

# FocusNote

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## AID EFFECTIVENESS IN MICROFINANCE:

### EVALUATING MICROCREDIT PROJECTS OF THE WORLD BANK AND THE UNITED NATIONS DEVELOPMENT PROGRAMME



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The Consultative Group to Assist the Poor (CGAP) is a consortium of 33 development agencies that support microfinance. More information is available on the CGAP Web site ([www.cgap.org](http://www.cgap.org)).

Microfinance is a worldwide success story. But how effective have aid agencies been in their support to microfinance institutions (MFIs)? Since 2002, CGAP member agencies have tackled this question through “peer reviews” and evaluations of project portfolios and country programs.<sup>1</sup> This Focus Note looks at the examples of two agencies—the World Bank and the United Nations Development Programme (UNDP)—that took the courageous step of asking CGAP for an in-depth external evaluation of their microcredit portfolios. The World Bank evaluation reviewed only “lines of credit,” where project resources were used to fund microlending; thus, the study did not include the Bank’s substantial activities in policy support for governments and technical assistance to MFIs.<sup>2</sup> The UNDP evaluation covered all that agency’s microfinance projects, but only two of those projects were policy-oriented and none of them provided technical assistance only.

The evaluations revealed a disappointing picture: in both agencies, less than a quarter of the projects that funded microlending were judged successful. The rest failed, or appeared unlikely, to produce long-lasting results—that is, retail institutions and programs that could continue offering clients quality financial services over the longer term without losing their capital and needing continuing infusions of money from governments or development agencies.

Both UNDP and the World Bank have talented, motivated staff managing their microcredit. The root of the problem is not weak staff, but rather agency environments and systems that do not give their staff the right incentives, information, and resources for microcredit.

Top managers in the World Bank and UNDP have responded forcefully to the evaluation findings, not only with policy documents but also with concrete changes that give staff better tools and incentives for effective microfinance.

Supporting microfinance is not an easy business. The problems identified in the evaluations are not unique to these two agencies. Most other microfinance funders face similar challenges to a greater or lesser extent and may find some of the UNDP and World Bank experiences relevant to their own microfinance work.

<sup>1</sup> The Consultative Group to Assist the Poor (CGAP) is a consortium of 33 public and private development agencies working together to expand access to financial services for the poor in developing countries.

<sup>2</sup> The World Bank evaluation did not include microfinance operations of the International Finance Corporation, an affiliated organization that invests in and provides technical assistance mainly to private sector entities.



A broader statement of lessons gleaned from peer reviews of 17 CGAP member agencies can be found in “Global Results: Analysis and Lessons,” a report of the Aid Effectiveness Initiative.<sup>3</sup>

## Introduction

During the past two decades, there has been a great deal of enthusiasm about microfinance—that is, the delivery of loans, savings, and other financial services to poor and near-poor clients. Evidence is accumulating that access to microloans produces significant improvements in household welfare.<sup>4</sup> Poor borrowers demonstrate that they value these services highly: even though the loans are not collateralized, borrowers repay them faithfully in order to keep access to future loans. What is more, borrowers are willing to pay interest rates that cover all the costs of lending. Well-run MFIs can become financially sustainable, maintaining and expanding their services without need of continuing infusions of scarce subsidized money. Almost all official international development agencies include microfinance in the portfolio of activities they fund. Over the past quarter-century, a substantial body of sound practice norms for microfinance funders has developed.<sup>5</sup>

The World Bank and UNDP have been among the larger providers of such funding, alongside the regional development banks and the European Community.<sup>6</sup> By 2002–03, both agencies decided to take a hard look at the effectiveness of their microfinance work.

In the case of the World Bank, several limited-scope internal studies over the preceding decade had questioned the quality and results of “lines of credit”—projects where financial institutions used World Bank money to fund loans to a target clientele, including microentrepreneurs in some cases and larger borrowers in others. These early studies suggested that default by borrowers was unacceptably high and that the credit line projects often hurt rather than strengthened the participating financial intermediaries. The World Bank adopted policies to address these problems, but it was not clear how well these policies were being implemented in practice.

In 2003, the World Bank’s Operations Evaluation Department (OED) launched an intensive review of all World Bank lines of credit during the preceding decade, and asked CGAP to evaluate the subset that involved microcredit. Technical assistance, policy support, and several other types of projects that contribute to broadening access to finance were not included.

In the case of UNDP, the agency volunteered along with 16 other CGAP members to participate in a “peer review” process. Mark Malloch Brown, the former administrator of UNDP, helped spearhead this phase of the CGAP aid effectiveness initiative. During each peer review, specialists from other agencies and CGAP core staff assessed whether the agency’s vision, policies, systems, staff, and funding instruments were well-suited for effectively supporting microfinance.

The UNDP peer review in late 2002 identified significant issues and recommended, among other steps, that the agency organize a project-by-project evaluation of the results of its on-the-ground microfinance portfolio.<sup>7</sup> Malloch Brown promptly accepted the recommendation of an in-depth evaluation and asked CGAP to carry it out.

Anyone familiar with the normal behavior of development agencies will recognize how unusual it is for them to submit their operations to evaluation by another agency. The decisions of the World Bank and the UNDP in this case were particularly courageous: even though both agencies knew that the

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<sup>3</sup> CGAP, April 2004, [www.microfinancegateway.org/files/19649\\_hlm\\_docu\\_globalresults.pdf](http://www.microfinancegateway.org/files/19649_hlm_docu_globalresults.pdf).

<sup>4</sup> Littlefield, Morduch, and Hashemi. “Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?” CGAP Focus Note 24. Washington, D.C.: CGAP, 2003. [www.cgap.org/docs/FocusNote\\_24.pdf](http://www.cgap.org/docs/FocusNote_24.pdf).

<sup>5</sup> CGAP. “Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance.” Washington, D.C.: CGAP, 2004. [www.cgap.org/docs/donorguidelines.pdf](http://www.cgap.org/docs/donorguidelines.pdf).

<sup>6</sup> World Bank spending for lines of microcredit averaged \$140 million per year over the evaluation period. UNDP spending averaged \$5.5 million of its own funds, supplemented by another \$18.1 million of other funds managed by UNDP, for a total averaging \$23.6 million per year. These are large amounts in absolute terms, but for both agencies, microfinance accounted for less than 1 percent of annual spending.

<sup>7</sup> The report of the UNDP peer review can be found at [www.cgap.org/docs/PeerReview\\_UNDPUNCDF.pdf](http://www.cgap.org/docs/PeerReview_UNDPUNCDF.pdf).

evaluation was likely to reveal problems, they agreed in advance that CGAP would independently publish the results, for the benefit of CGAP's other member agencies.

In both agencies, the evaluations found that the quality of projects funding microloans was disappointing. Such results are not necessarily typical, let alone inevitable, for all development agency support to microfinance. Some funders have had better success. But many other agencies besides the World Bank and UNDP have serious problems in microfinance. Most microfinance funders have to deal with a similar set of challenges, so many of the issues discussed in this Focus Note will be relevant for the broader community working on microfinance.

## Scope and Methodology

### Scope

The UNDP study covered 66 microcredit projects that were active in 2003 or had ended in 2001 or 2002. Almost all of these projects funded retail credit delivery.

The World Bank evaluation covered 69 lines of microcredit that had been approved during the years 1993–2002. It is important to note that in addition to funding credit lines, the World Bank also supports microfinance through policy work and technical assistance. Such projects were outside the scope of the evaluation, but there is reason to believe that they have been considerably more successful than the lines of credit.<sup>8</sup>

Most of the projects in both agencies supported formal MFIs where paid staff managed or supervised the lending. A minority of projects involved community-managed revolving loan funds—small community groups whose operations, including loan approval and collection, were managed by the group members themselves without paid, professional supervision. Most or all of the lending to group members were financed with a capital injection by the funding agency, usually in grant form. As described below, these revolving fund projects were judged by different standards than the MFI projects.

### Grading Standards

Projects that funded formal, professionally managed MFIs were graded on the extent to which they resulted, or appeared likely to result, in sustainable levels of loan repayment and cost recovery, so that the MFIs could provide continuing service to increasing numbers of clients without losing their capital and requiring an indefinite succession of future subsidies from governments or development agencies.

Why use cost recovery as a test of success? After all, the ultimate objective of microfinance is improvement in client welfare, not financial sustainability. But testing the impact of financial services on clients is surprisingly complex, expensive, and time-consuming, which explains why most microfinance projects, including the projects evaluated here, do not report such information.<sup>9</sup>

Sustainable collection and cost recovery, the benchmarks used in these evaluations, are intermediate objectives—that is, means to an end. However, measuring them is relatively direct and practical. Collection and cost recovery are crucial contributors to client impact, because without them services to clients either cease or are limited by the unreliable availability of scarce subsidies from governments or international development agencies. There is a widespread, though not universal, consensus that in most settings, well-managed MFIs can and should operate sustainably within a few years, even when very poor clients are involved.

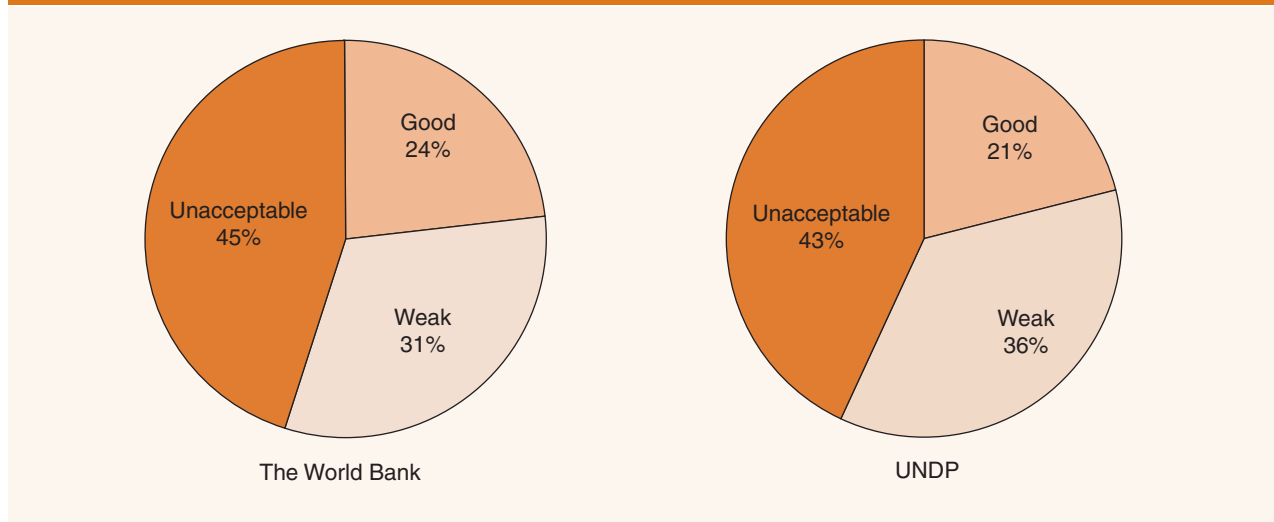
In contrast to MFIs, community-managed revolving loan funds are usually not set up with the expectation that they will become institutions that can finance their own growth to serve ever-larger

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<sup>8</sup> At the time of the evaluation, part of the World Bank's Africa region had a policy against doing microcredit lines, because results had been unsatisfactory, and concentrated instead on policy support and technical assistance/training.

<sup>9</sup> Client-level impact studies have been conducted in a wide variety of microfinance projects. The methodology of some of these studies could be challenged, but a mounting number of credible studies tend to find that continued access to microfinance over the years produces a range of significant benefits for client households (cf. footnote 4). A number of groups are now trying to develop inexpensive methods that simply track client progress without establishing what caused that progress. Future years may see tracking reports of this latter type in more microfinance projects.

**Figure 1 Overall Quality of Microcredit Operations**



numbers of members. Accordingly, the evaluators judged them by a less rigorous standard: whether loan repayment by members was high enough for the funds to continue to revolve for five or more years. Otherwise, resources intended for the whole community are quickly siphoned off by a minority of defaulters—a situation that is not only inequitable but can damage a community’s “social capital” by producing animosity and distrust. Not surprisingly, the defaulters who capture revolving funds this way tend to be the more powerful members of a community.

A panel of three microfinance experts graded each project independently on a five-point scale, ranging from projects that were so good that they should be widely reported as examples to emulate (graded 4), to projects that were so bad that they may well have been doing more harm than good (graded 0). In this Focus Note, those five grades are sometimes collapsed into three: Good (4 or 3), Weak (2), and Unacceptable (1 or 0). There was a high correlation among the experts’ independent grades for each project.

The grading was a desk exercise based on documents and questionnaire responses. Field reviews were commissioned for a dozen projects; it turned out that the added information from these reviews did not substantially alter the grades.

## Findings

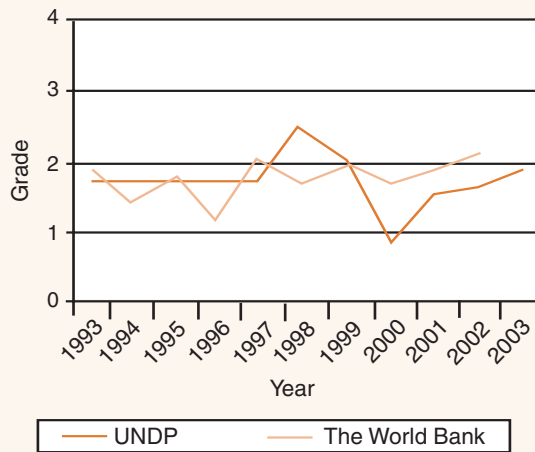
### Overall Effectiveness

The average grade of both agencies’ projects was toward the lower end of Weak: 1.77 for the World Bank and 1.79 for UNDP, on a scale of 0–4. Fewer than a quarter of the projects in each agency were rated Good. The high-rated projects included some stellar successes, but the overall performance can be regarded only as unacceptably low, even after recognizing that microcredit is a challenging business for development agencies, all of whom will have some failures under the best of circumstances.<sup>10</sup> See Figure 1.

Many of the projects that the evaluators rated Weak and Unacceptable had been described as successful by the officers and departments managing them. Some of this discrepancy may be due to a natural bias in favor of one’s own projects. But most of the discrepancy probably stems from the fact that most of the agencies’ microfinance projects are designed and monitored by generalists, or staff specialized in other areas, who are not familiar with established norms of good practice in microfinance and, therefore, have difficulty judging performance adequately. (As discussed later, projects designed

<sup>10</sup> The main risk in funding microfinance projects does not come from borrowers’ willingness or ability to pay their loans, but rather from uncertainty in predicting the future competence of microfinance managers.

**Figure 2 Average Grade by Start of Year for UNDP and the World Bank**



with input from financial-sector specialists tended to perform better and to be more accurately evaluated by their managers.)

### Improvement over Time?

There was no evidence of substantial improvement over time in either agency. See Figure 2.

### Two Portfolios in UNDP

Although the overall picture at UNDP was troubling, closer examination revealed that the agency had one model that was working well in most of the microcredit projects that used it.

The headquarters technical office that supported microfinance in UNDP was located in a sister organization, the United Nations Capital Development Fund (UNCDF). UNCDF's microfinance unit had developed a model for supporting microcredit providers called "MicroStart," which includes four main elements:

- Project implementation is done, or closely guided by, a *technical service provider* from a prequalified list of providers that have already demonstrated their ability to produce sustainable microfinance.
- There is regular *reporting*, including reporting of key indicators such as number of clients, average loan size (a very rough proxy for client poverty), repayment, and cost recovery.

- *MFI*s that do not meet performance standards are *dropped* from the project, unless the technical service provider is confident that the MFI manager will correct the problem.
- UNCDF's specialized microfinance unit collaborates closely with the country office in designing, implementing, and monitoring the project.

The MicroStart program works. Out of 16 MicroStart projects, 11 achieved a rating of Good, which is strong performance in a risky endeavor like supporting MFIs. Of a total of 14 successful UNDP projects, all but one either used the full MicroStart model or at least used a MicroStart-qualified technical service provider.

This finding is very encouraging: it suggests that UNDP could radically improve the effectiveness of its microfinance support by the simple expedient of requiring that country offices implement the core elements of the MicroStart program whenever they fund retail microlending. The track record of other approaches at UNDP is so bad as to justify prohibiting them.<sup>11</sup>

### Performance Reporting

With the exception of the MicroStart projects, relatively few of the projects in either agency reliably and consistently reported performance in key areas such as outreach, loan repayment, and cost recovery. Microfinance specialists have known for years that projects that report better are likely to perform better. This pattern held true in the UNDP and World Bank evaluations.

### Community-Managed Revolving Loan Funds

Revolving fund projects are becoming increasingly popular. For instance, World Bank use of this model climbed from 10 in 1993–1997 to 17 in 1998–2002. Despite the easier standards applied to these revolving fund projects, their ratings were very low. In UNDP, 14 of the 66 projects were revolving funds: not a single one got a Good rating, and 10 of them were graded Unacceptable. At the World Bank, 23

<sup>11</sup> The World Bank had no equivalent to MicroStart. However, the evaluation found that World Bank projects done by units with financial-sector expertise tended to perform better than other projects.

out of 64 projects were revolving funds, only one of which was rated Good.

In the UNDP and World Bank revolving fund projects, loans to group members were financed mainly by an up-front capital injection by a development agency or government. This kind of project practically never works well: most of the revolving funds don't revolve for very long, because defaulters expropriate the resources that were meant to fund lending services for all group members over time.

A subsequent CGAP study of 70 revolving funds financed by various agencies produced similar results. However, successes were found in two other community loan fund models: savings-based groups and "self-help groups." In savings-based groups, members are lending out funds they have contributed through their own deposits, rather than external funds from development agencies or governments. Not surprisingly, lending and collection are much more careful in groups that are working with their own money.

In the self-help group model, which is the dominant form of microfinance in India, groups often begin by collecting and then lending out their own savings, but some groups eventually get external loans from formal banks. Some of these self-help group programs appear to be working well, although a majority of them seem to be weak.

### **Stand-Alone Projects versus Components**

Most World Bank microcredit funding took the form of one component among several in a multi-sectoral project where most of the components were nonfinancial. In UNDP, a quarter of the microcredit operations were components in multi-sectoral projects.

In both agencies, the components lodged in broader projects averaged a full grade or more lower than the stand-alone projects. The result is not surprising. When microcredit is only one component among many, it is less likely to receive specialized technical input, the task managers' attention is more likely to be diluted, and financial-service objectives are more likely to be swamped by other project objectives.

Despite this general pattern, some microfinance components performed well. In the final analysis, the quality of technical input and management that the microfinance activity receives is more important than the project structure. Nevertheless, the important point is that microfinance components in multisector projects are less likely to get strong technical input and management.

### **Government Involvement**

UNDP prides itself on its close partnership with local governments. The World Bank's main funding instrument is lending to governments. Both of these factors seem to be comparative *disadvantages* when it comes to microcredit funding.

UNDP projects were categorized according to the degree of government involvement. Of the 66 graded projects, 25 had substantial government involvement in their design and implementation, including direct retail delivery of microcredit by the government in one case. Of the 25 "government-intensive" projects, only one produced sustainable loan repayment and cost recovery. Almost all of UNDP's successes occurred in projects where government involvement was low.

The World Bank projects were not tagged and statistically analyzed for level of government involvement, but a similar dynamic was visible.

These results are consistent with experience in other agencies, but need to be interpreted carefully. Designing, delivering, or supervising good retail lending is hard for governments. Sound credit delivery involves time-consuming pilot tests before moving large numbers of loans, exclusion of high-risk borrowers, interest rates that cover costs (which are higher for microloans than ordinary loans), and vigorous loan collection. None of these things is politically popular. They all run counter to the practical incentives of even the sincerest working politician, who has to maintain support in order to govern. There are occasional instances of government banks in which stable, competent management is effectively insulated from political pressure and produces good microcredit. But these are very much the exception rather than the rule and

involve a constant push against the natural flow of political dynamics and incentives. Retail lending tends to work best when government involvement is low.

This is not to say that government has no role in microfinance. The incentive problems just mentioned are specific to credit activity, and don't necessarily apply when a government offers deposit services, money transfers, or insurance. Thus, it is considerably easier to find good government savings services than good government credit programs. Furthermore, government has a critical role in providing macroeconomic stability and enabling regulations when microfinance is ready to move into the formal financial sector and take deposits.<sup>12</sup> But almost all of UNDP's government-intensive microfinance projects supported lending, not deposit mobilization or regulatory policy support.

### Project Size

A number of projects in the UNDP portfolio are smaller than is normal in microfinance. In 17 projects, the total budget, including UNDP and other contributions, was below \$500,000; in 14 other projects, total budget was below \$1 million. UNDP's own contribution to the project was often quite low, in absolute terms (17 projects had UNDP funding of less than \$500,000) and also in relative terms (UNDP funded half or less of the project in at least 27 cases).

Where the total project budget was below \$1 million, only a single project achieved a Good rating. The same is true where the UNDP contribution was below \$500,000. The main reason for this pattern may be that smaller projects tend to get less serious attention from the country office staff. It is probably more difficult to bring in high-quality technical assistance for smaller investments, especially since the present demand for microfinance consultants is stronger than the supply of good ones, with the result that the good ones command high fees.

On the other hand, bigger is not always better. Projects with very large budgets may experience pressure to disburse money rapidly even where there is not adequate absorptive capacity in the

MFIs. In the World Bank, projects tended to be larger, and disbursement pressure was probably more of an issue.

### Why Has Quality Been So Low?

The root cause of the problems with microcredit in both the World Bank and UNDP is not staff incompetence or lack of commitment to doing good work for poor people. On the contrary, the evaluators found a general pattern of motivated, capable professionals facing *incentive*, *information*, and *resource* problems.

#### Incentives

*Approval and Disbursement Pressure.* The binding constraint in microcredit is more often a shortage of competent retail-level institutions than a shortage of funding. Insisting on sound practice norms in microcredit often means an agency must be more selective in the institutions it will fund and must disburse performance-based funding in installments that are tied to specific achievements. This approach inevitably reduces the amount of microcredit funding an agency can move. To this extent, sound practice runs counter to the incentives of funding agency staff.

Development agencies always face pressure to defend their budget and staff levels by disbursing high funding volumes. Not surprisingly, promotion and other rewards for employees in such agencies depend significantly on getting projects approved and disbursed. When positions rotate frequently, it is difficult to hold staff accountable for project results—results that may not be clear until years after the people who were responsible for the decisions have moved elsewhere. One consequence of these patterns is the observed fact that UNDP and the World Bank have funded too much microcredit in circumstances where success was highly unlikely from the beginning.

This incentive to move funds is not likely to change radically. Most, if not all, development funding agencies face a similar problem, to a greater or

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<sup>12</sup> Duflos and Imboden. "The Role of Governments in Microfinance." CGAP Donor Brief 19. Washington, D.C.: CGAP, 2004. [www.cgap.org/docs/DonorBrief\\_19.pdf](http://www.cgap.org/docs/DonorBrief_19.pdf).

lesser extent. The problem is widely recognized and deplored. Occasionally someone tries to fix it, but no one appears to have come close to eliminating it. The problem seems to be inherent in public funding agencies, so that the best one can expect is to control it, helping people make better decisions by providing them with information about good practices, by developing sound corporate guidelines, and especially by creating countervailing incentives, such as mandatory performance reporting and real enforcement of policies that incorporate good practice norms.<sup>13</sup>

*Government priorities.* Another incentive problem has to do with the two agencies' relationship to host governments. UNDP prides itself on maintaining an especially close partnership with local governments and being more supportive of their plans and aspirations than some other development agencies are. Similarly, the World Bank in recent years has laid special stress on becoming more client-responsive—clients being mainly the governments that borrow from the Bank.

The problems of government involvement in retail lending have been indicated above. Nevertheless, microcredit is currently very popular with governments, who are attracted both by the promise of welfare benefits for their countries' poor population and by the political appeal of massive loan programs. When a government is anxious to have a credit project in a particular place, or wants to exercise its authority over the operation, it is hard for development agency staff to say no. An agency's refusal to accede to government wishes can entail substantial costs, including souring of the relationship, reduced ability to move funding, and sometimes career consequences for the staff involved.

As noted earlier, the World Bank faces a particular constraint: while most good microcredit is delivered by private organizations, the World Bank's predominant funding instrument is large loans to governments. Such loans are, of course, subject to the incentive problems mentioned above. In addition, even money destined for private microfinance providers has to pass through the government, often resulting in government involvement in man-

agement decisions. Even though institutional capacity is the binding constraint more often than funding is, governments usually don't want to borrow to finance technical assistance and other capacity building, because they don't see these activities as generating resources to repay a loan.

By contrast, UNDP grants are a somewhat more flexible funding vehicle. Nevertheless, UNDP faces the same problem as the World Bank—a tendency toward excessive government input in credit projects. UNDP's culture of seeking especially close and cooperative relationships with host-country governments is highly useful in some other areas of development, but doesn't work well for microcredit.

Problems that stem from institutional incentives cannot always be fixed by giving staff better information. The incentive structure has to be realigned. Policy pronouncements need practical enforcement mechanisms. The two agencies need to find a way to ensure that credit projects managed by non-specialists get help from, and effective review by, financial services experts. Mandatory reporting of core performance results is another powerful incentive to design projects with care and to fix or end them promptly when they don't perform.

“Tightening the screws” through process requirements mandated by headquarters runs against the grain in both agencies. UNDP has, and probably should preserve, a culture of country office independence—headquarters constraints on project operations are not embraced warmly. For its part, the World Bank has been trying hard in recent years to simplify its bureaucratic processes. These orientations in both agencies are healthy, and management is rightly hesitant to add more rules, approval requirements, and reporting burdens. The evaluation findings confronted UNDP and the World Bank with a basic question: was the problem with their microcredit performance serious enough to justify making changes that may have some drawbacks from other perspectives?

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<sup>13</sup> The World Bank's long-standing official policy on lines of credit is well aligned with sound practice norms. But this evaluation, like several previous studies, revealed a lack of effective enforcement mechanisms to ensure implementation of that policy.

## Information

During recent decades, many development agencies have moved in the direction of a less specialized, more generalist, core staff, and increased reliance on outside consultants for technical expertise. This may have happened more at UNDP than at the World Bank; but in both agencies, few of the core staff responsible for the design and implementation of microfinance projects are financial-sector specialists.

Development agency staff that manage projects do not need to be microfinance experts. However, they do need a basic level of familiarity with microfinance issues and experience. Project managers who are not “microfinance literate” are less likely to consult in-house experts or to hire high-quality external consultants. Most of UNDP’s successful projects involved an in-house designer or manager who had some previous training in microfinance issues.

A few days’ training of generalist project management staff in development agencies can pay strong dividends. At the same time, if the incentives of a project officer and her manager run counter to what she has learned in microfinance training, the incentives will often prevail over the training.

## Resources

In response to pressures from shareholders who want to control staff size and administrative costs, World Bank budgets for preparing and monitoring projects have been substantially reduced over the past decade, and Bank staff are being stretched to cover more mandates. At the same time, the shareholders expect to see improvements in project quality. At least in the microfinance arena, this mix of expectations and resources has proved unrealistic.

Both UNDP and the World Bank have a number of strong microfinance experts on staff. But many projects take place without input from these specialists. In some cases, project managers are simply unaware of the need for specialist input. In others, project designers avoid financial services specialists because they fear the specialists will place more demanding hurdles in front of project approval. But in a significant number of cases, the office designing a project doesn’t use in-house specialists because

agency charge-back rules make an in-house specialist too expensive, or (in the case of the World Bank) because trust funds for project preparation can be used to pay for outside consultants but not World Bank staff.

UNDP country offices with limited budgets for project preparation and supervision are reluctant to use in-house experts because those experts have to charge out their time at a fully loaded rate that includes all UNDP overheads, making them significantly more expensive than outside consultants.

## Key Findings/Recommendations

Three decades of experience with microfinance, and even longer experience with other forms of development credit, have yielded quite a few guidelines of sound practice that are well established, quite widely agreed on, and articulated in a variety of documents (including the consensus document “Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance,” commonly referred to as the Pink Book<sup>14</sup>). There is no need, and insufficient space, to repeat that body of sound-practice project guidance here.

However, it is important to note a few core recommendations for the two agencies’ internal procedures that emerged from these evaluations. These recommendations are probably relevant for many other development funding agencies as well.

### ■ Credit policies need sanctions to be effective.

At least for credit projects, publishing policy documents may not do much to improve project effectiveness unless there is some practical mechanism to ensure that the policies are implemented. Both the World Bank and UNDP had sound policies articulated for microcredit, but noncompliance with those policies carried little cost, so actual practice was driven by other incentives and constraints that tended to hurt overall project performance. The package of sanctions that will be practical and effective varies considerably from one agency to another. Generally, independent review of projects by

<sup>14</sup> CGAP. “Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance.” Washington, D.C.: CGAP, 2004.

financial services experts and transparency about results will be helpful.

- **Meaningful reporting of a few core performance indicators will probably improve average credit project performance markedly.**<sup>15</sup> Staff in many development agencies are already burdened by too many reporting requirements, some of which are not much related to project effectiveness. So the recommendation to insist on specific reporting for all credit projects is made reluctantly. But funders will continue to lose resources in too many unsound microcredit projects unless meaningful project performance reporting within the agency becomes the norm. Such performance reporting improves information, but more important, it alters incentives. If core indicators of outreach, loan collection, and cost recovery are meaningfully reported within the agency, then projects will be designed more carefully, attention will be better focused on the crucial dimensions of performance, and failed activities will be terminated more quickly.<sup>16</sup>
- **Generalist core staff who are responsible for microfinance projects need some level of microfinance literacy to do effective work.** Agencies cannot expect outside expertise to produce good projects unless their own staff are aware of basic microfinance principles. For most staff, this means at least a few days of training, along with other means to disseminate good practice messages. Such training will not turn them into experts, but it will teach them how to think about microfinance, prevent some basic errors, and improve the likelihood that the consultant experts they hire will be competent. This training can be expensive in the context of other demands on staff time and limited travel and training budgets. But the absence of training has proven to be much more expensive.
- **Agencies need to improve mechanisms, incentives, and resources for bringing financial-services expertise to bear on project design and implementation.** Having in-house microfinance specialists is important. But they won't have much effect if they are not used by the others who are designing and managing microfinance projects. The World Bank has some top-flight microfinance experts, and UNDP had one of the strongest headquarters technical units of any of CGAP's member agencies, but only a minority of projects in both

agencies benefited from this expertise. Here again, the factors that prevent use of in-house expertise vary from one agency to another, so the appropriate remedial actions will vary.

Note that in some other problem areas (e.g., environmental impact of projects), many agencies require approval by designated technical specialists before a project can move forward. Adding to the list of formal clearances required before a project is launched has significant costs, including delay and dilution of responsibility. Agencies require such clearances only when management is convinced that they are needed to deal with a major problem. An individual agency has to decide whether it has that kind of a problem with microfinance.<sup>17</sup>

- **Community-managed revolving loan funds, where the lending is funded mainly by a development agency's injection of capital and there is no professional management or oversight, should be abandoned as a delivery mechanism, because the odds of success are unacceptably low.** This conclusion does not apply to savings-based funds, where the outside funder provides promotion, organization, and training/technical assistance, but injects no outside money into the group for on-lending, or injects outside money in amounts that are both modest in comparison with the group's own savings and made available only after the group has proved successful in lending its own savings and collecting these loans. Likewise, the conclusion does not embrace the self-help group model as used in India, where the groups sometimes take out loans from banks that are perceived as being serious about repayment.

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<sup>15</sup> The indicators are outreach (number and economic status of clients), cost-recovery, loan collection, and efficiency (reasonable administrative costs). Guidance on calculating and interpreting these indicators can be found at [www.microfinancegateway.org/content/article/detail/32627](http://www.microfinancegateway.org/content/article/detail/32627).

<sup>16</sup> The list of indicators an MFI ought to report to its stakeholders, including a funding agency, is fairly long—cf. [www.cgap.org/docs/Guideline\\_disclosure.pdf](http://www.cgap.org/docs/Guideline_disclosure.pdf). However, reporting *within* the funding agency itself can be limited to a few basic indicators, including outreach, loan repayment, cost recovery, and efficiency. For a practical guide to calculating and interpreting these core indicators, see [www.microfinancegateway.org/content/article/detail/32627](http://www.microfinancegateway.org/content/article/detail/32627).

<sup>17</sup> As noted in the next section, both the World Bank and UNDP have adopted measures that ensure the design of microcredit projects will be reviewed by in-house specialists. However, at the World Bank, and to a lesser extent at UNDP, rules for cross-charging in-house technical support still make it more difficult to hire internal experts.

- **Development agencies should usually avoid credit projects where a government agency is the retail provider of loans, or where the government is actively involved in designing or supervising the credit delivery system.** Nevertheless, such projects can be successful in some unusual circumstances, so they should not be prohibited completely.
- **Credit projects tend to perform poorly if their amount is too small to command suitable expertise and management attention. Microfinance components that are embedded in larger projects tend to perform less well, not only because they may attract insufficient expertise and management attention, but also because the project's other objectives sometimes distort the financial services component.** Microfinance components should not be completely prohibited, because some of them perform well. However, inclusion of such a component in a larger nonfinancial project is a risk factor that has to be addressed. Designers of such components need to ensure that the microfinance activity has solid technical input, sufficient management attention, and regular reporting of core performance indicators.

### **How Have World Bank and UNDP Management Responded?**

**The World Bank.** When management received the Bank evaluation department's review of lines of credit in October 2004, it responded with strong decisions:

- Regional and country units were instructed to flag all new projects containing any line of credit and submit them to the Bank's network of financial-sector specialists. (A year later, after finding that most but not all lines of credit were complying with this rule, management instituted a check-box on the cover sheet for all new project appraisals, making it much easier to find lines of credit.)
- Every line of credit would have to be reviewed by financial-sector specialists before the project was approved, including, at a minimum, a representative of the central financial-sector unit.
- The Bank's quality assurance unit would oversample line-of-credit projects in its quality-at-entry and quality-of-supervision samples for the next two years.

- Lines of credit that did not report specific key performance indicators would not be given a satisfactory evaluation rating.
- Semi-annual project status reports and final completion reports would be required to include core performance indicators agreed to when the line of credit was approved. Management agreed to designate an officer who would regularly review all reports on lines of credit for compliance with this policy.
- The overall quality of the Bank's line-of-credit projects would be reviewed again in two years.

**UNDP.** CGAP's evaluation report was formally delivered to UNDP early in 2005 and disseminated in the agency. The findings were taken seriously: UNDP's executive team approved an action plan with the key recommendations of the Peer Review and the Portfolio Review before mid-year.

Subsequently, the new administrator of UNDP, Kemal Dervis, reviewed the evaluation and endorsed a strong program to improve UNDP's effectiveness in microfinance. The agency adopted the executive team's recommendations, some of which represent departures from normal UNDP operations and culture. In particular, quality of country programming will be ensured by UNDP regional bureaus joining with UNCDF to provide technical support and oversight for microfinance in country offices. Additional changes included the following:

- Whenever UNDP funds (or administers others' funding for) microlending, it will use the principles of the MicroStart program:
  - Implementation will be guided by a technical service provider with a proven track record of producing sustainable microfinance, drawn from UNCDF's list of qualified providers.
  - Regional microfinance specialists, who report jointly to UNCDF and their regional bureau, will participate with the country offices in design, implementation, and monitoring. A specialist certifies that each new credit project complies with UNDP microfinance policy.
  - Key performance indicators will be reported every quarter to a public database, using industry-standard calculation methods.

- Performance-based agreements with financial service providers will be developed and adhered to, with nonperformers dropped from the program unless the technical service provider is confident that problems will be corrected.
- A senior UNCDF officer will be designated to coordinate technical support for UNDP microfinance projects and update the policy as needed.
- Training in basic microfinance concepts will be required for any UNDP staff and government counterparts responsible for designing or implementing microfinance activities.
- Microfinance will be done as much as possible in stand-alone projects, rather than as components of multi-sector projects.
- There will be no new community-managed revolving loan fund projects in which the loans are funded by UNDP infusions.<sup>18</sup>

UNDP's new microfinance regime includes actions of real substance that directly address the core problems identified by the evaluation. Implementation of this regime will no doubt entail some

challenges, but its adoption is a major step forward. Management's willingness to make tough decisions reinforces UNDP's leadership role in the process of addressing issues of aid effectiveness in microfinance.

## Conclusion

In the final analysis, large volumes of funding for microfinance projects are ineffective if they do not produce durable results. Both UNDP and the World Bank took the unusual step of initiating independent evaluations of their operations that funded microcredit, and agreeing to publication of the findings. The evaluations revealed serious problems, but also highlighted promising corrective measures. By aggressively implementing concrete reforms, managers at both agencies have continued to demonstrate their seriousness about doing good microfinance work.

<sup>18</sup> This prohibition does not apply to UNDP funding for organization, training, and ongoing support of *savings-based* revolving funds. Likewise, it does not apply to models like Indian self-help groups where the group starts out by lending out its members' savings but later may borrow from a bank, as long as the bank in question has a track record of being serious about collecting its loans.

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