Microfinance Research in Conflict Environments: State of the Art and the Road Forward

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Abstract

This is a brief note summarizing the major lessons emerging from research to date on microfinance in armed conflict settings to identify areas for further examination to better understand and expand the frontier of microfinance in conflict areas.

Many lessons have emerged and have been disseminated, yet a disconnect remains between these lessons and current practices. In addition, several lessons pertain only to post-conflict settings with little relevance to fragile areas *amid* conflict and/or that are facing the possibility of a new conflict or the recurrence of a previous conflict.

There is a need to offer improved guidance on microfinance in conflict areas in order to better analyze various types of conflict settings. Using current guidance and the lessons learned as a foundation, further research could promote a more thorough understanding of the appropriateness of microfinance for conflict mitigation and management. In addition, further research on the following topics could help practitioners in starting, designing and implementing microfinance activities in various conflict settings:

- effects of sequencing and combining microfinance with other services
- types of institutions for implementation
- client targeting and market assessment
- provision of products other than micro loans
- product standardization and tailoring
- costs
- operational guidelines
- performance benchmarks

This brief note, based on a substantial literature review and field experiences, is a summary of the major lessons emerging from research to date on microfinance in conflict settings to identify areas for further examination to better understand and expand the frontier of microfinance in conflict situations.[1]

[1] In a companion Micronote entitled "Microfinance Amid Conflict: Stock taking of Available Literature", the literature consulted for the note is provided along with

Crucial Lessons from Post-Conflict Settings

Debates continue on defining the three types of conflict situations – pre-conflict, ongoing conflict, and post-conflict. The various types of conflict situations often overlap within a particular context and constantly evolve as conflicts erupt and subside. Generally, post-conflict refers to a situation when some form of peace agreement (not truce) is reached and armed conflict has relatively subsided in the majority of the areas. A post-conflict situation can be at its early stages when refugees and internally displaced persons (IDPs) have yet to return to their original homes, when violence still prevails in some areas, and when the government has yet to become functional. These early stages may later progress into a more settled stage for the majority of the population as the situation proceeds toward a greater degree of normality.

Microfinance in post-conflict areas is an emerging field, even though experiences date back to the 1970s. The first formal experiments with microfinance in Bangladesh were a response to restore income generating activities after the war and floods of 1972. While several microfinance programs started in post-conflict settings failed due in part to faulty designs, the experiments have continued. Microfinance is now advocated extensively and is used as a powerful developmental tool in conflict areas. While much less was known a decade ago, we are now endowed with a reasonable body of knowledge that can be used to advance the field. Critical lessons can be drawn from the experiences documented so far.

- *Microfinance works in post conflict environments.* Micro-credit is likely to reach the poor and un-banked in a sustainable and efficient way if, as in non-conflict environments, a demand-driven approach is followed.
- *Few environmental condi tions are required* for initiating microfinance in post-conflict settings. An early start is crucial to quickly transition from relief to development.
- *Microfinance best practices can and should be adopted* from the start of a given intervention to ensure sustainable outreach to the targeted clientele. This particularly applies to market pricing of financial services, rigorous and transparent credit appraisal, and strict loan collection efforts.
- *Standardized products used in normal conditions need to be adapted to suit the post-conflict situation.* This requires a clear understanding of the capabilities of microfinance and the realities of the post-conflict environment, such as damaged physical infrastructure, broken social ties and trust, and populations accustomed to quick relief, short-term gains and grants.
- *There are no shortcuts in designing appropriate products for conflict areas.* Insightful market research is more crucial in conflict settings relative to normal situations.
- *Group loans are effective, but individual loans also work in post-conflict settings.* Individual loans, however, involve higher risks and costs, and require close follow-up, guarantees, support of community leaders and the incentive of future loans to encourage repayment.
- *Security of staff and funds matter.* Damage to a society's structure and decreased rule of law can affect the physical safety of MFI staff and cash on hand. Thus, adequate physical security must be in place to safeguard staff and cash. Internal control, good management and transparency in operation are also essential for assuring the safety of capital.
- *Qualified staff is crucial for success.* Personnel, management and field staff with experience in microfinance should be hired from the start whenever possible. If experienced candidates are not available, training is required to help develop skills in designing and delivering microfinance products and in effec-

a brief highlights from the consulted studies.

tively managing and monitoring operations. Incentive may be required to motivate staff to remain focused on the target clientele and to ensure a high portfolio quality.

- *Initial start-up and operating costs are high in conflict environments.* The costs are especially high due to salary and security expenses. Relative to normal areas, loan losses may also be high in situations immediately following conflicts, at least in the short-run.
- *Sustainable operations are possible.* It is not uncommon, however, for MFIs initiated in early post-conflict settings to require a little more time to attain financial sustainability compared to similar MFIs in non-conflict situations or post-conflict areas in their late stages.
- *Microfinance is only one of the development tools* for rebuilding a war torn society and should be used with care. To facilitate the development of a post-conflict society, non-financial services may be required to precede and/or support financial services provided through innovative and competent institutions. Indeed, there are situations in which it may be more appropriate to use grants rather than microfinance.
- *Say "No" to subsidized financial services and a loose repayment culture.* Governments and donors should avoid pushing MFIs to directly subsidize the clients through cheap financial services. This can potentially undermine the microfinance sector for a long period of time. Also, MFIs must be strict on loan collections from the beginning and must clearly educate their clients on the differences between grants and loans.

A Disconnect Between Emerging Lessons and Current Practice

Lessons from microfinance in post-conflict situations are now being actively disseminated, and consensus has been reached on some issues, such as the role of microfinance in reconstruction. The lessons have helped develop guidelines to facilitate design and implementation of microfinance programs in conflict environments. However, in several field level operations, disconnect exists between lessons and actual practices. This is especially evident in relation to the use of microfinance best practices on product pricing and portfolio quality.

Many microfinance providers claim that the above lessons and guidance are derived primarily from microfinance experiences in later-stage post-conflict environments—situations in which conflicts have transitioned into relatively peaceful times. Therefore, they find them less useful for areas currently in conflict and countries just emerging from conflicts or facing the possibility of recurrence. Several practitioners point out that the guidance thus far, has been too general and theoretical to help them with specific and practical activities, such as the actual design and implementation of microfinance interventions in a particular conflict situation. Some practitioners note that the presence of many non-financial service providers offering some form of supplementary financial services can distort the market, rendering the use of guidelines difficult.

Research to date has advanced our thinking on microfinance in post-conflict areas, but gaps remain. Further research is necessary to improve our understanding of the role of microfinance amid conflict, and practical tools are needed to help us apply them.

Need for improved guidance on microfinance in conflict areas. The present guidelines generally consider a linear or circular transition from war to peace with intermediate phases, such as peace settlement, and various post-conflict stages. The guidance is widely used to recommend relief, reconstruction and development initiatives. However, it is limited in its ability to advise on programmatic interventions (such as microfinance) in places where conflict situations overlap and/or recur, and where relief and development activities may merit simultaneous interventions. More rigorous analytical tools are needed to examine the role of microfinance under various conflict scenarios in order to systematically document relevant field evidence. These analytical tools need to adequately incorporate the following:

Environmental context analysis. Clustering of conflicts by social, political, religious and economic contexts may help distinguish each conflict environment..

Characteristics of conflict situations. There is a need for more precise understanding of the characteristics of different types of conflict situations, such as emerging and ongoing conflict, post-conflict, urban and armed conflict and "normal" state.

Impacts of poverty and impacts of conflict. Many conflict-affected countries are afflicted with high levels of poverty before, during and immediately after conflicts. Indeed, poverty often worsens in a country with the additional presence of conflict. Hence, there is a need to distinguish the impacts of conflict on a country's overall poverty level from the specific impacts of conflict on a country's microenterprise markets.

Cultural sensitivities. Microfinance programs that target specific client populations must carefully analyze the country context to understand the implications of targeting strategies and to ensure that market distortions are not unintentionally created.

Microfinance is not a panacea. While microfinance can be an effective economic development tool, helping to improve enterprises, increase employment and reduce poverty, it cannot solve all problems. Microfinance may be less effective when the conflict involves non-economic issues, such as tensions between religious factions.

By grouping emerging lessons into various prototypes, they could reveal patterns that would greatly improve the current understanding of how to adapt microfinance interventions in conflict-affected environments. This may require in-depth studies of carefully selected institutions and situations based on distinct criteria, such as demographics and causes of conflict.

Need for clear understanding of links between various types of crises. War-related conflicts often accompany one or more of other systemic risks such as natural disasters and HIV/AIDS. Lessons from managing and mitigating other systemic risks are seldom incorporated into project designs for conflict environments. Furthermore, analysis of systems and organizations that survived through these systemic crises could reveal successful design characteristics for recurrent armed conflict situations.

Need for information on alternative financial systems. Less is known on the informal arrangements than the formal approaches to microfinance amid and in post-conflict situations. Informal and indigenous systems may offer valuable insights for developing effective design and implementation mechanisms that suit local conditions. For example, information is scarce on informal arrangements, such as pawning, money-lending, remittances and safe keeping services, provided in refugee camps and in areas where returnees and refugees are settling down. A study on the hawala system - an informal money transfer system - in Afghanistan during the Taliban regime offered important lessons for developing efficient microfinance operations through strategic alliances. In addition, the role of Rotating Savings and Credit Associations (RoSCAs), traders, and linkages could be examined more carefully, especially during conflicts.

Areas for Further Research

There is clearly a need for further examination to help practitioners make informed decisions on applying microfinance in various conflict situations. By using a good analysis framework, further research could be very useful in the following areas:

Appropriateness of microfinance. This research will help identify situations where microfinance needs to be withheld or introduced with caution. There is a need to go beyond the preconditions identified by Doyle (1998) – reasonable security, emergence of markets and return of displaced populations - for initiating microfinance in the midst of conflict. These conditions apply well in post-conflict areas for offering micro-credit services through Microfinance *Institutions* to a fairly settled population. But demand for micro-credit and other microfinance services exists amid conflict from war-affected populations, such as refugees and IDPs. Microfinance *programs* may be better than institutions for catering to the demand from mobile populations. Such programs have to be studied for lessons on design and implementation issues regarding appropriate products for selected clients and their ability to be efficient and sustainable in reaching their clientele.

Sequencing of microfinance and other services. Regardless of the conflict situation, it is now clearly understood that microfinance can work only when it is demand driven. However, reduced market opportunities, risk aversion and easy access to grants can reduce or even choke demand during conflicts. Practitioners indicate that there may be instances where demand for microfinance needs to be created to jumpstart the economy. To accelerate market access, some initial investment in developing complementary services, such as business development services (BDS) and health systems, may be required. The jury is still out on whether it is best to offer complementary services such as BDS before, during or after microfinance implementation. There needs to be more exploration in this area as well as research on the potential for strategic alliances and linkages between Microfinance Institutions and other service providers.

Institutional choices. Early on, the nonprofit non-governmental organization (NGO) was the primary institutional structure used to provide microfinance in conflict situations. Recently, however, a variety of grassroots institutions, including credit unions (e.g. Rwanda) and cooperatives (e.g. Nepal) as well as formal financial institutions (e.g. downscaling banks in the Balkans and specialized microfinance banks in Southeast Europe, Southern Africa) have performed well in conflict situations. Their products and implementation mechanisms seem to suit several war-affected populations in certain conflict situations. The choices have created competition to the benefit of clients, as seen in Uganda, Bosnia-Herzegovina and Georgia. Several post-conflict countries have spawned an array of institutional types; however, countries amid conflict are often limited in their choices of institutional types. Hybrid structures should be explored to maximize the results of each institutional type.

Targeting through specialization. There are studies that warn against targeting special populations, such as IDPs and demobilized soldiers, due to the possibility of isolating them, which can lead to further tensions. Targeting war-affected populations can, however, generate positive results by focusing on certain demographic groups, such as women and youth. There is a clear need to understand how to integrate youth and women into microfinance initiatives amid conflict. Reaching youth is especially important given their role in conflict reduction and in reconstruction. Products and implementation mechanisms will differ by target populations as they should be designed based on the specific demands of the target markets.

Assessing demand. The need for demand driven microfinance is accepted by most stakeholders involved in conflict areas. However, there is confusion regarding methods to assess demand in various types of conflict settings. Too often microfinance programs are designed strictly in response to client needs when, for example, pricing is better left to cost accountants taking demand analysis into account. In addition, available market assessment tools are generally tailored to suit post-conflict areas. As a result, they are inadequate to guide market research in areas amid conflicts. Applying existing tools in such areas can be frustrating and ineffective for designing products.

Need for information on microfinance other than credit in conflict settings. General guidelines exist for when to offer microfinance in post-conflict areas, but the literature has provided little practical advice for the development and supply of microfinance products outside traditional micro-credit, such as savings, money transfers and insurance products.

Standardized vs. tailored products. In general, standardized products using group guarantees seem to be efficient, but clients have indicated a preference for products designed to suit their individual needs. Often times, however, catering to demand must be balanced by efficiency and profitability targets. There is a need to carefully assess long-term costs and benefits of standardized products especially for deposit products. Standardized savings products can be cost effective but may limit accrual and accessibility features. This renders savings products less useful in cash flow management and risk mitigation/management, which is crucial in conflict settings.

Cost of services. There has been a huge disparity in the pricing of microfinance products among various types of institutions operating in diverse conflict settings. Clearly, microfinance programs absorb some of the risks of working in conflict affected areas, otherwise loan pricing would be unaffordable to most clients. However, some justify cost-covering interest rates from the start, while others advocate for a gradual increase in interest as the market expands. In general, there has been ambiguity regarding cost-covering strategies. Some established loan product pricing methodologies are not very useful in conflict settings, largely because of the added risks inherent to working in a conflict context. Furthermore, Islamic values and ideals on interest rates and borrowing are seldom incorporated to suit the societies served.

Guidelines for assessing whether microfinance providers are capable of working in conflict affected areas. Donors need an efficient way to identify and link up with those microfinance providers who are experienced working in conflict-affected areas so they can channel funds effectively. There now exist guidelines specifically developed for conflict situations to facilitate needs assessments and program designs using best practices. But, detailed guidance for identification and evaluation of appropriate partners to implement microfinance programs in conflict situations is lacking. While donor guidelines were developed in 1995 by a consortium of donors for the selection of implementing partners, they are not particularly useful for conflict situations. Clear guidelines are required to help donors locate good institutions capable of implementing microfinance in conflict-affected areas. These donor guidelines would need to consider a range of contexts in order to be widely applicable.

A number of issues merit further research, such as the effects of subsidies for capacity building, the role of apex and lead institutions, and the use of informal/semi-formal credit tracking systems and service provider networks to improve the effective delivery of microfinance services in conflict areas.

Research can only answer outstanding questions if it is drawn from on-the-ground experiences and based on practical realities. This calls for operations research partnered with practitioners and researchers, who can learn from one another to expand the available knowledge.

Resources

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