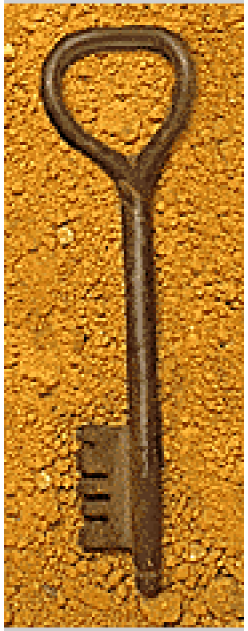
Key Principles of Microfinance: Institutional Structure and Delivery Mechanisms

Presented By:-

Deepak Pareek

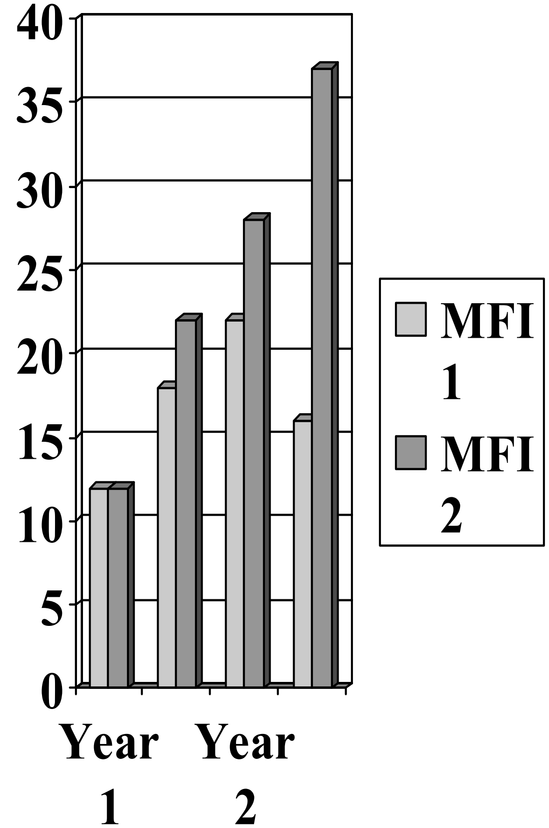
March, 2001

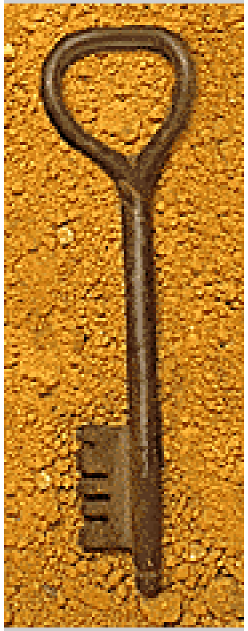
Micro Finance Congress, Mumbai



Institutional Structures and Service Delivery Options

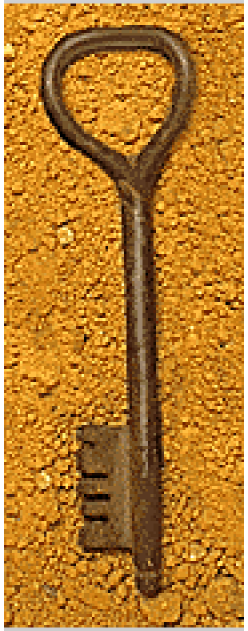
- ***Objectives***
- Discuss key elements in choosing institutional structure
- Discuss the range of institutions delivering Microfinance
- Discuss leading service delivery methodologies
- Present indicators of success – sustainability, outreach





Institutional Structure: Common Choices

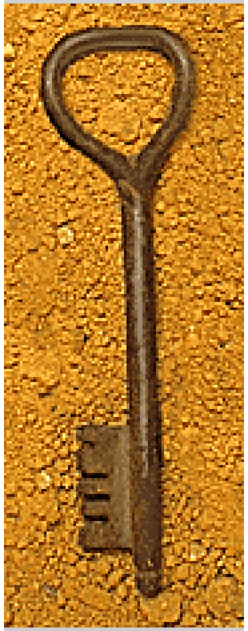
- Commercial bank
- Government bank
- Finance company
- Credit cooperatives (urban, rural)
- Foundation
- Project (supervised by government agency)
- Non-governmental organization (NGO)
- Credit union federation
- Savings and loan federation
- Village banks federation



Institutional Structure: Factors That Affect the Choice

♦ Institutional structure choice linked to:

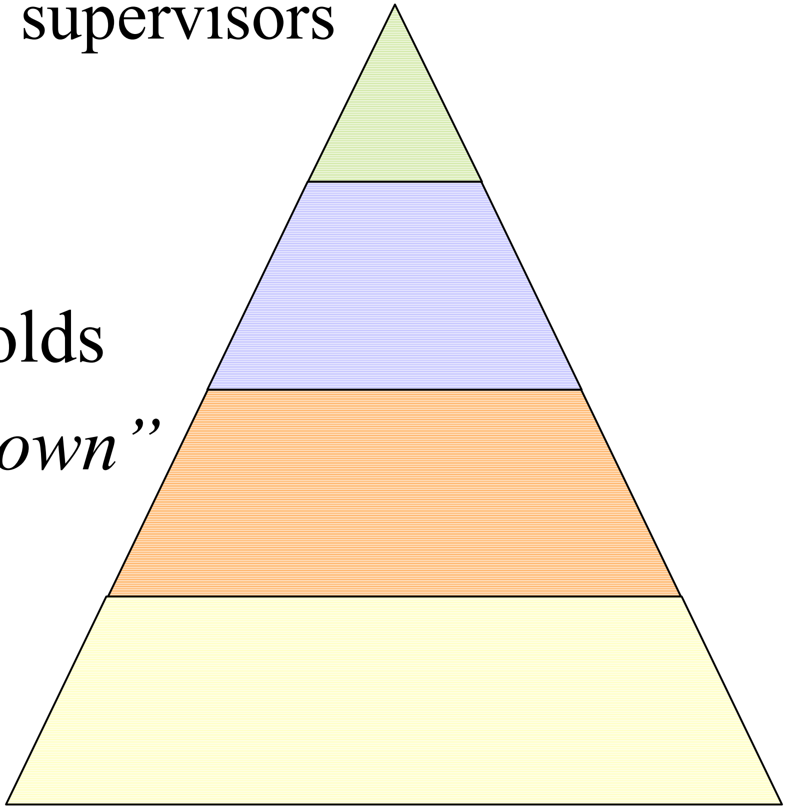
- Mission statement
- Existing financial system
- Target clients
- Credit only (minimalist) vs. Integrated approach
- Provision of savings
- Local economic setting
- Social capital
- Investors’ preferences
- Legal options

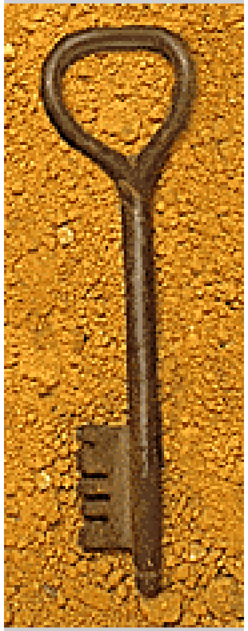


Institutional Structure:
Fitting Into the Financial System

- Government regulators / supervisors
- MFIs (private, govt)
- Community groups
- Businesses and households

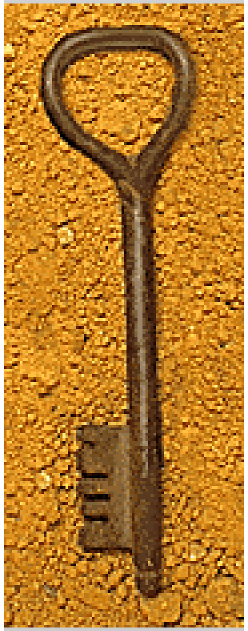
➢ *"Looking up, looking down"*





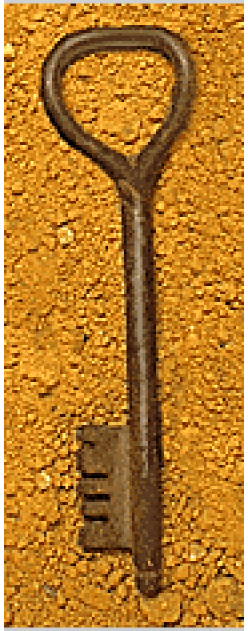
Institutional Structure:
Why MFIs are different

- Decentralization in service delivery:
  - Fewer branches, mobile banking, clear levels of approval, credit committees, standardized products, and audit safeguards
- Management Information System to:
  - Track administrative costs
  - Monitor loan portfolio quality
  - Inform Board
  - Chart of accounts, financial statements, easy audit trail
- Productivity is driven by:
  - Client retention, staff retention, staff salaries, staff training
  - Internal controls (fraud, internal audit, heavy on-site monitoring)



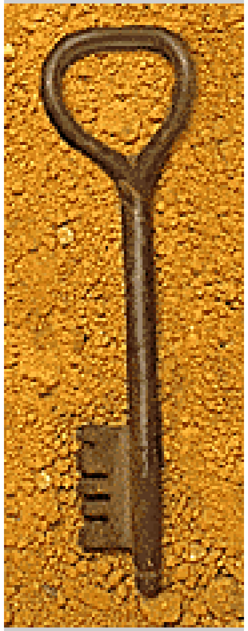
Evolving Institutional Structures

- **Managing Growth and Transformation**
- Risk of mission drift
- Skills and experience on the Board of Directors
- Legal issues
- Funding issues: Donated equity, member and public savings, shares to investors
- Cost structure issues
- Decentralization and internal control issues
- Methodology/product mix diversification issues
- (Examples – AKRSP in Pakistan; FPC in China)



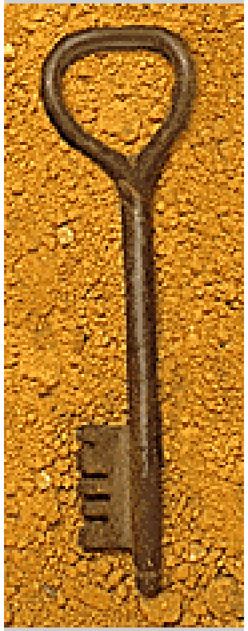
Financial Services:
Best Practices

1. Offer services that fit client needs, constraints
   - *Short loan terms (3 months to a year)*
   - *Relatively unrestricted uses (rational client assumption)*
   - *Regular repayment, not lump sum*
   - *Public image of welcoming low income clients*
   - *Less than client needs at first, then increasing amounts*
2. Streamline operations, standardize lending process
   - *Automatic decisions, decentralization, low fixed assets*



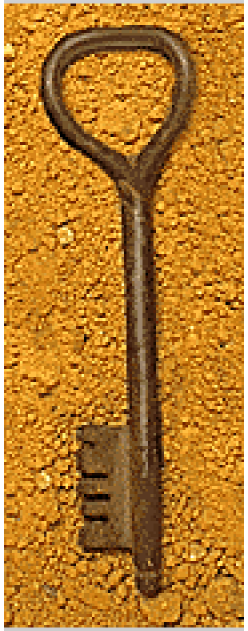
Financial Services:
Best Practices

3. Motivate clients to repay loans on time
   - *Guaranteed access to next loan*
   - *Prompt repayment rebate*
   - *Preferential interest rate for good performers*
   - *Clear enforcement rules, fines, no flexibility for loan officers*
4. Charge full-cost interest rates and fees
   - *Cover all costs of service delivery -- administrative expenses, inflation, cost of capital, profit margin*
   - *Keep competition in mind*
   - *Effective interest rate is what matters, not nominal rate*
   - *Access often more important than interest rate*



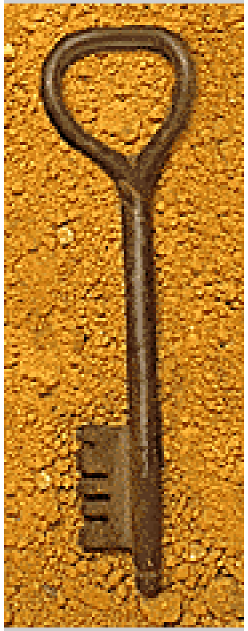
Individual Lending Model
(Mobile Banking)

1. Collateral required, but flexibly defined
   - *Co-signer, consumer good, community leaders and suppliers provide character references, blocked savings*
2. Faster processing to match client constraints
   - *Less paperwork (low literacy level)*
   - *Site visit (mobile banking, not branch banking)*
3. Stepped increase in loan size for good clients
   - *Often 25% or more increase in follow-up loans*
   - *Longer maturity period for follow-loans*
   - *Lower interest rates*
   - *Different products (e.g. Share India housing loan)*



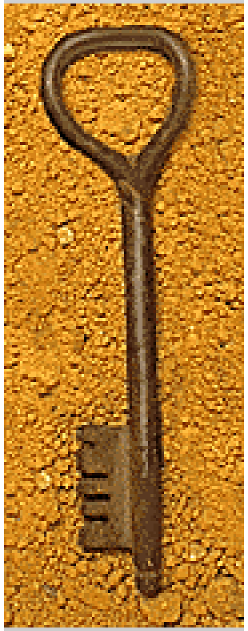
Individual Lending Model
(Mobile Banking)

4. Urban model
   – *Costs of reaching clients, frequency of contact, amounts*
   – *SEWA Bank (India), Bank Dagang Bali (Indonesia)*
5. Revenue potential higher…risks lower?
   – *Larger loans generate more interest and fees; Set-up costs low, supervision costs moderate, commercial interest rate acceptable, more traders (with cash flow)*
   – *Urban clients can be more transitory, not the very poor, may sell on credit more*



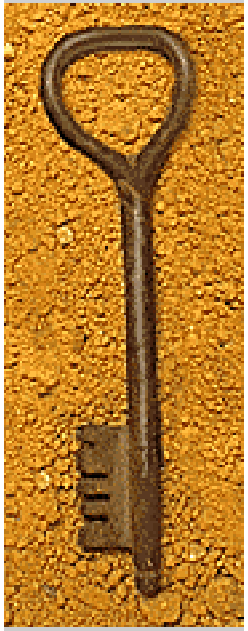
Group Model

- ♦ 3-50 members, self selected
- ♦ Cross guarantee, cross default
- ♦ Non-collateralized loans
- ♦ Standard terms for members
- ♦ Step credit
- ➢ Savings
- ➢ Self Administration



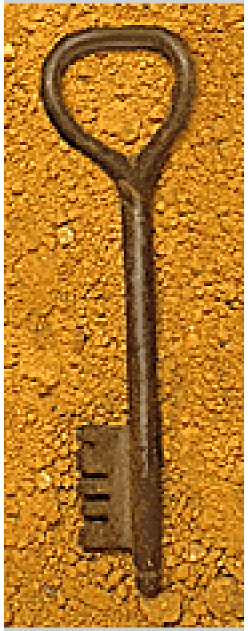
Solidarity Group Model

- 3-5 members, mostly women
  - self – selected
- Cross (or solidarity) guarantee, cross default
  - borrower of record is individual
  - group members are 100% guarantors
  - members are expected to cover defaults
- Short-term loans (<12 months)
  - term depends on purpose
- Primarily for working capital
  - rapid turnover trade
  - home production
  - services
- Urban or rural
  - off-site v. On-site product delivery
- Savings not required, no self-administration



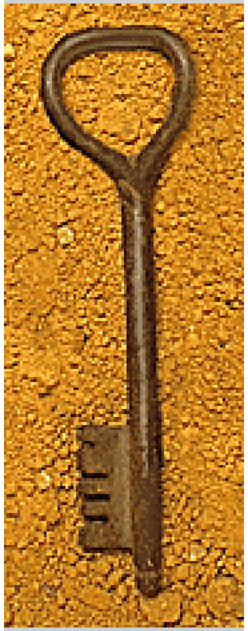
Village Banking Group Model

- 10-50 members
- Self-selected
- Cross guarantee
- Group is lender of record
- Group members guarantee 100% repayment by group
- Group default
- Individual default ≠ group default
- Standard Terms
- Individual incentives, step credit
- Group incentives
- Working Capital
- Savings Required, Group Savings (Internal Account)
- Self – Administration
- On-site Delivery



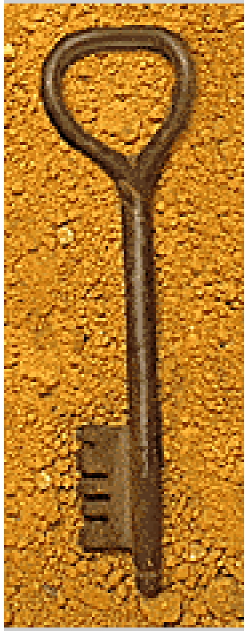
Grameen Methodology

- Solidarity Groups within Communities
- Collective responsibility for individual
- Mutual support
- Alternating, Successive Borrowers
- Individual default = group default
- Urban and Rural
- Little Self – Administration
- On-site Delivery



Group-based Models

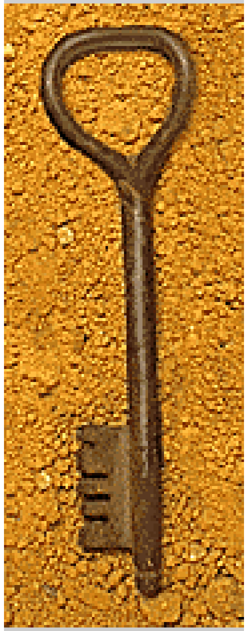
- Compartamos, Mexico
- FINCA Kyrgyzstan
- TPC Cambodia
- FPC China



Group Lending:

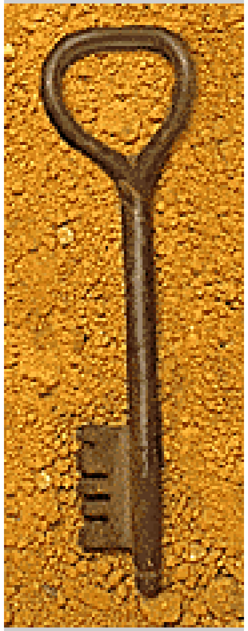
Best Practices

- Start Small, Build a Credit Record
- Peer Pressure as collateral
- Cross Guarantee/Cross Default
- Mutual Support
- Self – Selection
- Evaluate household



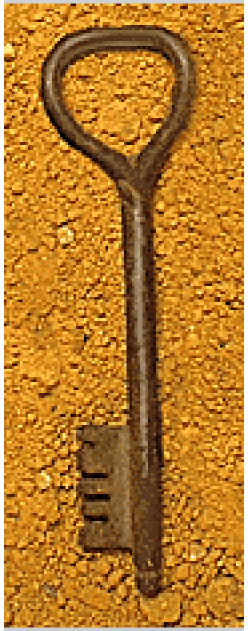
Group Lending:
Advantages and Disadvantages

- ⌖ Information barrier
- ⌖ Reaches those without collateral
- ⌖ Builds experience with credit
- ⌖ On-site or nearby delivery
- ⌖ Mutual support
- ✖ Inflexibility of products, terms
- ✖ Opportunity Cost of cross guarantee
- ✖ High set-up costs
- ✖ Opportunity cost of participation
- ✖ “Elite” dominance of group



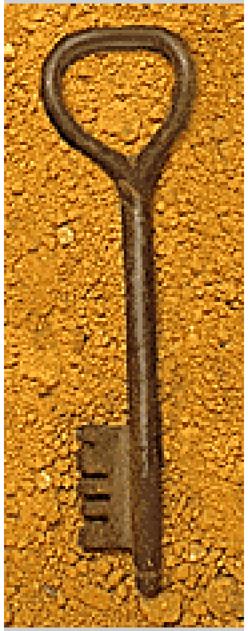
Key Indicators

- Client Satisfaction - Turnover
  - Self – selection
  - Personal issues
  - Business problems
  - Fatigue
  - Group Problems
- Profitability – ROA
  - Self-Sufficiency
  - ROE
  - Adjustments



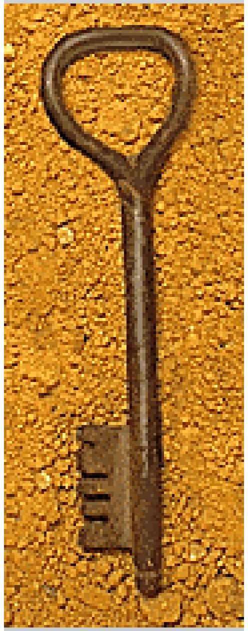
Key Indicators

- Productivity/Efficiency – Portfolio/Staff
  - Staff ratios
  - Expense ratios
- Asset Quality – Portfolio at Risk (PAR)
  - > 30 days
  - > 90 days
  - write – offs
- Funding – market based funding
  - Leverage



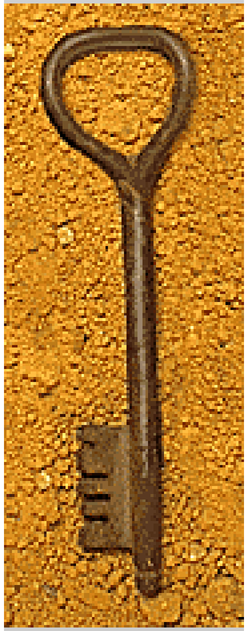
How to Measure

- Client Data
- Monthly financial statements
- Portfolio Reports



Conclusion:
Gaps in the Microfinance Market

- ♦ Institutional Structures
  - – Balancing regulation framework and supervision requirements with “space” for the industry to innovate
  - – Healthy to have different types of institutions competing
- ♦ Delivery of Financial Services
  - – Savings and other services, competing delivery systems
  - – Using technologies to lower service delivery costs
  - – Long term lending products (housing Microfinance)
  - – Insurance for micro businesses



Conclusions:
The Ability to Evolve

- Tension between graduation of best clients and MFI product diversification and sophistication
- Tension between standardization (to keep costs low, manage scale of demand) and tailoring products and delivery to clients.
- Moving beyond donors to investors
- Demand for savings vs. Credit only