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Matching Grant II

MID-TERM EVALUATION

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List of Acronyms

CIDA	Canadian International Development Agency
CIF	Catastrophic Insurance Fund
DFID	Department for International Development (formerly ODA)
DIP	Detailed Implementation Plan
FHI	Food for the Hungry International
LOS	loan orientation seminar
MFI	micro-finance institution
MIS	management information system
ODA	Overseas Development Agency
OLGs	On-Lending Groups
PVO	Private and Voluntary Organization
TA	technical assistance
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

On April 1, 1995, Food for the Hungry received a 5-year Matching Grant of $3.4 million from the United States Agency for International Development (USAID). Matching Grants, managed by USAID's Office of Private and Voluntary Cooperation, support activities designed to strengthen the institutional capacity of U.S. private and voluntary organizations (PVOs) implementing international development programs. Specifically, the purpose of FHI's Cooperative Agreement was to:

- create a regional microenterprise loan program, "Faulu Africa", that will consist of a regional coordinating office and a network of branch lending offices in participating African countries, which will be self-sustaining operationally and financially, both as branches and overall;
- provide increased access to credit services to the poor in Ethiopia, Kenya, and Uganda;
- enhance Food the Hungry International (FHI's) institutional ability to establish, professionally manage, evaluate and monitor microenterprise loan programs;
- encourage greater involvement of women as loan clients, leaders of credit groups, and as Faulu Africa staff members; and
- establish a link to FHI field programs in Latin America and Asia, so they can benefit from the methodologies, models, systems, lessons learned, and staff expertise developed in Africa.

After nearly three years of implementation, the progress made toward accomplishing these objectives has been significant. Today, not only has the Faulu Africa regional coordinating office been created, it has attracted an extremely competent staff. By the end of 1997, Faulu Africa had some 107 staff members, 6,830 clients, and a total outstanding portfolio of $1,192,754. More importantly, the overall default rate to Faulu Africa at the end of 1997 was only 1.36%. Faulu Africa has demonstrated the replicability of its methodology and operating systems by opening its second unit in Kampala, Uganda. Finally, the Matching Grant investment has leveraged other investors. In 1995, the U.K.'s Overseas Development Agency (ODA), which is now the Department for International Development (DFID), provided a $2.25 million grant to finance Faulu Kenya's expansion. DFID is likely to provide additional resources to Faulu Africa in the near future. Faulu Uganda has received a grant from Compassion Canada and its partner the Canadian International Development Agency (CIDA) for $700,000. In addition, Faulu Uganda hopes to receive USAID support from the PRESTO Project for further expansion.

The institutional development and program performance of Faulu Africa are not trivial accomplishments. Its most mature country unit, Faulu Kenya, is already emerging as a leading microfinance institution in that nation. The Matching Grant has been used with great purpose to establish the credit delivery capacity of Faulu Africa. About that there is no question. Annex E of this mid-term evaluation rates the level of development

of the two Faulu country units in the areas of program management, portfolio quality and outreach, and financial sustainability. Both Faulu Kenya and Faulu Uganda are rated average or most often above average for all elements considered. While the report offers some technical recommendations for Faulu to consider at the country unit level, the credit delivery performance of both units is good, and demonstrates a firm command of best practice principles.

Looking strictly at its technical accomplishments, one can easily forget that Faulu is only five years old, and has experienced much of its growth in the last two years. It is often the case that there are leading and lagging sectors in a young institution's development. If establishing technical competence has been the focus of Faulu Africa to date, the area least developed is that involving the organizational structure of the network. Questions remain unanswered as to what the network will look like and how units will relate to the regional office. Some issues revolve around the legal status the units will need, others deal with the degree of autonomy and self-governance that will be given as the units mature.

How Faulu Africa ultimately defines itself will influence its prospects for sustainability. The path that must be followed to achieve financial sustainability at the unit level is well marked. Given these clear performance benchmarks, progress of the units will be easy to determine. The path for sustainability of Faulu Africa in total, however, is not so clear. Technical proficiency is necessary, but not sufficient for the sustainability of Faulu Africa. This is the next major challenge for Faulu as it passes the mid-point of Matching Grant II. It is crucial that attention now be directed to the institutional issues that will influence its long-term survival. Key to this survival is the identification of sources of earned income for the regional office that will permit Faulu Africa to continue and pursue its vision. Another dimension of sustainability is the size of the network. Faulu Africa needs to use the period of the Matching Grant support to carefully identify additional country units. Faulu is fortunate in that its mastery of the credit delivery technology somewhat releases it to address these new challenges.

This mid-term evaluation provides a variety of recommendations that are intended to assist Faulu Africa as it enters the final two years of the Matching Grant. In many cases, the ideas raised are not new, and were already being worked on. The recommendations in this case are to encourage the direction already being taken. The following is a summary of the recommendations made throughout the report, and outlines actions that could improve the prospects for Faulu Africa's success:

Faulu Regional Office

Business plan for the regional office: A specific business plan is needed for the regional office, which identifies potential sources of income and sets clear targets by which progress toward financial sustainability will be measured.

Technical assistance agreements with country units: There is a need for more parity in the quanity of technical assistance provided to country units. To help ensure all units

have adequate access, work plans for specific services to be delivered should be negotiated.

Expansion of Faulu Africa: By the end of the Matching Grant, there should be concrete evidence that Faulu Africa will be able to provide credit services in at least three countries.

Product development: Continue efforts to develop new products and refine existing services, especially those that encourage savings within the current legal limitations.

Country Units

Expansion Path: Expansion within the country units is typically done by establishing new branch offices, a strategy that seems to be working well. At this point in time, Faulu Kenya actually has excess operating capacity. The number of clients being handled by loan officers in one randomly surveyed branch, Mt. Kenya, ranged from 15 to 185. Of the 9 loan officers, only 2 had more than 100 clients. Until a new, major source of funding is identified, plans to open another branch in Kenya should be put to the side. A more cost effective growth strategy is to focus on improving the productivity of the loan officers currently on staff. Of course, efforts should continue to expand through new branches as funding becomes available. This two-pronged strategy should allow Faulu Kenya to experience significant growth in the number of clients served by the end of the grant. A factor that could slow expansion is a deterioration in portfolio quality, and Faulu Kenya will need to watch that its repayment rate is maintained as it expands.

Incentives: The desired movement toward increased client load could be substantially helped through the introduction of an incentive pay system. Faulu is encouraged to seriously consider using this tool to enhance productivity.

FHI

Non- FHI countries: Under the current organizational structure, Faulu is limited to working in countries where FHI has a field office. This could be limiting as Faulu Africa looks to where it should logically be. For example, Tanzania is in close proximity to Kenya, and logistically makes a great deal of sense. However, FHI is not there. FHI is encouraged to find creative ways in which it can allow for the expansion of Faulu Africa beyond FHI's current locations if necessary. As the evaluation neared its end, there were indications that FHI was prepared to entertain this possibility.

Policy Flexibility: FHI has already had to make changes in its internal policies to accommodate the special needs of Faulu Africa. Continued flexibility is required. An immediate policy revision that is needed is permitting the Faulu units to pay salary incentives to loan officers based on portfolio performance.

Resource Mobilization: FHI is encouraged to assist in any way possible to mobilize additional resources for the Faulu Africa program.

Creating a regional microfinance loan program is, of course, not easy. There have been many lessons learned along the way. As Faulu Africa and FHI move forward, it is expected that they will continue to experience growing pains. This evaluation is an opportunity for Faulu Africa to step back from the daily pressures of implementation, and strategically consider its organizational and financial future. With regard to sustainability, the performance standard has been set very high. FHI has chosen the strategy of expanding its programming capacity by creating a regional microfinance unit to provide the services typically expected of a headquarters' office. The strategy being pursued is unique, in that typically the cost of the headquarters' technical unit is, at best, only partially covered by income from field activities after the period of donor subsidy ends. Faulu Africa has committed to eventually being able to cover all of these costs from within its network. Few other PVOs have even attempted to so aggressively operationalize sustainability. There is every reason to believe Faulu Africa and FHI can be true leaders in demonstrating a fully cost-recoverable mechanism for developing and supporting MFI's that serve the poor. The risk of not pursuing this vision is to reduce Faulu Africa to being just another donor dependent entity at the "headquarters" level. Another reality is that FHI does not today have plans to assume support the regional office when the Matching Grant ends. The institutionalization of this strategy hinges on Faulu Africa's ability to support itself in the near future. Faulu Africa will not be sustainable by the end of the current Matching Grant. However, by the end of the grant period, it should be expected to have a clear financial plan for and be making progress toward that goal. If this broader concept of sustainability is accomplished, the Matching Grant investment will have provided a return that goes well beyond what has traditionally been considered sustainable credit delivery to the poor.

1. INTRODUCTION

1.1 History of Matching Grant II

On April 1, 1995, Food for the Hungry was awarded a $3.4 million Matching Grant from the Agency for International Development, which will be matched with an additional $3,693,000 by the recipient. The purpose of the 5-year agreement was to: 1) create a regional microenterprise loan program, "Faulu Africa", that will consist of a regional coordinating office and a network of branch lending offices in participating African countries, which will be self-sustaining operationally and financially, both as branches and overall; 2) provide increased access to credit services for the poor in Ethiopia, Kenya, and Uganda; 3) enhance Food for the Hungry International (FHI's) institutional ability to establish, professionally manage, evaluate and monitor microenterprise loans programs; 4) encourage greater involvement of women as loan clients, leaders of credit groups, and as Faulu Africa staff members; and 5) establish a link to FHI field programs in Latin America and Asia, so they can benefit from the methodologies, models, systems, lessons learned and staff expertise being developed in Africa.

The seeds for the current Matching Grant were planted in 1991, when FHI began a pilot microenterprise lending program in the Mathare slums of Nairobi under their first Matching Grant. Matching Grant I supported a disparate collection of projects including: water - Marsabit, Kenya; irrigated farm - Garissa, Kenya; Faulu loan scheme - Mathare, Kenya; and water/literacy/agriculture - Bolivia. An important lesson learned from the experience was that FHI needed to have sectorial focus in future Matching Grants to achieve significant impact. Based on its pilot experience in Kenya, FHI proposed to use Matching Grant II to increase its expertise and involvement in microenterprise credit programming through the formation of Faulu Africa.

The Faulu Africa regional program is itself the major output of the Matching Grant. A review of the purposes of the grant reveal that the task that FHI set out to accomplish is not modest. Not only would Faulu Africa provide a means to deliver credit services to the poor in three countries, but it would do so in a sustainable manner. The traditional emphasis of the Matching Grant Program has been the strengthening of the institutional capacity of U.S. PVOs like FHI. Since the time this grant was awarded, the emphasis has shifted to more deliberately include the sustainability of supported programs as well. The FHI Matching Grant fits the new Matching Grant paradigm extremely well. When microenterprise programming is added to a multi-purpose organization like FHI, the conventional pattern is to establish a technical unit within the headquarters offices. Faulu Africa represents a strategic decision by FHI to place all of its technical capacity in the region. This point is made here to clarify that the regional office functions of Faulu Africa are a combination of the functions that would normally be provided by headquarters and/or a local MFI, e.g. resource mobilization, accounting systems, MIS, methodology development, etc.

This is perhaps the time to make an observation about the range of FHI's purposes for creating Faulu Africa. The Matching Grant proposal and the subsequent Detailed Implementation Plan (DIP) include the following two additional purposes, which where not made part of the Cooperative Agreement:

- To foster an improvement in business ethics and values among loan clients; and

- To encourage an attitude of self-reliance and participation among loan clients, as individuals and groups, and foster their democratic involvement in, and influencing of, societal systems that affect them.

There is anecdotal evidence that the Faulu Africa program has positively influenced each of the above areas. Because of the difficulty in measuring progress, analysis of these purposes was not made part of this mid-term evaluation. This point is made to acknowledge that FHI had, and still has, a broader set of objectives for Faulu Africa than is included in the formal agreement.

In summary, the underlying question posed throughout the mid-term evaluation is the effectiveness of this very decentralized regional strategy, in terms of institutional structure, quality of service delivery and cost recovery. The intent of the subsequent observations about sustainability are to help identify a realistic benchmark by which Faulu Africa can be measured.

1.2 Overview of Faulu Africa

Faulu Africa is a regional microfinance program of Food for the Hungry International (FHI) with lending operations in Kenya and Uganda. Faulu Africa was designed to become the equivalent of a regional economic development bank for the poor, with a network of semi-autonomous units operating as microfinance institutions (MFIs) at the country level. To enter a new country, a large branch is started in the capital city, directly supported by the regional office in Nairobi, Kenya. As operations begin, an advisory board is established to provide oversight. After the branch has been functioning for one or two years, a Head Office is set up to provide full management and support for the new MFI. To expand outreach capacity, additional branches are then opened. While there are slight variations among units, Solidarity Group lending is the main credit product offered within the network.

Faulu Kenya was the first of the Faulu Africa country units, with its origin dating back to the 1991 pilot activity supported under Matching Grant I. Since that time, much progress has been made. Today there are about 110 staff members employed throughout the system. As of December 31, 1997, Faulu Africa had 4,798 loans outstanding totaling almost $1.2 million. A recent mid-term evaluation conducted by the U.K. Department for International Development (DFID) described Faulu Kenya as "... a serious candidate to become a major player in the field of micro-finance in Kenya." Faulu Uganda was established in 1995, and had 1,692 clients by the end of 1997. At the time the USAID Cooperative Agreement was signed, Faulu Ethiopia was envisioned as being the third

unit of Faulu Africa. In 1997, a Unit Director was hired and detailed feasibility work for Ethiopia was started. During the course of the evaluation, FHI reached a decision to not pursue establishment of this unit, which is discussed more fully in section 3.3.

1.3 Purpose of the Evaluation

This mid-term evaluation occurs with a full two years of implementation remaining in Matching Grant II. The main purpose is to assess the accomplishments of FHI to date, its prospects for achieving the overall objectives of the Matching Grant, and to provide recommendations for the remainder of the grant period. The scope of work, which is provided as Annex A specified four major areas of inquiry: 1) the creation and development of Faulu Africa as a regional microfinance institution, capable of providing technical assistance to country units in an effective and sustainable manner; 2) the effectiveness of each of the country units as providers of microfinance services; and 3) the effectiveness of a decentralized, regional strategy as it relates to FHI's programming capacity and institutional needs. The analysis presented in this report is organized around these three broad areas.

1.4 Evaluation Methodology

The field work for this report was conducted during the period February 15 through February 25, 1998. The analysis was based on review of USAID grant documentation, numerous internal documents and forms, financial statements, prior evaluations, and extensive interviews with staff members. In addition to time spent in the regional and country unit offices, site visits were made to the Nairobi Central and Nairobi West Branch offices of Faulu Kenya. In Uganda there is only one office compound, which houses both the country unit offices and the one branch currently operating. Branch visits included interviews with Branch Managers, loan officers, and clients. Most client interviews were conducted without the presence of Faulu representatives. A total of six Solidarity Group meetings were attended in Kenya and Uganda. Data presented in this report is largely based on the audited financial statements of Faulu Africa and internal reports generated by the management information system.

Faulu Africa and FHI headquarters were just completing a week long strategic planning session as the evaluation began. The timing of this event made it possible to interview FHI's Executive Vice President for International Operations, Randall Hoag in the field. These interviews fulfilled the needs of a headquarters visit.

To facilitate the technical analysis of the country units, a diagnostic tool was developed, and is provided as Annex E. This tool was used to score each unit in terms of: 1) institutional capacity; 2) quality of service delivery; and 3) prospects for sustainability.

2. FAULU AFRICA AND THE REGIONAL OFFICE

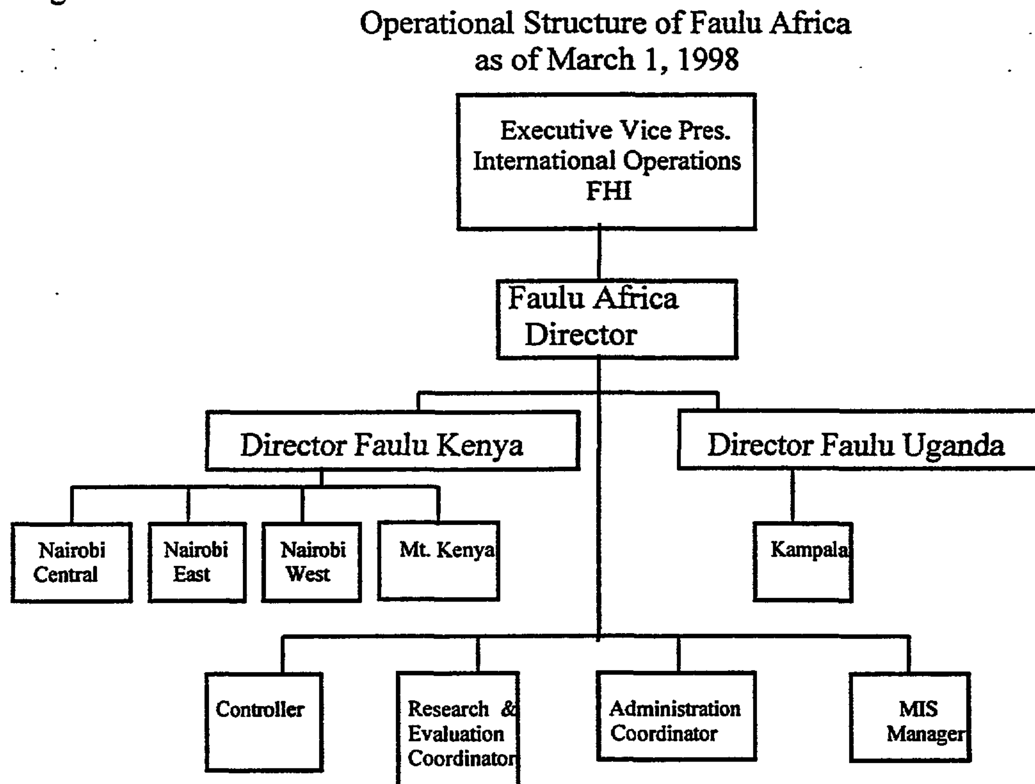
A principle purpose and output of Matching Grant II was the creation of a regional microenterprise loan program, "Faulu Africa", that will consist of a regional coordinating office and a network of branch lending offices in participating African countries, which will be self-sustaining operationally and financially, both as branches and overall. The following section of this report assesses the effectiveness of the regional coordinating office in terms of the structure of Faulu Africa, the methodology, the organizational capacity to deliver services to the units, prospects for sustainability, and the need for expansion.

2.1 The Regional Concept: Institutional Structure and Approach

As has been mentioned earlier, Faulu Africa is structured as a regional entity, with semi-autonomous units operating at the country level. These units, in turn, deliver credit services through a network of branch offices, see Figure 1.

Figure 1

Operational Structure of Faulu Africa
as of March 1, 1998



It is the expressed vision of the program to run each branch, unit and Faulu Africa overall as a business. The Faulu Africa regional office, headquarted in Nairobi, coordinates the continued development and improvement of all systems necessary for its MFI units to operate. Faulu's regional presence is expected to evolve in a manner similar to that of a holding company that provides technical services and capital to its units. To date, Faulu Africa operates under the legally registered umbrella of FHI Kenya, as does Faulu Kenya. Similarly, Faulu Uganda is registered under FHI Uganda.

The organizational structure of FHI is very flat, delegating the majority of program implementation decisions to the field. The strategy of exclusively placing their microenterprise expertise in the field is consistent with FHI's structure, and has worked well, both in terms of ability to adapt credit services to local needs and cost effectiveness. The Faulu Africa Director reports directly to FHI's Executive Vice President for International Operations in Scottsdale, Arizona.

While the current organizational structure has been satisfactory to date, it will need to evolve as Faulu Africa continues to grow. Faulu is already one of the largest programs of FHI. With only eleven professional staff at the Arizona headquarters, it is important that Faulu develop more independent capacity to govern its operations. Even though there is a Faulu Africa Management Team, which meets quarterly, almost all of the policy and vision responsibility rests with Faulu Africa's Director and FHI's Executive Vice President. The Management Team is made up of the Faulu Africa Director, the Directors from the MFI units and the regional office staff. As Faulu expands, the attention it will require can be expected to grow, and it is not realistic to expect that this additional attention can be given from FHI headquarters. A positive step in the institutional evolution of Faulu will be the establishment of a body that assumes many of the oversight and policy roles typically filled by a board of directors. Under this recommended structure, FHI could protect its interests as a major investor through appropriate representation. Accountability of the regional office to a board of directors will help ensure Faulu Africa receives the oversight attention it requires from those most informed to make decisions. To be effective, FHI must be prepared to allow the governing body to substantially influence Faulu Africa's future.

Another dimension of the organizational structure is the relationship between the Faulu regional office and its units. Faulu Africa refers to all of the country units and their respective branches, and all of Faulu Africa is part of FHI. The country units were designed to operate as branches of the regional office, having much the same relationship as a branch would have to the head office in an MFI. This structure is based on the premise that extensive cost efficiencies could be gained by developing accounting and management information systems and methodologies that could be shared by a number of programs. The just mentioned components are all critical to any MFI. They must be donated or purchased from some source. Most networks provide these services to their members. But, Faulu Africa has a vision that goes beyond providing these traditional services. What makes Faulu different is the sense of a much tighter relationship. It is important to FHI that all units operate in a manner that is consistent with FHI's institutional culture. This attitude reflects both a practical desire to protect investments

made in the units, and a desire to have a structure that can use income generated within the network to expand by opening new units. The regional entity is one organization with parts that can succeed or fail, but are always part of the whole. It does not make sense to talk about Faulu Kenya or Faulu Uganda without the existence of a regional office that provides support.

Some unanticipated implications of FHI's regional strategy have surfaced with the passage of time. As units mature they begin to look more and more like autonomous MFI's with their own national identity. These mature units could potentially rely less on Faulu Africa. This poses a dilemma, in that the success of Faulu Africa's units depends on being able to attract strong directors and advisory boards. Such strength is generally consistent with a desire for increased autonomy. However, autonomy, complicates and changes the dynamic of the relationship. Faulu Africa is still evolving in this area. An example of the complex organization issues being faced is the legal status that is required of the units. How will these be registered, and what are the implications? How much autonomy can Faulu Africa give its units? How can FHI protect its interests in the units it creates? Does FHI need full ownership and full veto authority over decisions of units as they mature? What a regional African entity really means is still being defined, and will be one of the major challenges facing Faulu Africa in the next year.

FHI's Cooperative Agreement makes explicit reference to a regional network with units. This early vision should not be the deciding factor in determining the institutional structure of Faulu Africa. USAID is encouraged to be flexible, allowing FHI to define the meaning of its country unit offices in a way that meets its needs. It is important that these organizational issues be resolved soon, before new units are added to the network.

2.2 Lending Methodology

Within Faulu, all loan operations are conducted by the branch offices of the country units. Faulu targets its loans to low-income business people who own or intend to own a small scale or micro-enterprise business. The main loan product of Faulu is the Solidarity Group loans. This methodology is an adaptation of the Grameen Bank methodology, and is well defined in a detailed operations manual.

Solidarity groups are generally self-formed groups that approach Faulu. The groups must consist of 15 to 40 people, and the decision to accept members is the prerogative of the group. To further encourage solidarity, the group is additionally structured around sub-groups of five which are the first line of guarantee. Prior to acceptance of the group's application, the loan officer carries out a detailed evaluation of the group and individual member businesses. Each solidarity group member becomes a client of the country unit program, i.e. Faulu Kenya or Faulu Uganda, and loans are advanced to individuals through the group. A one-time fee of about $1.75 is payable per person during initial registration.

All incoming groups are required to enroll in a loan orientation seminar (LOS), which is designed to equip members with an overview of available services and basic

business practices. The LOS is offered in six 2-hour sessions and is held over a 2-week period. A non-refundable fee of about $2.60 is charged for the LOS, in addition to the cost of training materials. For a first-time Solidarity Group borrower, there is an 8-week countdown period prior to loan disbursement. This period is used to build weekly savings discipline, work on group dynamics, and development of group record keeping systems. Also during the countdown period, loan applications are appraised and approved. Not all loans are given at the same time. In consultation with the group, the loan officer prepares a schedule for the loans to be disbursed to individual members. Once an individual client has successfully repaid a loan, he or she may immediately apply for another loan without having to undergo another countdown period.

Faulu loans are not secured using traditional methods of collateral. The Loan Security Fund (LSF) is a means of building security for the loans over time. Its sole purpose is to help secure the loan capital in case of default. All loans must be cross-guaranteed by all group members, and further protected by the deposits of group members in the LSF. Upon approval, disbursements to individual members of a group are made by check. Payments of principal and interest are due weekly. The group is responsible for making payments to the Faulu bank account prior to the meeting, and having a stamped receipt available for the loan officer to collect during the meeting. This weekly requirement may be relaxed for older groups with a good repayment record.

The first loan size typically begins at $200 and can go to $1,300. The actual loan size for each client is based on the assessment of the business, willingness of the group to guarantee the loan, and performance of the group. If too many group members have arrears, no loans will be made. As a general guide, if more than 10% of the group members are in arrears, further disbursements to all group members are discontinued.

Interest rates are established by the country units, in consultation with the Faulu Africa regional office. Loan set-up fees are charged, which are typically 1% of the face value of the loan. A LSF deposit is required of each member. During the 8-week countdown, new borrowers are required to make weekly deposits before receipt of their first loan on the ninth week. All first and second loan borrowers are required to make a weekly deposit, for the entire term of the loan of 1% of the face loan amount toward the LSF. A minimum of about $1.75 per week is required for subsequent loans. Clients receive a bonus that is earned monthly, and accrued semi-annually on deposits they have made into the fund. Clients are allowed to make one annual withdrawal from their LSF account but must leave at least 25% of the face value of their current loan amount.

The Catastrophic Insurance Fund (CIF) is a pool of premiums from all borrowers within a Faulu branch. Borrowers pay 1% of the face amount of each loan received, payable at the time of loan disbursement. Premiums are non-refundable. The purpose of the CIF is to provide partial loan insurance as a last resort against the outstanding loan balance of members upon the event of death or catastrophe making them unable to continue business operations. While it maintains the CIF, decisions on settlements from the fund are made by a committee consisting of the group leaders. Information collected during the evaluation indicates that CIF is a service valued by clients. Some groups, in

fact, have requested an even larger contribution be made to provide the group a greater sense of protection.

2.3 Operational Capacity

The Faulu Africa regional office is staffed by five professionals and one administrative support staff. The regional staff, e.g. the Director, Controller, MIS Manager, Research & Evaluation Coordinator, and Administration Coordinator provide critical support to the field units (accounting systems, MIS, methodology development/loan operations, and administrative procedures), and are staffed by individuals who are above average in technical competence. It is exceptional to find such excellence at all levels of an organization, including the country unit directors.

There is no question that the staff has the capability to deliver the critical services needed. The issue is whether they have the time and resources that are necessary. As it grows, Faulu Africa will need to be careful about how regional office staff time is allocated. The units are the clients of the regional office. How will Faulu Africa ensure all units receive the technical assistance they need? One recommendation is to negotiate annual or semi-annual work plans with the units that outline their technical assistance needs. Currently, the majority of the regional staff's time is spent on providing services to Kenya. Some of this time is legitimately used developing pilots for later transfer to other units. The regional office needs to be able to separate the R&D/pilot nature of its work from more routine technical assistance support, and to therefore be aware of any subsidy it is providing. There is a general perception that Kenya disproportionately benefits from regional office services, because of its close proximity. In fact, the regional office has space in the same building as Faulu Kenya's headquarters. This is where a governing/advisory board of directors can help. All stakeholders can agree where the attention should be placed. What can also help to ensure equity is identification of a standard set of services that can be expected by all units.

2.3.1 Accounting Systems

The accounting systems of Faulu Africa are maintained in an open and transparent manner. Faulu Africa accounts and those of its units are kept completely separate from the FHI country operations, and all financial reporting and transactions of Faulu Africa are done directly with FHI headquarters. Balance sheets, income statements, and cash flow statements are prepared monthly, for each unit and consolidated for Faulu Africa overall. Audited financial statements are prepared on an annual basis. Balance sheets show an acceptable provision policy for loan losses, and reflect a reasonable depreciation policy. Internal controls were found to be adequate, with appropriate separation of approval and disbursement functions.

2.3.2 Management Information Systems

The Solidarity Group methodology being used by Faulu Africa for the majority of its portfolio is highly dependent on an elaborate MIS, especially the loan tracking program. Faulu Africa has developed its own, very sophisticated, MIS that uses microbanker as the core of its loan tracking database, with extensive modifications to the front and back ends of the system. Detailed reports on the status of the portfolio and staff productivity are distributed weekly. Portfolio data is produced in summary form, but also by branch and loan officer to allow for precise monitoring. While the system is serving Faulu well, it is noted that the such a sophisticated system is highly dependent on specialized support which is currently provided by the MIS Coordinator who designed the system. It will be some time before the administration of the system can be expected to be routine. Nevertheless, it is noted that few MFIs have a management information as comprehensive as Faulu Africa's.

2.3.3 New Products

An important function of the Faulu Africa regional office has been product innovation which builds on the experiences and lessons learned from a variety of contexts. The basic loan product of Faulu has been the solidarity group methodology. When it began its lending program in 1991, it logically accepted the methodology of an established Kenyan credit provider, K-REP. While the basic loan product has worked well, Faulu is now in a position to be a methodology leader. The experience of the past three years has provided a rich understanding about what works. Faulu is an institution interested in learning and making innovations, and has a staff member, the Research & Evaluation Coordinator (R&E), devoted to this. One of the most impressive attributes evidenced during interviews with the R&E Coordinator was his serious commitment to understand and respond to Faulu's customer's needs. This focus will certainly serve the program well.

Faulu has used a second loan product, On-Lending Groups (OLGs), with limited success. The OLG methodology was first used to take advantage of pre-existing groups that were already involved in informal savings and lending activities. Typically group members make a weekly payment of a predetermined amount, with each member having access to the collected amount in turn. The group determines the order in which funds are made available. The idea of providing capital to existing groups was that older groups would be more cohesive, and bring with them a stronger sense of solidarity than new groups. On-group lending differs from Solidarity Groups in that one loan is made to the group, who internally manages its distribution among members. In practice, Faulu's On-lending loans have not performed as well as Solidarity Groups. One reason that is suspected by Faulu staff is that old groups have bad habits that are hard to break. It is also possible that introducing external capital has somehow weakened the member's sense of responsibility for repayment, e.g. it is no longer your friends money that you are using.

Despite its earlier problems, Faulu Kenya is the unit interested in trying On-Lending groups again. This unit has a desire to expand into more rural areas, and sees On-lending as a way to lower the program's administrative costs. Faulu is warned that bulk loans to groups will not necessarily produce the low cost results the Kenya unit desires. To justify deviating from its classic model, Faulu needs to consider more carefully how it will ensure groups will manage the loan in a responsible way. Experience would indicate that perhaps inadequate group preparation was done in earlier attempts. On-lending could learn some important lessons from Village Banking about how to train and empower groups. Group empowerment and development is not inexpensive, nor is it easy. For solidarity groups, Faulu is basically saying to its clients, "We will manage the details of credit for you. You need not learn banking skills, use your time to focus on your business." On-lending does put at least some management burden on the groups, otherwise it is just a typical Faulu Solidarity Group. Faulu should weigh the cost savings it expects to gain against the extra costs of group training that will be necessary. There is a concern that Faulu does not understand village banking nor does it have much experience in training groups for financial management, and therefore needs to proceed carefully with its On-lending pilots. Without modification, the original On-Lending model will likely fail again. Faulu Uganda is not starting new On-Lending Groups, and is suspect about Kenya's ability to implement the methodology well.

As implementation proceeds, Faulu is noticing that some clients seem to be advancing more quickly than others in their group, and need a higher level of credit. In some groups, differing loan sizes have weakened the group's cohesiveness. For successful clients who have been with the program for more than four loans, there is a need to provide higher loan amounts. Insisting that these clients remain in large groups may not be advantageous to them or their group. Newer group members are asked to assume a larger amount of risk relative to their individual loan. If a large loan fails, an entire group could collapse. Smaller groups of higher loan members should lead to greater solidarity, in that their interests are more likely to be similar. These smaller solidarity groups could become profitable for Faulu. At some point, the high value of business assets will make a few clients eligible for individual loans. The regional office is in the process of developing a variety of lending products that cover a broad range of client needs. This strategy will provide the network the capacity to offer a tailored set of credit services appropriate to the country context it finds units working in. While cross-fertilization does occur, Kenya has been the pilot for testing all of new products. Faulu Africa must be careful to ensure that new products are relevant to the entire network. While it is tempting to use the cost savings of conducting pilot testing in Kenya, there is a need to balance this benefit with the potential costs of missing other unit's experiences.

One indicator of the impact that Faulu Africa is having on clients is the drop-out rate. It is noted that for every 10 members it gained in December 1997, Faulu Kenya lost 4 members and Faulu Uganda lost 8. The author is unaware of an industry standard for attrition rates, but certainly the rate for Uganda is high. As a target, it seems reasonable to strive for a ratio of new to exiting clients of 10:2. Lower drop-out rates will not only improve program efficiency, but will also reflect that the credit product is meeting client needs. High turnover rate is not unique to Faulu, but is something that most microfinance

programs are struggling with. It is encouraging that Faulu: 1) collects detailed data on a weekly basis so that the trends can be monitored, and 2) is aggressively seeking ways to retain more members, including documented exit interviews with clients and a willingness to change its products. To illustrate how seriously drop-outs are taken, when the Faulu Kenya Director was asked what variable he first looked at when he received the weekly performance report, he said it was the number of exiting members. While they have not yet found the answer to this problem, Faulu is working on it.

In addition to helping refine the lending methodologies, the R&E coordinator is involved in helping to define a savings product for Faulu Africa. The ability to launch this effort is currently limited by Faulu's legal status, but it is the opinion of the evaluator that Faulu is again on the right track. Excess funds contributed to the Loan Security Fund indicate that this is a particularly promising area for development. Faulu Africa is encouraged to develop and offer mechanisms that encourage savings.

In summary, the regional office is playing an important role in the refinement and development of the methodologies needed by its units. The challenge will be to be certain adequate attention is given to those produces as they are moved beyond Kenya.

2.4 Financial Sustainability

Faulu is making significant strides toward sustainability planning at the unit level (See Section 3.1.3), and it is very likely that Faulu Uganda and Faulu Kenya will each achieve full financial sustainability within the seven-year period required by USAID policy. The methodology, systems, and staff are in place to make this happen. Perhaps more importantly, sustainability is a goal that is being pursued in a deliberate fashion. It is less clear what the prospects for the sustainability of the regional office are. During the first years of the Matching Grant, attention has been focused on ensuring the methodology and related information systems are working well. Growth, both within Kenya and expansion into Uganda, has been very demanding on the regional staff. As Faulu Africa grows, it is vitally important that it begin to pay a commensurate level of attention and effort to developing a realistic plan for the financial and institutional sustainability of the regional office itself. As of yet, there are no clear answers to the basic question of where the money for regional responsibilities will come from when the Matching Grant ends.

While they still have the benefit of grant support, it is time for Faulu Africa to seriously address this issue. A first step is to be explicit about what is meant by sustainability. From one perspective, Faulu Africa is one entity with profitable units. Therefore, one could make the argument that the network, as a whole, will one day reach a point where its revenue exceeds expenses. The issue is more complex than this simple argument would suggest. An insightful analysis requires that each of the components of the network be considered individually. It is absolutely true, that financial sustainability of the units is a necessary condition for the sustainability for Faulu Africa. It is not, however, sufficient. There needs to be a way to transfer resources from the units to the regional office on an on-going basis.

Operational units, of course, generate income from loans to clients. Sustainability for the units, therefore, is within their control and is based on performance. The challenge facing a regional office is to identify a parallel source of support. The units of Faulu Africa are the clients of the regional office. Their needs should be identified, along with what they should be expected to pay. This is the same business concept that appears in much of Faulu's literature. What is needed now is more specifics about the implementation of the model. Again, it must be emphasized that these ideas are not new to Faulu, and most of the options offered below have already been discussed internally. A specific revenue generation strategy needs to be agreed to so that the regional concept of Faulu Africa will not be vulnerable in the future.

To stimulate thinking in this area, the following options are offered for Faulu's consideration. It should be noted here that no one of the following options is expected to be the solution. A more effective strategy will likely involve a blend and balance of each of the following actions. At a minimum, the regional office needs to have a source of income to support its current level of activity. To open new units without a donor, the regional office will need to generate an even larger surplus.

Option 1. Regional office charges units a percent of their portfolio.

This suggestion is based on the argument that larger programs require more attention, and benefit absolutely more from the services provided by the network. When a new unit is opened, it requires a significant amount of the up-front investments in loan capital, fixed assets, installation of accounting and management information systems, and staff training. It is like a business venture that is expected to produce a positive return over time. One of the greatest advantages of this option is that is provides a predictable, stable source of income, that will grow over time. Another advantage is that it can be used to cover the fixed overhead and administrative costs of the regional office, i.e. there are no additional services required that would increase variable costs. A fixed percentage charge is one way for Faulu Africa, as a regional entity, to recover its initial investments so that the process can be repeated elsewhere.

There are some limitations to this option. One is that donors, in general, do not like covering regional/headquarters costs when presented on a formula basis. There is a higher level of comfort in having expenses more directly related to services provided. Another limitation of this approach is that charging a percent of the portfolio provides no incentive for the unit to grow, or for the regional office to be responsive in its provision of services.

Option 2: Fee for Service Agreements

Faulu Africa has a valuable set of services it provides units in its network. To date, these services are subsidized through expenditures of the Matching Grant. There has been a reluctance to charge units for them, because it would slow their progress toward sustainability. One needs to be cautious about this approach. It is a fact of life that services are more valued when the customer is asked to pay for them. Instituting a fee for service agreement between the regional office and its units have several beneficial outcomes. First, it will expose the services of the regional office to a pseudo-market test, making it more likely they remain relevant and cost effective. As part of Faulu Africa, units don't really have a choice about where to buy services. However, if the units are required to pay, they will certainly be more aggressive about questioning the quality and quantity of the technical assistance provided. Likewise, the regional office will be more often reminded that it is the profitable country units who enable Faulu Africa to continue. Second, a service contract will help ensure a more equitable and rationale distribution of resources. Currently, there is a perception that Kenya receives a disproportionate share of the benefits of the regional staff because of its physical proximity. Annual work plans can be negotiated, which make commitments and prioritize technical assistance needs. The fee for service system requires good faith from all parties. Units, for example, should not excessively avoid requesting TA to lower their operating expenses. Likewise, regional staff must be prepared to go where they are paid to be. New units and units planning for significant expansion typically have donor support available. For them, it is a matter of accurately presenting in their budget the cost of purchasing the services they will need to handle their grant effectively. More mature programs should be prepared to pay based on the improvement they will see in their bottom line. On balance, the benefits of accurately stating costs more than compensate the resulting slower growth path toward financial sustainability of the units.

Option 3. Loan Capital Retailing

In the near future, Faulu Africa will have the credentials to mobilize capital from a variety of commercial sources on behalf of its operating units. It is unlikely that donor capital will be sufficient to finance the capital needs of portfolios that begin to reach over 10,000 clients. The Faulu regional office can provide a capital mobilization service beyond the capacity of any individual unit. It is assumed that a significant amount of the capital will be acquired on concessional terms. As a wholesaler of credit to its units, the regional office could earn income from the spread, while helping units evolve toward commercial loans. Rates charged to units could be kept lower by pooling capital from a variety of sources that include grant funds, thereby blending the rate charged. Even just a .5% or 1% of the capital provided operating units could eventually become a significant source of income. Once it reaches a certain level, this activity may even justify the hiring of a resource mobilization coordinator.

Option 4. Creating a Commercial Service Division

Faulu Africa has several products that have the potential to be marketable to other MFIs. A product currently under active consideration is the MIS. This idea could be expanded to include other services like accounting systems, operations manuals, staff training, feasibility studies and evaluations for donors.

It is recommended that Faulu continue to explore all of the above options, and others that will expand its resourse base. Each fiscal year, fees can be factored into the budgets of the various units, and included as an operating expense in the sustainability calculations. The time to initiate fees is now, while the network is still young, and most units have yet to be added. Initially, the big carrot is that units are solely dependent on the regional office for all of their support and systems. The reality is that once a unit has the systems, it is more difficult to introduce a fee. Faulu also needs to be careful to protect its name. One way to do this is to establish performance standards that must be adhered to. This type of a mechanism would be somewhat like a franchise agreement between Faulu and its units. Faulu Africa will provide the methodology and systems, but the country unit must implement its program in a responsible manner.

A diversified income strategy for the regional office will optimize Faulu Africa's prospects for sustainability. Income from mandatory fees should be a relatively small part of Faulu's income, but can be helpful in covering fixed administrative costs. The majority of the income should come from the technical agreements for services. This means that units will need to build TA services into their proposals to donors. The regional office can help by providing accurate estimates of the costs of services, and outlining the complete package of services that are needed to accomplish various institutional development tasks. For example, what is needed by Faulu Kenya is quite different than the package needed by less mature units.

A substantial part of this mid-term evaluation has been devoted to discussing issues regarding sustainability. It is acknowledged that Faulu Africa, in its role as a technical unit of a U.S. PVO, is being held to a higher standard than that of any PVO this evaluator is aware of. A hard line was taken on this issue for several reasons. First, FHI has chosen the strategy of creating a regional microfinance unit which provides most of the services typically expected of a headquarters office. The fact is that FHI has a limited capacity to support this activity from headquarters without donor support. Therefore, until Faulu Africa develops independent sources of income, it will be vulnerable. The challenge that FHI has set for itself is to make Faulu Africa sustainable. To achieve that goal, these must be clarity about what that means. Faulu Africa should use the next two years to carefully develop a business plan for the regional office, that looks realistically at all sources of income.

Before it can seriously discuss cost recovery, Faulu Africa must be able to justify the expenses it is incurring and place a fair market value on its services. It is the opinion of the evaluator that the economies of scale argument is potentially valid, but that it has

not been demonstrated. Units need to be able to present their full costs to prospective donors, and analyze their sustainability based upon those costs. All involved parties must also be prepared to accept slower progress by the units. Ultimately, this is the only fair way to compare among programs. Hiding a subsidy does not provide a service to anyone. The fixed investment in development of MIS, accounting system and methodologies has now been made, however, continued revision and enhancement will always be required. As earlier units benefited from donor assistance, it is now time for them to contribute to the network so that it can improve effectiveness and expand coverage.

In the early stages of development, new programs require considerable time and expense in installation, tailoring of systems and working through the trials of implementation. Older units will rely on Faulu Africa for enhancements that improve the effectiveness and help address the issues involved with scale, e.g. ensuring systems can handle the demands of serving 10,000 - 20,000 clients. Given these two needs, the regional office will have a continuing market for its services. To help keep services relevant to its units, a significant portion of regional staff salaries and operational expenses should be based on the concept of billable days.

At the end of the day, there must be a mechanism to bring resources back from the country units delivering services, otherwise the regional office will not be sustainable.

2.5 Expansion Strategy

How many country units will it take to make Faulu Africa sustainable? With Uganda being so young, it is tempting to suggest that the remainder of the Matching Grant should be spent building upon the base already present, bringing it to scale. It is the opinion of the evaluator, that the ultimate success of the network will depend on its ability to bring new units in. Mathematically, it is accepted that two units with very high portfolios could generate as much income as several smaller volume units. There are some practical considerations, however, that make settling for a two program strategy inadequate. Both Kenya and Uganda are still in a position to need donor support to accomplish their growth objectives. To be competitive, each unit must achieve full financial sustainability within a reasonable time. Higher costs to support the regional office will slow their progress. More units would enable Faulu Africa to defray its costs among more parties, thereby taking greater advantage of the economies of scale.

Faulu Africa is close to getting a replicable set of services available. New country units represent opportunities to widen the base over which operational costs can be spread. Once established, new units are going to grow. If one assumes that each new unit will one day have a client base in the range of 10,000 - 20,000 clients, the argument for horizontal expansion of the network through entry into new countries is compelling.

2.6 Key Issues and Outlook for the Regional Office

With respect to the output of creating a regional coordinating office, the obligations of the Matching Grant have been fulfilled. The Faulu African regional office today is providing all of the services necessary to create and support MFI units. The following recommendations point to some areas in which the regional office may be able to improve its performance even more.

Business plan for the regional office: Develop a business plan for the regional office which outlines potential sources of income and sets clear targets by which progress toward financial sustainability will be measured.

Technical assistance agreements with country units: There is a need for more parity in the quanity of technical assistance provided to the country units. To help ensure all units have access, work plans for the delivery of specific services should be negotiated.

Expansion: By the end of the Matching Grant, there should be concrete evidence that Faulu Africa will be able to provide credit services in at least three countries.

Product development: Continue efforts to develop and refine new products, especially finding a way to encourage savings within the legal limitations currently faced.

3. ANALYSIS OF FAULU COUNTRY UNITS

3.1 Faulu Kenya

Started in 1992 as a pilot project under Matching Grant I, Faulu Kenya is the oldest unit of Faulu Africa. Faulu Kenya shares that same headquarters as the Faulu Africa regional staff. Early in the life of the Matching Grant, Ted Vail filled both the role of Faulu Africa Director and the Director of Faulu Kenya. Peter Ondeng was brought in May 1997, leaving Vail to focus solely on Faulu Africa. The Faulu Kenya Director reports directly to the Director of Faulu Africa. While Faulu Kenya does have an Advisory Board of seven members, ultimate decisions are made by FHI/Faulu Africa.

There are now about 90 staff in the Faulu Kenya system. As the most mature unit of Faulu Africa, Faulu Kenya's structure reflects a well developed, decentralized hierarchy. Credit services are delivered through a network of four branches: Nairobi Central, Nairobi West, Nairobi East, and Mt. Kenya. Each branch is headed by a Branch Manager who reports to the Operations Manager. The Branch Manager is responsible for all aspects of lending operations within the branch area of operation, including managing staff, meeting targeted portfolio growth and quality targets, and achieving branch profitability. In addition to the Manager, the typical branch has an accountant, accountant assistant, data input operator, 6-10 loan officers, and various support staff. The branches are supported by the unit's central office that in addition to the Director and Operations Manger, includes a Communications Officer, Product Development Officer, Information Systems Administrator, and a four-person finance unit.

While the overall management structure is performing well, Faulu Kenya continues to look for ways to improve. There is a plan under active consideration to consolidate the loan tracking and processing functions. Not only would this reduce the need for equipment, especially back-up generators, but would allow for more efficient distribution of work flow.

3.1.1 Financial Performance and Prospects for Faulu Kenya

Key Summary Statistics
as of December 31, 1997

	Faulu Kenya	Total Faulu Africa
Number of registered clients	5,138	6,830
% female clients	52%	58%
Number of outstanding loans	3,342	4,798
Outstanding Loan Balance	$1,005,237	$1,192,754
Average Loan Size	$300	$249
Operational Self-sufficiency	45%	
Repayment Rate	109%	
Default Rate to Faulu	1.7%	

Annex E.1 provides a summary rating of the performance of Faulu Kenya. In all categories considered, performance was found to be average or above. This means no serious deficiencies in the credit delivery system were identified. The categories receiving average ratings are discussed below, to point to areas where performance could still be enhanced. In the category of institutional structure, Faulu Kenya still needs to resolve issues surrounding its legal status. Among other things, this is prohibiting it from capturing savings.

In the area of portfolio quality and outreach, the performance is above what is typically found of a program of its age. In this set of indicators, only "evidence that services reach the poor, especially women" was rated average, with all other indicators being above average. Faulu Kenya has developed a natural market niche that address the needs of a more business-minded clientele than served by "poverty lending" programs. Average loan size is often used as a proxy to measure depth of outreach. Faulu Kenya's average loan size of $300 is above what is typically found in village banking programs. Based on this observation, it is likely that Faulu Kenya clients are not the poorest in the nation. Nevertheless, it is the finding of this evaluation that this target client group is appropriate, and that Faulu Africa is addressing an important development need for these individuals. The percent of women being reached is now about 52%. Performance in this area was considered average, because the percent of female clients generally reflects the representation of women in Kenya's population.

The scores in the final section on sustainability are generally above average, acknowledging Faulu's impressive annual planning process. Progress in expanding outreach was rated average, because Faulu Kenya currently has excess capacity, and needs to improve the productivity of its loan officers.

3.1.2 Financial Sustainability

Faulu Kenya is currently operating at 45 % operational self sufficiency. Branch managers interviewed are certainly cognizant of their role in contributing to the sustainability of the Faulu Kenya unit as a whole. The recently completed 1998 Annual Planning Process was conducted in a manner that should result in great productivity of staff, and thus improve sustainability results. Among other things, the plan began with a review of 1997 performance. Loan officers were then asked to establish 1998 targets for themselves, along with a detailed strategy for accomplishment. This was the first time planning had actually started at the operational staff level. The result has been impressive. Loan officers feel a commitment to accomplish their goals because they were so involved in establishing them. Self analysis has resulted in creative suggestions and solutions to problems. Particularly evident was an awareness of the location of the groups, and a strategic effort to cluster new groups for improved efficiency by improving the number of active clients per loan officer. The same participatory approach could be used in the future to improve drop-out rates for example, or to increase the average loan size in each loan officer's portfolio. Another opportunity to improve sustainability is to find how to distribute the costs for services provided by the central office to the units in the way that encourages efficiency. Faulu Kenya is already looking at ways to centralize

MIS data entry functions to lower costs. Kenya is also looking at how the branch areas of operation might be redefined to lower the infrastructure costs needed to provide services.

3.1.3 Key Issues and Outlook for Faulu Kenya

In summary, the performance of Faulu Kenya has been strong. When one looks at the age and resources that have been dedicated to this program, the results are impressive. The following are two recommendations that could improve performance even more.

Expansion: Expansion of units is typically done by establishing new branch offices, and the fundamental structure seems to be working well. At this point in time, Faulu Kenya actually has excess operating capacity. The number of clients being handled by loan officers in one randomly surveyed branch, Mt. Kenya, ranged from 15 to 185. Of the 9 loan officers, only 2 had more than 100 clients. Until a new, major source of funding is identified, plans to open another branch in Kenya should be put to the side. A more cost effective growth strategy is to focus on improving the productivity of the loan officers currently on staff. Of course, efforts should continue to expand through new branches as funding becomes available. This two-pronged strategy should allow Faulu Kenya to experience significant growth in the number of clients served by the end of the grant. A factor that could slow expansion is a deterioration in portfolio quality. Faulu Kenya will need to watch that its repayment rate is maintained as it expands.

Incentives: Positive movement toward an increased client load could be substantially helped through introduction of an incentive pay system. Faulu Africa has thought about incentives, but there have been two constraints to implementation. First, incentive systems are not currently permitted within FHI, and would require a change in policy. This obstacle has limited the extent to which incentives have been explored. The second constraint is more difficult to address. Faulu is well aware of how complex incentive systems are to design, and feels they have not yet seen one that meets its needs. Faulu Africa is correct in being cautious. Incentive systems are indeed complex and difficult to get right. Nevertheless, the potential benefit to be gained makes it worth pursuing. Difficulty should not preclude exploration. It is recommended that use of salary incentives be seriously considered by Faulu Africa, and the following are some considerations that should keep in mind:

Incentive systems should encourage loan officers to increase their case load and average loan sizes within their portfolio, but must also balance growth with maintenance of portfolio quality. Faulu Africa should identify all of the elements that it wants to encourage and likely results it wants to avoid.

- The incentive system must be monitored to ensure it is achieving the desired result. Be transparent, and above all keep promises that are made. This means one must be careful about what those promises are. If there is uncertainty about a new incentive system, present it as a pilot that will be evaluated and modified after a certain period.

- Key variables most programs use to award bonuses include: portfolio quality, # new clients, # repeat clients and average outstanding loan size. Note that the total number of loans was not included because that can be outside the control of the loan officer as a portfolio may be divided/redistributed.

- Typically, incentives are paid at specific times of the year so they do not become an expected part of income. Incentives also need to be large enough to be perceived of as being significant. Future salary increases may need to be slowed to allow the bonus to become a significant portion of the loan officers salary.

3.2 Faulu Uganda

In 1995, Faulu Uganda began operations. Until seven month's ago Bruce Larson served as both Unit Director and Kampala Branch Manager. A Branch Manager has now been hired, relieving Larson to focus on Unit Director responsibilities. The Kampala branch office now has nine loan officers, some of which were recently hired. Therefore, there is currently room for portfolio expansion through enhanced productivity. Faulu Uganda is also ready to open another branch office as soon as funding becomes available.

3.2.1 Financial Performance and Prospects for Faulu Uganda

Key Summary Statistics
as of December 31, 1997

	Faulu Uganda	Total Faulu Africa
Number of registered clients	1,692	6,830
% female clients	71%	58%
Number of outstanding loans	1,456	4,798
Outstanding Loan Balance	$254,533	$1,192,754
Average Loan Size	$175	$249
Operational Self-sufficiency	%	
Repayment Rate	109%	
Default Rate to Faulu	.2%	

The Faulu Uganda unit was scored using the same rating form that was used for Kenya. The results of performance were quite similar, and the following discussion only covers areas of difference between the two programs. For two indicators, Faulu Uganda scored one level below that of Kenya, and for one indicator it scored one level higher. For all categories considered, performance was at least average, with no major problem areas identified. One of the indicators scored lower for Uganda was access to critical technical assistance and services. While it was still deemed acceptable, Faulu Uganda has not had the same benefit of regional office as Kenya. This is a general observation that the regional office should address as it plans to add new units. Start-up units will

take extensive staff time, and planning must realistically allocate this scarce resource. In progress toward expanded outreach Uganda ranked slightly below Kenya, which is largely a function of its relative age. In outreach to the poor and percent women reached, Uganda scored higher than Kenya. It was interesting that the Uganda program has made some minor modifications in the methodology that will likely result in reaching a lower income clientele. First of all, they have lowered the minimum loan size for the first loan from $300 to $200. Uganda has also lowered the set-up fees for clients. Finally, the MIS shows that Faulu Uganda has a larger percent of female clients than Kenya, 71% vs. 52%.

3.2.2 Financial Sustainability

Faulu Uganda recently completed a business plan as part of its application for USAID PRESTO funding. This plan projects that this unit, based on the establishment of four branch offices, will be self-sufficient by the year 2000. Assuming that donor funding is available to open the branches, achievement of the plan's objectives is likely.

3.2.3 Key Issues and Outlook for Faulu Uganda

Performance of Faulu Uganda was found to be somewhat above average. The Faulu methodology appears to have traveled well from Kenya. While circumstances can change quickly, there is every indication that Faulu Uganda is off to a good start. While more years of implementation are needed to declare success, management has their eyes on the right indicators, and has acted decisively in the past. The next challenge will be how Faulu Uganda manages growth, i.e. the opening of new branch offices. The unit director will soon need the equivalent of an operations manager to help with the day-to-day demands of a larger network.

3.3 Faulu Ethiopia

Documentation on Faulu Africa often refers to three MFI units, e.g. Ethiopia, Kenya and Uganda. In fact, Ethiopia is still at the pre-lending phase of development. In 1997, Richard Reynolds was hired as Unit Director for Ethiopia. To date, an office has been opened, two initial branch sites have been identified, and a project agreement was signed between FHI Ethiopia and the government to run a microfinance program for three years. However, a challenging situation has developed. After the Matching Grant Cooperative Agreement was signed, the National Bank of Ethiopia (the equivalent of a Central Bank) announced that it will regulate all microfinance programs and that all such programs must be set up as microfinance companies immediately. This short time frame forced Faulu Africa to make decisions about organization structure sooner than had been expected. Some serious issues could not be answered quickly. For example, there is concern about government policies that prohibit non-Ethiopian board members, a questionable ability to make foreign equity investments and uncertainty about the ability to repatriate profits to the regional office.

3.3.1 Key Issues and Outlook

Near the end of the evaluation, FHI made the decision to not add Ethiopia as its third unit. This decision is determined to be prudent, given there were too many factors that didn't seem to fit for Faulu. After reviewing the Cooperative Agreement and FHI's proposal, it is the opinion of the evaluator that Ethiopia itself is not a critical determinant of the success of the concept. It is not yet an anchor country, and a limited investment has been made. Another country could be substituted for Ethiopia, without seriously compromising the purpose of the Matching Grant. Therefore, it is recommended that FHI identify a new third country to met the terms of the Cooperative Agreement.

4. FAULU AFRICA AND FOOD FOR THE HUNGRY INTERNATIONAL

4.1 Impact of Matching Grant II on FHI

The essential quality of all Matching Grants is the strengthening of the institutional capacity of U.S. private and voluntary organizations (PVOs). Two of the five purposes of Matching Grant II relate directly to FHI as an institution, e.g. to enhance FHI's microenterprise program capability and to link the lessons learned in Africa to field programs in other regions. Progress toward achieving each of these purposes is discussed in Section 4.2, but before making specific observations, let us first consider the broader impact Matching Grant II has had on FHI as an implementor of development programs.

Matching Grant II has shown FHI the value of concentration and focus in program implementation. By doing one thing very well, FHI has been able to develop and demonstrate its technical competence in a demanding sector. The regional and sectoral focus has combined to result in the creation of a best practices programming capacity that did not exist prior to Matching Grant support. Without the critical mass of technical and financial support provided by Matching Grant II, the Kenya pilot program would likely have disappeared or be operating at a very low level of service delivery. Given Faulu's success in disseminating microcredit best practice standards, FHI may want to use a Faulu Africa type model to establish "regional centers of excellence" in its other technical program areas like child survival, water and sanitation, etc.

What does this new asset, Faulu Africa, mean for FHI? What will FHI do with this improved program capability? At a minimum, a microfinance programming capacity has been established in East Africa. Alone, this is no small feat. It is early for FHI to be considering replication of the Faulu model in other regions at a similar level. Certainly during the remainder of the MG II grant period, attention is better spent on internal growth and expansion within East Africa. The priority should be to solidify what has been accomplished.

Aside from the introduction of best practice standards, another important contribution of Matching Grant II was the practical exposure to sustainability programming. The Faulu Africa program is designed on a full cost recovery basis, and more importantly showed FHI that program beneficiaries can and will pay for services. However, services must be valued, and delivered in a cost effective manner. The very process and discipline of FHI focusing on sustainability applications is hoped to have a spillover affect into other programming areas.

4.2 Accomplishment of Purposes Relating to FHI

Two of the Cooperative Agreement purposes relate directly to FHI and are discussed in turn:
Purpose 3: Enhance FHI's institutional ability to establish, professionally manage, evaluate and monitor microenterprise loans programs.

As an extension of the institutional capacity of FHI, the Faulu regional office has certainly demonstrated its capability to accomplish this purpose. The organizational structure of FHI is very flat, with responsibility for program implementation largely resting with Country Directors. This is reflected in the small professional staff of eleven which provides support from Scottsdale, Arizona. The strategy of regional placement of expertise has worked technically. Decisions made during the next year will determine the extent to which Faulu Africa remains a permanent, viable institution, capable of continuing to deliver these services.

Purpose 5: Establish a link to FHI field programs in Latin America and Asia, so they can benefit from the methodologies, models, systems, lessons learned and staff expertise being developed in Africa purposes achieved.

The DIP and proposal envisions workshops be held in Latin America in the last several years of the grant. It is questioned whether this will be the most efficient use of staff time and grant resources. FHI is encouraged to look for alternative mechanisms to communicate its experiences. One option discussed with the Faulu Africa Director during the evaluation was the potential of using e-mail to establish a link between Faulu Africa and other programs in the FHI family who are interested in the implementation of credit programs. The level and nature of follow-up can be set based on interest and specific tasks to be accomplished. This strategic intervention is more likely to yield productive results.

4.3 Recommendations for FHI

The following recommendations are made to FHI:

Non-FHI countries: Under the current organizational structure, Faulu Africa is limited to working in countries where FHI has a field office. This could be limiting as Faulu looks to where it should logically be. For example, Tanzania is in close proximity to Kenya, and logistically makes a great deal of sense. However, FHI is not there. FHI is encouraged to find creative ways in which it can allow for the expansion of Faulu Africa beyond FHI's current locations if necessary. There are some early indications that FHI is receptive to this suggestion.

Policy Flexibility: Because of its size and the unique needs of of credit agencies, FHI has already had to make changes in its internal policies to accommodate Faulu Africa. Continued flexibility is required. An immediate policy revision that is needed is permission for the Faulu Africa units to pay salary incentives to loan officers based on portfolio performance.

Resource Mobilization: FHI is encouraged to continue to look within its overall network for support to Faulu Africa and assist in any way possible to mobilize additional resources for the program.

Annex A

Scope of Work

Food for the Hungry
Faulu Africa
Regional Microenterprise Loan Program

Scope of Work for a Mid-Term Evaluation
of the 1994 Matching Grant

1. Background Information

1.1 History of the Grant

The Cooperative Agreement for this Matching Grant was signed by AID and Food for the Hungry (FH) with an effective date of 1 April 1995 and estimated completion date of 31 March 2000. The total cost of this project is $7,093,000 with AID expending $3,400,000 and Food for the Hungry matching this sum with $3,693,000 of its own resources.

1.2 Program Goal

The goal of the Faulu Africa loan program is to assist poor urban people to increase their income levels through participation in a microenterprise loan program that fosters good business ethics and values, and which encourages an attitude of self-reliance and democratic participation, so that they are capable of determining and meeting their development needs.

1.3 Program Purpose

The purpose of the program include:

1. To create a regional microenterprise (ME) loan program, "Faulu Africa", that will consist of a regional coordinating office and a network of branch lending operations in African countries in which FH operates, which will be self-sustaining operationally and financially, both as branches and overall;

2. To provide increased access to credit services for the poor in three countries (Ethiopia, Kenya, and Uganda);

3. To foster an improvement in business ethics and values among loan clients;

4. To encourage an attitude of self-reliance and participation among loan clients, as individuals and groups, and foster their democratic involvement in, and influencing of, societal systems that affect them;

5. To encourage women to be involved in ME through involvement as loan clients, within leadership of client groups, and as Faulu Africa staff;

6. To endeavor to influence public and economic policy within the participating countries so as to provide a more enabling environment for microentrepreneurs and the poor;

7. To enhance FH's institutional ability to establish, professionally manage, evaluate, and monitor quality ME loan programs; and

8. To establish an inter-regional link to FH field offices in Latin America and Asia, so they can benefit from the methodologies, models, systems, lessons learned and staff expertise being developed in Africa.

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Purpose of the Evaluation

The AID matching grant continues to be a critical vehicle in achieving the goals of Food for the Hungry. This evaluation provides an opportunity to validate and/or improve upon the implementation of the project and make suggestions for ways to better fulfill or adjust the previously mentioned goal and purpose.

2. Statement of Work: Evaluation Questions

In defining key questions for the mid-term evaluation, that have been structured to begin with the big picture and ask questions related to the progress toward meeting the goal and purpose of this grant and Faulu Africa.

2.1 Questions Related to the Program Goal

1. Recognizing the we are only at the mid-term of the project agreement, where is FH in the process of achieving the goal of the Faulu Africa Loan Program?

2.2 Questions Related to the Program Purpose

1. Recognizing the we are only at the mid-term of the project agreement, where is FH in the process of achieving the purpose of the Faulu Africa Loan Program?

2. To what extent are each of the program purposes listed in Section 1.3 being achieved?

3. Are there recommendations for any mid-course adjustments in any of the purposes listed in Section 1.3 so that the overall program goal and objective will be better achieved?

2.3 Questions Related to Program Level Outputs

1. To what extent are the desired overall regional program level outputs being accomplished?

2. To what extent are the desired country level program outputs being accomplished?

3. Do there need to be any mid-course adjustments in categories and targets of any of these anticipated outputs?

4. Do there need to be adjustments in any of the other critical indicators?

2.4 Questions Regarding Impact Monitoring and Evaluation

1. There are a number of issues regarding the best way to monitor and measure the impact of microfinance programs on loan clients, and do so in a realistic and cost effective manner. What recommendations can be made to improve in this area?

2.5 Questions Related to Sustainability Plan

1. Are there any recommendations that can assist in the process and strategy of reaching overall operational and financial self-sustainability? (Loan products, pricing, delivery mechanisms, etc.)

2.6 Specific Questions by Region and Country

2.6.1 Faulu Africa Regional Office

1. Have the program targets, timelines and growth of the regional office been met to date as set forth in the Detailed Implementation Plan?

2. Are activities of the regional office furthering the overall Faulu Africa goal and purpose?

3. What, if any, mid-course adjustments need to be made to ensure that grant objectives are met?

4. Does Faulu Africa overall have adequate financial and programmatic monitoring and reporting

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4. Is FH building up the institutional capacity to fund microfinance programs so as to utilize the institutional capacity to do the activities described in Section 1.3 point 7?

5. What lessons is FH learning from this grant experience and the setting up of Faulu Africa that can be useful for other FH developmental sectors and other FH fields around the world?

3. Evaluation Design

The evaluation will take place at the following sites: Nairobi, Kenya; Kampala, Uganda; Food for the Hungry Headquarters in Scottsdale, USA. The evaluation team leader, Devorah Miller, will set the agenda and process for the evaluation, taking into account all the preceding factors.

3.1 Evaluation Team

The evaluation team will consist of Devorah Miller (team leader), Randy Hoag and Ted Vail. Ms. Miller works for Lassen and Associates, a consulting firm in the Washington, DC area, and has experience in evaluation of microenterprise programs. Mr. Hoag is the Executive Vice President of Food for the Hungry International, in charge of all operations worldwide. Mr. Vail is the Director of Faulu Africa overall.

Ms. Miller will be involved in both the field visits and home office evaluation. Mr. Hoag will participate in the home office component. Mr. Vail will take part in the field visits. There will be staff members from throughout Faulu Africa from the regional office and country-based units available as well to assist in the evaluation.

3.2 Work Schedule

- 7 days at Faulu Africa regional office in Nairobi and Kenya operations (Feb 16-21, 1998)
- 4 days at (plus to/from) Uganda (Feb 22-25, 1998)
- 1 day in Nairobi writing and final field information gathering (Feb 26, 1998)
- 2 days at FH headquarters (dates open)
- 5 days to write the report (dates open)

Annex B

Evaluation Itinerary

ANNEX B

EVALUATION ITINERARY

2/14/98	Arrive Nairobi, Kenya
2/15/98	Meeting with FHI Executive Vice President, Randall Hoag & Faulu Director, Ted Vail
2/16/98	Background briefing by Faulu Director and document review
2/17/98	Extended interview with Research and Evaluation Coordinator Continued document review
2/18/98	Field visit to Nairobi Central Branch - Staff and client interviews Interviews with Faulu Kenya headquarters staff, operations & finance
2/19/98	Field visit to Nairobi West Branch - Staff and client interviews Interview with Faulu Kenya Director
2/20/98	Interviews with Regional Faulu Africa staff: Controller, Adminitration Coordinator, & MIS Manager Debriefing of principal findings with senior Faulu Africa and Faulu Kenya staff
2/22/98	Arrive Kampala, Uganda
2/23/98	Day-long meeting with Faulu Uganda Director and introduction to staff Document gathering and review
2/24/98	Field visit with 3 client groups
2/25/98	Continued interviews with Country Director and Branch staff Evening departure for the U.S.

Annex C

List of Key Persons Contacted

ANNEX C

LIST OF KEY PERSONS CONTACTED

Randall Hoag	FHI Executive Vice President, International Operations
Ted Vail	Director, Faulu Africa
Andrew Mwikamba	Administration Coordinator
Mesfin Assaye	Controller
Robert Mwadime	Research and Evaluation Coordinator
Rick Richter	MIS Manager
Peter Ondeng	Faulu Kenya, Director
Isaiah Kahuki	Operations Manager, Faulu Kenya
Bruce Larson	Faulu Uganda, Director
Godwin Kihuguru	Kampala Branch Manager

Annex D

References

ANNEX D

REFERENCES CONSULTED

Coopers & Lybrand, 1995 and 1996 audited financial statements.

Faulu Africa: Internal reports from MIS including: Monthly Monitoring Report, Loan Officer Summary Monitoring Report, Branch Detail Monitoring Report and Branch Summary Monitoring Report.

Faulu Kenya, *Business Plan 1998-2000*, presented to USAID IGP Program, December 1997.

Faulu Kenya Shirika Operations Manual (Version 1 5), August 1996.

Jensen, Karl and Anicca Jansen, *Faulu Kenya - Institutional Field Assessment,* USAID Microenterprive Innovation Project - Microserve, Junr 1997.

Rutherford, Stuart and Harry Mugwanga, *Faulu Kenya Mid-Term Review,* Overseas Development Administration, September 1996.

USAID/BHR/PVC, official file including Cooperative Agreement, Detailed Implementation Plan, and Annual Reports.

Annex E

Unit Performance Rating Form

ANNEX E

Faulu Kenya
Unit Performance Rating Form

Level of Development[1]	Level 1	Level 2	Level 3	Level 4	Level 5
Institutional Structure & Country Program Management					
Clear vision and mission.				x	
Organizational structure, including goverance.			x		
Quality of program management: Performance targets set and monitored..				x	
Access to critical TA and services.				x	
Level of staff capacity and skill competency.					x
Accurate financial management information ysetms in place.					x
Accounting systems and financial controls in place and adequate.					x
Financial Services, Portofolio Quality & Outreach					
Credit and operational policies well defined.				x	
Appropriateness of loan pricing policy.				x	
Methodology well defined and appropriate for target clients.				x	
Range of services responsive to client needs.				x	
Evidence that services reach the poor, especially women.			x		
Cost effectiveness of lending services.				x	
Adequacy of delinquency and loan loss control.				x	
Progress in expanding outreach and market penetration.				x	
Financial Sustainability					
A strong business plan for expansion and sustainability.			x		
Meaningful targets vis a via sustainability.				x	
Degree of compliance with business plan.				x	
Existence of cost center budget.				x	

[1] Level 1: None
Level 2: Partial or inadequate
Level 3: Average or acceptable
Level 4: Above average with most elements met
Level 5: Optimal with all elements met

ANNEX E

Faulu Uganda
Unit Performance Rating Form

Level of Development[1]	Level 1	Level 2	Level 3	Level 4	Level 5
Institutional Structure & Country Program Management					
Clear vision and mission.				x	
Organizational structure, including goverance.			x		
Quality of program management: Performance targets set and monitored..				x	
Access to critical TA and services.			x		
Level of staff capacity and skill competency.					x
Accurate financial management information systems in place.					x
Accounting systems and financial controls in place and adequate.					x
Financial Services, Portofolio Quality & Outreach					
Credit and operational policies well defined.				x	
Appropriateness of loan pricing policy.				x	
Methodology well defined and appropriate for target clients.				x	
Range of services responsive to client needs.				x	
Evidence that services reach the poor, especially women.				x	
Cost effectiveness of lending services.				x	
Adequacy of delinquency and loan loss control.				x	
Progress in expanding outreach and market penetration.			x		
Financial Sustainability					
A strong business plan for expansion and sustainability.			x		
Meaningful targets vis a via sustainability.				x	
Degree of compliance with business plan.				x	
Existence of cost center budget.				x	

[1] Level 1: None
Level 2: Partial or inadequate
Level 3: Average or acceptable
Level 4: Above average with most elements met
Level 5: Optimal with all elements met