SDC – Workshop 2002 on Financial Viability

"Balancing Target Group Outreach and Profit Orientation"

Prerequisites for MFIs Financial Viability

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Introduction

- This paper discusses the key ingredients of financial viability for MFIs.
- It also looks at the crucial question of whether the pursuit of financial viability, sacrifices MFIs social objective: Outreach to Poor People.
- The paper draws experience from K-Re, which started as an NGO in1984 and pursued and recently established specialized microfinance commercial bank.
- The writer is a co-founder member of K-Rep and the founder & CEO of K-Rep Bank, with over 20 years experience in development finance.

Introduction

- First a brief history of K-Rep & its reasons for pursuing financial viability.
  - Bank established in 1999, by an NGO (K-Rep).
  - The NGO started in 1984, as a project.
  - Original objective - to support the development of SME through other NGOs, as a means of increasing employment opportunities and incomes of poor people.
  - Some of the key features of the original approach:
    - Loans at subsidized rates & free technical assistance.
    - Solely dependent on donors for continuity – where each plan was funding plan.
    - Operated as a project as opposed to an institution – living from one grant to another.

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- Results of initial approach.
  - Outreach to clients very limited –e.g. over the first 5 years reached only 5,000 people.
  - Project could not continue without donor support as it could not meet even 25% of its cost.
  - On time loan repayments rate less than 50%.
  - Technical assistance did not translate into any changes in the businesses supported (This does not mean TA is not important – on the contrary appropriate TA has immense impact)

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- Some of the key changes made
  - Incorporated project as local development agency in 1987.
  - Changed approach to then emerging minimalist and later financial systems approach.
  - Developed a institutional development plan and used donor funds as capital, as opposed funding for recurrent expenses.
  - Support to other NGOs took form of loans as opposed to grants.
  - Started direct lending program in 1989 following the financial systems approach.
  - Developed a long-term institution strategic plan, in 199.
  - Transformed into a commercial bank in 1999, in sync with the trends of transforming MFIs into regulated financial institutions.
  - BUT retained NGO to continue with product development of new approaches, systems & products for deepening poverty.

Introduction

- Against K-Rep's background, the microfinance sector, globally was involving.
  - In the 70s NGOs promoted (through loans & training) income generation projects to assist the poor increase their incomes & employment opportunities.
  - Many if the enterprises we group based or owned.
  - Else where in Indonesia few commercial banks began targeted the micro-enterprise market.
  - In mid 70s NGOs world wide began targeting the microfinance market (ACCION in Brazil in 1973, Grameen Bank in Bangladesh, in 1976)
  - In Africa many credit unions, rural banks & NGO expanded their income generating projects.
  - In 1980s many NGO MFIs had successful micro-lending programs.
  - In 1989, PRODEM in Bolivia pioneered the transformation of NGO-MFIs.
  - In the same period IPC experimenting with different models.
  - In the 90s transformation became an important strategy for NGO-MFIs.

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Outreach data over the years -

Prior to adopting a financial systems approach			After adopting Financial Viability (Operationally Sustainable)			After transformation into a bank (Financially Sustainable)				
Year	No of Loan Clients	Portfolio	Year	No of loan Clients	Portfolio US$ '000	Year	Loan Clients	Deposits Clients	Portfolio US$ '000	Deposits US$ '000
1989	1,246	124.6	1991	1,253	580.6	2000	14,636	20,251	4,667.7	3,565.7
1990	4448	370.1	1992	2,852	982.9	2001	15,911	28,084	9,203.9	5,318.1
			1993	4,331	1,087.1	Oct' 2002	34,800	36,500	12,455.7	8,457.3
			1994	5,149	3,514.7					
			1995	11,137	4,601.4					
			1996	12,885	4,534.3					
			1997	10,856	3,622.0					
			1998	13,150	3,816.6					
			1999	13,636	3,228.6					

Key factors for MFI Financial Viability.

- Institution as opposed to a project.
  - An on-going business concept, reflected in all aspects of the institution (governance, management, staffing etc).
  - A business plan distinct from a funding plan, with the later as a strategy especially if donor funds.
- An appropriate institutional form.
  - To gain legitimacy from public & market.
  - Some type of institutions have inherit handicaps as financial institutions (Churches, NGOs, Government units, charitable entities etc.)
  - Image & growth potential as a finance institution is largely confined to regulated financial institutions.
- Suitable governing & management structure.
  - NGOs, Charities, Gvt & churches have limited capacities to effect this.
  - Lack of financial stakes limits sound governance & accountability on part of management.

Key factors for MFI Financial Viability.

- An appropriate & sustainable funding or capital structure.
  - The nature of donor grants makes planning difficult and impairs MFIs chances to respond to demand.
  - It must be noted though that grants play an important role in institutional capacity building. The permissive nature have also afforded MFIs the opportunity to innovate, experiment & make mistakes – resulting in what the sector is today. But it is not a sustainable source.
  - MFIs require a stable & long term funding base.
  - Deposits & other commercial sources have enabled MFIs to grow immensely.
  - Moreover, savings is in itself an important service to the poor that enables them to build their assets base.

Key factors for MFI Financial Viability.

- An appropriate service delivery method
  - Globally, the MFI sector has developed best practices in delivering microfinance products/services:
    - Group Based
    - Individuals
    - Wholesale
    - Co-operative or credit union model
  - Most of these methods are founded on
    - Peer pressure & group guarantee
    - Character assessment given more weight that appraisal of the business.
    - Close monitoring of clients.
    - Some elements of linking deposits/savings to credit – although voluntary savings has proven to be a very important factor in the growth of deposits.
  - Most importantly system must reflect the way clients are most comfortable on doing business.

Pictorial Example of service delivery system

Service clients where they prefer or Banking Anywhere You Please

Examples are missing...

Key factors for MFI Financial Viability.

- Performance standards.
  - Realistic business plan, financial & operations projections.
  - Targets and performance bench marks for each production unit/person.
  - Clear procedures for lending & recovery.
  - Sound supervision, reward & reprimand system.
  - Linking financial performance to outreach parameters.
  - Regular analysis of results based on established performance standards
    - Portfolio quality
    - Cost ratios
    - Sustainability / profitability measures.
    - Productivity (client load, disbursement rate, client retention rate etc.)

Key factors for MFI Financial Viability.

- Pricing of products.
  - Interest rate set to recover cost of operations, loan losses, return on capital & cost of funds.
  - Sound policy on computation and booking of interest.
  - Fair rates that do not exploit clients due to inefficiencies of the MFIs.
  - Interest rates usually higher than what commercial bank charge but lower than informal market rates. Rates are coming down though – owing to competition.
- A business oriented culture of service, as opposed to charitable culture.
  - Strict regular monitoring & adherence to policies.
  - Prompt recovery of doubtful loans.
  - Good and fast service
  - Response to clients views.

Key factors for MFI Financial Viability.

- Good MIS
  - MIS not necessarily computerization but the later helps due to volume.
  - Accuracy, consistency, simplicity and standardized application most crucial.
  - Accounting treatment for loans, interest & loan loss provisioning – crucial
  - Integrated loans/savings with the general ledger.
  - Good data on other operations parameters crucial (eg. In group based system – attendance of meetings, group fragility ratios, latent client force etc).
  - Terminology that is simple and clearly understood by clients, with regular update of information to clients.
  - Clearly understood by all staff.
  - Integration of service delivery process with MIS

Key factors for MFI Financial Viability.

- Staffing
  - Well trained and motivated.
  - Clearly understand mission, vision and objectives of MFI.
  - Committed to the social objective but with string technical skills.
  - Performance recognition through bonuses, promotions etc.

Tradeoffs: Financial Viability Verses Outreach.

- Arguments against the pursuit of financial viability
  - Causes MFIs to focus on profit maximization at the expense of the social objectives.
  - Exerts pressure on MFIs to shift focus from the poor/low-income clients – to a less poor with slightly higher size of loans or savings.
  - Does not allow for innovations to deepen outreach.
  - The sector grew because of the permissive environment under which it developed & the pursuit of financial viability will curtail growth.
  - In the long run make MFIs behave like bank.
  - Small & micro-enterprises require subsidies to grow.
  - It is socially just to channel subsidized donor/public funds to the poor.

Tradeoffs: Financial Viability Verses Outreach.

- Arguments (or incentives) for the pursuit of financial viability
  - Enables MFIs to grow independent from scarce donor funds.
  - Will positions Microfinance within respective financial markets, as an integral part of legitimate financial institutions, as opposed to the peripheral activity, it is perceived.
  - Increases accountability & transparency, which in turn:
  - Addresses the ownership issue.
  - Enhances effective governance and management, MFIs.

Tradeoffs: Financial Viability Verses Outreach.

- These in turn, bring:-
  - Recognition & legitimate.
  - More funds to the sector.
- Addresses the ownership the ownership question, that has impacted on a number of MFIs.
- Enhances effective governance and management, MFIs.
- These in turn, bring:-
  - Recognition & legitimate.
  - More funds to the sector.

Tradeoffs: Financial Viability Verses Outreach.

- Concerns are justified.
  - There could be tradeoff if an MFI does not institute measures to balance between the two goals.
  - These can however be mitigated by appropriate measures & structures at the ownership, governance & management levels.
  - The pursuit of the two, seemingly opposing objectives, is not a contradiction but a necessary creative tension, which results in innovations that lead to an exploration of new horizons in accessing financial services to the poor.
  - In K-Rep’s experience the profile & characteristics of clients has not changed – but there has been pressure from many quarters that could lead to changes.

Donors Role.

- Help build capacity of MFIs towards financial viability.
- Funding should designed to help MFIs become financially viable.
- Support establishment of private sector entities that work with MFIs.
- Develop new funding instruments that help MFIs transform into regulated or specialized financial institutions.
- Encourage sharing of experiences, through exchanges & forums.
- Desist from promoting unfair competition amongst MFIs, through subsidies.
- Monitor social & economic impact of financially viable MFIs to better inform all concerned.
- Encourage MFIs to secure independent valuation (or rating).