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**KEYS TO FINANCIAL SUSTAINABILITY**

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**DRAFT OUTLINE**

## 1. INTRODUCTION

Until recently, most institutions concerned with microfinance focused their attention almost exclusively on outreach. For most, financial sustainability meant meeting cash flow needs. Extrapolating from the fact that smaller clients are more costly to serve per dollar lent or mobilized, most practitioners have felt that reaching the poor with microfinance services is essentially an unprofitable endeavor and to impose requirements on programs that they be financially viable is akin to forcing them to abandon their target group. As the kind of work Yaron has been doing at the World Bank shows, most microfinance programs continue to depend on subsidies and could not operate on a commercially viable basis (Yaron 1992).

As a recent study for USAID demonstrates, this axiom may not hold true (CHRISTEN, RHYNE, et al, 1994). A handful of highly specialized programs have developed during the past ten years which are achieving both broad outreach and long term financial viability. More importantly, the study concludes that institutions must achieve the financial goal of long term sustainability first, as a precondition for achieving broad scale impact with financial services for the poor.

Once the analysts had corrected for explicit and implicit subsidies, they found that several programs operating in widely varying economic contexts and that utilize different service delivery mechanisms, were achieving returns on earning assets comparable to private commercial banks in their respective countries. In most cases the institutions studied could reach these levels of returns on assets were they to adopt more adequate interest rate policies or increase the volume of their loan portfolios. All have adopted the financial and service technology that would enable them to be financially viable in the long run.

Originally, much of the impetus to concern ourselves with financial sustainability came from the desire of donors to wean microfinance programs from the steady flow of subsidies both in anticipation of budget cutbacks and in order to derive more long term impact from donations. Only recently have we begun to realize that the key advantage of financial sustainability is the

leverage investors can obtain with their funds, multiplying many times over the final outreach impact of their initial capital contributions. (author indebted to Richard Rosenberg for focusing his attention on the power of the following discussion)

The following typology of microenterprise finance programs illustrates the manner in which strong financial performance provides programs the opportunity to leverage their initial investments into ever increasing levels of outreach with decreasing levels of new capital investments. This typology is based on one simple criteria:

If a donor puts one dollar into a microenterprise finance program today, how much in microfinance assets will that dollar have generated after several years?

The classification scheme that follows does not represent airtight categories but rather is illustrative of different outcomes possible given different levels of financial performance.

#### LEVEL 1: SUBSIDY DEPENDENT PROGRAMS

At this level, a microfinance program does not break even on a cash flow basis and requires constant injections of fresh funds to cover out of pocket expenses. This means that if these injections are not forthcoming, the program will quickly consume its equity to finance the operational costs of administering its assets, or, in the absence of these funds, let its portfolio quality deteriorate. Either way, without constant capital injections, the program will cease to exist within a brief period of time. A donor dollar invested at the beginning of the year is worth considerably less than a dollar at the end of the year (if it remains at all). Because of their prospects, these programs have virtually no ability to leverage their initial equity investment by "borrowing" from third party sources.

#### LEVEL 2: SELF SUFFICIENT PROGRAMS

A program at the second level has achieved at least a breakeven point on a cash basis. It completely covers the

out-of-pocket expenses associated with the administration of its assets. Such programs may also cover most or all of their non-cash operating expenses such as fixed asset depreciation, impact of inflation on the program's equity, creation of reserves, and the opportunity cost of subsidized sources of funds. Over time, programs at this level show an ability to maintain themselves without continual injections of new capital. Under normal circumstances, a donor dollar invested into self sufficient programs is still worth approximately a dollar in later years. In situations of high inflation, however these programs are susceptible to having their portfolios eroded unless they implement aggressive interest rate policies. Programs at this level are usually managed by NGOs or specially created government financial intermediaries, generally with significant initial capital contributions.

Programs that are self-sufficient can usually leverage their equity by obtaining limited commercial or donor loans on the strength of their solvency. If the program is managed by an NGO, sustained solid financial performance will allow it to develop commercial financial relationships with banks. In several countries, banks have demonstrated that they are willing to lend up to two dollars for each dollar of program equity. At first these loans have typically been backed by additional guarantees (offered by donor or technical support agencies) but after a time, have been granted on the basis of sustained high levels of portfolio quality and financial performance with no collateral guarantee. In this case, the investment of one donor dollar yields about two to three dollars of total microfinance resources for poor clients.

### LEVEL 3: PROFITABLE PROGRAMS

Level three programs have demonstrated sustained profitability. Sustained profits have three basic and immediate effects: 1) They directly increase the program's equity base, 2) They can potentially attract additional outside equity participation, and 3) They can cause others

4

to replicate the experience in the hope of attaining those same levels of profitability.

Ultimately, profitable programs may eventually be allowed to become a recognized financial intermediary by regulators. Once an institution is considered a formal financial institution, whatever its type (license), it immediately gains some sort of access to 'commercial' sources of funding; meaning either access local capital or credit markets, or ultimately even permission to capture savings directly from the general public.

That would allow them to fund their credit portfolio fully in commercial financial markets, either by tapping into the national savings pool by capturing individual savings deposits or by attracting institutional investors through the issuance of bonds or securities. It is here that one dollar of donor investment can really pay off, leveraging up to twelve dollars of microfinance assets after a few years (Basil note). Even more so, were donor funds were responsible for establishing a program which was commercially successful and motivated private entrepreneurs to form other similar institutions, the leveraged effect of a one dollar investment could potentially far exceed even the twelve dollars in microfinance assets.

The following results from ten of the best microfinance programs demonstrate that we currently have the technology to generate microfinance services for vast sectors of poorer economies on a financially sustainable basis.

The remainder of this paper focuses on what these widely dispersed programs that operate various service delivery technologies do specifically to ensure their financial performance and their ultimate ability to reach vast numbers of poor with financial services. Interestingly, virtually all of these programs share these same features although their individual

manifestation in each may differ significantly. Given the brevity of this presentation, and the great similarity among programs, the remaining discussion will be kept at a conceptual level with only occasional use of particularly striking anecdotal evidence to illustrate individual points.

## **2. KEY AREA NUMBER ONE: INTEREST RATE POLICY COVERS ALL INSTITUTIONAL REQUIREMENTS**

The most important key to financial viability, as revealed by the USAID study, is the interest rate policy adopted by microfinance programs. Interest and fee income must cover four basic concepts: the institution's cost of funds, its operating or administrative expenses, losses related to risks incurred in asset management (loan losses) and a return on capital invested in the institution. For none of these concepts can microfinance institutions expect to require less income than commercial banks if they are to project their operations over vast sectors of the local lower income economy.

In order for microfinance institutions to grow, they require massive funds. To obtain these funds they may follow any of three strategies: raise funds from international support organizations, mobilize local savings and access local financial markets. The first option, and the one most frequently followed, has its natural limits. In the beginning, concessionary funds are relatively inexpensive as the amounts are also relatively small. As the funding requirements grow, so too does the cost of the concessionary funds until such a point that the subsidy stops being a subsidy and the principal advantage of donor agency funds becomes that of liabilities restructuring.

An institution that seeks to raise funds from the national savings pool in turn has two basic options: raise resources from institutional investors through time deposits that have a low administrative cost but high interest rate sensitivity or mobilize small deposits from low income clients (taking advantage of the loan distribution infrastructure) which have a relatively high

administrative cost and a low interest rate sensitivity. In either case it would be difficult to imagine a highly specialized financial institution, whose target population of low income clients will be perceived (incorrectly) to be relatively higher risk clients, can mobilized local savings at a lower total cost than pre-existing financial intermediaries.

The same argument holds true for those institutions who wish to access local financial and capital markets through issuance of bonds, stocks, or by borrowing from other financial intermediaries. It would be unreasonable to expect that significant funding could be raised in local markets at a lower cost than other institutions, unless these strategies encompassed some sort of implicit subsidy such as a government guarantee that were not equally applicable to other entities.

The principal defect most microfinance programs have when they fix their interest rate policies is that they do not assign a cost of inflation to their equity which is then eroded away in real terms as the institutions complacently generate nominal profits year after year. This problem becomes particularly delicate in countries whose experience with inflation is relatively new since both program managers and clients resist inflation adjusted interest rates because they deem them to be usurious. Indeed, many business activities should not be funded at these inflation based rates since they may be only marginally profitable.

Given that administrative costs represent a much higher percent of earning assets in a microfinance institution than in a normal commercial bank, programs cannot reach financial viability unless they charge higher rates of interest than normal commercial banks or they operate exclusively with subsidized liabilities. Even the most efficient microfinance institutions require a level of administrative expenses of between 10 and 15 percent, compared to the between 3 and 5 percent most commercial retail banks require in developing markets. Finance companies who specialized in small transactions and credit card operations in these same markets spend about twice that of commercial retail banks, or around 10 percent of average annual assets. Although the average size of individual loan transactions in finance companies may be similar, most of these concentrate their operations on salaried employees who do not present

significant costs to the institution related to information gathering and borrower selection.

Most of the best microfinance programs maintain loan loss rates of less than two percent of their average annual loan portfolios, levels that are compatible with those of the commercial banking sector. Although some of the very best microfinance programs have managed loan portfolios with virtually zero defaults, the vast expansion these programs will undertake will naturally increase these levels when they take on slightly riskier clients as they penetrate their target markets more deeply. Thus their loan loss levels will more closely reflect those of the general financial sector and will tend to move in conjunction with overall local economic trends.

If microfinance institutions are to grow at the exponential rates necessary to reach an important sector of low income clients in the next few years they must generate a new capital base at each stage along the way. In many smaller countries the capital requirements to reach an important subsector of low income clients may not be so high as to be out of reach of private venture capitalists or donor agencies (3 to 15 million dollars). In most larger countries and in all of the largest countries, the primary source of new capital will probably be the net income programs generate from services they offer; or stated more clearly, reinvestment of profits. In fact, much of the capital the successful programs have generated has been out of net profits rather than direct contributions from donors or governments. Over time and as programs grow this proportion becomes even more skewed towards the reinvestment of capital.

Once adjustments have been made to take into account both explicit and implicit subsidies, many of the better microfinance programs are generating real returns on average total assets of between 2 and 5 percent, rates that would place them in a completely competitive position with commercial banks. In a fully leveraged financial intermediary (risk adjusted assets equal to twelve times equity) these returns would be the equivalent of between 24 and 60 percent return on equity; enough to sustain the growth curves for most programs in all but their first years when they can double in size annually. To do so, these programs must charge interest rates that are somewhat higher than those

commonly charged by traditional financial institutions to their normal clients.

### **3. KEY AREA NUMBER TWO: HIGH LOAN PORTFOLIO QUALITY STANDARDS**

The second key to long term financial viability is for programs to maintain very high portfolio quality standards. Late payment problems cause additional expenses two ways. Loans that are not repaid pass directly through the profit and loss statement as an expense. Many development credit institutions consider that annual loan recovery rates of above 90 percent are very good. Nevertheless, in order to be financially viable an institution would have to cover these losses out of its interest income as already discussed. An institution that had to add 10 percent to its interest rate to cover loan losses could find itself pricing itself out of the market, especially since the net interest margin in financial markets for this sized loans may generally around 24 percent annually.

A more serious problem for institutions that face repayment problems are the less obvious costs this situation imposes. For example, short term late payment rates usually run at two to three times the final loan default rate. Therefore, an institution that runs a long term recovery rate of 90 percent (with a 10 percent default rate) would probably have a portfolio where at least one third of its clients would be regularly late on payments. Thus, the institution's staff must spend the majority of its time convincing, cajoling, and pressuring its clients to pay, rather than on more productive tasks such as projecting that institution's growth.

More debilitating is the fact that the nature of the relationship that evolves as a result is negative. Instead of the program being perceived by borrowers as one that supports them in time of need, most of the time spent with program staff focuses on the more unpleasant aspect - repayment. As the general levels of delinquency increase in programs this issue becomes critical since borrowers must be pressured even more intensely to compensate for the fact that they are aware of clients who are

not keeping up. Thus begins a negative downward spiral in staff productivity and program dynamics.

Given the very small size of individual operations, the additional cost of extracting repayment from reluctant borrowers usually exceeds even the capital amount recovered, in spite of late payment charges and interest penalties. Although programs rarely calculate the true cost of late payment recovery in staff time and productivity, once an institution gets itself into a negative spiral, it will usually require 100 percent of that institution's operational budget, plus some additional effort, to turn it around.

Finally, late loan payments reduce net interest margins by either reducing the net portfolio interest income or by increasing the institution's cost of funds. In the first instance, even if institutions charge penalty interest and fees to late borrowers to compensate partially for increased operational costs they impose (and these charges effectively covered those costs), the first point of negotiation with delinquent borrowers in order to motivate them to repay is usually for the institution to offer to condone part of the interest charges.

In the second instance, if repayment is not prompt, it may cause institutions to face liquidity shortfalls. If, in order to meet to meet operational expenses or loan demand, it must borrow relatively high costs short term funds, then its average cost of funds increases which in turn decreases its net interest margin. In summary, institutions who fail to maintain loan loss levels considerably below five percent in relation to their average annual portfolio face generating the downward negative spiral that makes financial viability virtually unattainable.

#### **4. KEY AREA NUMBER THREE: STRONG PRODUCTIVITY ORIENTATION**

Microfinance institutions that have shown themselves to be financially viable all demonstrate a strong administrative culture based on productivity enhancement. All viable programs concern themselves fundamentally with the productivity of their staff, and actively seek ways to improve service technologies in ways that will produce greater results with the same level of

operational expenditures. In fact, operationally, successful programs look very similar in spite of the fact that they operate in widely differing local economies, institutional structures, and cultures. This strong productivity orientation can be typified in three major characteristics common to all successful programs: Operational methodologies which base key functions on community or peer group involvement, Decentralized administrative structures, Appropriate infrastructure, both human and physical, which generates the lowest cost without sacrificing maximum effectiveness.

The most difficult aspects of lending to poor clients are borrower selection and enforcement of timely repayment. The informal nature of their enterprises and the character of their capital assets are such that traditional lending techniques prove virtually worthless for both purposes. As a result, successful microlending programs have taken a page out of the moneylenders book and have developed character based technologies which place borrower's willingness to repay above their capacity to repay in the credit decision (Christen 1992).

Rather than spend time and resources on technically based analysis of borrower repayment capacity, successful programs base their repayment assessment primarily on prior credit performance; starting new clients off with small, riskless loans and then moving up into larger loans as borrowers demonstrate their capacity and willingness to repay. These programs transfer important selection, enforcement, and transactions functions to the client and his peer group. Although many feel that this transfer may have some efficiency benefits, for example the consolidation of several subloans into one administrative operation, the main financial benefit of this consolidation probably lays with the increased effectiveness achieved, apparent in extremely low loan loss ratios. These technologies are not particularly low cost, as the prior discussion has already demonstrated.

Successful programs incorporate community knowledge in the selection, enforcement and transactions processes. The exact form varies. In some cases programs use solidarity groups of four to five participants who band together for the purpose of taking out a group loan that is then divided among the members

who each are equally responsible before the program for the entire loan's repayment. In other cases programs work through local community structures where village leaders participate in the loan approval and follow through process, and may even be hired as program staff. Village banking programs utilize groups of thirty clients to generate social pressure and gather necessary information for credit decisions.

In all of these cases the systems developed allow for individual credit decisions to be made effectively on the basis of information that would not be available to traditional style institutions, and in a way that can be financially sustainable even for the tiniest of loans. Although great interest has been generated by attempts to apply traditional credit scoring and other tradition borrower selection techniques to microfinance, none of the most successful programs have based their programs on them as of yet.

The second important aspect of the productivity based culture of successful programs is that they all, without exception, administer their microfinance services through a decentralized, performance based, modular, operational structure. These operational modules, in turn can be characterized by four common attributes: 1) Horizontal organizational decision structures, 2) Performance based incentives systems for staff, 3) Strong internal controls and ex-post auditing functions, and 4) Efficient information systems that permit timely and accurate loan tracking.

Virtually all of the successful institutions manage their operations through modules composed of between 4 and 12 staff, most of whom are dedicated to client service either in an office or in the field. A typical module would consist of one manager, several credit officers or field workers, an administrative support person or two, and possibly cashiers.

These modules normally exercise great operational autonomy in the granting of loans within the guidelines established by the program. They normally act as their own credit comite, except for particularly large or complex loans which may be remitted to a higher authority within the program. The organizational structure tends to be very flat, with relatively little management superstructure imposed on these units.

Central management tends to focus its efforts on funding activities, general policies, auditing, administration, and institutional development. As much as 85 percent of the institution's staff work in operational units and central offices frequently operate more as service entities to the branch network.

As a result, the type of control the central office exerts on the operational units tends to be through ex-post means such as audits and incentives systems. Rather than burden operational decisions with impractical and stifling hierarchical controls the better programs opt for audit procedures which verify through sampling procedures that units comply with the guidelines clearly established by the central office. This reduces costs considerably, in addition to tremendously enhancing the effectiveness of the operational decisions that result.

The other part of this is the incentives system programs' design so that these operational modules maintain high levels of productivity. Most financially successful programs have designed incentives systems that tie between 15 and 50 percent of total operational staff remuneration to the results they obtain with clients.. Usually these systemes combine some sort of positive compensation for amounts disbursed to both new and returning clients with some sort of discount for late repayments.

In most systems the entire incentive is lost when loan repayment falls below relatively strict thresholds, which may be the key ingredient explaining their consistently superior performance in the face of frequent administrative problems. The importance of incentives systems is so great that cases have even been observed where loan repayment performance has been maintained at above 98 percent even where centralized information systems have completely failed, management has been ineffective, and staff rotation has been high.

The best programs all generate timely loan tracking information at the module level. Given the very short amortization schedule (60 to 180 days) for many of the loans and the high payment frequency (weekly and semi monthly), "timely" usually means that information about payments made during a particular day

are provided to the field staff at the opening of the following days' activities. In those cases where payments are made to a third entity such as a bank for security reasons, information seldom takes more than 48 hours to reach the loan officers who then pursue delinquent clients aggressively.

The third main aspect of productivity based programs is that they take special care to seek out appropriate human and physical infrastructure for the nature of the services provided. For example, a program in Indonesia that captures savings accounts whose average size is only 25 dollars operates out of one room, austere offices that open only 5 hours a day and are staffed with local community members for very low wages since this activity represents a complement to their farming and other income earning activities. The program is among the most successful both in outreach and viability terms primarily because it has structured itself appropriately for the services it offers.

If programs are borne as part of donor based projects, where outreach, not financial viability is the immediate primary goal, then NGOs may lock in a relatively expensive human infrastructure composed of university graduates and other highly qualified individuals, when in many settings, the basic operational functions of the programs could be carried out by lesser prepared individuals

On the other hand, those programs whose philosophy has been to base their operational technologies on community staff actually have a great advantage in this area, which has actually permitted them to reach out with very low average sized operations in a financially viable manner while some NGOs, who reach out to larger sized clients with more highly qualified staff are less viable.

This conclusion may be somewhat modified by the fact that in some settings, the gap between the general preparedness level of potential community based staff and that required to manage microfinancial services may be too great, leading necessarily to higher multiples. The evidence is intriguing, but insufficient to want to make broad and definitive generalizations. Clearly though, programs who seek financial viability must look to

generate a staff structure where employee skill levels are the most adequate for achieving both operational efficiency and effectiveness. This may not necessarily require individuals with highly honed, academically based skills, as the low multiple programs demonstrate.

In the USAID study recently finished, the only cost related variable that proved statistically significant as a predictor of financial viability was the relationship of the program's average annual salary per employee to GNP per capita. This relationship, expressed as a multiple proved highly significant in a regression equation. Programs that paid relatively less as a multiple of gnp per capita were more profitable than those that paid more. Most notable are the differences between the programs with the lowest multiples and those with the lowest.

For example, those with the lowest (between 1 and 3) were the programs that utilize extensively local community structures and personnel to staff their operations. All hire directly from the communities they serve on the basis of character and basic skills necessary to undertake the program's tasks. On the other end of the spectrum, three programs which only recently have begun to evolve out of donor and project based NGO structures have the highest multiples (between 13 and 21 times).

## **5. KEY AREA NUMBER FOUR: EFFECTIVE LIQUIDITY MANAGEMENT**

One of the most complex issues the majority of microfinance institutions have faced up until now has been funding. Since most are not savings based, but rather depend on a series of donor agency and government budget and disbursement procedures, they experience frequent liquidity crisis. In addition, since most of their funds come from these sources, they are pushed to fully disburse before receiving additional funds, making liquidity management almost a misnomer. The only liquidity management most microfinance institutions engage in is that of pushing money out the door as fast as it comes in.

Frequent liquidity problems cause costly difficulties for programs donors usually underestimate; costs that, if fully calculated, could even exceed a commercial source of funds were

it available. For example, liquidity shortages cause programs to delay disbursements, deny credit, and engage in other restrictive policies that indicate to customers that the institution may not be healthy. That perception threatens their future relationship with the institution and provides a strong incentive to default on loans or withdraw savings which in turn provokes more of the same type of crisis.

Programs that try to avoid the costs of this negative cycle by recurring to short term commercial sources of credit to keep disbursements flowing incur the additional cost of borrowing the most expensive funds available. Although programs that maintain some degree of liquidity may appear to be losing a chance to be more profitable by lending these resources out at high rates of interest, this cost does not outweigh the cost of being perceived by clients as an illiquid institution.

Both donors and microfinance institutions need to improve their liquidity management consciousness in order to enhance financial viability in the long term. This extends to the issues of improving the program's capacity to do adequate financial projections, the donor's ability to disburse on schedule and not impose counterproductive measures such as requiring programs to draw fully down before receiving additional funds, and assistance to institutions to help them restructure liabilities to more completely match their maturities structures with those of assets.

Some programs are seeking to mobilize local savings as a response to these issues. While the scant evidence available demonstrates that institutions can actually generate a highly liquid position once savings services take hold, the transition from being a lending based to a savings based organization is far more difficult and fraught with dangers than most realize. It requires a fundamental change of mentality. Rather than disbursing rich peoples' money, microfinance staf must realize that when they mobilize local savings they are in fact protecting and investing poor peoples' emergency reserves and future. Long run financial sustainability of microfinance undoubtably requires programs to obtain funds from local savings pools, but the challenges that lie ahead in the regulation and supervision of

these specialized institutions catering to the poor and that utilize very different operating procedures are great indeed.

## **6. COMPLEMENTARY CONSIDERATION: ROLE OF CAPITAL IN INSTITUTIONS THAT PROVIDE FINANCIAL SERVICES TO THE POOR**

A complementary consideration for private operators of microfinance institutions is the issue of access to capital. Once these institutions have figured out how to operate successfully in a local environment they experience exponential growth. If indeed, their future lies with the mobilization of local savings as regulated financial intermediaries then their owners will be required to regularly increase their equity contribution to match expansion. Most superintendencies will require that owners contribute in paid in capital at least half of the required amount (the rest being financable out of retained earnings) to ensure that the institutions continue to "belong" to someone who has an important stake in its future.

To the extent that these private ventures consist mostly of NGOs and social investors with limited access to capital, microfinance institutions run the risk of having their very success driving them towards insolvency as they grow. Those interested in the long run financial sustainability of microfinance institutions must concern themselves with this issue and not blithely rely on retained earnings, even were these apparently sufficient in early years. Fortunately, as discussed in the opening section, strong financial performance by microfinance institutions potentially increases the interest of commercial investors in this type of activity, which is the ultimate solution to the problem posed above.

A.