Access to Microfinance & Improved Implementation of Policy Reform (AMIR Program)

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Treasury Management Workshop

Final Report

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Treasury Management Workshop

29 - 30 July 2001

Summary

Memo To:	Mr. J. Whitaker, Component Leader
From:	Graham Perrett, Consultant
Date:	July 31, 2001
Re:	The Workshop on Treasury Management

The above-mentioned workshop was held over a 1.5 day period during July 29-30, 2001 at the offices of Microfund for Women (MFW). Appreciation is expressed to the management of MFW, and to the Training Team of AMIR, for assisting in the setting up and conduct of the workshop. The attendance at the workshop was good, with all MFIs sending representatives, as follows:

Mr. Y. Kandah	AMC
Mr. A. Thyabat	AMC
Mr. Y. Fraheed	CHF
Mr. K. Muhiesen	CHF
Mr. H. Jaber	JMCC
Mr. H. Sayees	JMCC
Mr. Z. Al-Refai	MFW
Ms. Z. Masannat	MFW
Ms. D. Bseisso	MFW
Mr. J. Whitaker	AMIR
Mr. J. El-Wheidi	AMIR
Ms. S. Qadoura	AMIR
Ms. R. Tell	AMIR

The goal of the workshop was to provide training in the basic principles of treasury management/ cash flow management, and to introduce a simple treasury management model which they can adopt to their own special circumstances. The workshop was extremely timely given the imminent launching of the Wholesale Funding Facility. The workshop agenda covered the following topics.

The importance of planning when managing an MFI.
The definition of financial planning, and the role of treasury management.
The definition of liquidity and liquidity risk
The goals and importance of treasury management
Sources of liquidity, and the pros and cons of tapping these resources
What are the best sources of liquidity to use during the various stages of growth of an MFI.
A brief outline of the Wholesale Funding Facility
How to negotiate facilities with potential lenders
Critical criteria of treasury management
A discussion of the major liquidity inflows and outflows.
Key issues to remember
The importance of a liquidity reserve
The management of funding gaps and funding surpluses
Maturity matching and mismatching
Risks
Crisis management

Liquidity ratios
Introduction to and practice with the treasury management model

During the course of the workshop several issues of interest evolved. These are discussed below, together with some general observations of the workshop itself.

(i). A primary concern is that some of the attendees will feel that, since the model is very simple (by design) and is based on EXCEL, that treasury management is easy. Moreover, these individuals could conclude that knowledge of EXCEL translates into knowledge of treasury management. This attitude could result in them misunderstanding the importance of making the correct assumptions for entry into the model, the need to clearly interpret the results, and the role of planning based on the model's output. While the more specific concerns in this regard are discussed below, this general observation is made since some of the MFIs may be gulled into thinking that they are managing their liquidity well, and will call for assistance only after they become illiquid. The potential of such an occurrence behooves the staff of AMIR to be proactive in this regard. Hence, it is suggested that, on a periodic basis, the MFIs should be asked for the details of how they are undertaking their treasury management planning.

(ii). While the workshop was completed within the allotted time, and covered the basics of treasury management, it is apparent that the concept of treasury management is a new one for most participants. Further assistance is likely to be needed, both to enable the MFIs to start undertaking basic treasury management, as well as to implement more sophisticated techniques as their financing needs evolve.

(iii). Some of the attendees are still not clear about the difference between cash and accrual accounting. Given that in most of the institutions the role of Treasurer will fall to the Accountant/ Finance Manager, this could quickly result in mismanagement of the treasury function, with dire results. The AMIR microfinance team will have to continue close monitoring of the institutions to ensure that the treasury managers do not include non-cash transactions in the cash flow forecasts.

(iv). While many of the attendees began to comprehend the concept as the workshop progressed, the basic understanding of risk, and risk tolerance, needs to be better understood. The level of risk undertaken by the MFIs will be increased considerably when they begin tapping into the Wholesale Funding Facility. While the workshop stressed the need for correctly identifying, quantifying, and managing the cash cushion, its importance will need to be continually emphasized by the AMIR staff going forward.

(v). Although the workshop included a section of negotiating with lenders, it is felt that the MFIs (particularly JMCC and MFW) will need some additional assistance when the time comes for them to start opening discussions on this issue. It would be useful if the AMIR staff discussed potential negotiation strategies with the MFI management teams prior to the latter commencing negotiations with lending institutions.

(vi). As is to be expected, there is a lack of experience regarding the short- term investment of surplus funds. This inexperience was evident amongst the former bankers and non-bankers alike. This inexperience manifested itself both in limited knowledge expressed regarding the range of investment options available, how to identify the appropriate maturities, and whether and when to pay-off outstanding debt with surplus funds[1]. When the MFIs are in the position of having short term surplus funds, the AMIR team should be prepared to provide guidance regarding the appropriate strategies to take.

(vii). The MFIs clearly intend to use the WFF as their first option for accessing debt capital. Nonetheless, they are not fully aware of the restrictions and responsibilities associated with drawing down under the Facility. The MFIs will need to be encouraged to review the WFF agreements well in advance of implementing negotiations with the Lenders and with the Facility Manager prior to accessing the Facility.

Hand Outs

[1] Some attendees were proposing that they borrow funds for investing in short term instruments that yielded a lower rate than the cost of the borrowing.

Treasury Management Workshop
Micro Fund for Women
29-30 July 2001

PLANNING:

Strategic Planning*:* The process by which the guiding members (founders, sponsors, donors, or board) of an organization envision its future and develop the necessary procedures and operations to achieve that future

Operational Planning: is the development of a framework for implementing the strategy outlined in the strategic plan.

The flow of the operational planning process is:

1. Start with the strategic plan

2. Establish the assets needed to achieve the goals of the strategic plan:
   Products
   Funding
   Staff
   Infrastructure
   Management Capacity

3. Inventory of what of the above you have on hand

4. Identify where you can find the shortfall

5. Establish the process and timing for implementation

6. Implement

7. Monitoring and follow-up

Financial planning outlines the projected monetary results of a successful implementation of your strategic and operational goals over the lifespan of those goals, and quantifies the resources needed to achieve those goals.

Three components of financial planning:
- Income projections
- Balance sheet management
- Cash flow management planning/Treasury Management

<u>LIQUIDITY:</u>

Liquidity: is the ability of a financial institution to honor all cash payment commitments as and when they fall due.

Liquidity risk: is the possibility of negative impacts resulting from the inability to meet current payment obligations in a timely and cost-efficient manner.

The classic sources of liquidity are:

- Retained Earnings
- Donor Funds
- Equity Investments
- Highly Concessionary Long Term Loans
- Wholesale Lending Facility
- Commercial Loans
- Creditors
- Shrinking your assets/Loan Portfolio

Retained earnings:

pros:

stable
very cheap
completely within your control

cons:

relatively small amounts compared to need
slow to accumulate

***Donor Funds*:**

pros:

large amounts
often paid in lump sums
cheap
once received, they are stable

cons:

timing can be erratic
can be restricted to certain activities
complicated reporting requirements (and forecasting)
can lead to donor interference in daily management

Equity Investments:

pros:

- very stable
- cheap
- not subject to restrictions

cons:

- small amounts
- tends to be offered after you are successful and don't need it
- investor may require
    - a seat on the board of directors
    - special reporting requirements

Highly Concessionary Long Term Loans*:*

pros:

- large amounts
- cheap
- normally are for medium and long term maturities

cons:

- terms can be very restrictive
- lender interference/reporting

Commercial Loans:

<u>*Short Term loans:*</u>

pros:

- available on demand
- little day to day interference
- terms and conditions clearly outlined
- use only on an as-needed basis

cons:

- expensive
- application/approval process can be slow and complicated
- might be repayable on demand (overdraft)
- not useful for long term capitalization needs

<u>*Long Term Loans:*</u>

pros:

- available as a lump sum (unless obtain on a rotating loan basis)
- stable for period of loan
- useful for long term capitalization needs

provides flexibility

cons:

expensive
reporting requirements to the lender
might be restrictive regarding purpose
the need to plan in advance for the repayment

Creditors

Pros:

Cheap
Easy to carry out
Carefully managed, little long term negative impact

Cons:

Key services can be interrupted
Reputation risk
Badly managed, major long term negative impacts

Shrinking your Loan Portfolio:

Pros:

Cheap
Improves liquidity quickly

Cons:

Impacts reputation risk
Negative effect on the loan portfolio

Wholesale Lending Facility

Pros:

Operates on a back- up guarantee basis.
Should be cheaper than non-guaranteed commercial borrowings. 300-400 basis points.
No direct monetary cost attached to using the WFF
Great flexibility. Can go to manager and request increases. The lender is more likely to make available a revolving credit fund.
A great opportunity to “earn” a large capital injection in four years time.

Cons:

An additional level of oversight (from Citibank)
Forces both the MFI and the lending bank to negotiate for the long term.
The WFF is forcing leverage (gearing) onto both parties, which the lender will want to resist.
In you run into trouble, Citibank should be treating you as a potentially bad loan. This can be an unpleasant experience.

Which are the best sources of funds in the following circumstances?

start-up
- equity investment
- donor capital

growth stage
- long term loans
  - subsidized
  - commercial
- donor capital
- equity

maturity stage:
- retained earnings
- equity capital

short term needs:
- short term commercial loans

*capital expenditure***:**
- specific donor funding
- long term funding
- commercial
- subsidized
- equity capital
- retained earnings

Dealing with Lenders

Without the wholesale lending facility:

1). The key is to produce projections that prove that the repayment of principal and interest is assured

2). Have a current business plan

3). Highlight the second way out for the lender. this will probably be your loan portfolio.

4). The lenders will focus on the principal and interest coverage ratios.

5). Lenders prefer small, regular repayments of principal and interest rather than bullets or balloons.

6). Stress the full range of services that you will require from the lender. all services are profitable to lenders.

7). Remember, in this situation the roles are reversed. you are now the borrower.

With the wholesale lending facility:

The need to negotiate for a match between (no) risk and reward.

Be clear on the issue of hidden charges.

Negotiate at the beginning the leveraging of the WFF. Don't allow them to back out of the leverage issue after 2-3 years.

Stress the possibility of the WFF being capitalized, which will strengthen your debt to equity ratio and improve any future interest coverage ratio.

Try and minimize the reporting requirements you have to provide to the lender, possibly using the same format as required by AMIR and/or Citibank.

CASH FLOW MANAGEMENT/TREASURY MANAGEMENT:

Cash flow management, or Treasury Management: is the technique used to ensure that the MFI has sufficient liquidity on hand to meet all of its short and long term obligations as and when they fall due, plus maintaining a reserve to cover any unforeseen circumstances.

The goal is to make a sufficient amount of liquidity available at the lowest possible cost to the MFI, and to maximize the returns on any surplus liquidity, without imperiling the financial well being of the MFI.

Why is Treasury Management important?
The critical aspect of all financial institutions is to maintain the confidence of their investors, depositors, clients and donors. This is achieved by being able to meet all of their cash flow demands without delay. This means having sufficient liquidity to hand at all times. Banks normally don't fail because they have isolated bouts of net losses; they fail when they cannot meet the cash requirements of their depositors, investors and borrowers.

For MFIs it is particularly important, since one of the main levers they have in dealing with their clients is that if the unsecured/ partially secured loan is repaid, they will receive another, possibly larger, loan. If there is no prospect of a follow-on loan, the incentive to repay is weakened considerably.

There are two components to treasury management:

- Making sure you have enough liquidity on hand.
- Investing/ managing surplus funds

Types of Treasury Management needs to be done

- Capital Cash Flows
- Operational Cash Flows
- Administrative Cash Flows
- Do a combined cash flow

The approach used depends on:

(i). Whether the source of funding is tied to a particular purpose.
(ii). There is a need to maintain separate bank accounts for specific types of outlays- operational and administrative

<u>Critical Criteria for Treasury Management:</u>

1. Keep it Simple

2. Establish a clear policy towards treasury management
   liquidity levels,
   in what form (cash, short term investments, line of credit)
   combined or separate approaches between portfolio and operational

3. Identify the responsible person for TM- who is most appropriate

4). The critical need of a good MIS system- bad data, bad treasury management

5). Ensure that everybody in the MFI, including the loan officers, knows what is the liquidity situation.

5. Frequency versus details

6. Update on a regular basis- weekly if possible, no more infrequently than monthly.

7. The importance of being easy to interpret and understand

8. The issue of timeliness versus accuracy.

9. The need for plan B

Components of Treasury Management

Opening Balance

Inflows:

- Loan Repayments-Principal
- Interest on Loans
- Donors Receipts
- Capital Subscriptions
- Borrowing Drawdowns
- Sale of Fixed Assets
- Liquidation of investments
- Interest on investments
- Recovery of loans written off.
- Membership fees
- Commissions

Outflows:

- Loan Disbursements
- Purchase of Fixed Assets
- Short Term Investments
- Repayment of Borrowings
- Interest on Borrowings
- Operational Expenses:
    - Salaries
    - Rent
    - Travel expenses
    - Motor Vehicle expenses
    - Communications

ISSUES TO REMEMBER

The issue of Uncertainty.
Treasury Management is short term management. The time horizons have to be kept short. (compare to strategic and operational planning).
The issue that treasury management is based on cash, not accrual accounting.
The difference between budgeted and actual expenses

CRITICAL ISSUE

- Treatment of late loan repayments-
- Allowance for non- repayment
- What is a reasonable allowance factor?
- Allowing for non-performing loans
- The need to track this for accuracy.

The Liquidity Reserve: is the minimum amount of funds that are kept in a readily accessible form to cover any emergency outlay that may occur. This liquidity can be maintained in terms of a current asset or by the capacity to borrow at call.

Forms of Liquidity Reserve:

Cash
Short Term Investments
Line of Credit/ Wholesale Lending Facility

Amount Of the Reserve:

No fixed rule.
Need to be prudent
Regulatory Requirements-current and future attitudes of Central Bank of Jordan.

Suggestion-
One months administrative expenses
Two weeks of gross borrowings

This issue of seasonality and its impact on:

Loan demand
Deposit withdrawal
Expenses

The lumpiness of expenses:

Expenses are not necessarily smooth-rent paid in advance, major repairs, bonuses.

Capital Expenditure outlays:

The tendency to overlook them
Payable in large lump sums

Donor Funds:

Don’t assume that donors will make funds available on the agreed date (don’t assume that all promises will be kept).

DISASTERS:

The impact on cash flow (question, what is the impact and how do you manage it?)

How to manage:

- Cash Reserve
- No new loans
- Clear plan for recovery in advance
- Approach donors with plan

The Funding Gap and the Funding Surplus: is the shortfall between the expected amount of liquidity available for future outlays and the projected amount of outlays that have to be paid.

The Funding Surplus is the excess of liquidity available over what are the projected outlays and liquidity cushion. These funds are available for short term investments.

In terms of investing surplus funds:

Two Issues:
(i). The trade-off between higher returns versus liquidity.
(ii). The issue is the purpose of the short-term investment.

The main aim is to put to use idle funds when they are not needed for the primary activity, which is microfinance. Therefore, liquidity purposes should overrule the maximization of earnings from short-term investment.

Be prudent, invest only in short term, low risk investments.

In terms of the funding gap:

- Know what your potential sources are in advance.
    - Donors
    - Creditors
    - Lines of Credit
    - Wholesale Funding Facility
    - Retained Earnings
    - New Equity
    - Shrink the portfolio

Be clear as to what you are borrowing for:

- The issue of maturity matching and mismatching.
- Borrow short term to cover short term purposes (operating expenses, short term working capital loans)
- Borrow long term for long term purposes (long term loan to buy fixed assets, or to finance long term loans)
- The issue of understanding your own cash cycle is the same as understanding your client's cash cycle.

- The low cost option may not be the best
  - Donor money can come with strings.
  - Lower cost is usually shorter term

The best matches between needs and funding:

Needs	*Sources:*
Operational Expenses	Short Term Loan
Long Term Funding For Portfolio	Long Term Loan
Short Term Funding For Portfolio	Short Term Loan
Fixed Assets	Long Term Loan
Disaster	Equity/Long Term Loan

Pricing of the funding gap:

Marginal cost versus average cost

The key is to manage your credit relationship with the Lenders- Bankers don't like surprises.

RISKS:

Actual Risks faced by Treasury Managers:

Incorrect assumptions
The issue of margin of error
Deterioration in loan portfolio quality
Maturity mismatch of assets and liabilities
Undertaking Treasury Management projections too infrequently
Donors disbursing slowly

How to Manage these Risks:

Undertake treasury management frequently –weekly
Always have a back-up plan B
Know your clients and your market place-trouble always starts here.

WHAT TO DO WHEN IT ALL GOES WRONG AND THERE IS A CRISIS:

- Stop loans to new clients
- No incremental step loans to existing clients
- Delay payments to creditors
- Cut operating expenses
- Prepare a business plan before going to funders.

Liquidity Ratios:

The issue of whether liquidity ratios are really useful in day- to-day treasury management. Conventional wisdom says yes, but the case made for them is weak. Why? The need for liquidity is a daily event and is measured in monetary amounts (JDs) rather than in trends and relationships. Hence, it is more important to focus on actual amounts needed, rather than on ratios. Moreover, most ratios are historical (backward looking), while we need a forward (predictive) ratio.

$$\text{Liquidity Ratio} = \frac{\text{Cash plus expected cash inflows in the period}}{\text{Anticipated cash outflows in the period}}$$

TREASURY MANAGEMENT MODEL:

1. The Interlinking of the cells:
   - Loan disbursements
   - Loan repayments
   - Interest

2. The order of entry into the model

Knowns:

- Cash on hand
- Loan disbursements/repayments
- Interest on loans
- Administrative/ Operational Expenses
- Other budgeted outlays and receipts

Unknowns:

- Borrowings
- Investments
- Repayment of borrowings
- Redemption of investments

Case Studies

CASE STUDY 1:

You are the General Manager of Microcredit, which is one of Jordan's leading Microfinance Institutions. You have been in operation for three years and are operating at about 75% operational sustainability. To date you have been funded solely by donor grants, but these amounts are now declining rapidly. You are currently working on your strategic plan for the next 5 years, and some of the relevant goals and projected results are:

Achieve operational sustainability by the end of year 5 (i.e. in the next 2 years).

Double your loan portfolio from JD1.0 million to JD 2.0 million within the next 2 years

Currently you are making 6 month working capital loans, but plan to make JD 300,000 in term loans with 2 year maturities

Your net operating losses for the next 2 years are projected to total JD 250,000

Your projected purchases of fixed assets during the next five years are JD 190,000.

Staff training costs are estimated at JD 100,000

The largest non-salary expense is rent on your office, which you must pay 12 months in advance at the beginning of each calendar year. Annual cost JD 36,000.

What are:

The best approaches to funding these expenses, assuming that donor capital and long term concessional loans are not available for all of the above?

There is the option to borrow in foreign currency. What factors would you consider before deciding?

CASE STUDY 2:

It is now Microcredit's fourth year of operations, and several issues have arisen that have a direct impact on your liquidity position:

Your Portfolio at Risk ratio has risen from its previous norm of 3% of the loan portfolio, to 6% of the loan portfolio. Furthermore, your on-time loan repayment rate has declined from 90% to 80%, while the level of loans in default is unchanged. Nonetheless, you have decided to increase your Loan Loss Reserve from 2% to 3% of the loan portfolio. How should this impact your treasury management?

Inflation has risen steeply from the previous level of 1%-2% per annum to 5%-6% per annum. How will this affect your Treasury Management?

Your Driver has crashed your Range Rover 4 wheel drive vehicle and you have a loss on disposal of the vehicle of JD 9,000 (book value JD 20,000, insurance payment JD 11,000). How will you allow for this for Treasury Management purposes?

Currently your liquidity reserve is held in cash in your checking account at your bank, on which no interest is paid. The Bank has approached you and proposed that you invest this money (JD20,000) in a Time Deposit and earn interest at 6%. Then using this as collateral they will extend you a line of credit for JD 16,000 at an interest rate of 9%. Is this a good deal for you?

You have introduced a hot new management product, the Back to School Loan. The loan has a maturity of 2 months, and with an annualized interest rate of 48% plus a commission, is highly profitable. Demand is expected to total JD300,000. What would be the best way to fund this?

Please advise.

CASE STUDY 3:

Microcredit is now in its fifth year of operation, and has been extremely successful. Operational sustainability is 125%, and financial sustainability is 110%, both with a positive trend. The portfolio is growing at a rate of 50% and the loan quality is exceptional with a portfolio at risk ratio of less than 1%. You are looking to expand the portfolio at a rate of 20%-25% per annum and you will do this by introducing short term seasonal loan products with a maturity of 2-3 months. To do this, though, you will need to expand your network of branches and invest heavily in a new MIS system

As a result of your successes, a lot of lenders, investors and donors are keen to work with you, and are offering all sorts of interesting proposals.

> Lenders are offering short term working capital loans (overdrafts) at the prime rate plus 1% of up to JD 100,000, and five year long term loans of up to JD200,000 at prime rate plus 3%. But they require quarterly financial statements in their own special format, and monthly payments of interest, plus a lien on your loan portfolio. For the long term loans they have stipulated strong restrictions on loan portfolio growth and on the types of products that can be offered.
>
> Investors are prepared to double your current equity base, from JD 250,000 to JD500,000. But three years after the investment, they want 50% of net income to be paid-out as dividends, 2 out of 5 of the seats on the Board of Directors immediately, and strict limits on capital spending.
>
> Donors are willing to grant you JD 150,000 spread over three years in equal installments, but want you to lend to specific target clients. Also, they insist on a seat on the Board and special monthly reporting requirements.

What are the positives and negatives of each of these offers, and which one (or which combination), would you choose?

CASE STUDY 4:

At Microcredit a new financial year is commencing and you need to prepare your initial Treasury Management forecast. The assumption/ facts are as follows:

Opening cash on hand 45,000

Loan Product:

A three month loan product repayable in equal 12 weekly installments of principal and interest.

Interest is calculated at 10% flat, repayable in weekly installments

You anticipate a 75% on time repayment rate, and 20% will pay one installment in arrears. Loans not repaid will amount to 5% of loans disbursed.

Loan disbursements and repayments over the next twelve months are as follows:

Period	*Loan Disbursement*	*Repayment Principal*	*Repayment Interest*
Week 1	18,000	10,000	1,000
Week 2	22,000	15,000	1,500
Week 3	26,000	14,000	1,400
Week 4	25,000	15,000	1,500
Month 2	100,000	113,700	11,370
Month 3	105,000	98,600	9,860
Month 4	106,000	103,700	10,370
Month 5	102,000	104,300	10,430
Month 6	110,000	106,000	10,600
Month 7	108,000	106,700	10,670
Month 8	112,000	110,000	11,000
Month 9	114,000	111,300	11,130
Month 10	115,000	113,700	11,370
Month 11	109,000	112,000	11,200
Month 12	114,000	112,700	11,270
Total	1,286,000	1,246,700	124,670

A Grant of 50,000 is expected in month 8

Loan previously written-off and then recovered are expected as follows:

Month 4	5,000
Month 7	8,000
Month 11	11,000

An investor has promised to invest 25,000 in month 5

You expect to sell one vehicle (original cost 25,000, accumulated depreciation 15,000) for 8,000 in month 3

You will buy a replacement vehicle in month 4 for 30,000

A new computer will be purchased in month 8 for 5,000

Your operational and administrative costs will be as follows:

Period	Operational	Salaries	Rent	Travel	Other.
Week 1	2,000	0	10,000	250	600
Week 2	0	0	0	250	400
Week 3	0	0	0	200	350
Week 4	0	5,400	0	200	400
Month 2	1,000	4,200	0	1,000	1,800
Month 3	1,000	4,300	0	1,100	1,900
Month 4	900	4,300	10,000	1,100	1,850
Month 5	750	4,300	0	1,100	1,800
Month 6	800	4,400	0	1,000	1,700
Month 7	1,000	5,800	10,000	1,100	1,700
Month 8	900	4,400	0	1,200	1,800
Month 9	900	4,500	0	1,200	1,800
Month 10	1,000	4,500	10,000	1,200	1,900
Month 11	1,100	4,500	0	1,300	1,900
Month 12	1,500	4,500	0	1,500	2,000

The costs of borrowing will be 12%, payable monthly in the following month

Interest received on short term investments will be 6% payable monthly payable in the following month

Establish your own cash cushion

If you finish early, allow for the following seasonal loan.

> Amount 300,000
> Maturity 2 months, repayable on one lump sum, principal and interest, at maturity.
> Interest rate on loan 5% flat
> Disbursed month 9, repaid month 11.