

Avoiding Apex Pitfalls: Local Initiatives Departments of Bosnia and Herzegovina

by Ruth Goodwin-Groen

This case study details a successful microfinance apex fund that was designed and managed by the World Bank with bilateral donor support from Italy, Switzerland, the Netherlands, and Japan.

Overview

The bad news is that most microfinance apex institutions have disappointing results. The good news is that one apex, the Local Initiative Departments (LIDs) of Bosnia and Herzegovina (BiH) avoided many pitfalls common to apexes and succeeded in developing a viable microfinance sector in a post-conflict country. The LIDs were set up in the devastated economy of BiH with the goal of jump-starting the microfinance sector and disbursing loans to war-affected citizens. The apex began in 1997 with 17 NGOs that knew little about microfinance. Five years later, there were nine profitable MFIs in the country whose portfolio value of outstanding loans (42,000) exceeded 50 million euros, and their number was growing. This success was in part due to the commitment of the lead international donor to building sustainable microfinance institutions for low-income clients, rather than simply to disburse loans.

Setting the Stage

In 1996, BiH was trying to rebuild its war-ravaged, former socialist economy. Microenterprises, which were considered shady activities that rarely paid taxes and had no future, did not appear desirable businesses to promote. However, a small pilot project funded by the Dutch government caused some rethinking when it revealed surprising demand for small loans on the part of microentrepreneurs. The Dutch loans were used productively and paid back on time. The BiH government accordingly decided to take a risk on a World Bank microcredit project.

The microfinance apex was the project of the World Bank Human Development Unit. The activities of this unit focus on social safety-net programs, including post-conflict income support. The BiH project was unique because it combined the immediate post-war goal of income support with the long-term goal of building a

sustainable, competitive microfinance sector. The project achieved these goals by means of a US\$21.75 million apex facility. The World Bank was the major apex donor, but seven other donors also contributed, including the United Nations High Commissioner for Refugees (UNHCR) and the governments of Italy, the Switzerland, the Netherlands, and Japan.

Avoiding Common Apex Pitfalls: The Donor Role

Potential Pitfall No. 1: No Viable MFIs to Fund

How did the World Bank start a microfinance project in a country where there were no MFIs? How did it find an implementing agency where there was no local knowledge of microfinance?

1. *The in-country donor staff person had microfinance experience.* Sarah Forster was the Team Leader in the World Bank Sarajevo office. She knew it was critically important both to provide access to credit and build financially viable microfinance institutions; she wrote both goals into the project document.



Reconstruction in Bosnia and Herzegovina, 2002. (Photo: Ruth Goodwin-Groen).

2. *Microfinance specialists were hired for all project missions.* Instead of using social safety-net consultants or post-conflict experts, only microfinance and banking experts were used on World Bank missions for the project.
3. *The microfinance technical-service provider for the new MFIs was excellent.* Ann Duval, a World Bank consultant, created an intensive, demand-driven training program for MFIs to learn the fundamental technical aspects of starting and managing an MFI. Over three years, the program arranged international field trips, group workshops with specialist consultants, and individual consultations. About US\$900,000, or 4.3 percent of total project costs, was spent on technical services. In order to avoid a conflict of interest, the training program was separated from apex monitoring activities.
4. *Funding was conditional upon MFIs meeting eligibility criteria.* The first set of eligibility criteria included participation in a four-day “What is Microfinance?” workshop, demonstrated knowledge of future clients, a good accounting system, and a business plan (plus the consultant’s gut feeling). After the MFIs were launched, ongoing performance targets were simple: portfolio quality, management quality, and progress toward sustainability. If the MFIs failed to meet these targets, loans from the apex had to be repaid. If they met the targets, they received ongoing apex funding. A legal agreement with the MFIs unequivocally laid out this condition and it was strictly enforced.
5. *Donor commitment to project goals ensured proper staff selection.* The World Bank commitment to the project included a willingness to use its leverage to request removal of a staff member who did not support project goals. Although atypical, the project could have failed without such a commitment on the part of the principal donor.

The Result: Viable MFIs. The new MFIs outperformed their peer group for the first three years and continue to do so. As of year-end 1999, the *MicroBanking Bulletin* stated that the “overall performance [of the LID MFIs] surpassed that of all MFIs in the MBB that fall within their age group (operating for less than 3 years).” This trend continues: on average, the LID MFIs are still outperforming their MBB regional and age (operating 4–7 years) peer groups. The performance of nine of these MFIs is compared to that of their MBB peer groups in the table below. Collectively, the nine institutions had a total portfolio outstanding of KM 100,051,447 (approximately 50 million euros) as of 31 December 2002.

Approximate Comparison of Nine LID MFIs with MBB Peer Groups (December 2002)

	LID MFIs, ¹ Weighted Avg.	MBB Regional Peers	MBB 4–7 yr Peers
Portfolio at Risk > 30 days	0.4 %	3.0 %	6.2 %
Adjusted Operating Expenses	22 % ²	21.0 %	22.2 %
Adjusted Return on Assets	0.4 % ³	-4.0 %	-7.7 %

¹All numbers rounded.

²Includes financial expenses, which are excluded from MBB figures.

³Not all liabilities adjusted, as is the case with MBB figures.

Potential Pitfall No. 2: Failure to Build Financially Viable Organizations

How did the apex build financially sustainable MFIs that can now access commercial financing?

1. *Apex financing was structured to motivate MFIs to reach financial sustainability.* MFIs were given two years to cover their costs from income and were required to share the cost of technical services. Although the apex gave grants for operations, the grants stopped in the third year. (Operational grants totaled over US\$4 million, or 18.5 percent of project costs.) Loans for portfolios were priced from 3 percent to 5 percent, which covered the government cost of managing the apex.
2. *Eligibility criteria for apex financing were set progressively higher.* Eligibility progressed to include the following criteria: PAR < 30 days under 5 percent, increased sustainability, and 10 percent of assets derived from local sources. Today, funding criteria are effectively commercial criteria.
3. *There was a clear early message that the project would end and that MFIs needed to look for long-term funding sources.* One motivation for the MFIs to build commercial relationships was learning that leading MFIs in other regions considered it important for long-term growth. World Bank staff assisted the MFIs by facilitating introductions to international investors such as Triodos in the Netherlands.
4. *Technical services focused on learning microfinance best practices.* Local MFI staff were very quick to learn and apply microfinance best practice principles in their country context. Technical services continue to be needed as MFIs face growth and consequent new financing challenges.

5. *The government turned a portion of loans into outright capital grants for MFIs who met strict capitalization criteria.* These grants gave the MFIs a capital base with which to leverage commercial financing. Loans to MFIs that did not meet the criteria, however, had to be paid back in full.
6. *LID MFIs did not immediately serve the poorest.* Few banks were functioning in BiH immediately after the war. Knowing they had to succeed, the LID MFIs were risk averse in choosing clients. As a result, they did not initially serve the poorest (i.e., riskiest) clients in the region. After major banking reforms in BiH, however, banks began to lend to low-income clients. Under this competitive pressure, the MFIs are now refocusing their operations to reach poorer clients. The average first-loan size for these MFIs is currently KM 3650 (912.50 euros).

The Result: MFIs Attract Commercial Financing. Nine partner MFIs of the apex now show profitability in their audited financial statements and five have a positive adjusted return on assets; their profitability is attracting commercial funds. Several institutions derive commercial and/or quasi-equity financing from sources outside Bosnia. Several other local MFIs have not yet attained profitability because they recently secured large soft loans and thus incurred a significant cost of funds adjustment.

Potential Pitfall No. 3: Disbursement Pressure

How did the apex avoid the pressure to disburse the money quickly when there were eight donors and cash was desperately needed in the post-war economy?

1. *The BiH government agreed to the dual goals of jump-starting the sector and providing loans.*
2. *Other donors also agreed to the dual project goals.* These donors took a less active role in the project due to World Bank management of the apex project.
3. *There were no preset disbursement plans.* Financing was based on MFIs cash-flow projections and available apex funds. MFIs were taught from the beginning to prepare portfolio and cash-flow projections. The apex then compared these projections to monthly MFI performance results, looked at its own cash flow, and made decisions on the amount and timing of financing.
4. *The project manager and apex staff spent time talking to stakeholders* about the importance of performance-based financing and institution building.

The Result: MFIs Found the Apex Too Conservative. Demand was so high that MFIs could often have used more money earlier, but the apex adhered to its funding principles. It was able to resist disbursement pressure because it was committed to disbursement principles as well as to performance targets.

Potential Pitfall No. 4: Political Pressure

In an ethnically sensitive environment, how did the apex avoid the pressure to disburse to special target groups based on geography or refugee/returnee status?

1. *The donor worked with apex staff and MFI leaders on the concept of building a national microfinance sector that was able to transcend political boundaries.* This perspective is very unusual in BiH.
2. *The client benefits of performance-based funding were explained to stakeholders.* Clients matter to all stakeholders, and they are better off in the long term if MFIs are sustainable and efficient.
3. *Use of unrestricted funds was encouraged.* It was possible to maintain performance-based funding of MFIs because of multiple donors. Funds restricted to certain geographic areas were allocated first, so that funds with no such restrictions could then be lent to those not directly targeted.
4. *Occasional political tradeoffs were accepted without changing MFI eligibility criteria.* It was accepted as a matter of equity that each ethnic or post-war status group in the country would be provided access to financing. In practice, this policy often meant that a loan to a strategically located MFI was rolled over rather than being called. Such an MFI was not required to meet new criteria of improved performance, but it still had to meet the conditions under which the loan was disbursed—and do a reasonable job of serving its clients.

The Result: Transparent Decision Making. Although the apex project is not politically independent, it is open about its decisions. Most management decisions are made on technical grounds and apex staff are trusted to be ethnically unbiased. The apex is not politically independent, however, because the government appoints both the board and management. The board and apex leaders consider the clients first, which sometimes has political consequences. It is an ongoing task to ensure that new board members become educated about the sector.

Project Benefits

The two most important benefits from the project were enabling clients in BiH to rebuild their lives after the war and the realization of the financial sector that low-income people can be good clients. As of 31 December 2002, LID MFIs had disbursed about 170,000 loans, each of which contributed to putting food on the table in low-income households. The high-quality loan portfolios of the MFIs have impressed the commercial BiH banks that lend to them. Consequently, some banks have begun to make small loans themselves. Looking to the future, the World Bank project is due to end in 2005. The apex will either then close altogether, its job well done, or continue in a modified form, depending on the best interests of the sector.

Conclusion

The BiH apex was a high-risk project. In a country with no MFIs, no microfinance experience, and negative attitudes toward microentrepreneurs, it could have easily failed. There were two main reasons it did not. The lead donor knew that building financially viable MFIs was the best way to provide long-term financial services to poor clients and worked tirelessly to achieve it. The staff of the apex institutions had the same vision and the courage to rigorously implement it. This case study shows that even in the most unlikely situations, microfinance donors can help build lasting institutions and create real opportunities for poor people.

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Contacts and Websites

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Interview with Sarah Forster, World Bank Team Leader

What happened inside the World Bank that contributed to the success of the apex project?

*"We at the World Bank office in Sarajevo **shared a sense of accountability with the apex staff** for the success of the project. Together, it was our job to make it succeed so poor people in BiH could rebuild their lives. We established a **participatory approach**, working with the MFIs to develop a common vision for the future of the sector. It resulted in high performance standards being agreed by all parties. We **hired individual consultants whom we knew were good (not a consulting company)**. [This] ensured high-quality technical services, but was a lot of work."*

"The two World Bank resident representatives believed in the importance of financial services for microentrepreneurs. On several occasions, they fought for this project with the Minister of Finance and even the Prime Minister."

*"**Regular staff development**, such as attending microfinance workshops and conferences, was supported by the World Bank and **was essential**. This also helped us find and choose good technical service providers."*

"Flying under the radar screen at headquarters made it much easier to take risks. Since this was a relatively small project, we were allowed more flexibility than is typical at the Bank."

Do you think this experience is unique or could the principles be applied anywhere?

"Both. There is no reason why another donor could not adapt these principles to a new context and make them work for another apex. But this is not a blueprint, and it's a lot of hard work!"