



WORLD BANK

A regular series of notes highlighting recent lessons emerging from the operational and analytical program of the World Bank's Latin America and Caribbean Region.

## Microfinance and Disasters Preparing for the Worst

Mike Goldberg and Sunita Varada

This note discusses natural disaster preparation and how MFIs and their staffs can respond. It is part of a series that summarizes a distance learning series with South American microfinance networks and government officials. Preparation for disaster includes understanding the risks and costs of disasters, establishing proactive approaches and concrete responses, and knowing the resources and partnerships that may prove helpful in an emergency.

### Unfortunately a common story...

Imagine the manager of a microfinance institution (MFI) arriving at the main office and finding windows smashed, the furniture, computers and files destroyed and the security system off-line. Even worse, most of the MFI's staff fail to report to work, and the police condemn the office building as structurally unsafe. Is the manager prepared for such a situation? Will the MFI be able to continue offering its vital services? If it is like most such institutions around the world, it is completely unprepared for the destruction the manager finds—and the price to be paid will be extraordinarily high, both by the MFI and its clients.



This chaotic scene has been repeated around the world in recent years—after earthquakes in El Salvador and Peru, hurricanes in Nicaragua and Guatemala, floods in Poland and Bangladesh, and the tsunami in South and Southeast Asia. However, as MFIs in Poland and Bangladesh have proven, MFIs can be important partners in preparation for disaster and post-disaster recovery efforts—thanks to their systems, products and relationships with low income community leaders and microbusinesses.

### The Risks and Costs of Disasters

Disasters can affect a microfinance institution in human, physical and financial ways. The upheaval can affect staff and consultants, borrowers and savers, donors and governments that provide financial support, and basic service providers (such as transportation and electricity). The costs can be extraordinarily high. Damages from Hurricane Mitch in Nicaragua in 1998 amounted to about 45 percent of the national GDP. After the short term destruction, the effects linger, as tens of thousands are dislocated and in need of new short term or long term housing loans and income-generating opportunities and productive assets.

**Costs** - In addition to the human costs, MFIs also suffer immediate financial shocks. They include liquidity ef-

fects, repayment issues, and changes in the priorities of commercial and other funders. Liquidity effects begin with the risk that the commercial banks holding the MFI's checking and savings accounts may suffer physical damage to facilities, or may be overwhelmed by liquidity requirements. Borrowers may contribute to the MFI's liquidity problems by failing to pay on time. Since microbusiness operators rarely have insurance coverage for income, assets and health care needs, they may turn to the MFI for new loans or to reschedule or refinance existing loans. This puts pressure on the MFI's ability to maintain adequate liquidity reserves. Also, repayment issues arise after a disaster. Donors may change priorities, leaving MFIs without sources of funds.

## Proactive Approaches and Concrete Responses

The opportunities and challenges for the MFI will change as the disaster cycle moves from relief to rehabilitation and long term recovery, especially in (i) pre-disaster planning and (ii) restoration of sustainable livelihoods.

**Pre-disaster Planning.** Before disaster strikes, the MFI's management should develop a contingency plan. Given the losses that could result from the lack of preparation, the MFI Board may also wish to review the plan and provide input. The MFI's contingency plan should deal with communications between branches and headquarters staff, clarifying the changes in internal policies and backup communications systems to be used in the aftermath of a disaster. Critical information should be protected—with electronic backups of records maintained on a regular basis in a secure location outside the MFI's offices—if the MFI Board considers this to be prudent.

Communication with clients is also important, so that there are clear expectations of what support may be available in the aftermath of a disaster. The MFI can ensure adequate pre-disaster communication by discussing disaster policies and practices at orientation of new clients, and reviewing the policies when clients apply for subsequent loans. If management decides that lending and collection policies are going to be more

flexible in the event of a disaster, staff should be provided a special brief operating manual. This will ensure that all clients receive the same information about what assistance and adjustments are available.

## Contingency Funds

The direct response to liquidity problems is a dedicated contingency fund. Periodically, based on a strategic target, the MFIs in disaster-prone areas should add to a special disaster recovery reserve fund. This earmarked fund can be used for disaster relief in the form of short term loans to clients, or as a recovery fund for the MFI (to repair or replace key equipment and infrastructure). Contingency funds can be an advantageous solution for the clients, the MFI, the Government and the donors:

- Clients can re-establish income streams quickly, getting funds for medicines, food and temporary housing costs.
- The MFI can reduce the risks of delinquent clients and loan loss reserves can be reduced.
- The government can focus on the logistics of rescue, emergency housing, and relocation.
- Donors often contribute to the initial capitalization of such funds, since experience shows that administrative costs are lower and response time decreases when contingency funds are in place.



There are three types of contingency funds. The first is assigned to a single MFI, usually a large one with many years of experience, efficient administrative systems, and nationwide coverage. The second is operated by a special administrative unit. The third is a contingency fund that is shared by various MFIs: each one responsible for regional coverage or specific communities.

Are disaster contingency funds appropriate for all MFIs? The most successful funds have been established in disaster-prone areas, such as South Asia (with annual flooding caused by monsoons). Larger MFIs are also more likely to benefit from disaster contingency funds, since they are in a better position to contribute the necessary reserves. There is a debate in the literature about whether such funds should be sustainable, once they are established with reserves. If the MFI can link to an existing contingency fund, then such reserves can be maintained at a minimum. (For information on

the Bank's Catastrophe Risk Deferred Drawdown Option (CAT DDO), see the Bank's website.)

**Restoration of Livelihoods.** The MFI should have policies in place concerning the types of loans to be provided on a temporary basis— consumer loans, housing repair loans, and working capital loans. Extended grace periods can help microbusinesses get back on their feet more quickly. The MFI may use previous loan repayment performance as one of the ways to prioritize which business operators receive the special business recovery loans. Communities may be asked to back a recovery loan with a character reference.

Branch offices should be trained in how to respond to requests for emergency loans by clients and others in affected areas. Management should establish specific lending limits for clients, new selection criteria, and possibly adjustments to collateral and other normal requirements. Whatever the decision, management should provide the disaster relief guidelines in internal written communications, in case branch office staff members are unable to get in touch with the headquarters office. When branch managers know what levels of lending authority and special loan conditions apply, they are better prepared to act independently to respond to clients' needs during an emergency. BRAC provides a good example of the kinds of quick adjustments that can be made to help clients (Box 1).

The 1997 floods in Poland provide an innovative example of disaster management by an MFI. Floods severely affected 1,400 small towns, destroying 50,000 homes, forcing the relocation of 160,000 people, and causing damage worth US\$4 billion. Given its national coverage, the MFI Fundusz Mikro was asked to manage a special disaster recovery fund. Fundusz Mikro opened a special lending window within its branches, developing a new brand for the emergency situation. This loan product had a different contract format and lending terms (24 month loan term, 10 percent near-commercial interest rate, and a six month grace period). A special window was established for processing loan applications.

Existing and new clients formed solidarity groups of five members, evaluated the damage and submitted loan applications. The solidarity group was responsible for assigning priorities to members with urgent needs. Fundusz Mikro disbursed the loan, monitored business performance, and collected the payment. Loan recovery was as-

### Box 1: Loan Product Adjustments for Disasters: The Bangladesh Rural Advancement Committee (BRAC)

Given the monsoon season, and the country's huge delta basin, floods are a regular threat to the productive assets of Bangladesh's micro businesses. In response, several MFIs have come up with financial products that address this risk. Specific adjustments in loan policies and credit characteristics include:

- Clients can withdraw savings up to a specific pre-established amount.
- Regular loan repayments can be suspended for a period.
- Interest rates can be reduced significantly for up to two months.
- Loans can be restructured for clients with marginal disaster losses (based on field visits).
- Loans can be refinanced for clients with high disaster losses (based on field visits).
- New loans for productive asset replacement of up to 12 months, at 15 percent interest.
- Option of disbursement in the form of seeds, animals, and other in-kind materials.

Source: Pantoja, World Bank, 2008

sisted by local municipalities. Since this was a one-time contingency fund approach, there was no capitalization of the fund.

By the end of the six-month emergency period, Fundusz Mikro had not only responded to the unique set of circumstances, it had identified a significant number of new clients for a long term commercial relationship. By setting a time limit on the emergency loan product, Fundusz Mikro maintained credit discipline, while building a reputation as a socially responsible MFI. With on-time repayment of 93 percent, Fundusz Mikro was able to demonstrate that, even under difficult conditions, its client selection methodology was sound.

As the Polish and Bangladeshi examples illustrate, MFIs can adjust or launch products to address specific disaster-related impacts. These new products can build client loyalty and minimize the response time to client requests. Such products include emergency loans, housing loans, cereal banks, remittance services, and subsistence loans (see Table 1).



**Table 1: New Products with implications for Disaster Response Time and Effectiveness**

<i>Financial Product</i>	<i>Results</i>	<i>Implications</i>
<i>Emergency loans</i>	Increased client loyalty.	Effective only during relief stages; partial safety net for existing clients.
<i>Housing loans</i>	Moderate repayment. Timely loans based on demand and flexible terms Only for housing repair	Effective only when issued quickly and based on demand.
<i>Cereal banks</i>	Used for smoothing consumption during droughts;	Effective only during relief stage for mild droughts
<i>Remittance Services</i>	Eases cash-flow problems of clients Increases client loyalty	Required immediately after disaster and based on demand

Source: Adapted from Nagarajan, 1998.

**Restoring Livelihoods: An Example from Nicaragua**

A recent Bank project in Nicaragua shows how a disaster response can build more sustainable livelihoods. In September 2007, Hurricane Felix hit the North Atlantic Autonomous Region (RAAN) of Nicaragua. About 200,000 people were directly affected by the disaster, and there was extensive damage to infrastructure and important productive sectors (agriculture and fisheries).

The Government and the Bank launched an Emergency Recovery Project, including work to restore the livelihoods of small-scale fishermen and women. This sector already suffered from low productivity, basic technology, and poor infrastructure. The region was also characterized by poor access to finance, due to the region’s high-risk climate and unattractive borrower characteristics (small loans, limited available collateral).

The government’s Rural Credit Fund (FCR) will administer the loans to groups of fishermen. The loans will be

in-kind, in the form of boats and some working capital. Since most borrowers do not have sufficient guarantees, the boats will also serve as a form of loan collateral. The project capitalizes a revolving fund and the interest rate policy is structured to maintain long term fund sustainability while still helping the fishermen during the emergency phase. A six-month grace period is followed by a phase where they will charge 5 percent interest and thereafter, the interest rate will be adjusted to account for inflation and all administrative and supervision costs.

**Conclusion**

MFIs have a unique combination of skills, networks, and client bases that make them valuable partners during a disaster. By coordinating with other MFIs, government agencies, municipal authorities and donors, the MFI is in the best position to be a strong partner in local and even national responses. With plans in place for the most likely human, physical and financial shocks in the aftermath of a hurricane, earthquake or flood, the MFI can serve the immediate needs of its clients. Some effective responses to disasters have included new types of loan products, adjustments to conditions for outstanding loans, and changes in delivery methodologies (such as allowing groups to set lending priorities among members). Whatever the response, MFIs should learn from the painful lessons of the past—because the benefits of preparing for the next disaster far outweigh the costs.

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**About the Authors**

Mike Goldberg is a Senior Private Sector Specialist and Sunita Varada is a Consultant, both with the Poverty Reduction and Economic Management Department of the Latin America and the Caribbean Region of the World Bank.