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Building a Viable Microfinance Sector in Afghanistan

Contents

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Overview

The microfinance sector in Afghanistan is going through a period of reform. This is due largely to the consequences of an early emphasis on rapidly achieving operational sustainability through growth in client numbers and loans made. This focus reduced attention given to issues of portfolio quality, accountability, and meeting client interests, and was coupled with a lack of acknowledgement of the existing informal credit market. All of this laid the foundation for the current problems that microfinance institutions (MFIs) are facing with increasing client default rates and, in some cases, fraud.

AREU research on the impact of microcredit on informal credit systems and rural livelihoods illustrated the viability challenges MFIs were facing. These challenges were linked to having invested little effort in determining the viability of clients by understanding the social and economic contexts in which they were to invest their loans or in offering loan products meeting client needs. This showed a lack of understanding of the interconnections between MFI viability and that of clients. Based on a growing understanding of these connections and recent lags in growth and performance, the Microfinance Investment Support Facility for Afghanistan (MISFA) has introduced a series of reforms at the sector level to refocus MFIs on quality instead of growth. These reforms include requiring partner MFIs to prepare more reliable business plans, have a trainer on staff to address capacity gaps in management and credit operations, and create internal audit units to improve control systems and reduce opportunities for fraud. To track MFI progress in implementing these reforms, MISFA has institutionalised an MFI report card system.

MISFA reforms have initially targeted MFIs' internal structures, capacity, and control systems. However, they also recognise the need to consider greater diversity of loan products and methodologies to meet client needs. To support diversification in the future, after internal reforms are in place, MISFA has committed to an action research agenda to investigate demand for savings products, agriculture and livestock loans, and Islamic finance products.

Some individual MFIs have instituted their own changes in light of the downturns they experienced. In some cases this has involved revising loan programme rules to better meet client interests—such as loan size, length of grace period, and repayment frequency. In other cases MFIs are exploring some of the new products MISFA plans to investigate, such as rural finance and Islamic banking products. Finally, some MFIs are implementing additional internal controls beyond those requested by MISFA.

While much of the attention in the reform process is on MFIs, MISFA is also working to improve monitoring of client performance through instituting social performance monitoring. This is being phased in through an incremental process of selecting indicators that all MFIs can collect. This is a difficult process in any context given the challenge of defining indicators that, at minimum, represent client viability, if not some of the wider social impacts monitored in other contexts, and the need to disentangle the effects of microcredit from other factors. As it stands, the selected indicators remain narrowly focused. This suggests that the process has prioritised what can be collected rather than what needs to be collected to, at minimum, understand the effects of credit on client livelihoods.

Considerable positive changes are taking place in the microfinance sector in Afghanistan. However, there remains scope to improve the focus of reforms to ensure they increase the viability of both MFIs and clients. This can be done through recognising the close interconnection between the two and working more explicitly to improve the latter. Some ways forward include:

- Implementing the planned expansion into rural finance within an integrated rural development approach and with a greater understanding of client demand
- Expanding the financial services offered to begin to address livelihood risk reduction needs, such as through voluntary savings and insurance products
- Focusing in the immediate-term on client viability, and ensuring that in time new performance monitoring tools do more to assess wider outcomes and impact
- Advocating for greater state and private investment in business and financial service training to build sector capacity
- Learning from informal credit systems to develop more competitive client-led microfinance products

1. Introduction

Large-scale microcredit programmes were introduced in Afghanistan in 2003 through the Microcredit Investment Support Facility for Afghanistan (MISFA). Investment in microcredit was justified primarily by a belief that Afghans, and particularly rural Afghans, lacked access to credit. Improving access to credit for productive use was expected to contribute to reconstruction and to the recovery of conflict- and drought-affected assets.

Ongoing AREU research in 2003 established the key role of credit in rural livelihoods.[1] Credit was used to attain basic needs and meet the costs of crises, as well as for business investments. However, this was credit offered through informal systems between neighbours, relatives, villagers, shopkeepers and traders. Further research on informal credit systems illustrated their diversity, prevalence and centrality to rural social protection systems.[2] These findings, coupled with the significant investments made in microcredit based on assumptions about lack of access to credit, led to questions about the influence of microcredit on informal credit and rural livelihood security.

Based on these questions, AREU conducted fieldwork in 2007 to assess the roles of formal and informal credit in rural livelihoods and how the two credit systems interact.[3] This paper reviews the findings of this study, particularly those focusing on challenges to microfinance

1 Jo Grace and Adam Pain, *Rethinking Rural Livelihoods in Afghanistan* (Kabul: Afghanistan Research and Evaluation Unit, 2004).

2 Floortje Klijn and Adam Pain, *Finding the Money: Informal Credit Practices in Rural Afghanistan* (Kabul: Afghanistan Research and Evaluation Unit, 2007).

3 Paula Kantor, *From Access to Impact: Microcredit and Rural Livelihoods in Afghanistan* (Kabul: Afghanistan Research and Evaluation Unit, 2009).

Microfinance and microcredit

Microcredit generally refers to small loans given to low-income people to facilitate entrepreneurship and self-sufficiency; it may also include loans provided for other purposes. It usually forms part of a broader programme supporting and developing the financial services sector of a country, called microfinance, which involves provision of credit, savings, remittance transfers, and insurance services.

institution and client viability, before discussing how the microcredit sector in Afghanistan has recently begun to change its focus and practices to address many of the concerns raised by the research. The paper ends with recommendations on how to enhance the current reforms to ensure that client viability joins MFI viability as a central concern.

2. Challenges to Viability

The viability of both MFIs and MFI clients should be outcomes of interest in the microcredit sector.[4] In the case of MFIs, viability refers to being operationally sustainable (i.e., meeting operating costs with revenues). For microcredit clients it means achieving greater levels of livelihood security. However, AREU's research, which explored rural livelihoods and credit use by MFI clients and non-clients, as well as the perspectives of MFI representatives, illustrates that interest in MFI viability often overshadowed that in client viability. Reasons for this relate to the sector's overall focus on achieving operational sustainability in a relatively short period and within Afghanistan's contextual constraints, and the tendency to ignore existing informal credit systems through the assumption that most Afghans lack access to credit. Both factors have led to problems attaining the goal of a vibrant microcredit sector in Afghanistan.

The drive for operational sustainability

Operational sustainability is a central aim of MFIs globally because this allows MFIs to reduce dependence on donor funds. It ensures their long-term presence, independent of development-funding dynamics. Achieving this independence is undoubtedly important, but MFIs must also guard against an overly narrow focus on their own sustainability, such that the financial needs of clients are overlooked.[5]

MFIs operating as MISFA partners were tasked with achieving operational sustainability in five years, reflecting the neoliberal consensus of that time.[6] This is a short timespan given the many challenges associated with providing credit services in the Afghan context. These challenges include: the security environment, which raises operational costs; lack of experience and capacity among national staff, leading to a reliance on expatriates in the short- to medium-term; the remoteness of populations increasing service delivery costs; and, in some places, resistance to credit with interest.[7] To meet this time frame, MFIs tended to focus on programme scale and outreach to reduce costs per client. This was often at the cost of meeting client needs and ensuring clients benefited from their involvement in the programme, with negative consequences for MFI sustainability in the medium-term.[8]

One of the key findings of AREU's study of the impact of microcredit on informal credit and rural livelihoods was that social and economic context matters significantly to the appropriateness of microcredit as a rural livelihoods intervention. The study was done in three villages,[9] and while small in scale, the differences between the study villages point to the need for a more considered approach to where and how microcredit is

4 Geoffrey Wood and Iffath Sharif (eds.), *Who Needs Credit? Poverty and Finance in Bangladesh* (Dhaka: The University Press Limited, 1997), Introduction; Susan Johnson and Ben Rogaly, *Microfinance and Poverty Reduction* (Oxford: Oxfam and ActionAid, 1997).

5 Client needs as understood from study respondents include products designed with grace periods fitting livelihood cash flow patterns, sufficient loan sizes to fund productive investments, manageable transaction costs, some repayment flexibility, and respect for clients' social values.

6 MISFA interview, June 2009.

7 MFI interviews, 2006.

8 Kantor, *From Access to Impact*.

9 The villages are in Kabul, Bamiyan and Balkh Provinces. See Kantor, *From Access to Impact* for more detail.

offered, to ensure it enhances livelihood security. This considered approach is more necessary in rural than urban areas, because rural economic opportunities tend to be more limited and risky, and have lower rates of return.[10] These factors make finding the money for repayments problematic for rural clients, something that strongly emerged among respondent households in the study.[11] This was even the case among shopkeepers, who are often a preferred client of microcredit programmes because of the expectation that they have consistent cash flows. However, shopkeeper respondents in all three villages reported considerable challenges due to village residents' low purchasing power and cash holdings. Shopkeepers often sold on credit and then had difficulty obtaining repayment from customers, which was required to support the repayment of their own microcredit loans.

Ultimately, in their push for greater scale and outreach to reduce costs, MFIs operating in the study villages tended not to invest significantly in assessing the social and economic viability of the community.[12] Some assessment of client ability to take on a loan was done but the quality and extent of this varied by MFI, and was often linked to loan size (the larger the loan, the more assessment of repayment capacity due to greater default risk). The lack of community-level assessment was most problematic in the Kabul Province study village, which had been severely affected by conflict and drought.[13] Its irrigation system had been nearly destroyed, meaning the main activity of grape production had been severely marginalised. This left villagers with few options for productive credit investment; action was first needed to rehabilitate the village's water and other infrastructure to create an environment supportive of economic growth. Credit provision was not considered as part of a holistic, sequenced development approach coordinated with agencies providing infrastructure or other services. In the end, this narrow focus on credit provision negatively affected both clients and the study MFI in the village, since the clients struggled to repay their loans, leading to drop-outs and negative perceptions of the MFI. These client struggles consequently limited the MFI's potential to achieve sustainable operations.[14]

In the two other study villages there was greater economic potential for productive credit investment.[15] In the Bamiyan village a strong potato crop provided an economic base to the community. However, even with this economic base, credit was used partly for consumption and productive investments were risky. Both factors led to repayment struggles among borrowing respondents. For some, this was evident through a cycle of debt, where borrowers were dependent on a new microcredit loan to repay informal credit taken to meet repayment deadlines from a previous microcredit loan. Their investments did not yet earn enough to support both MFI debt repayment and consumption needs. However, given the economic potential of the potato crop, if other agencies had delivered additional interventions prior to or in tandem with MFI credit (i.e., infrastructure, market access, risk reducing mechanisms), the scope for livelihood improvement could have been stronger. In the Balkh study village there was also potential for microcredit to positively influence livelihoods. Some study respondents expressed willingness to move out of informal credit relations with wholesalers, which often left farmers with little or no negotiating power over crop prices because they sell their produce to wholesalers who also give them credit for input purchases (such as supplies to make winter greenhouses). However, the study MFI's stringent eligibility criteria at the time made some potential clients decide not to become involved.

[10] Malcolm Harper, "Microfinance and Farmers: Do They Fit?" in *What's Wrong with Microfinance?*, edited by Thomas Dichter and Malcolm Harper (Rugby, UK: Intermediate Technology Publications, 2007), 83-94.

[11] Kantor, *From Access to Impact*.

[12] Kantor, *From Access to Impact* and the AREU microcredit case studies.

[13] Please see the appendix for summaries of the case study contexts.

[14] Paula Kantor and Erna Andersen, "Microcredit, Informal Credit and Rural Livelihoods: A Village Case Study in Kabul Province" (Kabul: Afghanistan Research and Evaluation Unit, 2007).

[15] Erna Andersen, Paula Kantor, and Amanda Sim, "Microcredit, Informal Credit and Rural Livelihoods: A Village Case Study in Bamyan Province" (Kabul: Afghanistan Research and Evaluation Unit, 2008); and Erna Andersen and Amanda Sim, "Microcredit, Informal Credit and Rural Livelihoods: A Village Case Study in Balkh Province" (Kabul: Afghanistan Research and Evaluation Unit, 2008).

The field study also raised the issue of the success measures used within the microcredit sector. Repayment rates were a frequently reported measure of success, and in Afghanistan at the time of the fieldwork, these were reported to be high. Microcredit clients among the study's respondents support this—they prioritised repaying microcredit for social and economic reasons. These reasons included avoiding the shame of default and the fines MFIs impose, and maintaining creditworthiness in both formal and informal credit systems. However, the strategies used by clients to repay often had negative effects on livelihood security. Clients might borrow from informal sources (thereby increasing debt levels), sell assets, or hold back some of the loan to meet repayments. These strategies and their effects do not support client viability, even if the resulting repayment rates illustrate MFI success. Ideally, the two outcomes—MFI and client viability—should support and not contradict each other. Over time, continued struggles to repay, coupled with changes in the economic environment (such as continued drought, rising prices for staple goods, and insecurity limiting economic options) led to declining repayment rates and MFI viability.[16]

The push for scale and outreach also led MFIs to limit the investments made in introducing their programmes to communities.[17] MFIs in the study villages tended to rely on information trickling out to inform clients about programme details. Meetings were held in local mosques with community leaders, and often women were not directly informed. This approach led to many misconceptions about credit programme rules, including around the sensitive social issue of charging interest. This meant some potential clients did not become involved, becoming a barrier to scale and outreach.

The desire to reach as many clients as possible also influenced some MFIs to develop a simple and limited range of credit products. These would be easy for new loan officers to introduce and provide a standardised product portfolio easy for the MFI to monitor, but did not necessarily meet a client's desire for loan products fitting their livelihood activities. The mismatch with client interests may have been particularly the case in rural areas, where cash flow is not regular, and returns are low and risky and come after a significant maturation period (of crops or livestock)—credit products needed to be sensitive to this. Therefore, product simplicity may have met MFI interests, but the strategy seemed to backfire by not being more concerned with client needs. This was the case with the Kabul MFI, which did little to adapt its programme to Afghanistan or rural areas, and was unpopular with study respondents. This was different from one of the Bamiyan MFIs studied, which sought to offer products adapted to rural activities in terms of loan size and grace periods, making it highly appreciated in the village. The need to match loan products to client interests also comes up in relation to the MFI sector's assumptions about Afghans' access to and demand for credit.

Access to and demand for credit

AREU's prior livelihoods research and the recent study on the impact of microcredit illustrate that while credit has a significant place in livelihood systems, informal credit plays a significant role in fulfilling this demand. Early claims that rural Afghans lacked access to credit and that microcredit would be in high demand for this reason were misplaced because they did not consider how households had structured their own support systems based on credit exchange through periods of conflict and crisis. Inattention to the presence of informal credit systems, which according to AREU studies are dominated by credit exchanges bearing no economic costs,[18] meant that MFIs overlooked the complexities of local credit markets and the need to develop products which compete, on loan terms or other features, with those already available in order to sustain client demand.

Table 1 (over page) shows aggregate data from MFI respondents in AREU's study on the role of microcredit in rural livelihoods. It provides data on levels of respondent borrowing over the three years prior to the study and is aggregated to the village level. The data illustrates that access to credit from informal systems is prevalent among respondents, and exceeds in sum that borrowed from MFIs in two of the three study villages. While average loan sizes from informal sources

[16] MFI interviews, May 2009; MISFA interview, June 2009.

[17] See the AREU microcredit case studies.

[18] Klijn and Pain, *Finding the Money*; Kantor, *From Access to Impact*.

Table 1: Aggregated respondent loan data						
Location	Sum of loans (Afs)		Number of loans		Average loan size (Afs)	
	Informal	Microcredit	Informal	Microcredit	Informal	Microcredit
Kabul	546,480	229,000	58	24	9,422	9,542
Bamiyan	806,970	689,000	40	24	20,174	28,708
Balkh	496,270	581,000	67	22	7,407	26,409

are smaller in two sites, the quantity of informal loans taken makes up for this. Respondents could often obtain multiple informal loans to raise needed funds.

Evidence from the case study villages of programme drop-outs and of respondents who considered borrowing but decided against it shows a mixed picture of MFIs' ability to offer products comparable to or competitive with informal credit. Drop-outs were more frequently reported in relation to the Kabul MFI (which was present in all three study villages). Its credit products did not compare well with available informal credit due to a small loan size and a weekly repayment structure. Many borrowers struggled to find the funds to begin repayments after the short one week grace period and tended to use the funds for consumption, since the loan size was insufficient to support productive investment. Therefore, respondents from the local MFI noted that demand for its services declined sharply after the first loan cycle.[19] These drop-outs and the complexity of credit portfolios among the Kabul village respondents imply that alternative credit sources were available and preferable, given the important role of credit in livelihood systems.

As noted previously, the MFI in the Balkh study village had quite stringent eligibility criteria at the time of the field study. For individual loans it required that borrowers provide guarantees from two shopkeepers in Mazar-i-Sharif. For both individual and group loans, it also required multiple visits to its office in the city prior to disbursement and existing savings of 20-25 percent of the loan balance. These requirements were directly and indirectly costly, through transport requirements and lost work time. This MFI's strict eligibility criteria reflect its relatively larger loan sizes and its interest in reducing its own default risk, but for some borrowers these criteria formed a barrier too high to overcome. Some could not obtain the shopkeeper guarantees and others decided not to, even though they were able to do so. In the latter cases it was because the respondents did not want the embarrassment of having to seek this support, highlighting the social costs of credit that borrowers take into account. The social costs of these eligibility criteria particularly affected those who were relatively wealthier or of higher status, closing off MFI access to key potential client groups. These respondents either avoided credit altogether, or chose to borrow from personal networks which, for these clients, involved lower economic and social costs.[20] For less-wealthy clients, both informal and formal credit can have social costs related to the inability to repay and the shame this brings. Avoidance of such shame can lead to negative strategies to find the money, including marrying daughters at a young age for the bride-price.[21]

To more sustainably support their own viability, findings point to the need for MFIs to pay more attention to client livelihood activities and livelihood security. This interconnection appears to have been missed in the push for scale to support the five year operational sustainability benchmark. Fault lines have emerged in the sector, backing up the study's conclusions around the risks inherent in a focus on numbers of clients and loans outstanding. This has led to considerable internal review within the microfinance sector with the aim of improving performance and long term viability. The next section reviews these changes and their motivations before concluding with an assessment of what more may need to be done.

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19 Kantor and Andersen, "...A Village Case Study in Kabul Province"; Kantor, *From Access to Impact*.

20 Andersen and Sim, "...A Village Case Study in Balkh Province."

21 For a discussion of daughters as "assets" in relation to creditworthiness, see Floortje Klijn, "Informal Credit Practices in Rural Afghanistan: Herat" (Kabul: Afghanistan Research and Evaluation Unit, 2006).

Table 2: Sector growth

Indicator	Jul-05	Jun-06	% chg	Jul-07	% chg	Jun-08	% chg	Jan-09	% chg
Active clients	127,580	204,277	60%	385448	89%	448307	16%	440615	-2%
Active borrowers	103,581	175,140	69%	333431	90%	372677	12%	346086	-7%
Gross loan portfolio, US$ millions	12.9	31.8	147%	87.6	175%	112.7	29%	104.3	-7%
Amount of loans disbursed, US$ millions (cumulative)		84.2		282	235%	470	67%	569.9	21%
Number of loans disbursed, (cumulative)		365,778		808,691	121%	1,184,623	46%	1,335,677	13%

Sources: MISFA Sector Update, January 09; MISFA, "Microfinance: Making a Difference"; MISFA Sector Update, July 2007; Microfinance Focus Newsletter, Issue 1, Volume 1, August 2005.

3. Microfinance Sector Reforms

In its early years, MISFA structured the microfinance sector around the goals of scale, outreach and sustainability, reflecting a project orientation which included a short expected lifespan for itself.[22] Sector growth was the priority to which partner MFIs responded, meaning investments in other aspects of the sector, such as diverse loan products or monitoring and evaluation, received less attention. The sector did grow, but at some cost. The current MISFA management is in the process of working with its MFI partners to refocus the sector on the aims of accountability, portfolio quality, and sustainability to counter some of the consequences of the push for high growth and sustainability.[23]

Sector growth

MISFA started its activities in 2003; however, due to funding constraints it remained at the scale of a pilot project through 2005.[24] It was from 2006-08 that the sector took off. It has achieved considerable growth in this period, as Table 2 shows. There has also been growth in the number of MFI partners, from four in 2003-05 to 12 in 2006, and currently 15.[25]

The data above clearly shows the fast pace of sector growth from mid-2005 through mid-2007. They equally show the considerable drop in growth from 2007–08, with growth in active clients and borrowers[26] and in loans outstanding (gross loan portfolio) becoming negative from June 2008 to January 2009. This covers the period of new MISFA management and the shift in focus from growth to accountability and quality. The numbers corroborate findings from MFI interviews, many of which highlighted a recent reduction in lending and a focus on strengthening internal systems in the face of viability threats.

22 MISFA interview, June 2009.

23 MFI interviews, May 2009, and MISFA interview, June 2009.

24 MISFA interview, June 2009; MISFA, "Microfinance: Making a Difference in Afghanistan," (Kabul: August, 2008).

25 MISFA, "Microfinance: Making a Difference"; MISFA Sector Update, January 2009, accessed from www.misfa.org.af, 2 July 2009.

26 For programmes only offering credit products, "active clients" and "borrowers" are the same. For those with a savings programme, active clients would include savings clients who may not hold a loan. Active borrowers are those holding a loan on a given date.

Consequences of growth

As discussed in Section II, MISFA's and therefore its partners' focus on operational sustainability led to the prioritisation of sector growth, with negative implications for many client respondents in AREU's study. This pressure has also had consequences for MFIs, which they described in interviews conducted in May 2009.

Many of the consequences of the pursuit of growth became apparent in late 2007 and 2008, as illustrated in Table 2 by the declining pace of growth. It is important to place this decline within the economic and security context, because influences external to the sector also had a role in affecting client and MFI viability.[27] During this period, Afghanistan faced continued deterioration of the security environment, which raised costs of doing business and influenced some MFIs to reduce operations in certain provinces and focus on urban or peri-urban sites. This concentrated MFI investments in fewer areas, resulting in competition for clients and clients borrowing from multiple MFIs, with associated portfolio quality implications.[28] Many areas of the country, particularly the North, continued to experience drought, which limited economic activity in both rural and urban areas, and therefore limited investment and repayment capacity. Internal and regional migration became a common coping strategy in some regions.[29] In 2008, rising global food prices added to economic stresses, limiting demand for credit as well as affecting repayment abilities. The devaluation of the Pakistani rupee further strained livelihoods for people in areas bordering Pakistan, where it is the currency most often used for exchange.

Given this economic climate and the low levels of investment made by many MFIs in understanding local economies and investment opportunities, it is not surprising that MFI repayment rates started to decline. Many MFIs became burdened with weak portfolios characterised by rising client default risks; this then affected the MFIs' creditworthiness to MISFA. Two MFIs halted lending for a period to focus on recovering outstanding debt, another wrote off a significant amount of loans as unrecoverable, and another was unable to recover loans they had extended to the nomadic Kuchi community.[30] MFI respondents related the problem of weak portfolios to poor MFI management and programme structures that did not fit clients' livelihoods or financial capacities. The portfolio weaknesses may also relate to the push to expand client numbers and decisions to lend to some clients who did not have the capacity to take on more debt.

Another consequence of the push for growth was rapid MFI expansion without concurrent investments in staff training or the establishment of monitoring and internal audit systems. This led to fraud within the sector.[31] Seven out of thirteen MFIs interviewed specifically mentioned facing problems with fraud among both staff and clients. This often happens through the creation of so-called "ghost clients," to whom funds are disbursed and who then disappear from the records. MFI staff may be complicit in this fraud and the lack of internal controls allowed it to happen undetected until the recent repayment problems led to greater internal review.

Many MFIs have also been slow to computerise their operations. This is particularly the case in branch offices which may lack the infrastructure to support it. The lack of oversight and management information systems, whether computerised or manual, coupled with rapid loan officer recruitment to meet scale targets but with little investment in training, set up an environment ripe for fraud. Additionally, although many MFIs in Afghanistan are linked to international agencies with considerable MF experience, few headquarters either monitored their Afghan branches or set up audit procedures or other checks.[32] This again provided opportunities for fraudulent practices to emerge.

In the end the push for MFI operational sustainability via rapid growth in client numbers and lending backfired. Many MFIs reported declining rates of operational sustainability due to loan losses and fraud. Additionally, nine out of thirteen MFIs interviewed reported downsizing their staff and

27 MISFA interview, June 2009.

28 This point was brought to the authors' attention by one of the anonymous peer reviewers.

29 This is based on fieldwork on livelihood change conducted by AREU in Sar-i-Pul Province.

30 MFI interviews, May 2009.

31 MFI interviews, May 2009.

32 MISFA interview, June 2009.

activities, and of these two have lost access to MISFA funds until they implement reforms. The reform process is not limited to these two MFIs. The next section assesses how MISFA and its partner MFIs are reassessing structures, processes and products to improve sector performance.

Reforms in process

MFI reforms are taking place at the sector level through changes led by MISFA that affect all partner MFIs and through changes implemented by the individual MFIs. Eleven of the thirteen MFIs interviewed are going through some sort of reform; some are only developing new products or adjusting existing products, while others are engaging in wider changes. Of the two MFIs not going through this process, one is new to Afghanistan and the other is going through a consolidation process with another MFI.

When asked about the most important change during the past year, five of the thirteen MFIs interviewed mentioned an improved relationship to MISFA. This is largely associated with MISFA's change in focus, which is perceived to be in the MFIs' favour because MFI capacity, accountability and quality are prioritised before sector growth. Some said they had felt pressured by the government and MISFA in the past, leading to poor operational decisions and the resulting portfolio problems.

How has MISFA's increased attention to capacity, accountability and quality affected practice at the sector level?[33] One way is through requiring MFIs to develop more realistic business plans for their programmes. This assists in better judging the feasibility of plans for product changes and expansions, and helps hold MFIs accountable for performance. Another change is the requirement that MFI partners now have a trainer on staff to address capacity gaps in management and in field operations. These trainers receive training inputs from MISFA and then pass them on within their MFI at main offices and field branches. A final change is the requirement that MFIs establish internal audit departments,[34] instituted in response to the general lack of oversight from MFI parent agencies. This has placed the oversight burden on MISFA, which it is seeking to re-establish within the MFIs. The audit departments are expected to improve internal controls and reduce incidences and opportunities for fraud. Another suggested change is for MFIs to collect client repayments at branches as opposed to locally. This would provide the MFIs with more centralised control over cash handling, but could also increase client risks and transaction costs. This may reduce client demand for microcredit if other sources of credit can supply similar amounts but with fewer direct and indirect costs.

MISFA leadership also spoke of the importance of diversifying loan products and lending methodologies.[35] It advocates a paced approach to these changes, placing initial emphasis on establishing internal controls at its partner MFIs prior to such expansion. In preparation for expanding financial products and methods, MISFA is supporting action research on new products and methodologies. It is creating an evidence base to inform new product designs, to ensure demand exists. Some of the topics on which MISFA has done or is planning to research include: demand for savings products, demand for agricultural loan products to learn what types of products are needed, and client interest in Islamic banking methods. In terms of the latter, MISFA reports anecdotal evidence of quite variable levels of interest, with it remaining unclear if demand would remain strong if these products are more expensive than existing loan products. However, as will be discussed, some MFIs are already experimenting, in some cases to reduce cash-based lending to avoid the risk of fraud.[36] Examining the presence and role of informal credit is not part of the proposed research, despite the emphasis among microfinance practitioners globally of the importance of understanding this part of the credit market when developing microfinance products and methods.[37]

33 MISFA interview, June 2009.

34 These departments in some cases include legal advisors who raise awareness about fraud and its consequences.

35 MISFA interview, June 2009.

36 MFI interviews, May 2009.

37 Ben Rogaly, "Micro-finance Evangelism, 'Destitute Women', and the Hard Selling of a New Anti-Poverty Formula," *Development in Practice* 6, No. 2 (1996): 100-112; Johnson and Rogaly, *Microfinance and Poverty Reduction*; Geoffrey Wood, "Breaking Out of the Ghetto: Employment Generation and Credit for the Poor," in *Who Needs Credit?*; Iffath Sharif and Geoffrey Wood, "Conclusion," in *Who Needs Credit?*; Stuart Rutherford, *The Poor and Their Money* (Delhi: Oxford University Press, 2000); Raja Ehsan Aziz, "Microfinancing in Afghanistan: Strategies and Options" (Kabul: Agency Coordinating Body for Afghan Relief, 2000).

A final innovation MISFA recently put into practice is MFI report cards.[38] They are a means of institutionalising MFI reviews against key performance and/or capacity indicators. The indicators reflect many of the changes described previously and are MISFA's way of understanding where troublespots might exist among its partners, and what changes are taking place to address them. There are four categories against which MFI's are assessed: governance and management capacity, sustainability and income, data management capacity, and impact and product.[39] Each of these has subcategories, which are discussed below.

The governance and management capacity performance area has five subthemes. The first documents the presence of an independent board of directors, its meeting frequency, meeting documentation, and attendance levels. This represents external oversight for the MFI and a means of holding the director accountable. The second subtheme relates to the presence of a country director. Given recruitment challenges, these indicators represent whether: the post is filled or not, the person resides in country, is Afghan, has relevant experience, and has developed an annual business plan. All but the last indicator represent efforts at "Afghanisation"—having an Afghan in the leadership position.

The next subtheme assesses the staffing, qualifications and performance of the MFI's finance departments. It documents the presence and qualifications of a finance manager, the conduct of an unqualified audit, preparation of an annual budget, availability of a finance manual, and the rating from a MISFA-led internal audit. The next subtheme focuses on internal audit, documenting the presence of the newly required internal audit department, who it reports to, whether the parent organisation conducts an audit, whether branch offices are audited and problems followed up, and whether a compliance manual exists. The final subtheme under the governance and management capacity category looks at the presence of Afghans among senior and mid-level management, staff turnover levels, and overall staffing levels. In the latter case the focus is on not having large gaps in staff numbers, by working toward achieving the benchmark of 85 percent staffing levels or higher across the MFI.

Sustainability and income generation is the next performance category, represented by three subthemes. The first is sustainability and focuses on scale and financial indicators, including outreach and geographic coverage, portfolio outstanding, yield and share of operation costs covered by revenues, and average loan size. The next subtheme is portfolio quality, the area where many MFIs have faced problems. The indicators include the share of portfolio that is at risk of default, repayment rates, and the MFI's write-off ratio. The final subtheme is efficiency, with indicators including cost per client, level of operating expenses, loan loss reserve percentage, client drop-out rate, and number of clients per loan officer (aiming for more than 225). The last indicator raises questions about trade-offs between efficiency and quality of service provision, particularly given the lack of knowledge of MFI programmes and rules shown by respondents in the AREU study. This many clients per loan officer may be detrimental to client retention, even if it is considered cost efficient and an appropriate benchmark in other contexts.

Data management capacity is the next category. It has one subtheme focused on management information systems, for which the indicators are computerisation of the head office and branches, and the ability to produce monthly financial reports. Infrastructure requirements and staff ability to use the systems are not elements of the appraisal.

The final performance category is impact and product, with a subtheme focusing on each of these two issues. The impact subtheme mainly focuses on MFI client and product targeting—whether it uses a pro-poor methodology, whether it is poverty targeted, its percentage of rural clients, and its percentage of agriculture/livestock loans. It also assesses the share of female clients, number of provinces where the MFI operates (not counting Kabul), loan collection frequency, and number of external assessments done. The collection frequency sets a target of semi-annual per loan, seeming to support longer grace periods. The benchmarks set for loan types and rural and female clients seem arbitrary, and end up documenting outputs versus the impact or outcomes of these targeting achievements. This

38 MISFA interview, June 2009.

39 June 2008 version of MISFA report card format.

Loan officer roles

MFIs employ loan officers to manage the daily work of microcredit-related activities. The loan officers are normally from the project area and hired because of their access to and knowledge of the local community. Their overall responsibility is to be directly in contact with the clients in terms of delivering information about microcredit and carrying out the daily activities in managing the loans. The loan officers assess the economic circumstance of the clients, and therefore are often given the authority to accept or deny potential clients. As such, loan officers act as gatekeepers between the villagers and the MFI. As the mediator between the MFI management and clients, the loan officers must keep up appearances toward both sides. The loan officer must ensure activities are carried out according to the rules and guidelines set by the MFI and document the positive outcome of the programme. Achieving both aims is challenging, not least because loan officers experience the practical circumstances faced by the clients on a daily basis that lead to difficulties with loan uses and repayment. These pressures often lead loan officers to flexibly apply loan programme rules, as documented in all three study villages, as well as find ways to ensure a success story is reported to branch and regional offices, often under pressure to do so by programme managers. This can be an untenable position.

MFIs could benefit from better acknowledging the role and local knowledge of loan officers and adequately training and outfitting them for their posts. Loan officers possess a broad understanding of the socioeconomic context of the local area, and have established personal ties to clients. Their roles could be enhanced by incorporating their knowledge into the overall monitoring and evaluation structures of credit programmes. This may serve to adjust the programme structure in line with the conditions of the context, to the benefit of all involved.

limitation crosses many of the performance areas and is returned to later in this section. Part of the problem may be loose use of the term "impact."

The product subtheme documents the mix of products the MFI offers, with more products being better. Voluntary savings and insurance are included as two of the listed products, representing attention to broadening the portfolio of financial services on offer. However, this indicator does not make an effort to capture client response to or take up of the products, seeming to value diversity separate from demand-led product change. A simple indicator based on share of clients using a product could capture client response to these changes.

Movement to an institutionalised means of assessing and tracking MFI structure, capacity and performance is a positive change. Many of the indicators will document important improvements to MFI practice as the sector matures and seeks to meet the new priorities MISFA has established. However, in some cases, the indicators provide more limited information than they might have because they focus primarily on outputs and numbers and do not attempt to understand issues of service quality or outcomes. MISFA recognises that this makes for a rather blunt diagnostic tool as MFIs go through reforms.

While MISFA has initiated a series of reforms amongst its partner MFIs, the MFIs have also made their own changes to their practices. Many of these relate to lending methods and loan products, at times in response to explicit or implicit client demands. Some changes have also been driven by the portfolio quality problems described previously.

Some MFIs have downsized in response to problems of fraud and low repayment rates. Two explained in more detail the new procedures they put in place to guard against similar problems in future.[40] In one case the aim is to make a leaner organisation in response to high levels of delinquencies and staff fraud. Downsizing branch and staff numbers is one element of the response. A second part is greater time and attention placed on training for regional, branch and credit managers in the basics of microcredit, accounting and field operations. It is also following MISFA requirements and establishing internal controls, including systems to crosscheck the existence of

40 MFI interviews, May 2009.

credit groups through an independent operations unit. In the second case, the MFI put in place new internal structures and capacity building programmes to reduce the risk of fraud. Loan officers have been a target of both changes. They are barred from handling cash, and a separate team maintains client files to minimise the ability of loan officers or others to create ghost clients. This MFI has also established a new recruitment policy which requires newly hired staff to provide three guarantors who will provide compensation in case of fraud. Loan officers are the frontline staff of most MFIs, and therefore play a vital role in maintaining links to clients as well as maintaining MFI integrity, as Box 2 shows. However, they may not have received the training and attention needed given their responsible positions. Some MFIs are trying to change this.

Apart from the changes outlined, many MFIs reported making changes in loan products and methodologies, ahead of the changes MISFA is investigating through its action research agenda. In some cases these changes mean greater flexibility for clients, which is positive and in line with the findings of AREU's research among microcredit clients. The flexibility in some cases is in loan sizes, with some MFI programmes implementing new individual credit products to offer larger loans to clients. However, the MFI studied that offered what clients considered very small loans has not been as responsive in this area. It has, however, offered more flexibility in repayment timing, offering clients a choice of weekly or monthly repayments. This is a positive move. Other MFIs have made similar changes, in some cases allowing clients to work with loan officers to set repayment timeframes. Similarly, there has been some change in grace periods offered, with a few MFIs extending grace periods for certain types of loans, in understanding of the cash flows associated with the businesses. This has been done for carpet weaving loan products and for agriculture and livestock loans.

Even with the challenges to offering rural finance products, related to the risks and low returns of many of these activities, more MFIs are exploring offering agriculture and livestock loans. However, there does not seem to be a coherent approach or an assessment of the risks involved in this type of lending, illustrating the need for MISFA's assessment of how to proceed in this area. For example, one MFI that will offer an extended grace period for its agriculture loans also plans to charge a higher fee to reflect the risk it faces. However, another MFI will charge a significantly lower interest rate compared to its other products due to its judgment that this sector is weak and cannot support higher fees.

Another area of exploration for some MFIs is Islamic finance. A few MFIs already offer Sharia-compliant products while others are applying to do so or investigating options.[41] This will be an up-and-coming area of the microfinance sector in Afghanistan that again requires careful study to ensure the right products are offered in response to clear client demand.

There is much less innovation at this time in savings and insurance products. This is largely due to institutional capacity constraints and the importance of institutional development prior to product expansion. Only one MFI offers deposit savings options while another has piloted a self-help group model which prioritises savings over credit and leaves group savings in the group for internal lending. In most other models, savings (if any are required) are held by the MFI and are often a form of guarantee against default. The lack of insurance products ideally can in time be addressed in the Afghan context, given the range of livelihood risks to which clients are exposed. Such products could make significant advances in addressing vulnerability and increasing resilience, whether targeted at individual-level risks (such as ill health) or community-level ones (drought, pests, etc).

Even with these reforms and adjustments to MFI practices, MISFA acknowledges that not all existing MFIs are certain to survive the current downturn.[42] It sees sector consolidation as one outcome of the current situation, reflecting the rapid increase in the number of MFIs. Such consolidation may improve quality control as there will be fewer actors to oversee. However, any such consolidation must be done with client interests in mind, so as not to provide greater strain on client livelihoods.

[41] This process includes engaging clerics to issue a *fatwa* in support of the products offered.

[42] MISFA interview, June 2009.

Due to both the internal structural problems MFIs have faced and the challenges in meeting and managing state demands on the microcredit sector, there is a need for a body to advocate for the interests of MFIs with state actors as well as to incentivise self-regulation. The Afghanistan Microfinance Association (AMA) could become such a body. Founded in 2005 and registered at the Ministry of Justice in 2007, AMA is a trade association created through MISFA funding that is meant to provide a forum for MFIs. AMA could ideally take on a regulatory and advocacy role, but at present it is still trying to establish its institutional identity and mandate. This was apparent from the MFI interviews, where not all respondents had a clear idea about the association's work or role. In time, with the right expertise and support, AMA could play an important role in supporting the sector through its reform process and future growth. However, at this time, MISFA sees itself as the main agency with the capacity and authority to set industry standards and monitor compliance.

Achieving a better understanding of impact

AREU's research outputs argued that the MFIs under MISFA were at risk of undermining client viability in favour of that of their institutions, driven by their focus on client outreach, repayment rates, and operational sustainability.[43] This meant that while the microfinance sector expanded in the short term, in the medium to long term this growth trend reversed because clients were unable to find the money to repay their loans or to find benefit from the programmes on offer. This reversal has led to the different sector reforms discussed previously.

In response to these internal portfolio and operational problems, coupled with concerns expressed in the MISFA-focused section of an external evaluation of the Afghanistan Reconstruction Trust Fund,[44] MISFA has given more attention to performance monitoring, using the term "social performance monitoring" (SPM). This is in line with movements in the global microfinance industry to focus on a "double bottom line": showing financial sustainability as well as progress on social indicators.[45] In standard practice, the social indicators are developed in relation to an MFI's stated objectives and may include poverty reduction, improved well-being, or empowerment. However, in the Afghan context SPM efforts remain more limited than this. MISFA reports that efforts so far have not reached the level of translating MFI objectives into measures of outcomes; instead SPM is used more for product development.[46] This reflects MISFA's prioritisation of institutional strengthening and capacity building prior to impact monitoring at scale. However, how institutional strengthening and capacity building can be separated from understanding the effects of microcredit on client livelihoods is not clear. This prioritisation seems to again place MFI interests before clients', missing the interlinkages between the two. These interlinkages justify offering stronger incentives to partner MFIs to move more quickly toward developing better understandings of how clients use microcredit loans and their livelihood effects.

MISFA has been working with two partner MFIs to develop a limited, pilot SPM system. This effort focuses on narrowing down a set of indicators which can be easily and reliably collected. In the pilot, 16 to 19 indicators have been collected with the aim of finalising a set of about six which can adequately assess what MISFA and its partners define as social impact. This is where some limitations emerge. As with the report cards, the social performance indicators end up focusing largely on outputs. While this may increase ease of collection, the measures do not push the sector far enough toward understanding how client livelihoods change due to involvement in microcredit programmes. This information should not be elective—dependent on MFI capacity or interest—but should be a central part of institutional learning advocated for and supported by sector actors to ensure investments in microcredit have the desired client-level effects.

In the end, the pilot forms miss aspects of

[43] Kantor, *From Access to Impact*.

[44] "Afghanistan Reconstruction Trust Fund: External Evaluation." (Oslo: Scanteam, 2008).

[45] See for example the Imp-Act website (www.imp-act.org). This programme focused on building social performance monitoring systems so that client needs are better met, increasing MFI market share through satisfying clients.

[46] MISFA interview, November 2009.

impact that AREU's study point to as important to understanding client viability. These include information on client credit holdings from all loan sources, which may increase with involvement in microcredit illustrating growing debt burdens, as well as information on how clients repaid microcredit loans, which can be linked to growing debt levels or at times other negative actions, such as asset sales. While these indicators may be slightly more difficult to collect, they may say more than the measures in their current form on the impact of credit on livelihood security. It may pay to focus on livelihood security initially—and not on broader "social performance"—to develop more rigorous and meaningful measures of client viability. This means moving beyond outputs, and focusing on those outcomes where microcredit can have a direct effect and which provide more information about how microcredit products affect clients. This involves some effort to disentangle competing effects, a challenge in any research aiming to understand impact. In the short term this will be difficult to achieve if there is a lack of baseline data from when clients joined the programme. As the amount of data collected from clients, and some non-clients, increases and becomes standardised around the indicators MISFA and its partners identify as appropriately capturing the potential effects of their work on livelihoods, then it will become easier to illustrate changes and to qualitatively disentangle the effect of microcredit among other factors; the MFIs' context knowledge will play a major role in the latter process.

4. Ways Forward

The microfinance sector in Afghanistan has gone through considerable growth since its inception. Pressures to achieve operational sustainability in a relatively short period have led to a focus on scale and outreach over quality and client demand. This has led to problems in the sector due to insufficient internal controls to manage the fast growth and less attention to available alternative credit sources. These problems are now being rectified through changes led by MISFA and made by individual MFIs. While the reforms reviewed in this paper are positive, there are still concerns that client viability is not valued at the same level as MFI viability. To this end, the following recommendations lay out further actions needed to improve the interconnection between MFI and client viability in the interests of both the microcredit sector and its clients.

Implement the planned expansion into rural finance within an integrated rural development approach and with a greater understanding of client demand. The findings of AREU's study, as well as a wealth of literature on microcredit, illustrate that microcredit alone is insufficient to promote either rural livelihood security or income growth. Structural barriers within the local and regional economy often limit opportunities for credit use. Planned expansion into rural finance must therefore be implemented in a sequenced manner, supported by wider economic development initiatives to address infrastructure gaps, limited access to resources including water, and local power dynamics (which for many may make the room for manoeuvring marginal at best). Without an integrated, coordinated approach to rural development, rural credit products may only assist clients to cope as opposed to stabilise or improve livelihoods. MFIs should improve links with planned and ongoing rural development initiatives, as well as with NGO counterparts when they exist, to develop integrated development strategies at the village, district and/or provincial levels.

Findings from MFI interviews also illustrated a lack of coherence among MFI approaches to rural credit delivery, with different understandings of the risks involved to MFIs and clients. More assessment of rural finance needs and best practice is required in Afghanistan to bring more consistency and client-led products into the market. MISFA's plan for action research in this area is a first step on this priority issue.

Expand the financial services offered to begin to address risk reduction needs. MFIs should assess the feasibility of either expanding or reprioritising the range of financial services they offer to better support risk reduction. Possibilities include opportunities for secure savings, health insurance (given the prevalence of health shocks and crises), and crop and livestock insurance. The social protection sector strategy of the Afghanistan National Development Strategy recognises this gap in market-based means of social risk management. It prioritises diversifying these market-based arrangements, which have largely been based on providing credit, to include community-based savings and insurance. This paper strongly supports action in these areas. Investing time in learning from innovations in microfinance service expansion in other relevant contexts is vital to support informed action. This is not for the purpose of directly importing existing models or programmes, but to inform an assessment of what is feasible and appropriate in the Afghan context. MISFA's action research on demand for savings products shows progress in this area. Further action could include coordination with the Ministry of Labour, Social Affairs, Martyrs and Disabled to explore ways of working together to develop a programme to extend insurance products, building from lessons learned in this and other regions.

Ensure performance monitoring tools do more to assess outcomes and impact. The introduction of MFI report cards and social performance monitoring are important investments in monitoring and evaluation. However, as noted earlier, many of the report card indicators focus on outputs and quantities, which may be easy to report but may limit the usefulness of the exercise. It is recommended that MISFA and its MFI partners continue to reflect on what some of these indicators represent, compared to what they could capture, to ensure sufficient richness emerges to improve practice. Capacity limitations within MFI partners mean a paced approach to improving indicators is needed, but expectations also should not be set too low.

The introduction of social performance (or impact) monitoring is happening in a phased way, reflecting the need for the monitoring to be done in a manner that is not burdensome and which reflects local data collection capacity. However, too much focus on feasibility may again make the exercise meaningless. As with the report cards, the risk is that only output data is collected (number of loans, sources of loans, school enrolment, assets owned) with little ability to understand the changes brought about through client access to and use of microcredit. A balance must be achieved between usefulness and feasibility, which can be adjusted as capacities improve.

Another consideration in SPM is the possibility of biased results if implemented by MFI staff. Clients do not want to lose the aid they have, even if they consider it imperfect, and they are savvy in understanding how to respond to evaluations so as to maintain existing programmes. Therefore, independent assessments must be built into performance monitoring plans to minimise the likelihood of clients telling MFIs what they want to hear. Another way to counter this is to engage in more regular and informal forms of client feedback to obtain information MFIs can use to adjust programme delivery, while letting clients see the usefulness of providing information in this process to improve programmes without risking their loss.

Advocate for greater investment in business and financial service training. Weak staff capacity brings considerable constraints to MFI operations and monitoring. Based on this, MISFA and others could advocate state and private education institutions to offer more courses and certificate and degree programmes that focus on building financial literacy, financial management, monitoring, and general business skills.

Learn from informal credit systems. Experience from other contexts as well as the data from AREU's field study demonstrate the need for MFIs to invest in understanding client needs, including their involvement in other credit systems, in order to design demand-led programmes. This has not been done sufficiently in Afghanistan, to the detriment of clients and the MFIs. While adding this analysis to MFI procedures may add time and increase costs, it is an investment worth making for the returns. Improved knowledge of informal credit systems in Afghanistan, including understanding demand for Islamic finance products, would make MFIs more client-led and more able to identify niche products that fill a demonstrated gap in demand, and may lead to a more dynamic, innovative financial services sector. As MFIs expand more into rural areas, this knowledge is especially important so that products match client livelihood activities and cash flows and microcredit programmes enter areas where investment activities can generate sufficient returns to support repayment. The knowledge about informal credit systems serves the interests of both MFI and client viability.

Appendix: Summary of Case Study Village Contexts

Kabul

The Kabul village is 20 km north of the capital. It has 386 households and its main livelihood sources are connected to the district bazaar by the main road to Kabul, which is a short walk from the village. Before the conflict with the Taliban the village thrived economically based on the cultivation of grapes and fruit. The vineyards and orchards are now recovering from conflict-related destruction and years of drought. A major constraint in the recovery of the plantations was the destruction of the traditional irrigation system during the rule of the Taliban. Hence, the population rely on off-farm livelihood activities, especially casual labour opportunities in Kabul, employment with the national police, and the market access provided by the main bazaar of Kabul.

At the time of the study the MFI operating in the area focused its programme on poverty reduction and social and economic empowerment of women and thus distributed loans primarily through groups of women. The groups were a guarantee system, with group members responsible for each other's repayments. Men often used the loans women took. The initial loan size was US$100, which was perceived to be too small to fit business investment needs. Repayment rules were perceived to be rather strict as the loans had to be repaid in weekly installments within a year. The local leader, or *malik*, held an important role in providing information to the MFI on the creditworthiness of village residents. The interest rate at the time was 17 percent of the loan amount.

Bamiyan

Located in a valley 15 km or 30 minutes drive outside the provincial centre, the village is comparatively isolated from the provincial market. Although livelihood activities are diverse, the main income of the villagers is from agricultural activities, either by cultivating their own land or as sharecroppers. At the time of the study the majority of the 140 households maintained a good income from producing and trading potatoes due to its high market price. A group of women earns important income from carpet-weaving, contracted by traders in the Bamiyan bazaar.

Due to periods of armed conflict, the villagers have a long history of forced migration to other areas. This has resulted in the need for economic recovery upon return. In the past villagers relied on credit from local lenders, often taken with high interest. This practice has changed with the entry of microcredit. There are at least three MFIs operating in the village, and the one which formed the subject of this case study was perceived to be the most successful by the villagers. This MFI offers both group and individual loans, which are designed according to its use. Loan products offered are solidarity group loans for the poorer clients as well as agricultural, livestock and business loans. Loan amounts start at US$300 and reach a maximum of $3,000. Characteristic to all of this MFI's loan products is a substantial grace period, which enables the borrowers to repay the loans according to the natural cash flow of their livelihoods. The loans are repaid either in one or two installments after harvest or livestock maturation. During the grace period, the borrowers pay the interest fee, which is 1. 5% of the loan amount per month.

Balkh

The village has about 300 households and is located 20 km north of the Mazar-i-Sharif, just off the main road, which means the villagers have relatively easy access to the main bazaar in the city. It is part of a larger village that is informally divided into sub-villages affiliated with separate mosques. The village's most important income is from agricultural production, but other major livelihood activities include livestock breeding, casual labour and trade. The climatic conditions allow two annual harvests, one in the summer and one in the winter, which means two periods of agricultural income. Farmers rely on traders and wholesalers for credit to buy the supplies needed for winter cultivation (plastic sheeting and other items to make greenhouses); these are generally the same people who then buy their produce. This makes the farmers less able to negotiate over the prices of their produce, and provides an opportunity for MFIs to offer credit to break these relationships.

The MFI studied in this case is a credit union established by a US-based international trade association and credit union development agency. The credit union is based on the principle of sharing risks and rewards, and aims at being not only a means of providing financial services to underserved communities but also fostering civic participation and democratic processes. At the time of the study the credit union offered individual and solidarity group based loans. Individual loan sizes depended on client creditworthiness and loan use; group loans start at 250,000 Afs for the group. Borrowers must meet several conditions before the loan is disbursed, especially for collateral and guarantee. First, savings are required to be 20-25% of the loan amount and second, the borrowers must provide either one or two guarantors who own businesses that are formally registered with the municipality in Mazar-i-Sharif. The loans must be repaid within 3-6 months depending on the use of the loan. The borrowers are also required to pay an administration fee of 17.5% of the loan amount.

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