DONOR BRIEF
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Helping to Improve Donor Effectiveness in Microfinance

CREDIT COMPONENTS

A significant proportion of donor funding in microfinance takes the form of credit components in multi-sectoral projects. Credit is often seen as a tool for achieving the goals of a range of projects that address complex development problems. Designed as inputs to larger projects with limited life spans, credit components run the risk of failing to provide the intended target groups with permanent access to financial services.

What are credit components?

Credit components come in many different shapes and sizes, but they can share certain common features:

- Credit is part of a larger project focusing on agriculture, environment, health, vocational education, post-conflict rehabilitation, or social services. Credit components range from large credit lines within integrated rural development projects to small revolving funds in empowerment projects.
- Credit is targeted at a particular group of people and used for the purpose of purchasing an input or changing behavior.
- Credit services are channeled through a financial institution or offered directly by the project.

How do credit components perform?

Since the mid-1970s, experience has shown that credit components have often performed poorly. By focusing on short-term objectives, donors can miss the opportunity to create permanent sources of finance.

- ***Credit components can de-capitalize quickly*** due to high costs, subsidized interest rates that do not cover costs, limited disbursements, and poor collection rates.
- ***Credit services may cease when a project is completed, offering little long-term impact***. Since credit components are not used to build institutional capacity, the targeted client group is often left without permanent access to financial services.

  > "The Integrated Rural Development Project has led to one-off increases in productivity, incomes, and employment but …[t]he gains are relatively short term (limited mainly to the duration of project interventions) … the impact on poverty, if any, is passing." –IFAD, Country Programme Evaluation, Sri Lanka, January 2002

- ***Credit designed as an input can create unsupportable levels of borrower debt.*** By encouraging people to borrow for investments they would not otherwise make, subsidized credit may impoverish the very people it intends to help.
- ***Subsidized credit components can crowd out the development of both local credit and savings organizations and branch networks*** of viable financial institutions. An ILO survey in Uganda found that the presence of large rural investment credit components caused MFIs to shy away from the sector. Given their commitment to long-term viability, the MFIs could not compete with subsidized interest rates nor tolerate high levels of delinquency and default.
- ***Credit lines can encourage donor dependence*** when channeled through financial institutions and provide strong disincentives for these institutions to begin or continue savings services. In addition, financial institutions often stop lending to the target group after the credit line finishes.

What are some reasons for the poor performance of credit components?

- ***Conflicting objectives.*** A perceived trade-off between supporting sustainable financial services and meeting specific objectives for a target group may lead donors to loosen sustainability requirements.

- ***Confusion between resource transfers and financial services***. Most agencies do not have clear policies for when professional financial services should be used to meet social or economic objectives, and when those objectives are better met through resource transfers or other types of interventions.

- ***Assumption that credit is a binding constraint.*** Project designs may assume that credit is a binding constraint for the target group, although this is not always the case.

- ***Management by non-specialized entities.*** The institutions or project units that channel credit components rarely have a specialized technical background in microlending or a commitment to long-term sustainability.

- ***Significant pressure to commit funds***. Credit can make a small project larger and attract clients to the project as a sweetener. It is also relatively easy to create a budget line for a credit component at the end of a fiscal year.

What can donors do to improve microfinance funding?

1. ***Avoid credit components where possible.*** Many donors have instituted policies to support the capacity to offer financial services over the long term by investing in retail institutions.

2. ***Verify that access to financial services is a true constraint*** for the target group. Analysis of existing sources of informal finance, savings services, or microcredit offered in the area is needed to confirm the target group's demand for credit. Understanding of client demand should drive the development of credit products and methodologies.

3. ***Include microfinance expertise in project design, implementation, and monitoring***, no matter how small the credit component. If the microfinance component is too small to justify hiring an expert, then it should not be undertaken.

4. ***Support the growth of institutions specialized in the delivery of financial services.*** Donors can support financial services that outlast project funding by linking with existing financial institutions that share their objectives. Sida's PRODEL project in Nicaragua matches concerns about affordable housing with the interests of financial institutions to offer housing finance to the same target market.

5. ***Institute accountability for credit components.*** Ensure that donor reports include key indicators that specifically track performance of credit components.

6. ***In the absence of existing financial services, support stand-alone microfinance projects***. In post-conflict areas, the UNDP and ILO have found that supporting discrete microfinance projects lays a foundation for the growth of permanent financial organizations.

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Where to go for more information. Articles: Samantha de Silva and Alexandra Gross, "Microfinance and Social Funds: Guidelines for Microfinance in Poverty-focused, Multi-sectoral Projects," CGAP-World Bank Microfinance Operational Note (forthcoming 2003). Mark Wenner, "Lessons Learned in Rural Finance: The Experience of the Inter-American Development Bank," IDB, Sustainable Development Department, Technical Papers Series (October 2002). Alexia Latortue, "Tackling Aid Effectiveness from the Top: Donor Peer Reviews Synthesis Report," CGAP (December 2002), www.cgap.org. Brigit Helms, "Anatomy of a Microfinance Deal," CGAP Focus Note No. 9 (August 1997). Robert Vogel and Dale Adams, "Old and New Paradigms in Development Finance: Should Directed Credit be Resurrected?" Harvard International Institute for Development (HIID), CAER II Discussion Paper No. 2 (1997).

Books: *From Donations to Investments: Donors and Sustainable Microfinance* (New York: UNCDF/SUM, forthcoming 2003).

Websites: CGAP - www.cgap.org**. IFAD** - www.ifad.org. **IDB** - www.iadb.org/sds/. **HIID** - www.cid.harvard.edu/caer2. **ILO** - www.ilo.org. **UNCDF/SUM** - www.uncdf.org/sum.

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