PN-ABJ-800
74492

Steps to the Creation of a Viable Financial Institution for Microenterprise Development in the Philippines:

Notes on a Process for the Staff and Board of Tulay sa Pag-Unlad, Inc.

GEMINI Working Paper No. ~~23~~ 24

GEMINI

GROWTH and EQUITY through MICROENTERPRISE INVESTMENTS and INSTITUTIONS
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Steps to the Creation of a Viable Financial Institution for Micro-enterprise Development in the Philippines:

Notes on A Process for the Staff and Board of Tulay sa Pag-Unlad, Inc.

by

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November 1991

This work was supported by the U. S. Agency for International Development, Bureau for Asia and Private Enterprise, Office of Small, Micro, and Informal Enterprise, through core funding to the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project, contract number DHR-5448-C-00-9080-01.

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Experience indicates that there are distinct steps an agency and its board of directors should take in order to make wise and fully-informed decisions at every step of the complex and important process of determining whether to become a formal financial organization.

The steps are outlined briefly below as a Table of Contents. The paper itself goes into considerably more detail concerning the nature of each of these steps.

This is not a quick process. It took Prodem three years to found the BancoSol; you can learn from their experience and shorten your time. But it needs to be thorough more than it needs to be fast!

DETAILED DESCRIPTION:

STEPS IN BECOMING A FORMAL FINANCIAL INSTITUTION FOR MICRO-ENTERPRISE DEVELOPMENT

STEP 1

ANALYZING THE VISION, THE PROBLEM, THE BENEFITS, AND THE COSTS

a. The Vision: TSPI is an organization with a clear, defining vision: to touch the lives of the poor by aiding small enterprise development; to develop values through training.

b. The Problem: TSPI is constrained in the number of lives it can touch; TSPI can reach only a tiny and static portion of the swelling ranks of the poor.

- TSPI has limited funds available to it.
- TSPI is dependent on donors, whose own funding priorities are subject to constant change.
- TSPI is dependent on donors whose own level of giving decreases over time.
- TSPI is dependent on donors, which limits its own control over its program and priorities.
- Raising donor funds is both labor and cost intensive; too many TSPI resources must be devoted to raising funds and cultivating donors, rather than to lending money to the poor.
- Being donor-dependent makes it unlikely that the TSPI program can ever become fully self-sustainable; the situation can only get worse.

c. Some Potential Solutions and Options:

- Become an intermediary for banks, selling them the services they need to comply with the "Magna Carta." This would provide TSPI with very large amounts of funds to lend, but TSPI might still need grant funding for anything TSPI wishes to do with the client group beyond handling their loans. TSPI would reach a vastly larger number of the poor, TSPI would be dependent on the bank and on banking legislation.
- Find another source of supporting income: sale of services, etc. What services could TSPI sell, to whom, for how much?
- Be a conduit for Government of the Philippines soft loan handling. TSPI already does some of this, but TSPI could make this the dominant focus of their program, and significantly expand the numbers of micro-entrepreneurs.

- Continue to seek concessional flows of foreign assistance. Drawbacks: dependence, declining pools, aging portfolio, very high maintenance and capital/labor intensive activity.

- Become a formal financial institution in its own right: TSPI creates or purchases a bank.

The TSPI board needs to consider the problem and weigh the options available to it. The options above are not the full list; there are undoubtedly several other paths open to TSPI. However, preliminary analysis seems to indicate that becoming or founding a bank is an option worth studying.

In Summary:

- The benefits of being a bank include having access to steady, significant and predictable new sources of income:

  - deposits
  - equity
  - loans

- The costs of being a bank:

  - Financial costs: 6% - 20%
  - Operating costs: 10% - 30%
    (including losses)
  - Profit: <u>10%</u>
  - Range: 26% - 60%
    of interest rate required

    $\frac{\text{Total Operating Costs}}{\text{Average Loan Portfolio}}$

Even with these costs taken into account, experience indicates that this model might solve TSPI's major financing problem.

d. Issues Identification

Once you have finished clarifying the TPSI vision, looking at constraints, and identifying options open to TSPI, it makes some sense to hold a brainstorming session, to identify as many potential issues as possible. Each issue is a "fact of business" to be studied in deciding whether to move to a formal financial institutional model, such as a bank. A few examples are given below; you will add many more.

The point of this exercise is not to resolve these issues, but to look at the trade-offs: what happens if we do this; what happens if we do not? Which brings us closer to making our vision real? Which overcome our constraints? Which are just comfortable?

This exercise will also help identify areas where more information and research is needed, and where there is - and is not - consensus.

1. **Issues of Service and Scale**

What alternatives exist if we wish to continue to serve the poor? (Let alone expand the availability of credit for microentrepreneurs).

a. Be an intermediary for banks seeking to comply with the Magna Charta. Probably still need grant funding for anything TSPI wishes to do with the client group beyond handle their loans.

b. Find another source of supporting income: sale of services, etc. What services can TSPI sell, and to whom, and for how much?

c. Be a conduit for GoP soft loan handling, as some TSPI funding is now, but make it the major focus of the organization and its fund seeking.

d. Continue to seek concessional flows of foreign assistance. Drawbacks: declining pools, aging portfolio, very high maintenance and capital/labor intensive activity.

2. **Issues of Credibility and External Judgments**

In order to attract investors, we need to be certain that our current program can meet the test of the market. Are we good enough at lending to put ourselves forward as a good investment for others to make? Do we have a methodology that is genuinely profitable? Are we completely sincere in offering to others the chance to invest in what we do, and to profit from it? Do we honestly want to put ourselves and our program to the test of the market, knowing that the money of friends and colleagues will be riding on this?

What happens if we fail, and our investors lose what they have placed in our trust? Can we unflinchingly face that possibility?

3. **Issues of Control**

Do we wish to limit our investment offering to those who share with us a vision of service, faith and community, or are we willing to allow the possibility that control of the lending and investment policies of this bank would be in the hands of those whose predominant interest in the bank is its (and therefore their own) financial success?

If not, how can we safeguard the values which are critical to the operations of the bank as we wish it to be? (Seek majority investment from within our own community, for example).

4. **Issues of Commercial Practice**

How do we deal with matters such as salaries for bank officers (vis a vis salaries for TSPI staff); benefits and perks, incentives and other bonuses, costs of doing business that are not common in the PVO community. Ethics of the bank. Ethics of its employees.

5. Issues of Profit and Cost

The cost of making loans to the poor is demonstrably more expensive than making larger loans, or loans to those with abundant collateral. Therefore, our bank will need to charge interest rates higher than those charged by normal commercial banks.

In order to attract the investors who will capitalize a formal financial institution, the financial plans will have to include an attractive rate of profit.

Since volume will be an important factor in bank profitability, the bank will need actively to encourage all sorts of borrowers; it probably cannot afford to have many criteria in selecting to whom it will lend. Does this raise any issues for us?

STEP 2

PRE-FEASIBILITY STUDY

A. General:

The pre-feasibility study should be carried out by a staff person or local consultant working closely with operating and management staff of TSPI. To do a credible job and to study all of the options available will take in the range of 3-4 months. In addition to the need for one person to be responsible for preparing the report, TSPI will need legal and accounting advice.

The pre-feasibility will have to be prepared in a form and in detail sufficient to get and hold the attention of potential investors, lenders and partners. This required level of professionalism is not necessarily the same as has been experienced to date by TSPI in dealing with donors.

The pre-feasibility study will contain two basic components; a narrative section and a financial model.

1). Narrative Section

Although they may seem obvious to the staff currently involved in the day to day activity of TSPI some very basic issues will not be so clear to all readers of the pre-feasibility study. Some time should be spent clearly describing the following as background to the study:

- Who are the clients?
- What is the product or service being provided or proposed to be provided by TSPI?
- How are the products or services delivered, ie. what is the operating structure or "Lending Unit" currently used or proposed? (ie. small decentralized offices that in effect go to the clients or larger offices that centralize the administration costs).
- What is the challenge or problem faced by TSPI?
- What are the structural options available to solve these problems or to respond to this challenge?

The above questions should be answered in as much detail as possible. For example, with respect to the clients, TSPI should describe where they are located, their economic activities, their level of assets or income, etc. TSPI should not assume that there is widespread understanding of or experience with the micro-enterprise or informal sector. Providing clear answers to the above questions means the reader is more likely to be able to understand the costs of providing services to the clients, the income to be earned from this activity and the conclusions of the pre-feasibility study.

The narrative should also provide a summary of the assumptions used in the financial model.

2). The financial model:

The financial model should be developed on Lotus 123 or some other similar and commonly used computer modelling system to provide a pro-forma Income Statement and Balance Sheet for the proposed institution for a period of at least 4-5 years. The first 2-3 years should probably be forecast on a quarterly basis whereas subsequent results can be forecast on an annual basis. A pro-forma Sources and Uses Statement and a Statement of Retained Earnings may also be integrated into the model as a further sophistication and as a check on the two basic statements. All proforma financial statements must be part of the same model and must be linked one to the other. A change in the value of the loans outstanding on the balance sheet, for example, must result in a change on the interest income on the income statement, cash from operations on the sources and uses statement and profit before dividends on the statement of retained earnings without manual adjustments.

Four options have been discussed to date with respect to the basic financial structure of the proposed institution;

- The conversion of TSPI into a formal sector for-profit bank (the PRODEM/BancoSol solution).
- The incorporation and start-up a new bank.
- The purchase a bank with a conversion of its existing activity from larger savings and credit services to micro-financial services.
- The addition of micro-financial service capabilities to an existing bank (closer to the BRI Unit Desa model).

For each structural option considered by TSPI a separate model should be constructed. If there are other options which TSPI would like to explore as potential solutions with respect to the issues of sustainability and funding for long term growth (the financial intermediary option, for example) models should be constructed for these as well.

The difference between **structural options** and **operational options** must be clearly understood. None of the options listed address the question of what is the most effective or appropriate methodology for lending to or collecting savings from the micro-enterprise sector. The choice of the best operational structure is a separate issue. TSPI must determine how it will organize its lending activities in the future (if different from current procedures) as well as how it will carry out savings collection. Once these operating characteristics have been designed they must be summarized as a collection of assumptions and variables and then applied to each structural model.

Some of the operating assumptions which go into the model will not be used for sensitivity analysis — others will be. We recommend that at least the following assumptions be modelled for sensitivity:

- Interest rates on assets (loans, certificates of deposit and other short term instruments) and on liabilities (deposits, inter-bank loans and loans from the Central Bank);
- Average loan size;
- Average loan term;
- Productivity, ie. the number of clients or the average loan portfolio managed per field worker; and
- Salary paid the field staff.

The result of the financial modelling process will be an answer, for each option considered, to the following questions:

- What will be the interest rate structure required in order for the institution to break even or to make a certain level of profit within a desired time?
- What will be the total funding required to accomplish the profitable operation of the institution?
- What is the optimal or preferred relationship between debt of all kinds and equity?

With this basic information TSPI staff and board members will have what they need to decide on the option which is most feasible and to begin discussions with potential partners, investors and lenders.

Note: A forecast period of 4-5 years was recommended primarily because it is felt that the institution should be profitable within this time period. TSPI may wish to forecast for a longer period. We caution, however, against using long term IRR or PV of cash flow for a period greater than 5 years as the primary measure of the profitability of the proposed institution. A feasibility decision based on discounted cash flow calculations which require most of the profits to be earned 5-10 years into the future for an operation such as this is not considered prudent. We reccmmend that TSPI not rely on long term profitability measures but rather on the number of years to break even and the forecast profitability on an annual basis.

B. Detailed Advice with Respect to the Creation of a Financial Model:

The pro-forma income statement and balance sheet will be developed simultaneously in a back and forth iterative process. The assets on the balance sheet tend to be developed first under the assumption that funding is not a constraint. The final step is to prepare a financing structure of debt and equity both to meet the minimum requirements and, at the same time, adequately fund the forecasted assets. The income statement and the balance sheet should be presented in the standard order for financial institutions as outlined on pages 12 and 13. The presentation will not be on a fund accounting basis.

1. The basic model should start with a forecast for the **loan portfolio outstanding** and **deposits** built up over time. By completing these two basic forecasts TSPI will also be forecasting most of the other income statement and balance sheet items, for example:

- **Fixed assets** since some investment in premises, computers, furniture, etc. will be required in order to be able to deliver credit or collect savings. A separate schedule of fixed assets over time should be prepared by asset category and should calculate the annual depreciation expense. The total **net fixed asset** value from this schedule and the **depreciation expense** should transfer to the balance sheet and income statement respectively,

- The number of staff required to attain the levels of lending and saving collection leads to an estimate of the **field staff salaries** required, the single largest component of the institution's operating expense once it reaches break even,

- **Loan interest income** derives from the loan portfolio forecast and will vary with the interest rate charged for loans,

- **Deposit interest expense** derives from the forecast for deposits and varies with the interest rate to be paid.

2. Next the layers of administrative staff and the salary costs associated with them should be added. This estimate will depend on the "Lending Unit" proposed by TSPI. A separate staffing summary should be prepared that lists the different staffing levels in terms of numbers of persons in each position as well as the salary levels for each position, field and administrative. The line from this summary that shows total **field staff salaries** and total **administration staff salaries** should connect to the income statement.

3. Regulatory items can now be added to the model. For example the requirement to hold **cash with the Central Bank** probably varies with the deposits held. These funds will appear as short term assets and will produce part of the **non-loan interest income** on the income statement. **Loan loss reserves and provisions for bad loans** may also be prescribed and should be built into the balance sheet and income statement in accordance with these regulations.

4. Formulas for **taxes** (based on profit or equity consistent with tax regulations) and **other general and administrative expenses** (may be forecast as a percentage of total salaries) can now be added. If there are any **non-interest income** or **other expense** items proposed these should be modelled also. **Cash on hand** requirements can be estimated as a percent of deposits outstanding. The experience of existing banks or other financial institutions can be of assistance here.

5. Now that all of the assets are in place on the balance sheet and the deposit liabilities have been included, assumptions with respect to **other debt** and equity in order to balance these assets can now be structured in the model. Other debt will produce **other debt expense** on the income statement.

If minimum equity requirements are in excess of asset funding requirements these excess funds will go to **other short term investments** and will contribute to **other interest income**.

The equity will be in two or three parts — **paid in capital** and **retained earnings** and possibly reserves (if these are required to be shown as part of capital). A separate schedule for paid in capital should be developed showing the amounts contributed or anticipated from each investor at various times consistent with regulations. A schedule of retained earnings should also be developed but this will depend on dividend policy and net profit. A circular logic problem will be encountered in the development of the total equity position since the retained earnings portion depends on **net profit** which in turn depends on income from surplus funds which depends on equity. One solution is to not add the profit earned in one period to retained earnings until the next period.

It is possible that the costs incurred in the creation of the proposed financial institution may be capitalized. Whether the funders will obtain equity for the **development expenses** will be determined by the local accounting standards and the regulatory body. If the expenses are acceptable this technique can reduce the total capital required to be raised for the institution.

The preceding steps will not apply to all situations that TSPI will want to model. They are offered, along with the attached blank balance sheet and income statement, in hopes they may be useful as a checklist for the preparation of these models.

SAMPLE BLANK INCOME STATEMENT

INCOME

Interest income:

loan interest income
non-loan interest income

Total interest income

Cost of financing:

deposit interest expense
other debt expense

Total cost of financing

Net interest income:

Other income

Total income from operations:

OPERATING COSTS

Salaries:
field staff salaries
administrative staff salaries

Total salaries

Loan loss provisions

Depreciation expense

Other general and administrative expenses

Expenses

Taxes

NET PROFIT

SAMPLE BLANK BALANCE SHEET

ASSETS

Short term assets:
cash on hand

deposits with the Central Bank

other short term investments

Total short term assets

Loan portfolio:
loans outstanding

loan loss reserve

net loan portfolio

Net fixed assets

Development expenses

Total assets

LIABILITIES

Deposits

Debt
- short term
- long term

Total liabilities

EQUITY

Paid-in capital

Reserves

Retained earnings

Total equity

STEP 3

PRELIMINARY DISCUSSIONS

Once the pre-feasibility study has been completed and the Board of Directors has a preferred structure in mind as a result discussions with a number of groups or individuals should be initiated. The reactions of these parties will allow TSPI to test the feasibility of the proposal and to revise it. It should be recognized that these discussions may represent the beginning of a negotiating process and that just because an investor or lender objects to something doesn't mean that the issue is a deal breaker.

The pre-feasibility study should be provided to the following and should be followed up with individual meetings and discussions:

a). Potential Investors

No matter which option is chosen by the TSPI as the most feasible there will probably be a requirement for equity. This is a new potential source for TSPI and time will have to be taken to understand the perspective and concerns of investors. TSPI should begin to make up a list of potential local and foreign sources of equity funds. This list may include the following:

- Local church members and church institutions;
- Local banks;
- The investment section of the Asia Development Bank; and
- The Calmeadow Foundation.

When discussing the project with investors TSPI should be trying to get information and reactions on these issues:

- Would the investor consider funding the development costs of the proposed institution (Step 4, page 16)?
- How does the investor react to the perceived risks and returns, both social and financial, of the project? Does the investor think that the return forecast is acceptable, if not what would likely be required? What risks are considered unacceptable?
- Would the investor expect to have some representation on the Board of the institution?
- Does the investor have an interest in providing technical or management assistance to the project?

b). **Potential Lenders**

Depending on the forecasts the proposed institution may require debt financing. This type of financing is only likely to be available if there is adequate equity and profit and consequently may not be feasible until several years of successful operation have been achieved. It would not hurt however to begin to develop a relationship with local and foreign sources of loans to learn about the terms and conditions that will likely be faced in the future.

The procedures and requirements for loans from the Central Bank should also be discussed. This source of funding may be more practical in the short term than commercial or private sector loans. These Central Bank funds may originate from foreign development institutions and the availability of these funds which may be available on concessionary terms should be investigated both locally and at the source.

c). **Potential Partners**

Existing Philippine banks may be potential partners to this venture and should be cultivated not only as lenders. The banks are required to lend to the small and micro sector and it is possible that how they can do this is still negotiable with the government.

Partners with technical and managerial experience in financial institutions should be sought out and brought into the project. PRODEM/BancoSol, BRI, GEMINI and Calmeadow Foundation and again the local banks are all potential partners in this process and should be included in the distribution of the pre-feasibility study and their reactions should be solicited.

In addition to initiating discussions with potential lenders, investors and partners TSPI, once the pre-feasibility study is complete, should also begin negotiations with its existing funders. It is possible that the structural strategy proposed will require the approval of donors if the proceeds of their grants or loans will be used in a manner inconsistent with agreements now in place. TSPI will have to develop arguments as to why donors should permit the organization to transfer its loans to a for profit bank (for example), if that is the preferred solution. This concept may be resisted unless presented in a logical manner that can be shown to be consistent with the donors own objectives. TSPI will want to spend time researching the stated and unstated policies of its existing funders in order to be able to present this proposal properly.

The final influential group whose reactions must be obtained include the professionals in the Philippine financial sector. The lawyers and accountants familiar with financial institution incorporation and approval should be approached. These individuals can advise TSPI with respect to when and how the Superintendent of Banking must also be approached.

STEP 4

CREATION AND FUNDING OF A PROJECT MANAGEMENT TEAM

The creation of a sophisticated new financial institution will require single minded dedication, professional skills and adequate funding. A project management team should be created to handle this process. The key person on the team should be someone with the potential to assume a major financial position in the proposed institution, perhaps the same person responsible for the pre-feasibility study. There must be constant communication between the project management team, the Board of Directors, and the existing staff of TSPI, particularly if this staff will transfer to the new operation.

Sufficient funding to support this activity must be committed before the team is authorized to begin work and the time and expense involved must not be underestimated. The whole process, from the time that the Board of Directors gives the authorization to proceed with the development of the new institution until its incorporation or start-up may exceed one year.

The work involved will depend on the structural option to be implemented but will likely include the following;

a). Completion of The Feasibility Study:

A more complete version of the work previously carried out (Step 2) will have to be prepared. A feasibility study will form the basis of two important documents - a submission to the Superintendent of Banking for approval to operate the new financial organization and a prospectus for investors and lenders. The one feasibility study can be repackaged to form the bulk of the two documents.

In addition to the final financial model (which will by then be completed) the feasibility study will also contain the following sections:

- Background; how has TSPI developed, what are the objectives and visions for the organization and what is the current situation that resulted in the proposed financial strategy?
- Operational description of TSPI; cost and quality summary of TSPI's lending activity to date.
- Market study; who are the target clients, what product or service is proposed, what is the competition, what is the forecast demand for the product or service (total and forecast market share according to the proposed plan).
- Description of the financial industry in The Philippines: now is it regulated, how is it segmented, what is the current and forecast interest rate environment.
- Summary of the legal and regulatory features of the proposed plan of action.

- Financial plan.
- Risk analysis.

b). Securing Financing

Share purchase commitments and agreements will have to be negotiated and legally documented. As a parallel issue the structure of the Board of Directors will have to be designed as will their roles and responsibilities.

c). Legal Incorporation

If a new entity is to be created it will need incorporation documents - statutes, bylaws and registration, etc. This process will be unique to the Philippines but will be fairly standard for any local corporate lawyer.

d). Regulatory Approval

The process of obtaining approval to operate a new financial institution is separate but linked to the incorporation process. The approval process must be clearly understood and only a lawyer familiar with the process can advise on this.

e). Conversion or Upgrading of TSPI

If TSPI is going to convert itself into a for-profit institution there will be need to improve the standards of accounting, monitoring and reporting within the organization in order to meet the information requirements of the investors and the Superintendent of Banking. This is not to say that TSPI's current procedures are not adequate for an NGO but a commercial financial institution obviously requires more in this area.

If TSPI is not going to convert into a bank or some other formal sector institution there will still be a great deal of design work to be done on systems, personnel policies, procedures for the new entity. Computer specialists as well as organizational consultants may have to be brought into the team for specific assignments.

It is clear from the above that a great deal of skill and work is required to create a formal sector financial institution even if it is going to serve the informal sector. This realization must not be overlooked in the decision by the Board of Directors of TSPI to proceed or not to proceed following the preparation of the pre-feasibility study and the subsequent discussions with investors, partners, etc. Whereas it is not an easy task, the example of PRODEM/BancoSol should encourage TSPI staff and Board members to consider the effort.

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*Publications of general interest

13. "Dynamics of Microenterprises: Research Priorities and Research Plan." Carl Liedholm and Donald C. Mead. GEMINI Working Paper No. 13. August 1990. [not for general circulation]

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