Decentralization of Microfinance Institutions

A Guide for Decision Making

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The SEEP NETWORK

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Preface

The Practitioner Learning Program (PLP) is a SEEP Network initiative that explores key challenges facing the microenterprise field. The SEEP PLP, a competitively run grants program, engages participants in a collaborative learning process to share and document findings and lessons learned, as well as to identify effective, replicable microenterprise practices and innovations to benefit the industry as a whole. The SEEP PLP is funded by the office of Microenterprise Development of the United States Agency for International Development (USAID). For more information on this and other SEEP PLP initiatives, see The SEEP Network website: www.seepnetwork.org.

The SEEP PLP in "Improving Efficiency—Maximizing Human and Physical Resources" was conducted from 2004 through 2006 and examined strategies, tools, and technologies that microfinance institutions (MFIs) use to maximize human and physical resources. There was a particular focus on low-technology solutions to increase staff productivity, decrease personnel or administrative costs, and increase outreach and client retention.

The "Improving Efficiency" PLP has produced a series of ten Learning Products—as well as an overview outlining the PLP process and its results—to share with the microfinance and microenterprise field that are explained in more detail below. All of these publications are available on-line at http://www.seepnetwork.org/.

Most of the participating institutions began with a rigorous analysis of their core processes, including credit delivery, accounting, and management information systems. Process mapping proved a crucial tool in shedding light on organizational bottlenecks and inefficiencies. Three Learning Products produced from this PLP are devoted to process mapping: case studies of Pro Mujer Nicaragua and of MI BOSPO, which used the tool to make significant changes to their core operations, and a technical note that compiles interviews with MFI managers who used process mapping in their efforts to boost efficiency.

Based on their institutional assessments, most of the MFIs identified a similar set of interrelated issues they need to address in order for them to become more efficient. Decentralization emerged as an overriding theme, especially the exploration of what kinds of institutional structures and systems would support a shift in decision-making authority for credit operations to branch offices. "Decentralization of Microfinance Institutions: A Guide for Decision Making" addresses these issues in depth.

Closely related to the topic of decentralization was the need to train branch managers. Many of the participating MFIs' branch managers had been senior loan officers and did not have many of the skills and perspectives needed to manage staff and operations. Two of our Learning Products are comprehensive training programs that address areas that were identified as key for branch management training: human resource management and financial management. The training manual on human resource management was developed by the PLP in conjunction with MEDA and is entitled "Branch Management Training for MFIs: Developing Staff Management Skills." The financial management training manual is "Principles and Practices of Financial Management." Based on an identified need for training materials in other topics, several of our other Learning Products have accompanying PowerPoint presentations that summarize key information in a format conducive to training.

Several other topics related to enhancing efficiency emerged during the course of this PLP. One topic was the importance of cultivating client loyalty. Loyal clients provide repeat business, contributing to both lower expenses and higher income. The second technical note, "Building Client Loyalty," explores this issue in detail. Another recurring issue was staff incentives and the dangers of implementing a system before it is thoroughly analyzed. The third technical note, "Pitfalls and Unintended Outcomes: Advice on Designing and Implementing Staff Incentive Systems," explores these issues. Another valuable tool that emerged from this PLP was a framework for mapping key operational tasks and areas of responsibility. This is explored in the fourth technical note, "Division of Responsibilities Framework: A Tool to Strengthen Operations Management of Microfinance Institutions."

PLP colleagues from India faced an inverse set of challenges to those posed to most of the other participating institutions—how to capture information from an extremely decentralized network of savers and borrowers in self-help groups and centralize it in order to create accurate, timely, consolidated financial reports. The solution they developed and implemented is explained in the learning paper, "Promoting Quality Bookkeeping in Self-Help Groups: The Mahakalasm Management Information System."

The ten Learning Products reflect both the range of institutions and issues explored during this PLP and the consensus that emerged regarding what is needed to efficiently utilize human and physical resources while remaining responsive to client needs. The participating institutions found the PLP to be a rich learning experience and we hope the lessons learned that are distilled in this series of Learning Products prove to be of value to the field as a whole.

- Tony Sheldon, PLP facilitator and Learning Products editor

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Introduction

Are you losing clients because of unnecessary delays in loan approval and disbursement? Are you unable to expand to new regions because you lack the capacity to operate over long distances? Is your back office feeling overwhelmed and exhausted? If your institution is facing these types of challenges, this guide can help.

As the microfinance industry continues to grow in size and complexity, microfinance institutions (MFIs) are facing the challenge of maintaining high-quality services while expanding to new regions and markets. Pressure from growing competition is forcing managers to look closely at costs and determine the most efficient means of serving an expanding and diversified client base. Decentralization can be a viable solution for enhancing efficiency and building institutional capacity to manage growth and diversification.

While decentralization can be a good solution for many of these challenges, several factors must be considered. MFIs perform many functions and processes; some may be more effective if decentralized, others may not. Effective decentralization of operational processes requires careful analysis of internal controls, risks, and benefits. Any effort to decentralize core operations involves changing the levels of delegation and decision making, which requires commitment and support from senior management and line managers.

Purpose of the Guide

The purpose of this guide is to help managers—from CEOs to regional managers to branch managers—think through the many factors involved in deciding whether, how, and to what degree to decentralize certain processes and decisions. While prudential norms and bank regulations may frame what is possible in this area for regulated institutions, this document should nonetheless be valuable to managers of regulated and unregulated financial institutions alike.

The guide is designed to enable managers to adapt the lessons presented here to their particular institutional contexts. It can also be used to communicate the rationale for decentralization to other staff. It attempts to summarize the most important areas of consideration with the intention of prompting a useful institutional introspection. The guide also provides references to specific analytical tools and techniques. Finally, to help the reader better appreciate the processes and decisions involved in decentralization, the guide provides practical examples from PLP participants. These examples demonstrate that there is no one formula for decentralization—decisions must be based on each organization's unique situation and context.

The guide covers five interrelated topics:

1. "What Do We Mean by 'Decentralization'?" defines key concepts and terms.
2. "Overview of Benefits and Risks of Decentralization" covers advantages, risk mitigation strategies and potential barriers to decentralization.
3. "Organizational Design, Governance, and Management" is an extended exploration of the organizational evolution of a model MFI.
4. "Business Processes Affected by Decentralization" identifies the core operational and back-office functions that can be productively decentralized.
5. And finally, the "Role of Internal Controls" examines the central importance of controls to a successful decentralization strategy.

We hope this guide will assist growing MFIs in their decision making about and their implementation of successful decentralization strategies that enable them to serve their clients in increasingly efficient and productive ways.

I. What Do We Mean by "Decentralization"?

Decentralization and Organizational Design

Decentralization, which can be described as increasing the level of decision-making autonomy at lower levels of an organization, is most often a response both to greater complexity within an organization and to market demand. As an institution grows and expands geographically, it is often important to consider decentralizing. Increasing numbers of clients in a given region, for example, is a common reason for opening a decentralized branch office there. Increasing operational decentralization can promote greater efficiency and enhance an institution's responsiveness to clients, while allowing senior management to spend more time on strategic issues.

Decentralization is a relative concept, not an "either/or" proposition: key decisions need to be taken concerning the degree of control and autonomy at each level of the institution (e.g., at the central, regional, and branch levels). There is no one organizational design that works best for every organization. Organizational design considers factors such as reporting relationships, allocation of tasks, and levels of authority within and among departments. Few management decisions have more far-reaching impacts than those related to organizational design (a topic explored in some detail in Section III).

An optimal organizational design achieves many things. It clarifies relationships and ensures efficient work and information flows. It minimizes duplication of effort, ensures neither over-control nor under-control of activities, and most importantly helps focus concerted attention on one of an organization's most important goals: customer satisfaction.

It is important to determine which aspects of an organization are better decentralized and which should remain centralized. These decisions should reflect the specific realities and context of each individual organization.

The appropriate time for an MFI to begin decentralizing will depend on its methodology, stage of development, context, etc., as well as on its ability to overcome the obstacles or limitations described below. The process should begin when the organization has sufficient managerial and administrative capacity and has addressed any weaknesses in its internal control system. When these problems are resolved and the organization's goals and objectives for growth are clear, it can launch an orderly decentralization process that has a far greater likelihood of success.

Table 1 describes some of the factors that affect whether and when an MFI should decentralize.

Table 1. Factors that influence the decision to decentralize

Methodology	Institutions that specialize in group lending may be able to decentralize earlier than those that specialize in individual lending because loan evaluation and approval are already significantly decentralized (e.g., groups make their own loan decisions).
Staff capacity at various levels	An MFI must determine whether staff is adequately prepared to assume greater responsibility, or whether it must train staff prior to decentralization. Decentralization often requires a greater investment in and management of human resources.
Internal controls	It can be dangerous to decentralize prior to establishing sufficient internal controls. An institution must ensure that strong internal controls are in place and can be adapted to the decentralization of decision-making authority.
Clients' geographical location/client density	Institutions working in more remote, sparsely populated areas should consider decentralizing earlier than those working in more densely populated areas. Institutions aiming for national coverage in a geographically large country may also see the need to decentralize earlier than those in smaller countries, where distances are more easily traveled.
Existing institutional policies	An institution must determine whether its existing policies (e.g., on credit procedures and accounting systems) are suitable for delegating greater authority to the field, or whether new policies need to be developed in order to manage increasingly decentralized operations.

Box 1. To decentralize or not to decentralize: That is the question

In general, some functions are appropriate to decentralize, others are best left centralized, and still others might reflect a combination of approaches. This guide's recommendations are as follows:

Front Office/ Operations: **Decentralized**
Administration: **Combination**
Finance: **Centralized**
Accounting/ Treasury: **Centralized**
Internal Audit: **Centralized**

Key Concepts

Decentralization has its own terminology, hence a glossary of key terms is important for understanding this guide.

Organizational design: The formal configuration among individuals and groups within an organization with respect to the allocation of activities, tasks, responsibilities, reporting relationships, and authority. Organizational design is communicated through organizational charts, job descriptions, policies and procedures manuals. Decentralization is a decision that directly affects organizational design.

Decentralization: An organizational design in which senior management shares decision-making authority and responsibility with middle-level managers and lower-level employees, or delegates this authority and responsibility to them. Decentralization is a matter of degree and relates most often to authority and responsibility for specific operational and administrative processes, often at the branch or sub-branch level. An organization is decentralized to the degree that its major operational processes are decentralized and decision-making for key processes is delegated. For example, a more decentralized approach to loan approvals is to delegate these decisions directly to the loan officer, rather than to a credit committee or branch manager.

Centralization: An organizational design in which senior management retains decision-making authority for most major operational processes. Similar to the concept of decentralization, centralization is a matter of the relative degree of autonomy and control. An organization is centralized to the degree that its major processes and associated decision-making authority are centralized, that is, the degree to which processes are not delegated.

Authority: The formally granted influence of a position to make decisions, pursue goals, and obtain resources to pursue those goals. Authority is recognized through job titles, job descriptions, policies and procedures manuals, as well as the willingness of subordinates to accept and follow the direction of supervisors. The distribution of authority at various levels of an organization is a key component of a decentralized organizational design.

Responsibility: The duty to carry out an assignment or conduct a certain activity and be accountable for the outcome. Responsibility is assigned to individuals by supervisors through written and verbal instructions. The distribution of responsibilities is a key component of a decentralized organizational design.

Delegation: The process of assigning a task to a subordinate or unit, along with the commensurate responsibility and authority to carry it out. Delegation of tasks is a process that leads to greater decentralization.

Span of control: The range or number of employees who report to a managerial position. Wider spans of control can reduce administrative expenses and increase self-management. Narrower spans of control can improve monitoring capabilities and compliance. Decentralized organizations may operate with either wide or narrow spans of control.

Chain of command: The lines of authority within an organization, that is, who formally reports to and receives direction from whom. Organizational charts are the most common means of communicating chain-of-command relationships in organizations, with vertical lines representing direct reporting relationships and horizontal and dashed lines representing coordinating, or lateral, relationships. Increased decentralization may dramatically impact chain-of-command relationships.

Empowerment: A sense of power, ownership, and control. Within an organization, empowerment extends beyond formal definitions of authority. It is fostered through participatory management processes and is the direct result of institutional culture and training. A strong sense of empowerment among lower-level managers within decentralized organizations is critical.

II. Overview of the Benefits and Risks of Decentralization

Decentralization Is a Matter of Degree

For microfinance institutions, the issue of decentralization hinges on striking a healthy balance between appropriate levels of authority on the one hand, and efficient levels of autonomy on the other. Just as extreme degrees of centralization can impede the performance of an institution, excessive degrees of decentralization can create inefficiencies or present serious risks, especially when proper controls are not in place. Decentralization will always have risks and costs as well as benefits. The goal of careful analysis and planning of decentralization is to ensure that the benefits far outweigh the costs. These processes also ensure that risks are carefully assessed and mitigated.

In addition to the benefits and risks summarized in the table that follows, an institution will also want to consider and factor into its analysis the financial cost of decentralization, including any costs necessary to mitigate potential risks, create additional offices, hire additional management staff and implement trainings.

Some of the costs of risk mitigation have to do with improving or expanding internal controls, changing the management information system (MIS), adjusting the internal audit system, and establishing buy-in both among board members and front-line staff (especially loan officers). These factors also need to be considered when conducting a comparison of the potential costs and risks associated with decentralization and those associated with remaining centralized.

Box 2. Getting buy-in for decentralization among board members at Pro Mujer Bolivia

In order to improve efficiency and profitability, Pro Mujer Bolivia (PMB) determined that it needed to decentralize certain operational processes. When it proposed decentralization to its board of directors, however, board members were very skeptical, voicing concerns about loss of control if greater decision-making authority was delegated to the branch level.

PMB was able to mitigate this threat by carrying out a thorough process mapping exercise that created process maps of all operations, thereby ensuring that adequate controls were in place prior to decentralization. The internal audit department regularly monitors compliance with these controls and reports directly to the board.

Pro Mujer Bolivia also undergoes regular external audits and ratings evaluations to ensure the highest level of transparency. The board of directors is now convinced that PMB is carefully managing the risks associated with decentralization. It also recognizes the improvements in efficiency that have resulted from these changes.

Tables 2A and B provide a list of the general benefits and risks of decentralization, as well as suggestions for risk mitigation. While many risks can be controlled for, it is important to keep in mind that not all the risks of decentralization can be eliminated.

Table 2A. General benefits of decentralization

Benefits	Description
Enhances an organization's ability to adapt to changing circumstances	Organizations are more able to adapt to changing circumstances principally due to the capacity for faster decision making and (when it occurs) lateral sharing of decision-making authority across departments.
Easier to tailor product innovation to local demand	Branch offices with greater decision-making power can make adjustments or create product innovations more quickly because they have immediate access to local market information and feedback from field staff and clients.
Healthy branch competition produces better performance	By functioning more independently, branches begin to compete with each other, thus encouraging consistently superior performance.
Allows branches to be run as separate cost centers	Separating branches into cost centers allows for better analysis of branch performance.
Shortens cycle times of operational processes	For processes limited to one or a few departments, the number of individuals involved in implementation and oversight is limited. As a result, tasks may be completed in a shorter time frame, which can lead to better customer service.
Increases middle managers' stake in implementing decisions	Transparency and broad participation in decision-making processes are enhanced in decentralized institutions; middle managers who are empowered to participate in decisions will implement those decisions more enthusiastically.
Encourages staff initiative	Staff at various levels are empowered with the responsibility and authority to make decisions. After seeing the results, they may be encouraged to take more initiative.
Improves decision making	Individuals with the authority to make decisions are often closer to the problem, have a more intimate understanding of the circumstances, and are empowered to make changes when necessary.
Enhances staff skills	Increased authority generally improves staff skills, although this outcome may require an investment in training or the hiring of more skilled staff.
Senior management can dedicate more time to strategic concerns	By delegating routine administrative and operational tasks, and/or direct supervision of operational personnel, senior management can dedicate more time to long-term planning and strategy, resulting in better overall direction for an organization.
Increases teamwork	Business units organized around relatively small groups of individuals may encourage more teamwork, given that the responsibility for group outcomes is shared.

Table 2B. General risks of decentralization

Risks	Description	Mitigation steps
Weakened organizational culture	Business units may operate more independently with less direct contact with one another and/or central office staff. Limited contact may result in the development of different organizational cultures. Individual workers may not identify with the goals of the entire organization. Rivalry among departments or units may evolve.	Strengthen communications and standard operating procedures. A strong brand identity can also strengthen internal organizational culture, as can reciprocal communications between branches and the head office.
Loss of control, plus decreased standardization and consistency in both product quality and service delivery	It may become more difficult to ensure compliance of increasingly autonomous business units with internal control procedures and other policies. Individual experimentation within business units may result in decreased standardization and less consistency in the quality of service delivery.	Institute strong control systems and standard operating procedures, including staff performance reviews. Rotate staff among branches. Conduct periodic training to maintain standardization of processes.
Generalist management/ lack of specialization	Decentralized structures with relatively autonomous business units typically demand managers who are "generalists," that is, who have a broad range of responsibilities. In MFIs this may mean overseeing loan disbursement and collection, human resource management, administration, finance, accounting, purchasing, and planning. This lack of specialization can negatively impact service quality, impede innovation, and decrease efficiency.	Identify and meet training needs. Encourage productive lateral teamwork between regional and/or branch managers and central office specialists. Have senior management regularly monitor branch operations to identify any risks and problems early on.
Duplication of functions	Autonomous business units with similar operational structures may result in unnecessary and inefficient duplication of effort. For example, if separate accounting departments are established at each branch office, the work is not necessarily performed better or more efficiently than at one centralized unit.	Centralize back office functions and strengthen the MIS to try to eliminate the need for accountants at the branch level. Again, upfront analysis of each key process is required to determine where decentralization or centralization is most appropriate If duplication is unavoidable, mitigate the disincentives for superior performance by conducting periodic performance reviews.
Lack of cross-fertilization	Smaller teams in autonomous business units may have a narrow focus ("tunnel vision"). With limited exposure to broader organizational concerns and possibly limited access to other business units, managers and staff may lack the opportunity for cross-fertilization. Organizations may not learn as quickly and innovation may be impeded.	Because innovation may also be enhanced by decentralization, this risk may be mitigated by strong intra-organizational communication across departments and branches.
Less control can increase risk of fraud and/or mismanagement of funds	Fraud and/or mismanagement of funds may go undetected in increasingly autonomous business units.	Implement well-structured internal controls, including periodic (often unannounced) visits of central office staff to branches; establish clear policies and procedures; institute strong internal audits.

Potential Barriers to and Limitations of Effective Decentralization

As with many major institutional investments, including those that involve product development or the implementation of a new strategy, decentralization of certain operations may be hindered by the following institutional or external barriers:

- inadequate training for, or insufficient leadership capacity among, lower-level staff, making it difficult to promote decentralization internally and to establish middle-management positions with decision-making authority
- inadequate internal controls (see Section V, "Role of Internal Controls")
- a burdensome cost structure that impedes sustainability (decentralizing inefficiencies may only replicate them further)
- information systems, or software, with limited operational flexibility that constrains an organization's capacity to handle a new institutional structure
- limited supply of banking or other necessary third-party services required to achieve decentralized operations (this factor greatly depends on an institution's methods of operation and context, but it can be a crucial factor)
- an institutional culture that does not favor shared authority and decision making (see Box 3 below)

In some cases, the above obstacles may be easily overcome, while in others, surmounting these challenges may be more difficult or take time. In many cases, what may seem insurmountable barriers can be resolved with creative thinking. Some solutions may be found using existing organizational resources, others may require new resources from outside the institution (e.g., more experienced personnel or an improved MIS).

Box 3. The importance of institutional culture in decentralization

Management attitudes and approaches are the key to building the right institutional culture. Certain organizational characteristics established by the work styles of senior management have the ability to either facilitate or hinder an institution's success in decentralizing operations.

- Senior management characteristics that may foster delegation of authority to lower levels:
  - Confidence and trust in subordinate staff to execute processes and make decisions well, thus empowering staff at lower levels.
  - Commitment to building the capacity of mid- and lower-level staff through investment in ongoing training.
  - Cultivating an atmosphere of teamwork by sharing responsibilities.
  - Participatory work environment and climate.
  - Culture of internal control and vigilance; putting systems in place that prevent or promptly identify potential problems.
- Characteristics that may discourage delegation and decentralization:
  - Difficulty trusting others to do a job well or according to policy.
  - Fears that delegation will encourage lower-level employees to try to take the positions of their superiors.
  - Concerns that since senior management bears the ultimate responsibility for performance and operations, it should retain all decision-making authority.

III. Organizational Design, Governance and Management

The most salient features of organizational design are reporting relationships and spans of control at each level of an institution. These relationships are generally expressed in organizational charts — graphical representations of the organizational structure that show relationships of supervision, coordination, and dependence, as well as organizational hierarchies. In many cases, analysis of organizational charts is an important starting point when considering how staff from different departments, branches, regions, and the central office will relate to one another.

Decentralization can involve making significant changes to an institution's organizational structure, multiplying lines of authority and subsequently creating major shifts in management systems to ensure continued strong governance. The executive director or CEO needs to foster clear lines of responsibility and delegation of authority, as described below, so that his or her subordinates clearly understand the different levels of decision making (i.e., who is responsible for which functions). While these considerations are also important within centralized institutions, they become increasingly important when delegating decision-making authority beyond the central office.

Governance can be understood as the system of people and processes that keeps an organization on track. It is the system through which an institution makes major decisions. In the broadest terms, the functions of governance are to:

- uphold an organization's mission and goals
- guide the organization's major strategic directions
- mitigate risks and maintain organizational health over time
- ensure accountability throughout the organization1

A human resource policy manual usually includes an organizational chart, a description of reporting levels and salary scales, as well as definitions of positions by department and the qualifications for those positions. It accordingly establishes the responsibilities of each organizational unit.[2] The roles of the board of directors and senior managers should be clearly defined either in the same manual or in an institution's bylaws so as to avoid any overlaps or gaps.

Table 4 outlines four sample stages of evolution for a microfinance institution, as characterized by the delegation of responsibilities in each phase. It presents a model of the measures required to achieve operational decentralization and the delegation of responsibilities at each level. Organizations of course may not structure themselves in strict accordance with these descriptions. These model stages are meant to provide an example of how an institution might develop as it grows and expands its operations—managing costs carefully and specializing functions and increasing decentralization as it evolves.

1. Taken from Council of Microfinance Equity Funds (CMEF), "The Practice of Corporate Governance in Shareholder-Owned Microfinance Institutions," consensus statement, CMEF, May 2005.
2. These policies may be published in a separate manual, or made part of a larger human resource policy manual that also includes policies on recruitment, hiring, evaluations, benefits, etc.

Table 3. Stages of MFI evolution, as seen in the delegation of responsibilities

Stage		Type of delegation
1	Initial	Highly centralized management
2	Take-off	Delegation of key responsibilities begins. The executive director increasingly delegates functions to the second level (branch and department managers). Decentralized branch offices assume responsibilities and may delegate some operational decision making to the third level (sub-branch offices).
3	Consolidation	Delegation is consolidated through decentralized branch offices. Sub-branch offices become operational arms of main branches.
4	Advanced consolidation	A strong management structure delegates many functions and processes to branch and sub-branch offices and functional departments. The organization is characterized by a high degree of delegation of responsibilities.

When an institution considers organizational growth, it is important to integrate these different stages of development into an overall strategic plan. This plan should map out projected growth stage by stage. As an MFI reaches each stage, it should have an implementation plan that fits within the overall strategic plan.

In the organizational charts below, vertical lines signify a direct relationship (supervision) and horizontal lines signify coordination relationships. Keep in mind that there is a lot that organizational charts do not tell us, such as the definition of specific staff positions or the extent to which authority or responsibility has been delegated. They do not tell us, for example, where loan decisions are made. Also, the estimated numbers of clients will vary greatly depending on an institution's methodology, geography, client density, etc.

Initial Stage

During start-up operations, decision making is centralized and costs are minimized by keeping staff lean and generally working out of a single office. Although there are separate functions or areas of responsibility, two areas may be covered by the same person. For example, the executive director may also oversee financial services operations. In this stage, there are generally no decentralized offices; loan officers work directly from the central office. Administratively, "finance and administration" may be comprised of an accountant and a clerical staff person. Initial internal control measures should be established and will be adapted as operations expand.

Figure 1. Organizational chart for start-up stage

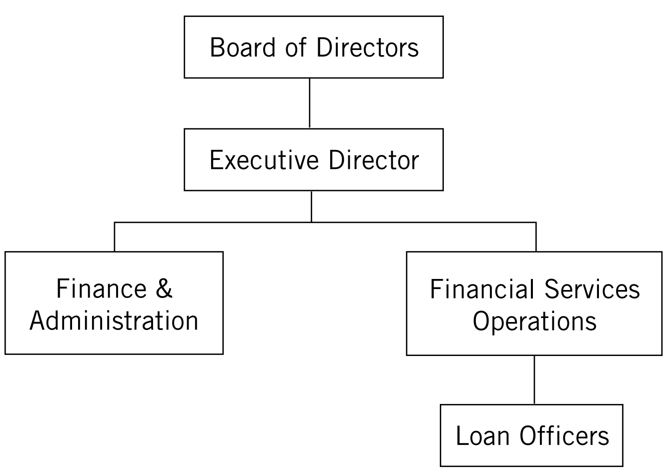


Table 4. Start-up conditions

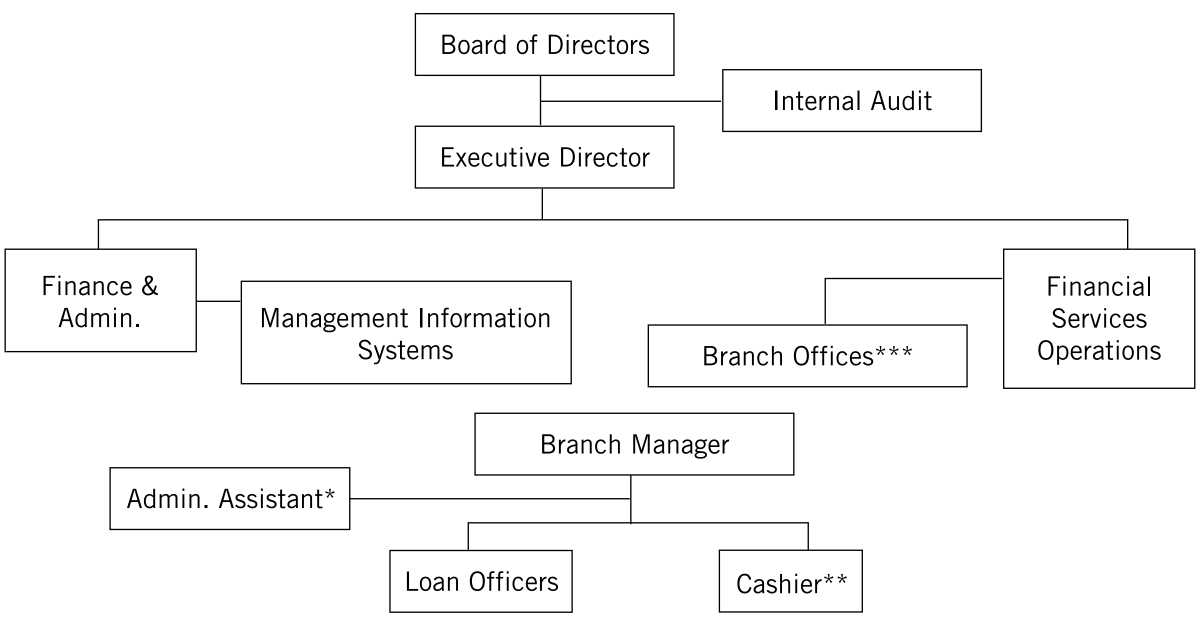
Context	Start-up MFI, fewer than 3,000 clients and/or small geographic scope.
Basic structural elements	Significant centralization in both lending operations and back-office functions.
Systems and procedures	Important to develop clear and well-defined systems and procedures (e.g., operational and administrative manuals, MIS, internal controls) in order to create a strong foundation for growth. Ideally, these systems are in place prior to initiating lending or very shortly thereafter.
Strengths	Costs kept low due to few senior managers and minimal office expenses.
Weaknesses/ vulnerabilities	Executive Director is usually very engaged in operations; MFI has limited capacity to reach new markets or develop new products.
Investment and capacity at branch level	No, or very few, regional offices or separate branches.
Sustainability	Very minimal.

Take-off Stage

As an institution starts to grow, both geographically and in terms of the number of clients, it may create new areas of responsibility, such as an MIS department, and begin to open branch offices to better serve its clients. Decision making is still centralized to a high degree. However, management begins to invest in greater staff capacity at the branch level in preparation for delegating key processes and decision-making authority to allow the institution to grow more quickly and efficiently. Some support functions, such as issuing checks and providing accounting information, may be performed at the branch level and sent to the central office. The finance manager now may oversee accounting, clerical, and MIS staff.

When appropriate, an operations or credit manager may be hired to relieve the executive director of day-to-day management of financial services operations. During this stage, the executive director should ensure that internal controls that support growth are put in place. An internal audit function should also be established, even if this task is initially contracted out (i.e., before the institution reaches a sufficient size to hire a full-time internal auditor).

Figure 2. Organizational chart for take-off stage



Notes:

* The administrative assistant may do data entry, manage the branch office, and perform light bookkeeping.

** A cashier may be required at a regulated financial institution or an MFI that offers savings products.

*** Actual reporting structures will vary according to the institution, e.g., branch managers may report directly to the executive director.

Table 5. Take-off conditions

Context	Growing MFI, up to 10,000 clients and/or increasing geographic scope.
Basic structural elements	Creation of decentralized branch offices with minimal staff. Credit/operations manager becomes key operations person. Specialized units, such as an MIS, may be created in the central office.
Systems and procedures	Strong internal control system and internal audit function should be put in place that can accommodate the growing complexities of the institution. MIS must generate timely, comprehensive, and accurate reports. Functions and/or systems that are fulfilled by branch vs. head offices must be clearly defined. Head office continues to assume major operational responsibility so as not to overburden branches. Head office also continues to exercise significant control over branch operations.
Strengths	Central office costs kept lean but grow appropriately to meet expansion needs. Institution able to enter new markets in a responsive and flexible way with decentralized branches. Institution maintains close relationships between head office and branches and across branches, e.g., everyone is on a first-name basis. Relatively few products and/or non-complex operations help ensure that procedures remain standardized.
Weaknesses/vulnerabilities	Tension between efficiency (and/or leanness) and capacity. For example, it may be a challenge to maintain sufficient head office supervision of growing branch offices.
Investment and capacity at the branch level	Purchase of more physical assets, including equipment, furniture, vehicles, etc. Central office administration must begin to ensure there is capacity at the branch level for strong human resources (HR) development. Continuous training for branch managers to develop their capacity to execute policies and procedures including HR, evaluation, incentive policies.
Sustainability	Sustainability is increasing, but institution must have a clear strategy and operating plan on reaching sustainability as quickly as possible, including allocation of head office expenses.

Box 4. Managing donors: The experience of Fundo de Credito Communitario (Mozambique)

Donors initially funded Fundo de Credito Communitario (FCC) to begin a microfinance program to alleviate poverty in a specific region in Mozambique. At the outset, FCC's operational costs were extremely high. However, donors placed greater priority on serving the region than building a strong, efficient, sustainable institution. Later, when donors redirected their focus to sustainability, FCC was criticized for weak management and the markets initially identified by donors were acknowledged as not being financially viable. As a result, donor funding ran out and FCC had to close all branches that were not sustainable.

It is very difficult to say "no" to donors' stated priorities. But it is even more difficult to build strong, sustainable institutions. As an institution begins to move into the take-off stage, donors must be made aware of sustainability concerns upfront and educated on the need to balance social and financial goals. Otherwise, both goals will suffer in the long term.

Box 5. Managing donors during growth: The experience of Pro Mujer Bolivia

In its 15-year history, Pro Mujer Bolivia (PMB) has used many types of funding. One of the main challenges the MFI has faced is balancing donor interests with its own institutional interests. During negotiations, PMB aims to harmonize donor requirements with its own strategy and goals.

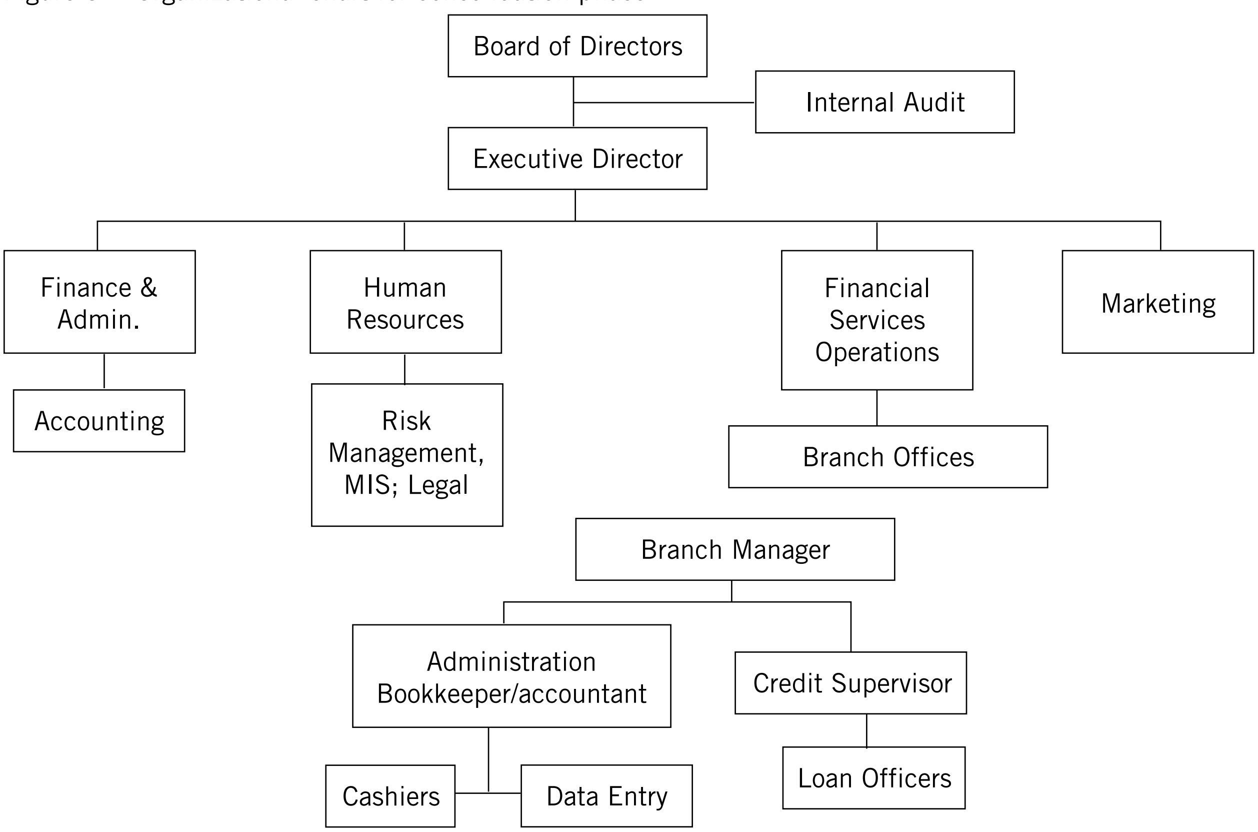
One of the problems that PMB has encountered most frequently is that funders respond to their own mandates, making funding contingent on conditions that may not be relevant to the MFI's product offerings, target market, or model for sustainable growth. Donors may provide funding targeted to a specific geographic location, population, or type of program or service. PMB has not always found it possible to meet these conditions.

PMB has nevertheless worked hard to develop its ability to negotiate with donors. In some cases, the PMB has learned that it is more efficient to turn down funding than accept it and be forced to adjust its institutional policies, procedures, and strategies to comply with donor conditions. The problems resulting from these types of adjustments are often greater than the potential benefit of the funding.

Consolidation Stage[3]

At this stage, an MFI has grown significantly in client numbers and geographic scope. It adds more staff at the head office as well as the branch level. New administrative areas may include human resources and risk management. New business functions often include marketing. Management takes advantage of increased staff capacity at the branch level to begin delegating greater decision-making to branch managers. A strong internal audit function ensures controls through regular training and audit visits. Strong communication channels become increasingly important in the decentralized organization.

Figure 3. Organizational chart for consolidation phase



3. While this example and the next show a very lateral senior management structure, institutions may organize themselves differently. For example, they may organize all functions under two senior managers (e.g., finance and operations) at this stage, then further divide these functions at the next stage (for example, into human resources, risk management, and development/marketing, which would also report directly to the executive director).

Table 6. Consolidation conditions

Context	Medium-sized MFI, up to 30,000 clients and/or significant geographic scope.
Basic structural elements	Core operations and decision making highly decentralized. Formal internal audit department reports directly to the board of directors. Human resources (HR) department is generally centralized at the head office. Depending on branch size, some HR functions, such as performance reviews, may be handled at the branch level. Beyond a certain size, a branch will need an additional manager or administrator to handle these functions. Risk management and legal functions are usually incorporated into the finance department. At this stage, however, depending on costs and the local context, an institution may have a separate internal legal counsel. If finance and accounting functions are centralized, branch offices should have a bookkeeper* to ensure their records are in good order. If finance and accounting functions are decentralized, branch offices need an accountant. A marketing department at the head office helps an institution become increasingly adept at entering new markets and planning for and managing growth in current markets. Administrative management is generally centralized, although decentralized branch offices may assume increasing responsibility for such functions as certain purchasing, branch-level accounting, and MIS. * A bookkeeper generally prepares trial balances and pays bills.
Systems and procedures	Institution has a strong, flexible, and often integrated MIS (i.e., loan tracking and accounting) with different levels of security. The internal audit function is crucial for strengthening controls when operations become more dispersed. The internal auditor must be a full-time staff member. Strong communications system needed both within each branch and between branches and head office. Regular, standardized reporting occurs between branches and head office; policies and procedures are standardized in design and implementation. Head-office capacity must grow in order to keep pace with the demands and needs of a growing institution.
Investment and capacity at branch level	Need to create strong career paths to manage turn-over, promotions and vacations. Purchases of office equipment and infrastructure (e.g., lobby/reception, phone and e-mail systems). Strong institutional culture, and an internal and external identity/brand, are needed.
Strengths	Organizational structure sufficiently responsive to enter new markets and meet client needs. Increased efficiency due to increasing scale. Generation of increasing profits. Regional offices can be established to serve clusters of branch offices in various geographic regions. Human resources show increased resilience, capacity and redundancy, reducing institutional exposure to employee departures. Better career paths and opportunities offered to employees, creating increased opportunity to develop staff loyalty.
Weaknesses/ vulnerabilities	Some potential for fraud because decentralized structure means senior management is less aware of operational details at the regional and branch level. Potential weakening of standardized operating procedures and/or policies. Potentially insufficient supervision by head office. Poor planning and implementation by even one branch can affect the entire institution.
Sustainability	Reaches or surpasses break-even for operational sustainability and even financial sustainability, with the goal of generating retained earnings to reinvest in institution.

Box 6. Decentralizing back-office functions to enhance efficiency: The case of Pro Mujer Nicaragua

As Pro Mujer Nicaragua (PMN) entered a consolidation stage, most of its back-office functions were centralized at the head office. However, PMN discovered that some back-office functions could be securely decentralized to achieve greater efficiency.

Some PMN branches operate in sparsely populated regions. As it grew, its centralized administrative functions created delays in responding to branch office requests. As a result, management decided to decentralize certain administrative processes, including the contracting of day-to-day services and purchasing of materials and supplies.

To do this, PMN first conducted a policy review that established petty cash amounts and authorization levels for purchases, set limits for purchases and credit, and delegated responsibility for signatures and accountability. It then established agreements with local suppliers to directly service its branches. Pro Mujer Nicaragua head office staff also trained branch staff to manage the bidding process for purchases. In this way, PMN was able to carefully delegate specific back-office processes to its branch offices, thus eliminating certain bottlenecks, while preserving high levels of internal controls.

Box 7. Vulnerabilities of expansion: Handling multiple pregnancies at Pro Mujer Peru

Over 70 percent of Pro Mujer Peru (PMP) staff are young women of child-bearing age. In order to accommodate maternity leave schedules, PMP implemented a system of rotating "promoters" (loan officers) who fill in for promoters on extended leave.

In 2005, however, something unusual happened. Pro Mujer Peru experienced eight staff pregnancies at the same time and was unable to train and prepare substitutes to coincide with their maternity leaves. The rotating promoter system proved inadequate and PMP faced a serious staff shortage. To alleviate the human resources strain, the MFI hired temporary staff for three months to replace women on maternity leave. Although effective, this solution proved to be very expensive, and portfolio growth in the regions involved was slower than projected.

Box 8. Developing the capacity to handle staff turnover: The case of FCC (Mozambique)

Because of its dependency on donor funds, FCC only hired staff members for fixed one- or two-year contracts. Management staff in particular were expatriates who stayed for a limited period of time. During their contracts, FCC invested in training to enhance their skills and productivity. At the end of their contracts, however, these staff members often left the institution, taking their knowledge with them and leaving a void in managerial positions, as lower-level staff were unqualified to fill them. This situation severely deterred growth and sustainability.

Rather than continue to depend on expatriate staff, FCC developed criteria to identify and hire local staff who demonstrated leadership potential and were more likely to remain with the institution. FCC trained these new employees to prepare them for managerial roles and implemented staff succession plans to smooth the transition from expatriate staff to local managers, thereby building a more stable personnel environment.

Box 9. Improving staff retention at Microfund for Women (Jordan)

Microfund for Women (MfW) experienced high staff turnover as soon as it began operating. This situation was due primarily to the nature of the loan officer position, which requires staff to spend a great deal of time outside of the office doing door-to-door promotion, an activity that is not culturally acceptable in Jordan, particularly for women. (Most women prefer to hold administrative rather than field positions in the country.) MfW solved this problem by enhancing loan officer benefits, namely, increasing salaries and incentives and defining career paths for field staff. Since then, the MFI has enjoyed an employee retention rate of about 85 percent among loan officers.

As part of its human resources strategy, MfW implemented a grading system that governs salary structures and incentive plans. For example, an entry-level loan officer is a grade one. As she demonstrates her ability to take on an increasing number of clients, maintain a strong portfolio quality, and score well on her annual employee evaluation, she moves up to grade two and subsequently, to the loan officer supervisor position at grade three. As an employee's grade increases, so does her base salary and benefits package. The grading system thus serves as an incentive for operational staff to take on greater challenges and move up within the organization.

Although its grading and incentive systems have improved employee retention, MfW also learned that it needed a staffing back-up system to fill gaps created by resignations and vacations. Its loan supervisors now serve as back-ups for branch managers, and branch managers serve as back-ups for the credit manager. To strengthen this system, MfW launched a training program for loan officers to prepare them for managerial roles in the future.

Box 10. The Covenant Center for Development and Self Help Groups (India): From decentralization to centralization

In a certain sense, self-help groups (SHGs) are the ultimate example of decentralization. Each 12–20 member group starts out as its own independent financial institution with completely decentralized operations, cash handling, information systems, management—even ownership. Yet SHGs face similar challenges to MFIs in achieving efficiency and economies of scale. In comparison with MFIs, however, the maturation process is almost exactly reversed.

The challenge for an informally organized set of SHGs is how to establish systems to coordinate activities and collect information, i.e., how best to *centralize*. The question becomes, how does a partner bank, MFI or NGO maintain an efficient and accountable relationship with SHGs in order to provide them with needed services (e.g., training, financing, etc.)?

In the case of the Covenant Center for Development (CCD), SHGs organized themselves into a federation comprised of 8 to 10 clusters, each of which constituted 15 to 20 SHGs. CCD wanted to develop a system that would allow the federation to ensure consistent procedures and documentation among all SHGs, as well as facilitate the aggregation of SHG data at the federation level.

CCD had to start from the bottom up. It provided management information system (MIS) formats and operating manuals to the SHGs to ensure consistency in documentation and procedures at the operational level. Similarly, it provided MIS formats for aggregating data at the cluster and federation levels, together with operating manuals for each. This standardization was the beginning of the centralization process.

During this process, CCD faced many of the same concerns encountered by MFIs that undergo decentralization: coordinating activities between a diverse set of operating units, ensuring consistent and timely collection of information, and maintaining a balance between independence and accountability.

Box 11. Decentralization and management information systems (MIS)

The process of decentralization can put increasing demands on the MIS software and processes of a microfinance institution. Accurate and timely information plays a key role in maintaining a healthy relationship between the central office and its branches. The MIS serves as the nervous system of the institution, carrying data and messages to the central office so that it can monitor the state of affairs at the branch level and coordinate branch activities.

Initially, an MFI operates out of a central office with little or no branch infrastructure, so fairly simple, stand-alone MIS software packages are usually sufficient to manage all of the institution's information requirements, including accounting and loan tracking. If the institution is very small, even a spreadsheet-based system for loan tracking may suffice for a time. But as the MFI grows and starts establishing increasingly independent branch offices, a number of important questions must be addressed to ensure that the institution's MIS is able to respond to decentralized information processes. What follows is a discussion of some of the key MIS-related questions that an MFI encounters as it decentralizes.

Should we computerize at the branch level?

One of the first (and most important) questions is whether or not an MFI should computerize at the branch level. Each approach has its pros and cons. By computerizing at the branch level, the institution can save significantly on data-entry costs at the head office, improve the efficiency with which branch-level data is captured, and potentially provide much more timely data to headquarters. Moreover, by doing data entry where the data is actually generated, clerical errors can be caught more easily. However, computerization at the branch level also increases branch infrastructure costs, as well as the level of training and capacity required of branch-level staff, particularly those that must use the hardware and software.

Should our MIS software support remote data entry and report generation?

If an MFI decides to computerize at the branch level, the next question is whether the software used by the institution supports remote data entry and report generation. These functions are required in order for branch-level staff to interact with the centralized portfolio database of the MFI. If the software *does* support remote access, the institution must ensure that the branch has adequate Internet connectivity. If the MIS software does not support remote access, then branch-level data entry must be done in "batches" that are then forwarded to the head office for electronic posting (see next question).

How should we transfer data between branches and the head office?

The issue of how to transfer data between branches and the central office is related to the remote data entry issue. The answer is obviously highly dependent on the configuration of an institution's MIS software and the degree of connectivity at the branch offices, as well as the MFI's geographic context. In many ways, the optimal solution is to have an online system where branch-level staff can directly enter data into and generate reports from a centralized server. This kind of system ensures that the most complete data set is always available with the least delay. However, the solution requires MIS software that supports remote access and branches that have adequate and affordable online network connectivity, as well as strong controls at the branch level. Alternatively, branches can maintain their own independent databases and transfer data periodically to the head office via physical media (e.g., CDs, USB memory sticks, hard drives, etc.) or an e-mailed file.

Should we consider using PDAs for field-level data capture?

Several MFIs around the world have taken MIS decentralization to the next level by equipping loan officers with personal digital assistants (PDAs), hand-held computers, and even mobile phones that can directly record client data and transactions in the field. This data is then transferred to a central server and integrated into the MFI's database. The benefits of increased efficiency and accuracy of data capture, however, must be balanced against the expense of the devices and of adapting the central MIS to interface with them. Certain MFIs have reaped significant efficiency gains by using such devices, while others have found that the expense and effort involved exceeded the benefits.

Advanced Consolidation Stage

As an institution reaches maturity, it will likely increasingly diversify its client base and product offerings. At this stage, a three-tiered reporting structure—central, regional, and branch offices—enables senior management to focus more on strategic issues, leaving operational management to regional and branch offices. This division of responsibilities facilitates continued growth and expansion and strengthens the capacity of staff to take on both operational and administrative decision-making power.

Figure 4. Organizational chart for consolidation phase

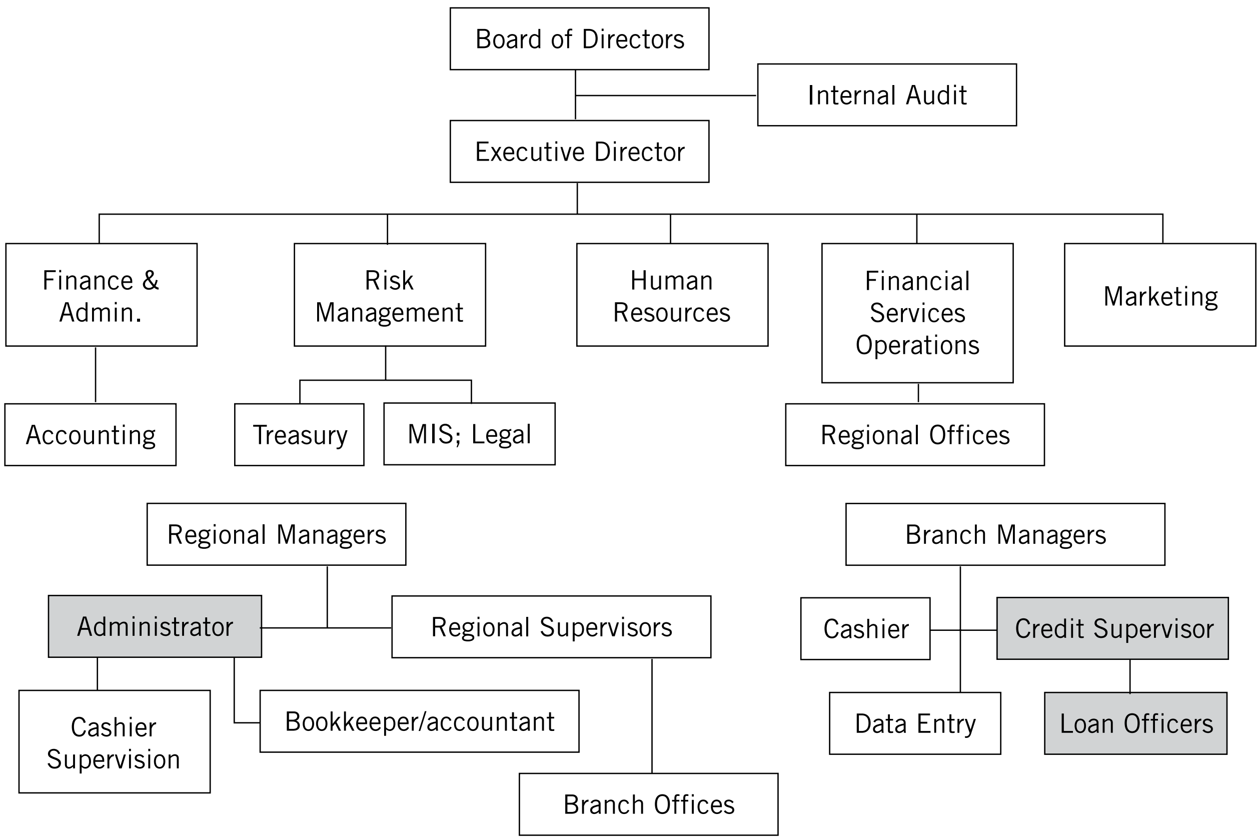


Table 7. Advanced consolidation conditions

Context	Mature MFI, diverse product range, more than 30,000 clients and/or extensive geographic coverage.
Basic structural elements	Policies set by head office. Sometimes risk management and/or treasury departments created at head office. High level of decentralization, with regional offices overseeing branch operations. Decentralized regional offices may fully assume certain administrative functions for their region (including for their respective branches). Branch offices enable the MFI to easily expand in existing markets and enter new markets. Key functions are decentralized to ensure rapid response to clients.
Systems and procedures	Reporting allows analysis at branch, regional and consolidated levels. All employees are able to use reports to see how their efforts contribute to an institution's growth. Benchmarking across branches and regional offices. Information collected at the regional or branch level to calculate incentives.
Investment and capacity at the branch level	Branches operate as business units and profit centers. Alternatively, they may serve as retail outlets, or agencies, with profitability consolidated at the regional level. Branch and regional managers are trained to calculate incentives and managers are trained to read and interpret financial indicators. Training should address the need to cultivate staff for promotions (i.e., for staff to move up in the institution, not simply to do their current jobs well).
Strengths	Decentralization results in shared responsibility, accountability and "ownership." Increased ability to grow, enter new markets, and adopt efficient methodologies. Increased client focus resulting from ability of branches to respond flexibly to local demand and disburse loans more quickly, together with a focus on new business development at the central office. Expanded human resource capacity and ongoing training enable the institution to identify redundancies and fill gaps that result from vacations, etc. Decentralization creates new positions within the institution, which gives staff career paths.
Weaknesses/vulnerabilities	Each institution must assess the trade-off between maximizing efficiency and ongoing investment in institutional capacity. The country context and other factors, such as strategies of competitors, will help determine the appropriate balance. MIS requirements are much greater. If these needs are not met, disaster can ensue. Institutional culture can be compromised as people interact less with the head office, although communication can mitigate this to some degree. Regular meetings for all levels of staff, including quarterly meetings for all staff, and more frequent meetings for branch managers and head office staff, are recommended.
Sustainability	Branches and regions are fully sustainable. Head office and regional costs are charged to branches. Retained earnings are generated to invest in expansion.

Box 12. The Importance of internal communication at Microfund for Women (Jordan)

As Microfund for Women (MfW) grew, communication between the head office and branches suffered. Branch managers felt isolated from senior management, as well as from their fellow branch managers. As a result, MfW decided to implement an internal communications system that would facilitate more direct channels between administrative staff and management in the head office, between the head office and the branches, and between the branches themselves. This system has strengthened the company's infrastructure and ultimately created a greater sense of value and ownership among its employees.

To achieve this objective, Microfund for Women developed the following:

- A monthly newsletter, which aims to increase staff awareness of MfW's latest social activities, business updates, and financial indicators for each month. The newsletter is sent to all employees (in Arabic) and to MfW's partners and networks (in English).
- Weekly staff meetings for the head office, monthly senior staff meetings for department heads, monthly operations meetings for all branch managers and for operational staff, and quarterly meetings for all staff.
- A social committee to increase interaction among head office and branch staff through regular social activities.

Box 13. Hiring more specialized staff at Pro Mujer Peru

As Pro Mujer Peru (PMP) expanded, its operations staff grew, with some employees moving up the ladder from loan officers to become supervisors and even branch managers. Once existing staff reached their capacity limit, PMP recognized the need to incur the higher costs of specialized personnel. PMP, for example, created new positions and areas, such as marketing, human resources, and internal auditing. Because these positions were highly specialized, the MFI was unable to fill them by promoting staff from within.

The location of an institution's central office can, moreover, become very important as it grows. In some cases, if an MFI's headquarters is not located in a major city where it can draw from a large pool of qualified staff, it may need to consider bringing in candidates from elsewhere. PMP had to fill positions with candidates from bigger, more developed cities, which meant higher staff costs.

As an institution grows and expands geographically, its organizational structure becomes more complex. An evolving MFI will strive to keep costs lean, but in order to facilitate robust growth and expansion, it will need to invest in both physical and human assets and create increasingly specialized business units.

The decision to decentralize should be the natural result of a young organization transforming into a complex, mature MFI. The four stages of institutional development presented in this section provide an example of how an organization might determine which processes and functions to decentralize and which to keep centralized. The following sections outline some of the principal issues that must be considered when determining what and how to decentralize.

IV. Business Processes Affected by Decentralization

When analyzing business processes, it is important to remember that effective decentralization means delegating authority, responsibility, and decision making. It therefore requires careful determination of which decisions can be made at lower levels of the organization and which should be made at higher levels of management.

What Do We Mean by Processes and Process Mapping?

A business process can be defined as a structured, measured set of activities designed to produce a specific output for a particular customer or market.[4] A process map is a visual representation that illustrates what activities are performed, where, by whom, in what sequence, and over what period of time. Process maps look beyond functional activities, such as marketing or finance, to reveal an organization's core processes and discover how its different parts work together to serve customers. Process maps allow an MFI to document, improve, streamline, and redesign the way it works.

Improving Processes Through Decentralization

In some cases, organizations may decide the best way to improve a process is not necessarily by changing it, but rather by decentralizing it, i.e., transferring responsibility and authority for the process to lower levels of the organization.

Generally speaking, processes cannot be completely centralized or decentralized. Decentralization is done in stages to allow for adjustments to correct distortions or difficulties encountered during the process. Before decentralization begins, processes and decision-making levels should be reviewed carefully to determine which will remain in the central office and which will be decentralized. This exercise also allows an MFI to establish the necessary levels of checks and balances as part of its internal control system (discussed in Section V below).

Some business processes are only partially decentralized, if at all. Examples include setting general policy and many back-office processes and functions, such as MIS, human resources, and finance.

Before decentralizing, it is important to compare the anticipated benefits of a decentralized process to the likely costs of decentralizing it. Each institution will face different costs and benefits, depending on the local context, the institutional structure, etc. A helpful exercise is to visualize the comparison by drawing a graph with one axis representing the benefits of decentralization and the other estimating the costs. (See Table 8 for a list of processes impacted by decentralization.)

4. Wim Vanhaverbeke and Huub Torremans, "Organizational Structure in Process-based Organizations," Netherlands Institute of Business Organization and Strategy Research, 1998.

Table 8. Institutional processes impacted by decentralization

Human Resources
Staff Recruitment
Coordination of performance evaluations
Implementation of performance evaluations
Staff training
Personnel administration
Administration
Purchasing
General services
Fixed asset acquisition
Accounting / Treasury
Financial monitoring and reporting
Financing
Operations
Loan authorization
Loan disbursement
Loan monitoring
Marketing
Market research
Product development, piloting & adjustment
Design & implementation of marketing strategy
MIS
Development
Support

Box 14. Decentralizing purchasing at Pro Mujer Mexico

Pro Mujer Mexico (PMM) needed to decide whether, and to what degree, to decentralize its purchasing. The benefits of decentralizing this process included greater flexibility in making purchases at the local level, not having to wait for supplies to be shipped from the central office, and a reduced administrative burden at the central office. The cost of decentralizing the process would be an inability to achieve economies of scale in making purchases all at once from the same supplier. PMM operates through a series of dispersed branch offices in a region where transportation is both infrequent and expensive. In addition, management was unable to identify a supplier with distribution outlets in all of the regions served by PMM. As a result, the benefits of decentralizing purchasing outweighed the costs of maintaining centralized purchases.

The following resources are useful for process mapping:

- MicroSave Process Mapping Toolkits http://www.microsave.org/toolkits.asp?ID=14
- SEEP PLP publication, "Process Mapping: Interview with Practitioners"
- SEEP PLP publication, "From Process Analysis to Organizational Redesign: A Case Study of MI-BOSPO's Experience with Process Mapping"
- SEEP PLP publication, "Pro Mujer Nicaragua: A Case Study in the Use of Process Mapping in Microfinance"

Box 15. Centralized accounting at Pro Mujer Bolivia and Pro Mujer Peru

Pro Mujer Bolivia (PMB) had originally decided to decentralize a many of its accounting processes. One accountant in each of the eight decentralized regional offices handled accounting for their respective branch offices. After analyzing the situation, PMB decided that it would be more efficient for the branch offices to send their accounting information directly to the central office, where data entry and consolidation could be done for the entire organization. This change lowered costs at the regional offices, which are now responsible for providing information only on the portfolios of their branches.

In a similar case, Pro Mujer Peru (PMP) decentralized its accounting function by placing accountants at regional offices. Later, process mapping revealed that despite clear job descriptions, regional accountants were doing the same tasks as the central office accountant. Management also noted that quality control at the regional offices was weak because regional accountants ultimately relied on the central office to catch and correct any mistakes. As a result, PMP reversed its decision and decided to re-centralize its accounting function. This move enhanced efficiency by eliminating task duplication and strengthened internal controls by housing the accounting function in one location.

Box 16. Decentralizing loan approval and disbursement at MI-BOSPO (Bosnia-Herzegovina)

MI-BOSPO decided to decentralize decision making on lending operations to serve its clients more efficiently. The shift focused on improving loan approval and disbursement processes. In evaluating the current system, MI-BOSPO linked delays in the loan approval process to the fact that credit committees were only held weekly or bi-weekly. In addition, loan officers, who traveled to the central office for these meetings, were only allowed to attend if they had a minimum of four applications (to justify the travel expense). Under this system, clients experienced significant delays in receiving loans. To solve the problem, MI-BOSPO decided to restructure, dividing their two regional offices into six branch offices, with a branch manager in each. The reorganization allowed branch managers to hold brief credit committees every morning (the four-loan minimum was no longer a requirement) and thus facilitate faster loan approvals and disbursements.

While decentralization made sense for its credit operations, MI-BOSPO decided that it would continue to keep much of its back-office functions centralized, as the investment necessary to decentralize these processes did not provide the same level of benefit as that gained from the decentralization of loan approval and disbursement processes.

Box 17. Decentralization Decisions at Microfund for Women (Jordan)

Process mapping helped Microfund for Women (MfW) identify those functions that would remain entirely centralized and those that should be decentralized. In order to maintain high levels of control and accuracy, all financial activities, such as writing checks and contracts, remained centralized. Similarly, MfW maintained the internal audit function at the central office to ensure consistency across the organization.

Certain back-office functions were, however, partly decentralized. In the human resources department, for example, prospective employees are interviewed and short listed at the central office, then sent for a final interview to the branch office. Marketing strategy is also first developed at the central office, followed by review, joint approval, and implementation by the branch offices.

Like many of its PLP colleagues, MfW improved efficiency and customer service by decentralizing some front-office processes, including the processing, review, and approval (up to a fixed amount) of loan applications, as well as data entry for loan applications and client inquiries.

V. Role of Internal Controls

As Joyce Lehman notes in "Internal Controls and Fraud Prevention in Microfinance Institutions:"

> In order for a microfinance institution to realize its mission, it must identify and mitigate the risks that pose the greatest threat to its financial health and long-term survival. . . . The management and board of a microfinance institution should consider each risk as a point of vulnerability. It is their responsibility to assess the institution's level of exposure, prioritize areas of greatest vulnerability, and to ensure that proper controls are in place to minimize the MFI's exposure.[5]

Lehman goes on to note that:

> Decentralization is often necessary to be efficient, but can increase the opportunity for deviation from approved policies, or for fraud because: (1) fewer staff are involved in the total loan process (approving, disbursing, monitoring, and collecting), and (2) there is an increased risk of error or manipulation when branches transfer information to headquarters.

What Is an Internal Control System?

An internal control system is comprised of the policies, procedures, and systems that an institution uses to mitigate its operational risks. While an internal control system can be defined more broadly to cover virtually all of the policies and procedures that govern an institution's activities, an operationally focused definition helps an institution focus on the ways it can mitigate ongoing operational risks, including poor portfolio quality, theft, and fraud. As Lehman defines it, "Risk management includes both the **prevention** of potential problems, the early **detection** of actual problems when they occur, and the **correction** of the policies and procedures that permitted the occurrence."[6]

An internal control system is a key element of an MFI's risk management strategy. It establishes a framework for all staff. The system allows management to delegate responsibilities yet ensure proper control through carefully thought-out policies and procedures, as well as regular and random verification checks. A good internal control system facilitates an institution's ability to decentralize operations without losing control over financial assets due to error, waste, or fraud.

An MFI needs to establish an appropriate "control environment" and the needed array of specific "control procedures." The control environment includes the overall culture established by management on transparency, integrity, and the crucial role of internal controls.

Once a well-designed internal control system is in place, it is the internal auditor's job to regularly monitor compliance with its policies, procedures, and rules and to identify ways to improve both the system and its implementation. The internal audit function (whether performed by a staff member or an outside contractor) reports directly to the board of directors, although it interfaces regularly with management. An annual external audit is also an important element of an organization's internal control system, as an auditor notes any significant weaknesses in internal controls or discrepancies between operating policies and actual practices in his or her "management letter." An internal control system is constantly evolving as an institution grows in scope and complexity.

At the branch level, it is the branch manager's role to ensure that internal controls are applied systematically in a way that is consistent with the institution's overall policies. In addition, the branch manager is responsible for detecting any weaknesses in the internal control system and communicating them to the head office. The branch manager must also implement recommendations made by the internal auditor.

Effective communication between branch managers and the head office is crucial for detecting any irregularities or weaknesses in internal controls. It is also important that branch managers cultivate the sense that internal controls are tools for strengthening an institution and that internal auditors are colleagues whose role is to assist in this process.

Controls should be analyzed in all key institutional departments: financial services, finance and accounting, administration, human resources, and management information systems.

5. Joyce Lehman, "Internal Controls and Fraud Prevention in Micro Finance Institutions," participant course materials prepared for 2006 Boulder Microfinance Training Program. Much of the material in this section is drawn from Lehman's work.

6. Ibid.

Box 18. Experience with internal audits: Staff resistance at Pro Mujer Peru

The internal audit function at Pro Mujer Peru (PMP) has enabled it to systematically document and improve procedures, as well as establish common criteria for all regional and branch offices. However, implementation of the system initially provoked staff resistance. Loan officers felt threatened by the new system and voiced fears that management mistrusted them, did not value their work, or considered their performance to be sub-standard.

Nearly a year after implementation, staff opinion changed. Operational staff now see value in the internal audit because the reports not only identify problem areas, but recognize high-quality work. Each report carries a numerical score, which in addition to quantifying compliance with internal control policies and procedures, creates healthy competition among staff and branches. A good score on an internal audit now generates a sense of pride and motivation.

Box 19. Internal auditors and supervisors work together at Pro Mujer Nicaragua

Pro Mujer Nicaragua (PMN) works in sparsely populated areas of Nicaragua. Much of its operations are therefore conducted in distant communities rather than in a centrally located branch office. While the number of its clients doesn't necessarily warrant more than one person be involved in the internal audit function, the dispersed nature of PMN operations requires more regular supervision. The MFI therefore decided to implement a regular monitoring system of front- and back-office functions by creating positions for an operations supervisor and a finance and administration supervisor. These supervisors assist the internal auditor; however, they report to their respective managers: the director of operations and the finance manager. Their work focuses on the prevention and mitigation of day-to-day operational risks, while the internal auditor detects problems after they happen.

The supervisors' job is to monitor compliance with organizational policies and procedures in addition to resolving any issues that arise out of internal and external audits. Their feedback is used to create improvement plans, which set deadlines for overcoming weaknesses. These plans also serve as the basis for future supervisory plans, creating a cycle of action, supervision, feedback, and action. This system has led to more consistent implementation of and compliance with organizational policies and procedures throughout Pro Mujer Nicaragua's geographically dispersed service area.

Components of an Internal Control System

The following outline provides an example of the different elements of an MFI internal control system, as reflected in the manuals related to each functional area of the organization. While individual MFIs may organize the information in different ways, all the elements together form the internal control system. Manuals should be developed for each area and should include clear guidelines for the process of drafting, approving, issuing, and updating policies and manuals.

- A finance and administration policy manual lays out an institution's accounting policies and procedures related to income, expenditures, fixed assets, and management of cash and investments (including loan disbursements and repayments). Other administrative policies may also be included. This manual is the core of the internal control system.
- A human resources policy manual defines an organization's structure and the functions of the various units, including the obligations and responsibilities of each unit and the lines of dependence, supervision, and coordination. It also contains job descriptions for the main positions, outlining required training, experience, personal characteristics, etc. Probably the single most important factor in preventing waste and fraud, especially in a growing, decentralized institution, is a motivated and well-informed staff.
- An operational policy manual maps out the policies and procedures that govern credit and other programs of the institution, including loan application, approval, disbursement, and monitoring. Consistent adherence to these policies by all field staff is essential, especially as an MFI decentralizes its operations.
- The management information system (MIS) policy manual serves to protect the nervous system of the

institution's internal control system. Without timely, reliable, comprehensive reporting, management cannot monitor operations or gauge institutional health, nor can the functions of an internal auditor be performed. The MIS should be designed to track the information needed to generate the reports required by staff, management, and the board to perform efficiently and productively. Performance reports fall into three broad categories:

  - Activity reports: These include regular reports that inform staff and management of operational activities, including loan disbursements, loan repayments, and portfolio agings (by credit officer, branch, region, product, etc.). These reports often show progress against an annual plan.
  - Financial reports: These include income statements, balance sheets, cash flow reports, performance indicator reports, variance reports (which show results against targets), etc.
  - Other reports: These may include internal audit reports or any other reports which management or the board of directors use to monitor progress and performance.

- An MIS technical manual is a specialized document that should be provided by the software developer or vendor. It describes the logical architecture and the design of the processes on which the system is structured. This document and the one described immediately below should be made part of the MIS provider's contractual obligation, along with installation of the software.
- An MIS user's manual helps a user rapidly understand and use the software application through a series of clearly described steps. It should facilitate easy, user-friendly operation of information system modules. If an MFI uses more than one piece of software (such as an accounting package and a separate loan-tracking system), then technical and user's manuals should be available for each.

Conclusion

While some institutions may not need to consider decentralizing, most MFIs need to do so in order to reach new clients and new markets as efficiently as possible. Key issues to look at when decentralizing include whether management is committed to delegating authority and whether lower-level staff are capable of assuming greater responsibility. Robust internal controls and a strong MIS need to be in place before undertaking decentralization of operations.

Most institutions find that decentralization is not an either/or proposition, but a matter of degree. Decentralization is not a cure-all for all growth issues and generally presents a new set of challenges that must be met. However, if carefully thought out and implemented, decentralizing core operating functions can help an MFI increase the number of its clients and expand to new geographic areas while achieving greater levels of efficiency.

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SEEP is an international network of institutional and individual members committed to reducing poverty through the power of enterprise. Its over 70 institutional members are active in 139 countries and reach over 25 million microentrepreneurs and their families. SEEP promotes professional standards of practice in microfinance and enterprise development, conducts capacity building activities for its members and other practitioners, creates and disseminates publications for application in the field, and serves as a center for collaboration on a broad range of sector-related issues.

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