



One Step Back from the Brink: Donors, Disbursement and Default

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A recent spate of [articles](#), [commentaries](#) and in some cases regulations have highlighted the pitfalls of [rapid expansion](#), [over-indebtedness](#) and default. The experience of the microcredit sector in Afghanistan is in many ways a microcosm of events occurring around the world. Absorptive capacity and potential market size were overestimated, national and international expectations were overly optimistic, and this optimism was reinforced by a period of rapid growth from early 2006 to early 2008.

However, by late 2008, cracks in the veneer of unbridled success attributed to the Afghan micro-credit sector were beginning to appear. Growth was slowing rapidly, arrears and default were rising, and in consequence the operations of a number of microfinance institutions (MFIs) began to deteriorate. At its peak in 2008, the MFI sector (excluding NGOs, SHGs, etc.) had 15 registered limited liability companies providing microcredit (and one in registration process), 428,929 clients, 373,080 borrowers and a portfolio outstanding of approximately US\$107 million.

At the same time the apex supporting the sector had a portfolio of US\$96 million, peaking in 2009 at US\$127 million amongst all 16 partners. By March of 2011, the number of borrowers had declined by 30% and the number of institutions by more than 40%. Today, although the sector stands at US\$110 million, 88% of this is held by just 3 institutions and the apex portfolio outstanding has declined to US\$56 million and the apex is actively engaged with just 6 of the 9 remaining microcredit institutions¹.

What then accounts for this spectacular rise and pull-back within the sector and at the apex? What mistakes or misplaced assumptions occurred, and ultimately what strategies and measures were used to ensure that, despite these errors, micro-credit and micro-finance would continue to play an important role in the promotion of an inclusive and developmental finance sector?

Background

In 2001/2002 there were few facilities available to people to access credit in Afghanistan. In 2003, the Microfinance Investment Support Facility Afghanistan (MISFA) was established at the invitation of the Afghan government to “get donor coordination right from the start and avoid the counter-productive efforts that have emerged from conflicting donor objectives in other post-conflict situations. It was established as a vehicle through which the Afghan government and international donors could channel technical assistance and funding to build Afghanistan’s micro-credit/finance sector².”

This effort was supported primarily via the Afghanistan Reconstruction Trust Fund³, with additional assistance from CGAP, USAID and other donors.

MISFA - MISFA was originally established along the lines of a time-bound project directed and overseen by the Ministry of Rural Rehabilitation and Development. A [similar approach](#) had been followed with seeming success in Bosnia-Herzegovina at the turn of the last century. An outside consultancy was contracted to establish the infrastructure and to vet MFI partner applications. In March of 2006, it was

¹ All quoted figures have been converted from Afghanis to US\$ at a rate of 50/1. The actual rates ending March for each year are 2006-50.01, 2007-50.06, 2008-50.05, 2009-51.51, 2010-48.25, 2011-45.21

² MISFA website www.misfa.org.af

³ The world’s largest multidonor fund with US\$2.3 billion committed by 30 donors -Baimes, Chiden “The World’s Largest Multidonor Trust Funds: A Primer” Devex - www.devex.com February 8, 2011

decided that MISFA should move from a project structure towards that of an institutional structure and was duly registered as a not-for-profit limited liability company, with an independent board and the Ministry of Finance as the sole shareholder. However, within the Memorandum of Association was a clause that, within a period of 5 years, the government either fully divest its position or wind down MISFA as entity.

At the close of the first financial year in March 2004, MISFA had an outstanding portfolio of US\$1.213 million, growing to more than US\$127 million by March of 2009. The strategic plan for MISFA, developed in early 2008, envisioned a potential market of 3.5 million borrowers, actual clients of 750,000 and a portfolio outstanding of US\$220 million by December of 2010.

Primary Drivers

Many of the issues that MISFA and its partners experienced were first documented by Dr. Fred Levy in the [CGAP Occasional Paper No. 6, published in January 2002](#). Capacity constraints and political imperatives for disbursement provide the primary rationale for the expansion of outreach followed by a rapid decline in portfolio quality and repayments. In addition, insufficient attention was allocated towards governance structures at a strategic level, and lack of definitive data regarding market potential and product usage resulted in unrealistic expectations. Finally, the entire success of the sector was overstated from the outset - when funds were withheld, the results were never as robust as previously described.

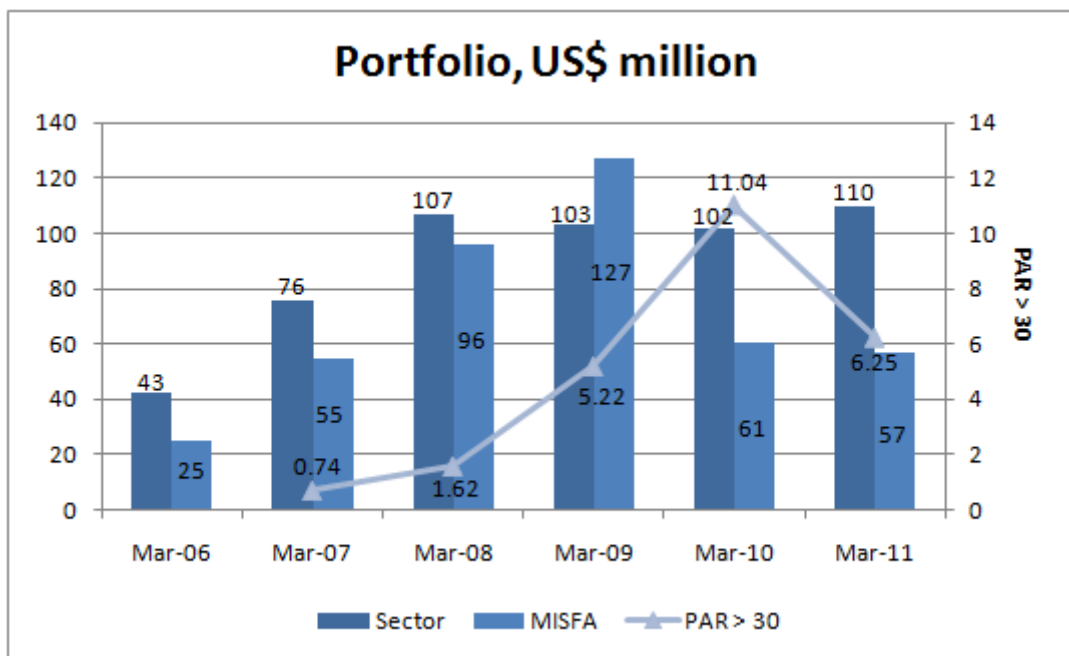
Market Potential - Estimates by MISFA and by the WB/CGAP in 2008 and earlier, placed market demand at 3 million persons plus. Given that, ideally, there would be only 1 loan per household from an MFI, the potential market appears to have been grossly overstated. The [National Risk and Vulnerability Assessment for 2007/2008](#) (released in late 2009) estimated the total number of households in Afghanistan at 3.4 million and the number of persons living below the poverty level as 36% on a national level. Given that most efforts in regard to micro-credit were targeted towards urban borrowers, and that only 26% of the population of Afghanistan is classified as urban, the potential market including rural areas (where considerable unmet demand exists) is probably closer to 1.5 million households maximum.

In addition, this demand has been further proscribed by the deterioration of the security situation, making some markets unavailable, or previously robust markets inaccessible, resulting in default due to an inability for micro-credit organizations to either collect on existing loans or offer new financing facilities. Clearly, the market was overestimated and expectations for demand and growth far exceeded the reality on the ground.

Donor and Stakeholder Disbursement Pressure - The fundamental approach pursued by donors and other stakeholders was flawed in that it sought to achieve or demonstrate short-term accomplishments using a long term developmental tool e.g. micro-credit. In order to demonstrate this progress, emphasis was placed on disbursements and outreach regardless of impact and capacity. Unfortunately, the reigning paradigm equated disbursement with accomplishment, at both donor and governmental levels, and MFIs were incentivized to expand rapidly in order to serve as a vehicle for funds placement.

At the end of its first fiscal year, MISFA was working with 3 partners and had a portfolio of US\$1.213 million. As MISFA was envisioned as a “project” of limited duration, a la Bosnia-Herzegovina, and as success was posited on establishing a sustainable commercial market within 5 years, there was a sense of urgency amongst the donors, the government and the implementing agency for MISFA to move rapidly in order to achieve these goals. An additional 5 MFI partners were added the next year and another 7 MFI partners the following year. By March of 2006, MISFA’s portfolio stood at just under US\$25 million (total portfolio outstanding in the sector stood at US\$42.5 million.) By March of 2008 MISFA’s portfolio had grown to over \$96 million (US\$107 million for the sector as a whole). Borrowers grew at a similar rate rising from 175,000 in 2006 to 373,000 by 2008.

Indicative of the emphasis placed on disbursement and outreach, it was not until 2007 that financial indicators were tracked or monitored. Success was judged based on outreach and portfolio, and MFIs were pressured to grow if they wished to receive further funding.



March 2011 figures do not fully reflect impact of further consolidation scheduled to conclude in 2011.

Dr. Levy remarks that [“Little evidence was found that apexes play a useful role in coordinating among donors and harmonizing requirements.”](#) Contrary to this assumption, MISFA proved spectacularly effective in focusing and projecting donor and other stakeholder agendas on to its partners, perhaps to their detriment. For many MFIs, MISFA was the sole source of funding and increasingly donors saw the MISFA as a simple tool for supporting micro-credit in Afghanistan. Funds for micro-credit quickly became monopolized by MISFA, and as MISFA relied on the [World Bank’s ARTF facility](#) for its funding, it was also beholden to these donor imperatives.

Similar to the growth pressures by private investors as outlined in Sanjay Sinha’s open letter to the CGAP Executive Committee members [“How to revive the collapsing bull”](#), donors and governments played a similar role where instead of ROI, growth and disbursement or “budget utilization” were the metrics of success and future funding was dependent on high “burn rates.”

Further exacerbating the problem was a tendency to use unrealistic expectations in regard to grant and loan funding mixes. Despite actual capacity or the reality in the field, MISFA and its partners were pressured to reduce the amount of subsidies for operational expenses and capacity building based on a percentage of total funding, especially since most partners were expected to be sustainable and not require operating grants in five years or less. Given that the ideal ratio was 20% grant (or less) to 80% loans for on-lending, grant requirements remained the same or increased, and on-lending calculations were not based on capacity or demand, but rather merely a function of the grant amount in many cases.

MFIs were increasingly asked to do more with fewer resources, resulting in MFIs competing aggressively in similar markets, multiple borrowing by clients, lax credit discipline (leading to possible over-indebtedness) and short-cuts at all levels from staff training, to client training and due diligence.

Apex funding is typically held back not by a lack of wholesale funds, but rather by [a dearth of capable MFIs within the retail market](#). Given the pressures on MISFA (projected onto the MFIs), this lack of capacity was ignored and funding was pumped through a “pipeline” that had not sufficiently developed the means to responsibly disburse the amounts of funding being made available via the donor community. The result was a high level of leakage throughout the system and, ultimately, the consolidation or exit of a significant number of MFIs beginning in 2009/2010, and which continues today.

Governance and Oversight - Both MISFA and its partners suffered from a variety of issues related to capacity and good governance. Prior to 2003, there was little experience in Afghanistan in regard to micro-credit and the programs which did exist, were generally a component of broader humanitarian efforts and not run on principles of self-sufficiency or envisioned as part of the creation of permanent and viable financial institutions.

Given the low levels of literacy and numeracy in Afghanistan and even lower levels of experience in running a financial institution it was perhaps somewhat optimistic to expect high capacity levels, rapid growth and reasonable portfolio quality in 5 years or less from MFI programs. [Hans Dieter Seibel's experience](#) seems applicable to the Afghan context - "there is no short-cut to sustainable poverty reduction and development; and certainly none outside a solid, prudentially regulated institutional framework".

The nebulous status of MISFA was compounded by the fact that, until 2007, loan agreements were written such that funds could either be provided to the MFI as a grant or that the loan facility could be extended. There was no explicit requirement to repay the loan in the agreements. The approach and assumption was that, at some point, the on-lending funds would be converted to grants. Even after 2006/2007, when loan covenants were modified and it was explicitly agreed that MFIs would have to pay interest and, ultimately, principal, the approach and attitude remained the same. MISFA continued to act as a grant "pass-through facility," rather than as a proper wholesale lender. It was not until the financial year ending March 2009 that MISFA actually created any provisions against its outstanding loan book.

Management [is key to an apex's success](#). Local capacity was weak, the long-term nature of the organization remained in question, and to expect that an apex could build capacity, while at the same time monitoring and overseeing its MFI partners, in a short time period was overly optimistic. MISFA addressed this by mainly working with international organizations with a reputation for success in providing micro-credit, depending heavily on outside technical advisors and rating/assessment agencies for periodic reviews and business plan development, and adopting a minimalist approach of passive monitoring based on self-reported indicators from the MFIs.

International reputation unfortunately did not always result in better local practice implementation. International staff and consultants were generally on short-term assignment (one year or less) and local capacity was weak. Outside assessors of organizations have limited value in a highly complex and fast-changing environment and were no substitute for continuous and active engagement on the part of MISFA. The use of outside experts to develop and present business plans and projections meant that the local leadership responsible for implementing these plans neither understood the plans nor had the needed commitment or buy in. MISFA's limited capacity to verify self-reported information meant that fundamental weaknesses were neither reported in a timely manner nor sufficiently addressed when identified.

In addition to these challenges, there were structural constraints in enforcing accountability and responsible use of funding. The disbursement mechanism developed by the donors and government consisted of MISFA's review and submission of funding requests to the ARTF, involving a myriad of time-consuming steps, followed by direct disbursement to the MFIs, not to MISFA. MISFA was a "pass-through entity," in which the funds did not even pass through.

Due to the onerous and time-consuming nature of funding requests, disbursement requests on behalf of the MFIs were generally large and sometimes for periods greater than one year, in order to avoid cash flow issues at the MFIs. MISFA had little ability to manage disbursements based on timely performance and the expectation that large sums of funding would be required exacerbated the problem.

MFIs

Many of the microcredit programs originated as adjuncts to broader humanitarian and developmental programs. As such, sustainability and cost management were not high priorities as long as funding was available. As late as mid-2008, MFIs were presenting business plans in which all costs were covered by grant funding and revenues were reserved for "a rainy day." In order to meet the expectations of the funders, business plans were posited on ever-increasing growth to meet the requirements that

20% of operational funding was off-set by 80% funding of the loan portfolio. Inevitably the grant funds were fully utilized and the on-lending funds remained undisbursed.

At the same time that MISFA was transforming to a non-profit LLC, all partners of MISFA were encouraged or required to transform their micro-credit operations to stand-alone entities with a similar structure. Since most of these operations were heavily or solely funded by MISFA and none of them were sustainable, paid-in capital was provided by conversion of grants for fixed assets and the original NGO sponsors were made primary or sole shareholders of the entities.⁴

As LLCs, they therefore had limited liability, mainly paid for by MISFA, and little-to-no actual shareholder equity at risk. Shareholders did have the possibility of financial benefit via NICRA allocations or restructuring at a later date as a dividend distributing entity. In effect, the formalization of the sector resulted in a management structure at the board/shareholder level with no downside for adverse performance, and unlimited upside as shareholders. Simply put, the new owners had no “skin in the game” - a situation prone to extreme moral hazard.

Outside of reputational risk, there was no reason to invest in oversight and monitoring and it was generally assumed that MISFA would perform this function. However, MISFA was relying on recognized international organizations to provide the appropriate governance structures. The result was an abdication of responsibility on both sides, and accountability and governance suffered as a result.

On the ground, a “revolving door” approach to senior management, with individuals on one-year contracts, meant that senior management often had no real stake in the organization either, as any errors or omissions would only be identified long after they had departed. High turn-over also often resulted in non-existent or part-time senior management for long periods, sometimes more than a year. The environment in Afghanistan requires competent, hands-on management. Coupled with aggressive expansion and a large in-take of new personnel, controls and procedures were not properly implemented and governance at the micro-level suffered.

Decline - By the year ending March 2009, MISFA was listed [among the largest apex organizations](#), measured by portfolio outstanding⁵. [A CGAP expert](#) noted:

'MISFA has completely defied all expectations of what one could achieve in Afghanistan.

While the [World Bank site claims](#):

With a further 5 million potential clients, demand for microfinance services in Afghanistan is huge, far outstripping current supply'.

With PAR only rising from 0.74% for the year-ending March 2007 to 1.62% for the year-ending March 2008, there was little focus on the quality of the lending, but mainly on how further growth could be achieved.

The focus in early-to-mid 2008 was on access to commercial funding sources and on how MISFA might address a shortfall of more than \$60 million required for further on-lending by 2010. In June of 2008 MISFA received approval for an additional US\$50 million of ARTF funding for the fiscal year and concluded a US\$30 million facility agreement with the Government of Afghanistan (GoA) and IDA. MISFA had 15 partners (with a 16th pending), had opened an SME window with a loan book of almost US\$14 million, facilitated the conclusion of a credit facility by a commercial bank with an MFI (US\$1 million) and the greatest challenge was how to speed disbursements to partners. June of 2008 was the high water mark of expectations and forecasts for MISFA.

It is expected that by the end of June 2011, MISFA will have 6-7 partners (with two additional developmental lenders operating outside of MISFA's portfolio). The number of borrowers will have shrunk to less than 250,000, for a portfolio outstanding of approximately US\$60 million, with an

⁴ MISFA's commercial bank partner and cooperative association relationship are slightly different and outside the scope of this discussion.

⁵ Duflos, Forster, Martinez, Cieslak, Kneiding "CGAP Apex Survey 2010". November 2010, unpublished

imputed cost of US\$1.40 per US\$1.00 of portfolio due to provisioning charges and shut-down costs in excess of US\$25 million.

How could the situation have changed so dramatically, and a fall from such heights have occurred? While external factors such as declining security and inflation in 2008/2009 contributed towards the challenges faced by MISFA and its partners, the primary drivers were internal. MFIs never had the opportunity to develop proper organizational structures to manage the growth that occurred between 2006 and 2008. At all levels, pressure was on disbursement. Portfolio quality began to decline, loan officers with little-to-no training were struggling to manage clients, branches were struggling to manage and report on the volumes of activity each month and head offices had insufficient capacity to manage the branches or even to enter and analyze the information that was coming in. To some extent, the answer is that the successes were never as large as presented, so the fall was not quite so large, nor so sudden. The other is that as long as large sums of money were coming in to the system it papered over the underlying pathologies. However, as the volume of non-performing loans grows, it requires ever greater inflows of new money to maintain the equilibrium. When the inflows stop, the cracks are soon evident.

Donors espoused a growth strategy to meet disbursement targets for internal needs and also expressed the opinion that unless microfinance is growing it will die. Adrian Gonzalez in [“Defining responsible financial performance: how to think about growth”](#) correctly posits that growth in and of itself is not necessarily problematic up to significant levels (250%), but qualifies this by stating that proper credit policies, risk management policies and systems need to be available in the MFIs. In most cases these, and many other important components were not in place.

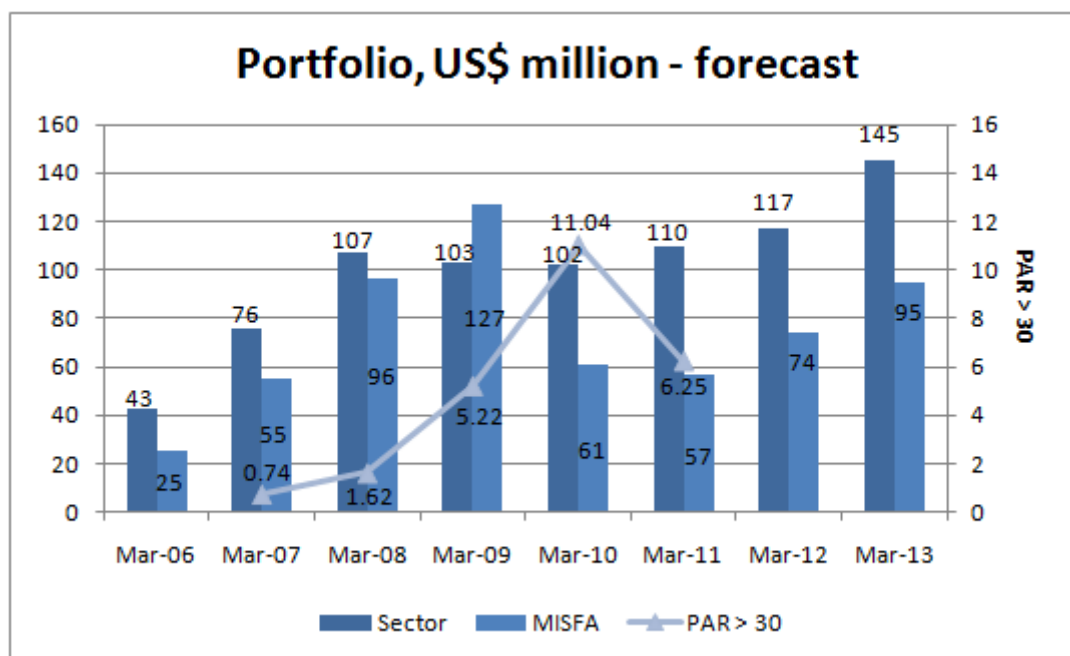
In retrospect, the market was not as presented at its high water mark in 2008. By March of 2009, MISFA had a portfolio US\$24 million greater than that being reported by the sector as a whole. Given that MFIs were sourcing funds outside of the MISFA facility, the discrepancy was even greater.

In the latter part of 2008, MISFA began to take a more pro-active approach to monitoring and evaluation. Management commissioned and implemented a sizeable portfolio audit predicated on perceived risk. PAR > 30 days levels had been reported as rising to 5.2%, primarily due to two large partners. However, the review uncovered significant variances with reported delinquencies at almost all institutions.

Further analysis did not reveal willful misrepresentation, but a general inability to collect, report and analyze data accurately. Exacerbating the situation was the fact that weak internal controls and management meant that definitions of delinquency were arbitrarily modified, the presence of “ghost groups” masked the long-term risk of default and, in some cases, new disbursements were used to bring old portfolios in to current status, rather than for new business activity. It appears that portfolio quality was never as good as reported, given the incidences of MFIs reporting 0% PAR > 30 in 2006 and 2007, and that the number of actual clients probably never reached the levels reported given the presence of ghost groups.

Due to the need to display short-term success in activities requiring long-term investment and capacity building, a series of “Potemkin Villages” were erected that ultimately did not withstand the test of time. The decline was not as significant as perceived due to the fact that the accomplishments at the peak were largely overstated

Microfinance in Afghanistan today - a “binge” of financing and unrealistic expectations in 2006-2008 has lead to a “hang-over” of almost three years and will take an additional two or more years to overcome. Fortunately it is just that - temporary aches and pains and not fatal. It is anticipated that MISFA partners will return to over 370,000 borrowers by March 2013 and that the figure for the sector will be at least 420,000 borrowers. The MISFA partners’ portfolios will increase from US\$107 to US\$145 and it is expected that at least 5 of MISFA’s partners will have achieved OSS above 100% by March of 2013.



* 2012 and 2013 do not provide estimates for 2 lenders with PO of US\$13.25 million as of March 31, 2011 for sector forecasts (no longer MISFA partners)

Strategic Lessons and Approaches

Where a core group of functioning MFIs does not already exist, the expectation must be that it will take time and effort to build capacity, before results for outreach, portfolio size and impact can be expected. Short-term donor imperatives are fundamentally inconsistent with institution-building and, in some cases, generational change. Results frameworks representing quantitative and nominal achievements versus qualitative results can result in dysfunctional approaches towards the development of microfinance.

Incentives and governance structures need to be aligned with building a sustainable industry. If an apex is established as a project, rather than an institution, it will be complicit in achieving short-term results with long term detrimental impacts. The approach will be more akin to that of a “check box” exercise than actual institutional development.

If an apex is established as an institution it will have a long-term interest in ensuring that its partners are performing properly and that the clients of the partners are benefiting from the services provided. If the clients benefit, the MFI will benefit and ultimately the apex will benefit as well. A long-term approach also brings credibility to the apex in negotiations with partners, as it is understood that lack of proper implementation and performance will have consequences, and that it is not merely a waiting game in which disbursement regardless of performance will occur at the end of the project.

Donors should also not circumvent control and enforcement measures of the apex by providing funding directly to the MFIs. Funds should flow to the apex prior to disbursement to the MFI, particularly if disbursements take a significant amount of time. This will allow the apex to use benchmarked and just in time funding mechanisms to properly manage cash flows and hold MFIs accountable.

Operational Lessons and Approaches

While it was apparent by mid-2008 that two of MISFA’s smaller partners would probably exit the sector, the extent of the problems beyond these institutions was not apparent. Although indicators were declining, they were not at alarming levels.

The approach was to passively monitor the partners based on self-reported figures. Trust your partners, but verify what they are reporting. An apex should conduct its affairs as any proper financial

institution would and protect its investments. It was naïve to expect that shareholder head offices, often thousand miles away, would be able to monitor and manage the operations of the national country activities. Proper monitoring and supervision, as well as external financial audits, must take place on a regular basis.

This, of course, requires building capacity at the apex institution. Dr. Levy points out [the need to have capable management at the apex institution](#) and this should be put in place very early in the process. Building capacity at the apex while trying to build and monitor MFI capacity is a herculean task. MISFA now has a dedicated monitoring and supervision department and has developed a set of performance standards based on better practice as outlined by SEEP, CGAP, Accion etc., and has contractually obligated partners to strive towards acceptable performance levels and to adhere to better practice. However, this is a work in progress and should have been done at the outset, not mid-stream.

Proper financial reporting and management should also be put in place. An apex needs to conduct its affairs from the perspective of a financial institution, rather than as a grant or supply-side intervention. Analysis and review should not be outsourced. Proper credit decision-making processes need to be put in place, rather than decision-making based on national budgets or disbursement targets.

Conclusions

While there are numerous other operational lessons learned (e.g. the need to be flexible and to have the ability and capacity to quickly react to adverse situations, the need for long-term management perspective at MFIs, the need for proper training - not number of courses, but quality of training, etc.), the core lessons are that a long term perspective needs to be established at the donor, government and apex levels and that lessons learned from the past need to be considered when developing new initiatives.

Disbursement is not a substitute for accomplishment. Unwarranted use of funds leads to waste and lack of impact. Funding can only go so far to overcome timing and quality constraints. At a certain point there is no substitute for time and consistency and the targeted clients deserve the highest quality of services that can be provided.

The pressure on disbursement at MISFA led to larger-than-expected levels of default, the creation of non-sustainable entities, and a massive restructuring effort. Fortunately, the resources and capacities were available and deployed so that the Afghanistan microfinance sector has a second chance and the prospects are positive. Not all national apex institutions will be so fortunate.

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