Guidance for Design of Community-Managed Revolving Loan Funds (RLFs) in Projects using a Community-Driven Development (CDD) Approach
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World Bank projects using the community-driven development (CDD) approach often provide communities with grants to finance projects that the community has prioritized. In some cases, communities wish to use a portion of these funds for loans to community members for small economic activities. Grant funds used for this purpose are defined in this note as Community-Managed Revolving Loan Funds (RLF). Villagers who take loans are expected to repay their loans with interest, so that the funds can revolve to other members. The purpose of this guidance is to provide project design teams with some observations gathered from both World Bank and other donors' projects that may help in the design of RLFs.

1. **In many cases, community-managed RLFs have not been effective tools for achieving the objective of sustainable financial services for the poor. They often don't revolve for very long and frequently are not housed in organizations that aim to become sustainable long-term providers of financial services.**
    - Some of the most common pitfalls are indicated below:
        - Borrowers are not required to save prior to receiving a loan. Savings are important because they instill financial discipline and oblige the borrower to shoulder some of the risk. Savings also enable people to acquire funds for emergencies and prepare for "lumpy" expenses such as education and health care, thus reducing the chance that the loan will be diverted for these purposes.
        - When loans are mainly financed by external capital, rather than savings, communities may not have the incentive to manage the funds with the same prudence that they would use if their own money was at risk. Unclear ownership of the RLF funds also contributes to this problem.
        - Borrowers may default on their loans if they perceive the funds to be government hand-outs, or they expect the community not to enforce repayment.
        - Communities often have no experience managing credit funds and lack relevant skills, including the capability to keep detailed accounts of the financial transactions and prepare key performance ratios.
        - CDD projects often rely on communities to procure expertise locally. However, the skills needed to build the capacity to manage financial services are often not available locally.
    - An RLF that de-capitalizes has several negative effects. Resources meant for the group are siphoned off by the defaulters. Community members that have used the RLF to start or expand their small economic activities no longer have access to the financial resources that they need to support the on-going development of their businesses. In addition, the culture of non-repayment is reinforced, making the efforts of MFIs and banks to provide sustainable financial services more difficult.

2. **Given the difficulties involved in establishing well-performing RLFs, it may be better to help professionally-managed microfinance institutions (MFIs) or banks provide financial services to communities rather than trying to develop community capacity to manage an RLF.**
    - Professionally managed microfinance institutions (MFIs) and banks already have experience with the management of financial resources, so probably require less capacity building than community groups. It is also more cost-effective to build capacity within a small number of professional organizations with extensive outreach than a large number of small community groups.
    - Banks are likely to need different technical assistance than specialized MFIs. MFIs have developed products and delivery systems to provide financial services for the poor, whereas banks usually do not have this experience.
    - Banks or MFIs can reach communities through direct service provision or developing relationships with community organizations that have financial capabilities. Examples include village savings and credit associations, village banks, and self-help groups.
3. **If service delivery through a professionally managed MFI or bank is not possible, consider providing the community with non-credit assistance.**
    - Grants can be provided to communities for economic infrastructure, as well as for training and technical assistance in business development. In some cases, matching grants for family-owned-and-operated economic activities might be appropriate. See "Grants for Income Generation in Social Funds and CDD Projects". [create link]
    - Technical assistance can be provided to develop the capacity of village organizations to manage their own resources. These resources include savings, interest on loans made from member savings, membership and other fees. Once they have demonstrated success with management of their own funds, they could potentially be linked with banks or professionally-managed MFIs.
4. **If funds for a community-managed RLF are provided despite the considerable challenges, ensure that it is housed in a community organization that has the following features:**
    - <u>Member savings.</u> Community organizations that have a strong history of member savings are more likely to be successful than those who start with externally provided funds. Not only do they have financial experience; they also have members whose own money is at risk. Therefore, an RLF should not be provided until a savings history has been demonstrated.
    - <u>Real Ownership</u>. The community organization should have real owners: members who are committed to it and invested in its success through savings. A "community" comprising everyone in the village, or all members of a sub-group such as women, is generally not sufficient, as it is highly unlikely that everyone will have this commitment.
    - <u>Vision</u>. The community organization should be committed to a vision of sustainable microfinance for the poor and be willing to implement policies that support that vision, such as pricing loans at interest rates that enable them to fully cover their costs, and strict repayment enforcement.

- Legal Status, Governance and Management. If the organization is informal, it may be helpful to review the options for formalizing the legal status, as lack of a legal structure may be an impediment to the organization's on-going growth and development. Even if it remains informal, there should be rules (constitution, by-laws, etc.) that clearly state who may become a member, how the organization will be governed and how it will be managed. In some cases, such as SHGs in India, an informal structure has been adequate, even for bank refinancing of SHGs, due to Government's strong support for SHGs through priority sector lending policies.

5. **A key success factor is provision of training and technical assistance.**
    - The project should consider the nature and cost of the technical assistance program during the project design phase. This includes determining whether or not local firms are available that have the required skills. If not, the project needs to either provide TA directly or build the capacity of local service providers.
    - Conducting an institutional assessment of a sample of organizations that are being considered as project partners to determine their goals, capabilities, strengths and weaknesses will help the project team to develop appropriate eligibility criteria for inclusion in the program, as well as development of a relevant technical assistance and training program.
    - If local organizations that could responsibly house a financial services operation do not exist, implement a pilot phase to develop and test a model with villagers that builds on previous experience within the community.
    - Develop a TA program that combines external assistance as needed with informal lateral learning. Specialized training in RLF management, accounting and loan tracking is often needed, but can be accompanied by visits from a cadre of locally-based paraprofessionals trained by the project and exchange visits between villages.
    - Setting up, maintaining and controlling the quality of financial records is a significant challenge in most cases. Therefore, training materials, guidelines and forms for the accounting, loan tracking and monitoring system should be developed at an early stage so that there is adequate time to impart these skills.
6. **Establish a monitoring system that collects and analyzes information on a set of quantifiable performance indicators.**
    - A small set of indicators that is well understood by all stakeholders, including members, management, the Board of Directors and donors, is preferable to a larger set whose meaning is not clear.
    - Key performance indicators measure outreach (number of active clients), client poverty level and loan collection performance.[1]
7. **Consider supporting the creation of federations.**
    - Federations enable community organizations to obtain services that they have difficulty obtaining themselves, such as external audit and bank refinance.
    - Federations are also an excellent means for lateral learning.

[1] See Rosenberg, Core Performance Indicators for Microfinance, Attachment A, CGAP, 2004.

- Community organizations should create the federation themselves so that they have a strong sense of ownership.
- Pay attention to the federation's sustainability.

8. **Build linkages between community organizations and the formal financial sector.**
    - The project design should include a strategy for developing business relationships between community organizations and banks, either directly or through federations. This relationship may be initiated with the opening of a bank account, and then nurtured so that the bank gets to know its new customers, and villagers get to know the products and services offered by the bank.
    - Over time, it is possible that either the organization or some of its members will gain access to other services. Examples include refinancing of the community organization's loan fund or the referral to the bank of clients who have successfully managed loans from the community organization.

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