIs, does the banking authority have the capacity to supervise them? Banking authorities are often strained beyond their limits trying to supervise a weak commercial banking system. Requiring them to supervise small MFIs can distract resources from their core job of supervising commercial banks, and may not produce adequate supervision of the MFIs. Supervising microfinance requires specialized new inspection techniques; regulatory reform projects need to address these issues realistically.

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