

Performance-Based
Agreements:
Incorporating
Performance-Based
Elements into Standard
Loan and Grant
Agreements

A Technical Guide

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All donors and investors use contracts to establish legal relationships with the partners they fund. Typically, these contracts define the permitted use of the funds and include general suspension or termination clauses. Unfortunately, many agreements do not include project-specific performance targets and do not define sanctions for failure to deliver minimum performance against those targets.

This Technical Guide presents the rationale for the use of performance-based agreements (PBAs) and suggests ways to incorporate performance-based targets and incentives into existing loan and grant agreements. The focus of this guide is PBAs for retail financial service providers, but some of the advice can be applied to other nonretail projects as well.

Why Performance-Based Agreements?

Funding agencies use loan and grant agreements as part of their standard operational procedures when partnering with financial service providers. Typical loan and grant agreements stipulate the permitted use of money loaned or granted, define the type and frequency of reporting required, and include general “boilerplate” provisions about suspension or termination of funding.

Standard loan and grant agreements, however, often fall short on defining expected results and creating positive or negative incentives to achieve those results. Absent such definitions and incentives, the parties tend to focus on disbursement of funds for permitted expenditures, rather than on producing the results that are the very reason for funding the financial service provider in the first place. We consider an agreement to be “performance-based” when (1) it is as clear and specific as possible about the expected results and how they will be measured, and (2) it strengthens incentives for good performance by defining sanctions or benefits that are tied to the achievement of the expected results. When there is regular reporting against the targets of a PBA, the funder and its partner are likely to spot problems more quickly and correct them more effectively, and funders are less likely to add resources for second and third phases of projects that are not delivering the right results.

Well-crafted PBAs lower the risk of misunderstanding and dispute between the parties.

Using PBAs does not imply abandonment of a funder's standard agreement models. Performance-based targets and sanctions can be integrated into any type of legal agreement between a funder and its partners.

Incorporating Performance-Based Elements into Loan and Grant Agreements

Converting a standard loan or grant agreement into a PBA requires a few essential steps and good collaboration among technical and management staff responsible for the projects as well as general legal counsel for the funding agency. The steps are as follows.

Identify Appropriate Performance Indicators

Funders and their partners should identify a core set of performance indicators to be tracked during the life of the partnership. These indicators should focus on the overall health and performance of the retail service provider, not just the portion of its activities funded by the particular donor or investor. Of course, the ultimate goal of the project is the welfare of clients, not the health of the retail institution. But sustainable, long-term delivery of services to present and future clients is impossible if the institution is unable to collect its loans and cover its costs.

Funders often focus on the number of active clients and the volume of loans disbursed as the main indicators in their project agreements. While important, these indicators reveal nothing about the provider institution's ability to continue and expand its services once project funding has ended.

For funding to retail financial service providers, minimum core performance indicators recommended are outlined in Box 1.¹ Most of these indicators describe the financial and operational soundness of the provider institution. Client welfare is more difficult to measure, and there is not yet a consensus on a standard minimum set of "social" indicators. However, the emerging progress on measuring social performance provides a range of useful measures.² Investors have selected a subset of social performance indicators for reporting by their partners, and these are being shared widely with other funders. While the indicators listed in Box 1 are suggested as a minimum, many funders will want to use other indicators as well. The

¹ See CGAP (2006). For additional information on calculation and interpretation, see Rosenberg (2009).

² See, for example, the Microfinance Information Exchange's Social Performance Standards Report (http://www.microfinancegateway.org/files/56433_file_Social_Performance_Report_ENGLISH.pdf) and the Social Performance Resource Center and Social Performance Task Force (http://www.microfinancegateway.com/resource_centers/socialperformance/).

<p>Box 1: Minimum Performance Indicators for Financial Service Providers</p> <p><i>Outreach and Depth of Outreach</i></p> <ul style="list-style-type: none"> - Number of active clients or accounts - Average outstanding balance per client as % of gross national income (GNI) per capita <p><i>Portfolio Quality</i></p> <ul style="list-style-type: none"> - Portfolio at risk (PAR) or - Loans at risk (LAR) or - Current recovery rate (CRR) and annual loan-loss rate (ALR) <p><i>Financial Sustainability</i></p> <ul style="list-style-type: none"> - For unsubsidized institutions: return on assets (ROA) or return on equity (ROE) - For subsidized institutions: adjusted return on assets (AROA) or financial self-sufficiency (FSS) <p><i>Efficiency</i></p> <ul style="list-style-type: none"> - Cost per client or - Operating expense ratio

funder should choose indicators together with the financial service provider, ensuring that they reflect the priorities of both parties as well as the institution's stage of development. To the extent possible, standard indicator definitions should be used, as published by respected microfinance industry sources.³

In addition, nonquantitative indicators that measure a major objective of the funding can be used. For instance, a project meant to help a provider start offering deposit services could have the following as an indicator: “has secured a deposit-taking license from the banking authority no later than....” Though such an indicator is not quantitative, it is unambiguous and verifiable.

When choosing indicators, it is important to bear in mind how each indicator will be used. Will a minimum performance threshold be set for that indicator, with defined consequences like interruption of funding for failure to achieve it? Or will the indicator be used only for reporting? The list of performance-threshold indicators with funding consequences should be kept short—often only two or three will suffice. Otherwise, there is a danger that nonessential performance measures will distract from the focus on the essential ones.

Even for indicators that will be used for reporting only, funders should not overburden a financial service provider with tracking things that are not useful for operations management or decision making. Collecting and reporting information has costs. When funders are asked to estimate how much time a partner has to spend preparing project reports, their estimate is often far below the actual time spent.

Finally, it is important to recognize that there are some important project objectives that cannot be captured in an unambiguous and verifiable indi-

³ See, for example, the SEEP Frame Tool (<http://www.seepnetwork.org/Pages/Frame.aspx>).

cator. Assessment of whether such objectives have been met will have to be a judgment call, so it may be best not to tie sanctions like disruption of funding to such indicators.

Establish Realistic Target Levels For Performance Indicators

As used here, a “target” is a level of performance that is expected to be achieved by the partner. The funder and its partner should jointly identify the targets based on the institution’s business plan, past performance, and industry benchmarks for institutions of similar characteristics. Targets can be modified by joint agreement between the funder and institution if circumstances change or it becomes clear that the original target was unrealistic.

Identify Minimum Performance Thresholds

It is important to distinguish clearly between targets and performance thresholds. A target will usually be a best estimate, based on a business plan or other projection, as to what will be achieved. A performance threshold expresses the minimum acceptable level of performance on an indicator, not what the parties think the project will produce. In essence, the funder is saying, “This is the minimum result necessary to justify our investment. If this minimum is not achieved, it will not have been worth our while to fund the project.” Thus, a minimum performance threshold will often be lower—sometimes much lower—than the target for the same indicator.

Not all performance indicators require a defined threshold in a PBA. Table 1 provides examples of performance targets and minimum thresholds for a young financial service provider. In this example, the focus is on portfolio quality, outreach, and financial self-sufficiency. For a mature institution, more of a focus on efficiency might be appropriate. The quantitative levels set for targets and thresholds in Table 1 are merely illustrations, not recommendations. Performance levels will depend on a range of country-, project-, and institution-specific circumstances.

Table 1: Sample Indicators, Targets, and Thresholds for a Young Financial Service Provider

Indicator	Year 1 of project	
	Target	Minimum Threshold
Growth in active clients	5,000	2,000
Portfolio at risk (30 days)*	≤3 %	≤ 10%
Financial self-sufficiency	90%	60%

*Calculated using standard write-off policies

Identify Noncompliance Measures

In addition to standard provisions in case of breach of contract, a PBA should specify sanctions for noncompliance with a minimum performance threshold. Most of these sanctions will be specified, not as things that must happen, but rather as rights that the funder can exercise. (As discussed below, the expectation should be that the funder *will* exercise these rights absent exceptional circumstances).

Before exercising some of its sanctions, the funder may give the partner a warning letter or other written notice of the noncompliance, and a period of time may be specified during which the partner can correct the problem without further consequences. If the agreement's standard (boilerplate) terms do not include a right to audit or inspect the partner at the funder's discretion, then this right should be specified in the section on performance sanctions, along with a clarification that the funder can exercise it as soon as it becomes aware of the problem, without waiting for any period that may be allowed for correcting the noncompliance.

Most commonly (but not exclusively), the sanctions will consist of suspension or termination of funding, and perhaps early repayment in the case of loans. Suspension or termination of funding is obviously a problem for the implementing partner, but it also complicates life for the responsible staff in the funding agency. Partners who have experience working with donors sometimes tend not to take such sanctions seriously, because they have seen that donors seldom exercise them, and will often find a face-saving way to patch things up even when a project has gone irreversibly off track. If the funder wants performance-based sanctions to serve as real incentives, it must be clear with its partner about its intent to use them, and demonstrate its credibility by enforcing sanctions when needed.

Although our discussion so far has focused on sanctions—that is, negative incentives—positive incentives (for instance, a bonus for beating a certain target) can be effective too, and sometimes more so than sanctions. However, funder policy or practice can make it difficult to pay such a bonus. Negative sanctions tend to be all-or-nothing actions, so they do not provide an incentive for achievement beyond a minimum threshold. Bonuses can be more finely calibrated, so that the amount of the bonus is linked to the amount of achievement. When positive incentives are possible within an agency's legal constraints and budget systems, the funder should think creatively about building them into PBAs.

When structuring incentives and minimum performance thresholds, care must be taken to avoid unintended consequences that could hurt rather than help the project. For instance, a high target for active clients in the early

years could lead a young provider to expand before it has taken the time it needs to test and refine its lending and operating systems.

Link Disbursements to Thresholds

In standard loan and grant agreements disbursements are linked to activities undertaken or a specified level of expenditures (budget spent). In PBAs, disbursements should, to the extent possible, be conditioned on the partner being in compliance with the minimum performance thresholds as of the date of the disbursement request. This is not very effective if most or all of the disbursements take place early in the project, before the funder can judge success or failure on the most important indicators. The disbursement schedule needs to balance the resource needs of the partner to achieve project goals against the funder's need to maintain the effectiveness of the incentive further into the life of the project. When a disbursement schedule is spread out this way, it is especially important that the funder fulfill its responsibility to disburse promptly, because the partner may have less of a cushion of unspent cash to withstand disbursement delays.

Table 2 compares a sample performance-based disbursement schedule with a more standard approach. In the PBA scenario, the funder schedules three tranches over three years, with tranches progressively increasing each year. Provided the financial service provider maintains the level of performance identified as minimum thresholds, the funding would be released on a predetermined schedule. In the standard agreement, the funder releases funding once the partner spends 75 percent of resources or completes specified activities regardless of performance.

Table 2: Sample Disbursement Schedule in Standard Agreement versus in a PBA

Standard Agreement			PBA		
Payment	Schedule	Trigger	Payment Schedule*	Amount	Trigger
1,000,000	Upon signature of agreement	Signature	Month 1, Year 1	500,000	Maintain min. threshold levels
500,000	Upon utilization of 75% of first payment	Fund utilization	Month 1, Year 2	600,000	Maintain min. threshold levels
200,000	Upon completion of final project report	End of agreement	Month 1, Year 3	600,000	Maintain min. threshold levels

* In a PBA, disbursement of tranches at the scheduled dates could also be conditioned on expenditures of previous tranches, in addition to meeting minimum performance thresholds.

Provide Sample Reporting Formats And Instructions On Reporting

Funders should negotiate with their partners the frequency and format of reporting to be submitted during the life of the agreement. To the greatest extent possible, funders should use standard industry reporting formats.⁴ They can also encourage financial service providers to report to existing platforms, such as MIX Market. The report format should incorporate all indicators, highlighting those with minimum thresholds. A sample report is provided in Annex 1.

Managing PBAs

Regardless of how well a loan or grant agreement is crafted, if funders do not have the capacity to monitor their partners' performance or the political will to enforce compliance, PBAs will quickly prove ineffective. Staff of funding agencies need to have adequate resources, tools, and incentives to monitor and enforce PBAs, including a system to capture and track performance data (management information system) from partners, and policies, procedures, and management support (including legal advice) for enforcing agreements.

Performance Monitoring

To monitor performance effectively, a funder must have qualified staff that can analyze the data and discuss corrective measures knowledgeably with the partner. A common problem in funding agencies is that, after microfinance projects or investments are approved, monitoring is delegated to a different team entirely, often involving nonspecialist staff, understaffed local offices, or individuals who rotate frequently. Clear responsibility for monitoring of each agreement should be assigned to a competent staff member. If a donor or investor does not have expert staff who can fill this role, oversight needs to be delegated to a qualified consultant or firm. In this case, the funder still needs internal staff who are literate enough about retail finance issues so that they can hire and supervise good consultants. Staff who have not had a minimum basic orientation in microfinance are far less likely to identify strong consultants.

It is not enough that performance information reaches the responsible project or investment officer. Core data should be uploaded to an agency-wide database that is available to everyone in the funding agency, including management. This makes it more likely that meaningful indicators will be used, that the information will actually be collected, and that the project or investment officer will respond vigorously to problem situations.

⁴ See SEEP Frame Tool (<http://www.seepnetwork.org/Pages/Frame.aspx>)

Enforcement of Compliance

In addition to the noncompliance clauses in the agreement itself, a funder should have clear procedures that staff can follow if partners do not meet their minimum thresholds. The funder's first step should be to understand the internal or external causes of the problem and then determine whether the problems can be corrected and whether the partner is willing and able to correct them.

If the problem is due to an external issue (e.g., natural crisis) beyond the control of the partner, the funder may wish to forgo exercising its sanctions. Delaying disbursement or demanding early repayment of a loan could force the partner out of business. This is the appropriate outcome only if the funder has serious doubts about the partner's willingness and ability to return the institution to a healthy and sustainable position. Otherwise, the funder may want to give the partner more time and perhaps additional support, including access to technical expertise. If the funder decides to waive its sanctions rather than enforce them, it should do so in writing and require the partner to commit to a new set of minimum thresholds.

If a threshold has been missed because of internal factors (e.g., mismanagement), a funder would normally respond more aggressively, beginning with formal notice to the partner that the problem exists and needs to be resolved. If the partner does not fix the problem within the stipulated period, or at least provide a convincing plan for fixing it without delay, then the funder will apply the sanction. Here again, suspending or terminating disbursements might drive the partner out of business. But where management cannot be counted on to put the institution on a sustainable basis, it is often better that the institution closes its doors now, rather than a few years later after additional funder resources have been spent—resources that could have been redirected to a more capable service provider or to other worthwhile development activities. Making such decisions is difficult, but they not only prevent waste of scarce development resources, they also are essential if funders expect to have credibility with its future partners.

References

- CGAP. 2006. "Good Practice Guidelines for Funders of Microfinance." Washington, D.C.: CGAP, October.
- Rosenberg, Richard. 2009. "Measuring Results of Microfinance Institutions: Minimum Indicators That Donors and Investors Should Track." Technical Guide. Washington, D.C.: CGAP, June.

Annex 1

Sample Reporting Format for Targets and Thresholds

Standard reporting formats often require narrative sections covering key accomplishments, problems, and risks, for instance. In addition, such formats should require concise, unambiguous reporting of all required indicators. Targets and/or minimum performance thresholds will have been set for some, though usually not all, of these indicators. Where targets and/or minimum thresholds have been set, the reporting format should make it easy to compare actual performance against the targets and thresholds, and to flag any failures to meet targets or thresholds. The reporting format should also require clear flagging and justification for any targets or minimum thresholds that have been changed since the execution of the original agreements.

