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SmartLessons
real experiences, real development

Small Beginnings for Great Opportunities

LESSONS LEARNED FROM 20 YEARS OF MICROFINANCE PROJECTS IN IFC

The IFC Global Microfinance program is implemented in partnership with Belgium, Japan and the Netherlands.

IFC International Finance Corporation
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Foreword

By increasing access to finance for out-of-reach households and families, microfinance continues to be an essential tool for improving livelihoods at the base of the pyramid. The last 20 years have seen remarkable growth in the microfinance sector. From its early stages in small-scale microenterprise lending, through its commercial expansion to offer savings and a broad array of financial services to low-income customers, to its entry into new markets and incorporation of technological innovations, microfinance is ensuring that an ever-greater number of households have permanent access to a range of high-quality and affordable financial services. The microfinance industry is estimated at $60 to $100 billion globally, where several thousand microfinance organizations reach an estimated 200 million clients, most of whom were not previously served by the formal financial sector. However, 2.5 billion adults still lack access to formal financial services. Financial services for low-income people are an important factor when it comes to poverty reduction, as it enables them to build assets, increase incomes and reduce their vulnerability to economic stress. Moreover, microfinance continues to be an important tool when it comes to empowering women.

IFC is the World Bank Group's main investor in microfinance, working with around 300 microfinance institutions (MFIs) and SME-focused financial institutions, which provide financial services in 91 countries. IFC is also one of the leading global investors in terms of volume. In fiscal year 2014, we committed $519 million in 43 projects with MFIs. Our cumulative investment portfolio in microfinance exceeded $3.5 billion, with outstanding commitments of $2.0 billion. In fiscal year 2014, IFC advisory services comprised $74.2 million, representing advisory assistance for 86 projects.We have taken an active role in advising microfinance institutions and building or strengthening comprehensive and robust credit reporting systems such as credit bureaus, which are critical to avoiding over-indebtedness and supporting responsible lending practices. In addition, IFC's work has been critical in post conflict countries: we have engaged in 32 IDA and 10 post-conflict countries, including Bosnia and Afghanistan, and with a particular emphasis on Sub-Saharan Africa, where we supported the creation of greenfield microfinance institutions in 33 countries. This SmartBook, titled *From Small Beginnings to Great Opportunities,* presents practical lessons learned from the work that we have been doing on microfinance projects over the last twenty years. From launching the Microfinance Enhancement Facility to help the industry stay afloat during the time of crisis, to working on a project to support microfinance clients to fulfill their housing dreams, these narratives are both engaging and insightful and we hope you will learn from them. We would also like to acknowledge the efforts made by IFC staff in not only working on microfinance, but also documenting some of these lessons for others to learn.

M. Holtmann

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Principal Investment Officer

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Global Lessons

The Need for Speed:

Helping the Microfinance Industry Stay Afloat in Times of Crises

Microfinance has been a lifeline for many low-income people at the base of the pyramid, helping them break the cycle of poverty and improve their lives. Yet the rapid growth of the microfinance industry, combined with limited financial literacy among its customers, made it particularly vulnerable during the 2008–2009 global financial crisis. To expand short-term financing solutions to the microfinance industry following the crisis and to keep credit flowing during a period of unprecedented financial strife, IFC together with KFW and other DFIs launched the Microfinance Enhancement Facility, one element of its comprehensive Counter-Cyclical crisis-response package. A timely response was critical, and implementation risks were high. This SmartLesson shows how strong cooperation with partners and the decision to develop an outsourced model contributed to the success and reliability of this crisis-response initiative.

Prior to the crisis in 2008–2009, the microfinance industry had experienced nearly 15 years of successful growth and had been recognized as a valuable financial-service tool for the poor, with strong growth potential at the base of the pyramid. While microfinance institutions had faced various local or regional crises such as political threats, inflation, recessions, and financial meltdowns, these prior threats were quite different from those prevailing at the time of the global financial crisis. The greater integration of microfinance into the financial sector and further commercialization of the industry were necessary to foster the growth and broad outreach of the industry. At the same time, these factors had drastically changed the beneficial circumstances and exposed the industry to new threats, putting its past achievements at risk.

Consequently, the financial crisis had an adverse impact on microfinance institutions by reducing their ability to tap commercial (local or international) funds for growth through loans, securitizations, or deposit mobilization. Resources for refinancing quickly dried up in many markets, and in some cases deposits began to erode. Therefore, leading microfinance investors and partners agreed that the foregoing developments required an immediate and coordinated response. As one of the industry's main players, IFC, together with its partner KfW Development Bank, recognized the need to instill continued confidence in the microfinance industry, catalyze uninterrupted access to funding, safeguard deposits, and counterbalance the potential reduction of access to financial services to underserved lower-income segments of the population.

In February 2009, IFC and KfW, along with other partners (EIB, FMO, OeEB, OFID, BMZ, and SIDA)[1], launched the $500 million global Microfinance Enhancement Facility (MEF), designed to provide short-term and medium-term financing to sound microfinance institutions that were facing

1 EIB = European Investment Bank; FMO = The Netherlands Development Finance Company; OeEB = Oesterreichische Entwicklungsbank AG (Development Bank of Austria); OFID = OPEC Fund for International Development; BMZ = Federal Ministry for Economic Cooperation and Development; SIDA = Swedish International Development Cooperation Agency.

Box 1: The ACBA Story

The Agricultural Cooperative Bank of Armenia (ACBA) was established in Armenia in 1995, initially to finance small and medium agricultural enterprises and individuals. In 2006, Credit Agricole S.A. of France made an equity investment in ACBA, and the bank was reorganized and renamed ACBA Credit Agricole Bank CJSC. The largest shareholder is Credit Agricole, with 28 percent. The other main shareholders are 10 agricultural cooperative regional unions.

The impact of the global financial crisis on Armenia was severe because of significant decreases in 1) trade with Russia and other major trading partners, 2) foreign investment, and 3) remittances (accounting for 20 percent of GDP) from Armenians in Russia, the United States, and Europe. As a result, GDP decreased by 14.4 percent in 2009, and the Armenian dram was devalued by over 20 percent on March 3, 2009.

In keeping with its track record of conservative financial policies and a strong management team, ACBA had implemented a variety of preventive measures both before and during the crisis. As a result of these proactive measures, the impact on the bank was minimal despite the economic turmoil that gripped the country. As of the end of 2009, the portfolio at risk greater than thirty days (PAR>30) was only 1.3 percent, and this was well provisioned. By December 2010, PAR>30 had decreased to under 1.0 percent. ACBA maintained strong profitability during the crisis, along with low leverage and high levels of liquidity.

As a sign of its confidence in the bank, MEF extended a $15 million loan to ACBA in October 2009. During the first nine months of 2009, in U.S. dollar terms, senior debt had decreased by over 10 percent, but it increased by nearly 11 percent in the six months following MEF's loan. While not the only factor, we believe that MEF's loan had an important signaling effect on the market.

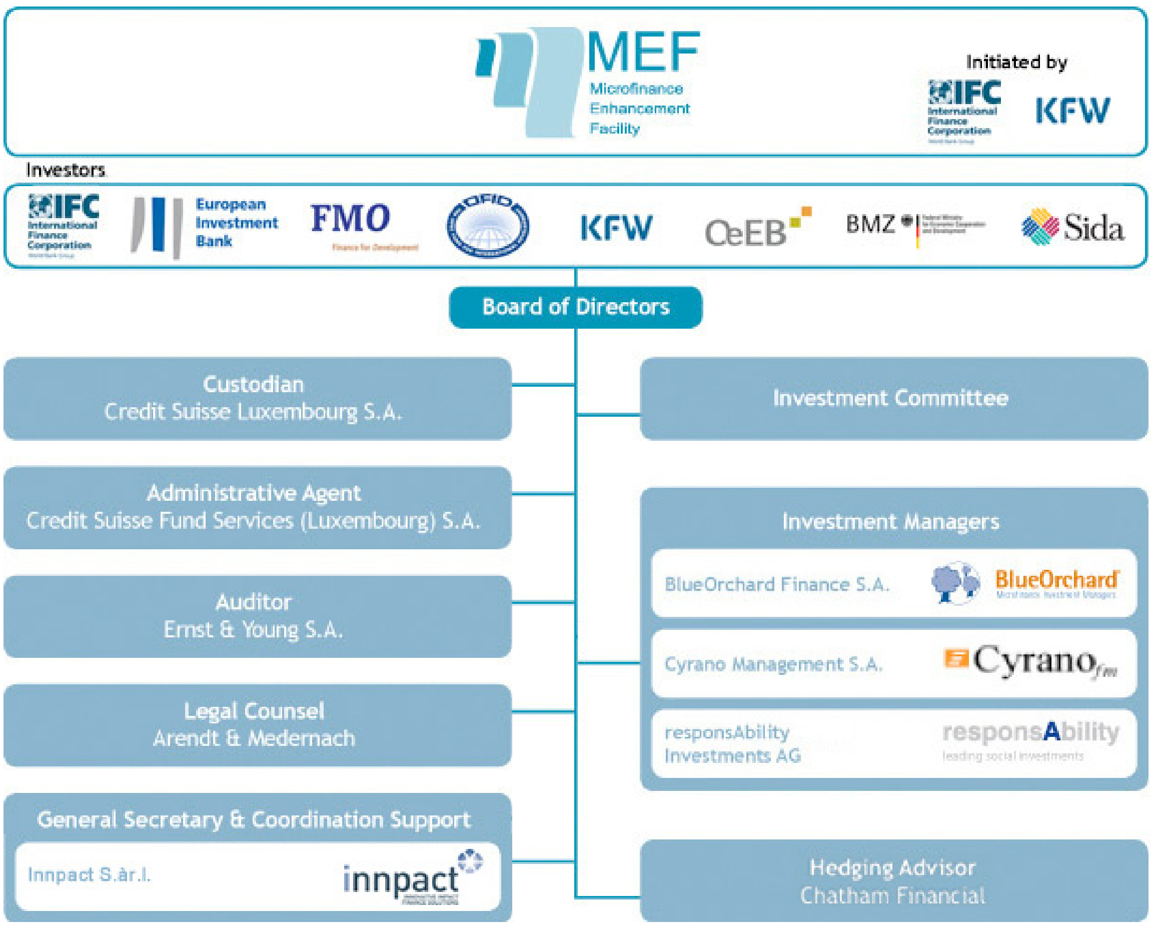
funding shortfalls during times of unprecedented financial stress. MEF's objective was to serve as a defensive facility to support strong institutions around the world that required liquidity so that they could conduct regular lending activities and keep serving their core clients with fresh credit. (For an example, see Box 1.)

MEF, established as a special-purpose vehicle in Luxembourg with three classes of shares, is executed through the industry's largest and most experienced fund managers (Blue Orchard Finance, Cyrano Fund Management, and ResponsAbility Social Investments AG) to provide a rapid and flexible response to market needs, achieve maximum possible outreach, and ensure efficiency. MEF also hired a general secretary responsible for coordinating activities and communication among the investors, investment managers, custodian bank, and hedging manager. (See Figure 1 for the detailed organizational structure of MEF.)

Overall, MEF succeeded in providing the important signaling effect required during the worst of the crisis and has contributed to the stabilization of the sector. MEF's investment pace picked up considerably during 2011–2013, with a growing pipeline and disbursements to a wider range of microfinance institutions that now cover all of the world's regions. The graphs in Figure 2 provide details of MEF's regional distribution and country distribution.

As of December 2013, the outstanding microfinance institution investment portfolio was $441 million in 150 loans to 86 institutions across 33 countries. Since its launch, MEF has cumulative disbursements of $651 million in 214 loans to 99 institutions. MEF has also responded to the market demand for local currency loans and has significantly increased its local currency lending to microfinance institutions, amounting to 20 percent of its portfolio as of December 2013. The whole local currency portfolio of MEF is fully hedged to the U.S. dollar through five different

Figure 1: Microfinance Enhancement Facility Organizational Structure

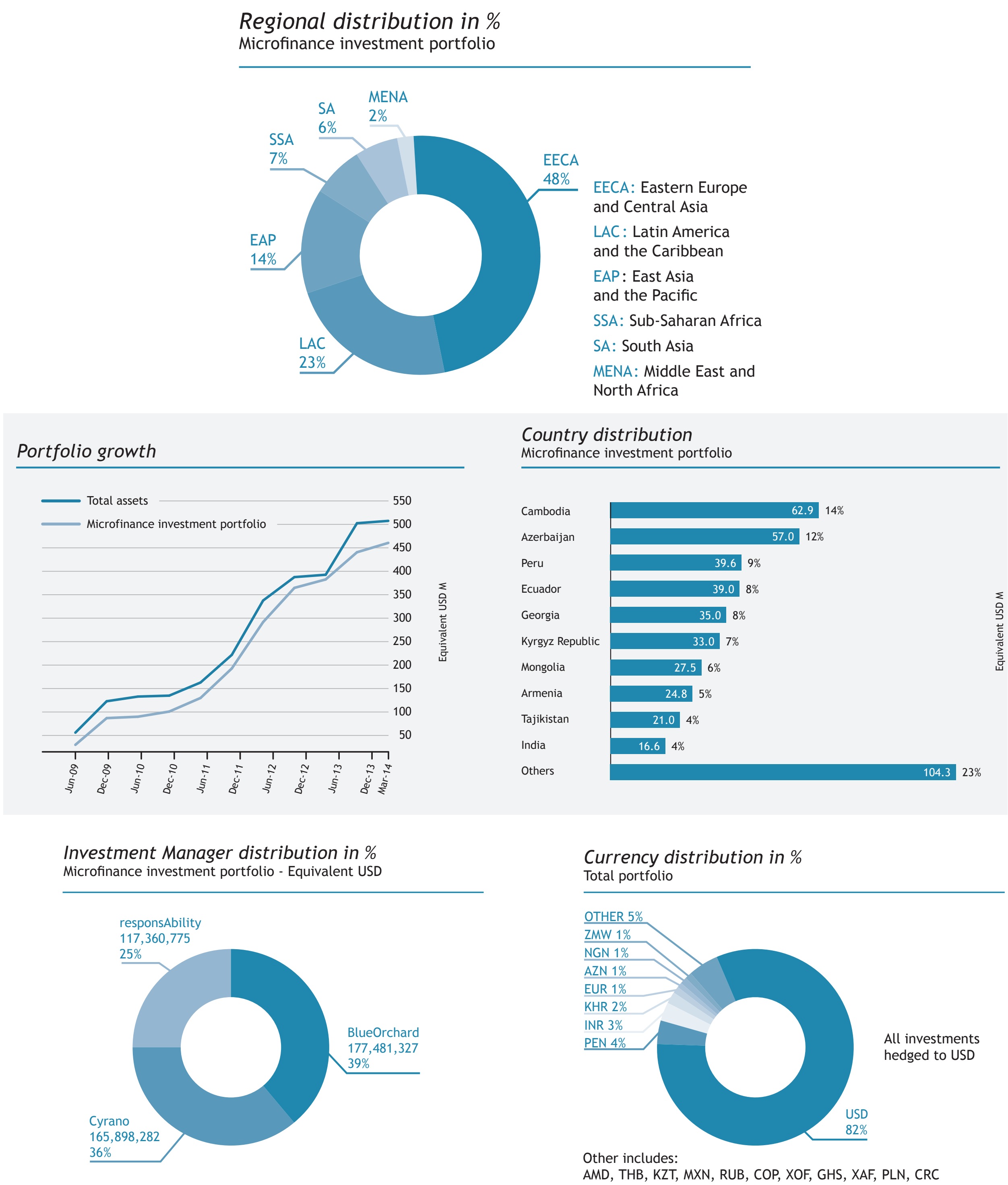


Source: Microfinance Enhancement Facility (http://www.mef-fund.com/about-mef/structure.php)

counterparts, including IFC. Portfolio quality has consistently remained strong, with impairments below 1 percent of the total portfolio, and the financial performance of MEF has exceeded targeted returns since 2011.

MEF has continued to evolve over the years, expanding into new regions, providing new products, and responding to unexpected local crises. As demonstrated by the crisis situations in Bosnia and Herzegovina, Nicaragua, India, and most recently in Cambodia, crises will likely continue to occur in the microfinance industry (with the current eurozone crisis as a salient example), and MEF will serve as a flexible vehicle that can respond quickly and decisively to provide stability.

Figure 2: Microfinance investment portfolio



Source: Microfinance Enhancement Facility (http://www.mef-fund.com/about-mef/structure.php)

LESSONS LEARNED

Lesson 1: Strong cooperation with key partners is a critical element behind quick launch and successful mobilization efforts.

While IFC played a leading role in the structuring of MEF through the combination of its sectoral expertise, knowledge of operational best practice, and expansive network, the partnership with KfW was critical in creating a sustainable and efficient liquidity facility with sufficient firepower to adequately support the microfinance industry and quickly react to market needs. IFC worked closely with the many stakeholders to react quickly and to create a structure that mitigated implementation risk resulting from the complicated structure and number of players involved. Using lessons learned from EFSE, a previous regional initiative established by IFC and KfW, the partners developed an efficient structure in a timely manner to meet market needs.

IFC and KfW stepped up and committed $150 million and $130 million, respectively, to provide comfort and send an important market signal to other investors to participate. IFC's strong cooperation and partnership with KfW facilitated significant mobilization from various governmental and quasi-governmental entities and other international organizations. Through the efforts of the two anchor investors, MEF was successful in raising over $470 million in investor commitments in a short time. This coordinated effort continues today as the investor group helps bring MEF additional funding from such private sector players as Deutsche Bank and other like-minded investors to meet the increasing demands of the facility.

Lesson 2: An outsourced funding structure resulted in reduction of the transaction time required to deliver crisis relief.

The MEF structure was created to deliver a rapid and flexible response, achieve maximum possible outreach, and ensure efficiency and rigorous risk management. To achieve these objectives, IFC and its partners decided in the structuring phase to outsource the origination, execution, and monitoring of loans and to proceed with an outsourced model that would execute the program through the industry's largest and most experienced fund managers, Blue Orchard Finance, ResponsAbility, and Cyrano Management.

These three investment managers were selected based on their reputation, professionalism, track record, and reach in the microfinance sector. To avoid any conflicts among them, each investment manager was assigned specific microfinance institutions from a list of systemic institutions. To ensure strong accountability from the investment managers and to be sure investments are made according to the MEF objectives, an investment committee composed of representatives from the largest investors was created and given the authority to make all final investment decisions. The investment committee's oversight of the investment process also ensures that investment managers present quality investment proposals in a consistent and standardized manner. Investment managers are also required to report on a monthly basis to the fund administrator and are rewarded an incentive bonus at the end of the year, based on their performance and achievement of selected indicators.

By streamlining the investment process and bypassing internal investor bureaucracy, the MEF structure is capable of achieving a two-week to four-week turnaround for a loan, as opposed to the months-long process typically required for IFC to book a senior loan. This reduced transaction time was critical for many microfinance institutions that required immediate liquidity funding, and it has created a strong reputation for MEF as a reliable and speedy source of funding for the microfinance industry.

Lesson 3: Multiple tranches of shares linked to one another can create complications in implementation if disbursements of specific tranches are delayed.

While the structuring and mobilization efforts of the anchor investors proved to be effective and timely, MEF experienced a slow deployment of funds after its launch in 2009. The inability of MEF to disburse loans following the first closing was mainly due to delays in receiving the first loss tranche from one of the investors. The delay was caused by administrative complications of disbursing the allocated funds, and it severely affected the ability of MEF to disburse other classes of shares due to restrictions agreed to in the structure of the facility. As part of an effort to keep the risks appropriately balanced among the different classes of shares, risk ratios were introduced that required a minimum outstanding balance of each class of shares compared to the overall investment portfolio and outstanding balances of the other classes of shares. In this case, the delay in the receipt of the first loss tranche limited MEF's ability to disburse A and B tranche shares until the agreed risk ratios were met.

The introduction of risk ratios is a necessary component of the risk structure of MEF. However, it is important to understand the ramifications these restrictions can have if there are any delays in disbursing specific tranches of shares, and their impact on a timely response in a crisis situation. While this was the main reason behind the early delays, the functioning of the facility—with the processing complexities involved with having three investment managers—also took some time to work itself out. MEF has since increased its efficiency in processing transactions and has picked up its investment pace considerably since 2011, with a growing pipeline and disbursements to a wider range of microfinance institutions, which is expected to continue in the years ahead.

CONCLUSION

Delivering a crisis-response initiative quickly was critical in providing the confidence needed to calm investors and markets and meet short-term liquidity needs of microfinance institutions. But ensuring that the initiative is efficient and effective in its implementation is just as important in delivering the desired impact.

Participation of the industry's main players, successful mobilization of funding to create a sizeable response, and creation of an efficient processing structure—all have contributed to MEF's ability to successfully serve the microfinance industry and to counterbalance the potential reduction of access to financial services to underserved lower-income segments of the population. Given the never-ending strong demand for its funding and the likelihood that the volatility of capital markets will persist, the investors of MEF decided in 2013 to extend the life of MEF another five years so it can continue to respond quickly and decisively to local crises and provide a stable source of funding for the microfinance industry.

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Network Holding Companies: A Pillar of IFC's Commitment to the Microfinance Industry

An early supporter of the development of the microfinance holding model, IFC has been investing in network holding companies since the early 2000s. The structure has been fundamental in quickly expanding access to finance in numerous regions and in bringing microfinance to several IDA and post-conflict countries for the first time. Holding companies have helped microfinance expand its reach and achieve commercial viability. This SmartLesson shares experiences from IFC's involvement in microfinance networks at the holding and subsidiary levels.

The rise of microfinance institutions as sustainable providers of access to finance—leading to their global presence today—is a remarkable success story. Some of this success can be attributed to the microfinance holding network, a model first pioneered by ProCredit at the end of the 1990s. As with other networks, holding networks have allowed microfinance institutions to achieve significant economies of scale, replicate successful models, and expand product offerings towards universal banking. In addition to these benefits, the ProCredit holding network model brought sponsors and development finance institutions together to develop commercially-oriented microfinance institutions, pairing operational expertise with much-needed capital. Once the model had demonstrated its success, others followed suit, with microfinance actors such as Advans, AccessBank, FINCA, and MicroCred, forming their own holding network structures.

A holding company is a company that owns other companies; in microfinance, a holding company network owns multiple microfinance institutions. As the parent company, a microfinance holding company typically helps to raise funding for and provide operational support to its network of subsidiary microfinance institutions. Depending on the historical background of the founding investors, or "sponsors," there are three types of network holding companies[1]:

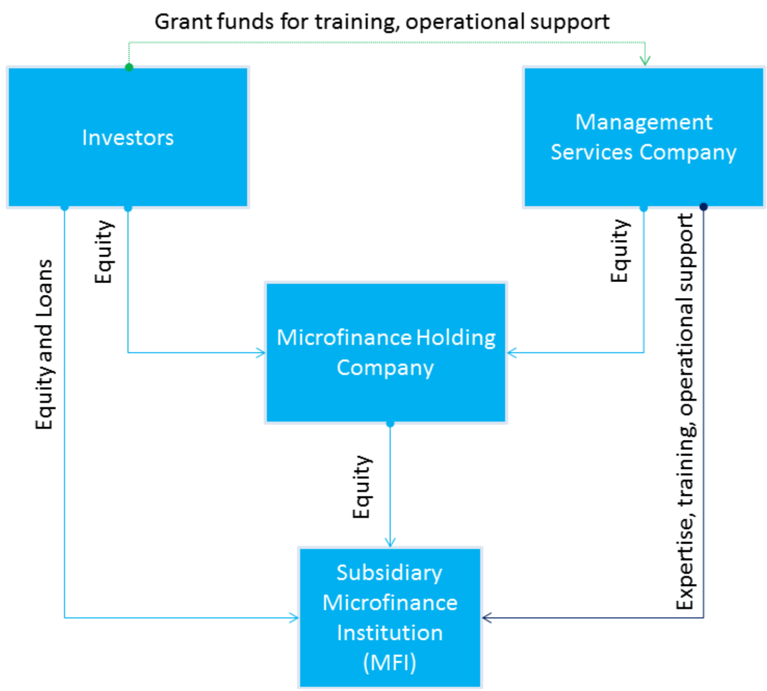
- Consulting-led holding companies are sponsored by technical consultancy organizations that expanded into microfinance institution management. Examples of this type (with the technical sponsors in parentheses) are Access (LFS), Advans (Horus), ProCredit (IPC), SMH (Fides), and MicroCred (Planet Finance).

- Network-support-organization-led holding companies originated as collectives of microfinance organizations, with a holding company subsequently formed as a centralized management entity. Organizations of this type are FINCA Microfinance Holding (FINCA International), BRAC International Holdings (BRAC NGO), ASA International Holding (ASAI), and Opportunity Transformation Investment (Opportunity International).

- Local bank-led holding companies use the holding company model to expand microfinance institution operations in collaboration with a technical partner. Ecobank-Accion is an example of this type.

1 Adapted from Earne, Jansson, Konig, and Flaming, "Greenfield MFIs in Sub-Saharan Africa: A Business Model for Advancing Access to Finance," The Partnership for Financial Inclusion (IFC, Sub-Saharan Africa, February 2014).

Figure 1: Sample Holding Company Structure



Source: Adapted from "Independent Evaluation Group. 2008. Financing Micro, Small, and Medium Enterprises: An Independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries. Washington, DC : World Bank. © World Bank. https://openknowledge.worldbank.org/handle/10986/6485

Figure 1 illustrates a sample structure of holding companies. The network holding model is useful to support the launch of new subsidiaries, mobilization of investment capital, and transformation and integration of network affiliates. In addition, when holding companies are equipped with robust corporate governance and a strong board of directors, they can also be effective in providing oversight and strategic support.

The scale of the impact achieved by the five network holding companies in which IFC invested at the holding level (Access, Advans, FINCA, ProCredit, and MicroCred) is substantial: the networks operate a combined 63 subsidiaries and collectively serve more than 5 million clients in 41 countries (19 IDA countries), and they have a loan portfolio of more than $5 billion (See Table 1).

LESSONS LEARNED

Lesson 1: The market development facilitated through holding companies, often in post-conflict countries, can have transformative effects beyond just direct outreach to subsidiaries. In many cases, holding networks were market pioneers in countries where no other bank or MFI had focused on the MSME segment.

IFC's work with partner FINCA International is illustrative of the impact that holding companies can provide. FINCA was founded in 1985 as an NGO in Latin America, where it pioneered village banking. Although it had already achieved significant outreach across four regions, operating in 16 IDA and five FCAS countries, FINCA sought

Table 1: Overview of Different Network Holding Companies

	HoldCo / Network	Promoter	Est.	#FIs	IFC Projects
Network	ACCION International		1961	22	El Salvador, Nigeria, Ghana, Cameroon
	BRAC International	BRAC NGO	1972	10	BRAC Bank in Bangladesh and Afghanistan
	Aga Khan Agency for Microfinance	Aga Khan Dev't Network	2004	13	Afghanistan, Syria, Tajikistan, Kyrgyz Republic
Holdco	ProCredit Holding**	IPC	1998	22	Holding, Romania, Moldova, Ukraine, Ecuador, El Salvador, DR Congo
	Opportunity Transformation Investment	Opportunity International	2000	15	OI Serbia
	Advans**	Horus	2005	8	Holding, Nigeria, Ghana, DR Congo, Cote D'Ivoire
	MicroCred Holding**	PlaNet Finance	2005	6	Holding, China, Senegal, Madagascar, Nigeria
	ASA International Holding*	ASA International	2006	10	
	Access Microfinance Holding**	LFS	2006	8	Holding, Azerbaijan, Tajikistan, Madagascar, Nigeria, Tanzania, Liberia, Zambia
	Swiss Microfinance Holding	Fides	2007	2	Senegal, Namibia
	FINCA Microfinance Holding Company**	FINCA International	2011	22	Holding, Georgia, DR Congo, Tanzania, Azerbaijan, Kyrgyz Rep

**Not an IFC client **IFC Holdco-level investment*

to better serve its clients by reorganizing its operations into a holding network at the end of 2011. The holding network model would allow it to raise funding to transform its network affiliate MFIs into commercially operated financial institutions, introduce new products, expand outreach, and achieve scale.

IFC was the lead investor of this project, providing key insights and technical expertise at the country, regional, and global level, in addition to equity investment. Restructuring to a holding company model is a major undertaking, but doing so itself yielded lessons on the importance of a strong center to standardize operations across the network in order to gain efficiencies, supported by regional hubs to implement the necessary training and technical support.

Doing so has allowed FINCA to transform 19 out of its 21 subsidiaries into commercial microfinance institutions, of which nine are now deposit-taking institutions, which provide low-income clients with access to safe and affordable savings accounts. This is remarkable not only given the heavy investment and time commitment required to undertake a successful transformation, but also because FINCA's model is to operate in the most difficult and frontier regions. Critical to this success was that, with IFC support, FINCA was able to set up a team dedicated to the transformation process, both at the holding and the subsidiary levels. In just two years following its transition to a holding network model, FINCA expanded its outreach by over 30%, reaching more than 1 million clients in 2013.

While FINCA and others have used the holding network model to consolidate, transform, and manage a variety of operations, the model has also been very effective in establishing completely new microfinance projects, or "greenfields. " Greenfield projects occur where no prior capacity exists in the field; in some cases, these have been undertaken in fragile and conflict afflicted states, such as FINCA Congo. In these cases, the holding company plays a critical role in establishing and developing the greenfield's mission, strategy, institutional capacity, and governance, transferring knowledge between subsidiaries. It also heavily invests in human resources, typically spending about 3 percent to 5 percent of operating budget on staff development. An unintended consequence of this high investment is that the good reputation of training programs makes their graduates a sought-after resource: staff turnover rates are high, and some holding companies expect to train more than twice the required number of staff to compensate. Although this can make operations more challenging to manage, it has the virtue of building capacity across the communities where MFIs operate by providing an infusion of freshly-trained skilled workers.

Holding network microfinance institutions also function as conduits for innovation in products, delivery channels, and service processes, as the central team can provide the backing for research and development. For example, ProCredit Bank-DRC introduced the first ATMs in the Democratic Republic of Congo, which were adopted by commercial banks soon after. AccessBank Madagascar has developed an agricultural loan product with flexible terms to accommodate farmers' cash flows. MicroCred Nanchong has paved a pathway for microfinance in China as a pilot microcredit company, offering microcredit and SME loans that were previously unavailable, while demonstrating that responsible finance is good business.

Lesson 2: Alignment of interests and a sound ownership structure are important for long-term success of the network.

A holding network structure inevitably involves a large number of actors working together. As a result, coordinating the various interests of each to achieve mutually-agreed upon goals can be challenging. This is greatly aided by a strong corporate structure that includes a technically able board. IFC's most successful experiences with microfinance holding companies have typically involved highly committed sponsors capable of forming and executing a clear, structured strategy.

In these ventures, all of IFC's partners– including sponsors, management, or other important decision makers– had significant financial ownership. This ensured a high level of commitment, as all of these actors had positive interests in the long-term success of the network and its subsidiaries. Without this, it is much more difficult to resolve operational difficulties that may arise, as they may require additional services for which no immediate compensation is available. A clear management service agreement can help reduce the potential for such conflicts of interest.

IFC has also encountered that it is equally essential for owners to agree upon the strategy and long-term vision of the organization from the outset. Strategic decisions, such as share issues or the procurement of technical assistance and management services, should require majority and supermajority board votes. IFC has worked with our partners to establish these shared objectives from the outset of each project. Establishing clear goals has been vital to ensuring the long-term success of all of its network holding company partners by avoiding any potential for fundamental disagreements. To do so, IFC has been a proactive partnering investor to its holding company partners through its board member nominees, prioritizing a sharp strategic focus: emphasizing a double bottom line mission and prudent expansion to regions with low access to finance. As a founding shareholder of Access Holding, for instance, IFC played a significant role not just in aligning other shareholders to carry out the microfinance business strategy but also in establishing its strong governance, with a proactive and experienced board, that could provide oversight, expertise, and governance standards to subsidiaries.

Lesson 3: Network affiliation is not a guaranteed pathway to success: performance depends on on-the-ground capacity, style, and business model.

Even in the best-in-class microfinance networks, not all subsidiaries perform equally well: having a successful subsidiary in one country does not automatically ensure success in the next. While the management capacity, financial resources, and expertise of the holding company are all crucial to the success of a microfinance institution, it is important to judge each new subsidiary engagement on its own merits. Holding company subsidiaries certainly benefit from standardized operational policies, procedures, and information systems. Nevertheless, these should still be tailored when entering new markets, since many local variables can affect the operational performance of a network subsidiary, and must be incorporated to its business model.

IFC is a co-investor with its holding company partners in 26 of their subsidiary operations—a testament to both IFC's level of commitment to its partners and its confidence in their strategy and operational capabilities. Nevertheless, each investment decision is based on the financial sustainability, development impact, and locally-contextualized risks of the subsidiary in its own right. So too should the viability of the project within the entire network be assessed: management capacity is a scarce resource in many countries where networks operate, making overexpansion a considerable concern.

CONCLUSION

The network holding model is a pillar of IFC's commitment to the microfinance industry. It is a complex model, requiring continuous collaboration on strategy, implementation, and relationship management. Nevertheless, the approach has been fundamental in expanding financial inclusion to some of the most challenging markets and providing access to finance to millions of beneficiaries. These institutions are the standard bearers for best practices and are important product innovators in their markets.

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AccessBank Liberia opens its doors.

Keeping a Stumble from Becoming a Fall: Lessons Learned from Global Workouts with Microfinance Institutions

For the last twenty years, IFC has invested in microfinance projects, committing $3.5 billion to 215 clients across 400 projects in 73 countries. During this time, IFC's microfinance team has learned several lessons from our projects with microfinance institutions (MFIs) that we can apply to help propel our partners to financial success. Many such lessons can be drawn from cases in which IFC had to undertake workouts, or deal restructuring, for projects that faced significant challenges in the start-up phases. In most cases, this involved delays in reaching financial and operational sustainability. In all cases, IFC portfolio teams in conjunction with the sponsors and other shareholders, had to provide very proactive supervision and onsite monitoring.

IFC's microfinance portfolio has been protected from complete failures such as bankruptcy or the collapse of a MFI. Instead, problematic investments have featured significant losses in capital or the inability to reach financial sustainability or break even. Another tendency is for MFIs to experience minimal growth and development. MFIs that have suffered these issues usually face heavy deterioration in capital that jeopardizes financial solvency. When this occurs, management and shareholders must evaluate options to recapitalize, merge, restructure, or sell the MFI in a process is called a workout. There are several common overarching themes that emerge from MFIs that have faced a workout as a result of these issues. These themes are helpful to examine as they have also manifested to varying degrees in institutions throughout IFC's portfolio.

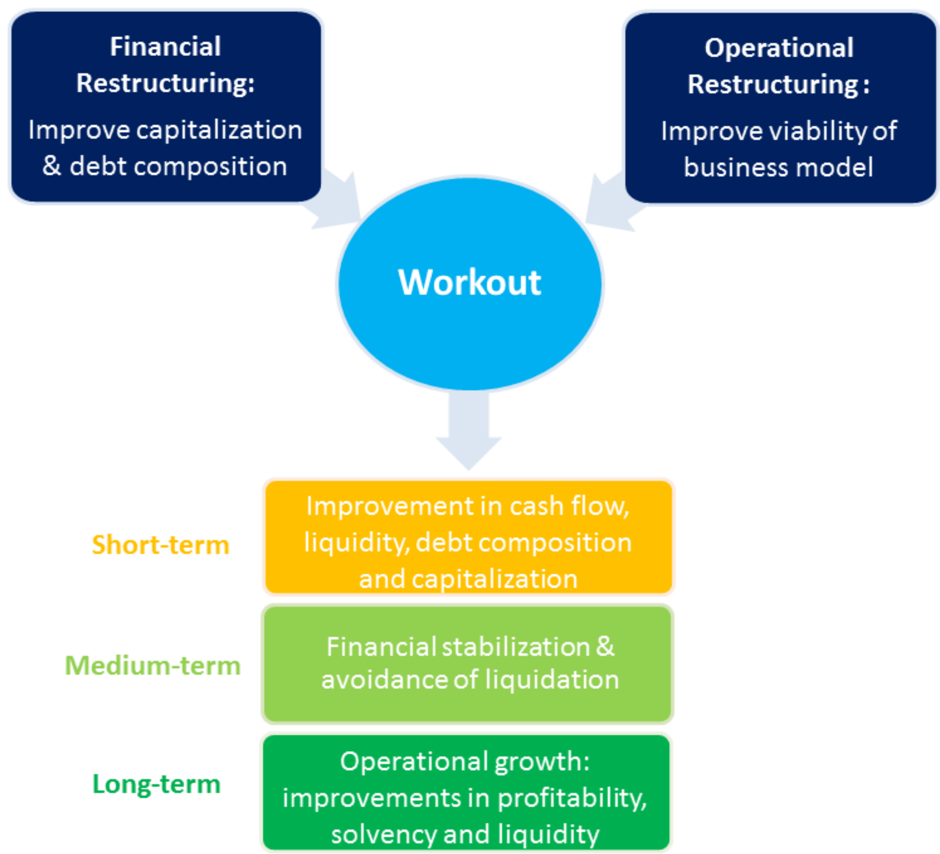
LESSONS LEARNED

Lesson 1: The role of the sponsor is essential in providing leadership and resources.

In microfinance investment projects, the sponsor is a lead investor (whether NGO or corporate owner) in a nascent MFI. The sponsor is often an experienced microfinance operator, bringing a combination of capital, microfinance expertise, and strategies for operational improvement. IFC has participated in several microfinance workouts that illustrate the importance of the NGO or corporate owner's role in providing leadership and strategic resources to fledgling MFIs. In some cases, the sponsor's inability to recapitalize the MFI when times were tough led to insolvency. In other cases, the sponsors failed to provide adequate technical assistance to the MFI, leading to managerial and operational problems.

One microfinance bank found itself undercapitalized as a result of operational challenges and bank regulatory changes. The cohort of social investors that supported this institution was unable to recapitalize the bank when need for a capital injection arose. Another internationally-sponsored microfinance NGO faltered as a result of the sponsor's inability to provide on-the-ground financial intermediation expertise. A management crisis led to high staff turnover and operational failures such as fraud and high portfolio at risk (PAR). As funders saw this occurring, they

Figure 1: Workout Processes and Outcomes



pulled commitments, leading to a liquidity crisis.

These examples illustrate how effective strategy and governance are crucial for rapid intervention and infusion of capital when a MFI faces issues. Unfortunately for these MFIs, they were the main sponsor's first experience in new markets. These were particularly difficult market environments, and the sponsors were unable to play the needed role of a deep-pocketed and technical sponsor. In other cases, financial resources were not the issue, but rather the staff deployed did not have the managerial depth or expertise to deal with a tough new operating environment. For instance, in some cases management selected branch location in areas that had significant security concerns. One clear lesson from this is to work alongside local partners and staff to develop proper knowledge and understanding of the local environment.

IFC's experiences with greenfield MFIs, new local institutions set up by a regional or international network or holding company who act as the main sponsor, are especially illustrative of the importance of leadership. Generally speaking, a greenfield can be considered a type of franchise, where the holding company can be expected to guide strategy, backstop operations, and provide standards for policies and procedures, among other duties.

However, in some cases this expectation has not been fulfilled. One greenfield in the Latin America and Caribbean (LAC) region, for instance, did not have the strategy and management structure to control growing operations in a very competitive market. Although strategic plans had called for opening only four branches in the first year of operations, instead six were opened, and PAR without write-offs soon reached 25 percent. Weak managers and young, inexperienced staff proved unable to successfully achieve the aggressive growth strategy with a quality loan portfolio.

Other factors that can affect workout situations are "key man risk," or the effect of losing a focal team member, and weak governance. Both of these factors can also result in ineffective board guidance through crises. In another example, a workout scenario occurred with a MFI with a strong network that had moved into a post-conflict environment and learned the hard way that the transfer of a credit methodology from one country to another is not always a successful strategy.

In this case, the board was comprised of different institutional investors but dominated by the lead foreign sponsor and strategic investor, which had neither the resources nor the ability to facilitate a turnaround. The sponsor was in a foreign market with no 'on-the-ground' presence, as well as an insufficient ability to grasp key cultural understandings required to operate a credit company in that market. They were unable to offer adequate management support, which led to high turnover, fraud, and other operational issues that could have been avoided by partnering more closely with local experts and implementing stronger credit risk management.

Lesson 2: Look out for flaws in the business model and technology, as these can lead to significant failure.

As touched upon above, in some of the projects that IFC has undertaken, our partners have entered new market segments by using the same principles, methodologies, and practices of existing loan products, without any tailoring to the new segment. This pitfall has occurred in particular when MFIs that IFC worked with tried to upscale from micro to MSME or SME lending, or from group to individual lending. For instance, two MFIs in LAC and the Middle East and North Africa (MENA) that had been highly successful with their original methodology for the micro sector, but then stumbled when they changed their target clientele.

In the LAC region, the MFI's leadership was very keen to meet the demand of clients for larger individual loans and so used the same principles to serve larger micro enterprise loans without adequate risk management procedures. In a short span of time, the portfolio went from being 100 percent microfinance to 60 percent SME loans. Little attention was given to the fact that the risk profile of a portfolio with larger loan sizes was higher, as each default has a greater impact on the portfolio at risk. This showed a lack of understanding of the different client segments within the market and resulted in an increase in PAR and write-offs, and an eventual need for recapitalization as a result of poor operational performance, which was then compounded by unanticipated contemporaneous regulatory changes.

Lesson 3: Avoid the peril of uncontrolled growth.

In some of these cases, the start-up entities that we have worked with did not have a corporate control structure which could effectively curb loan losses. In these situations, there was rapid growth in branch network or loan approvals without appropriate or effective risk assessment, audit, monitoring of loan officers, or internal controls. The management instead focused on growth in portfolio and profitability over short time horizons and sacrificed the quality of their loan book as a result.

This situation is clearly exemplified by the previously mentioned greenfield MFI in LAC, which involved an international sponsor entering a highly developed and competitive microfinance market, with an aggressive growth plan and insufficient human capital to manage this growth. By opening six branches within the first year while relying on a poorly trained loan officer workforce and foreign interns, this MFI ran into inevitable operational issues that could have been avoided by employing qualified managers and properly trained loan officers.

The example of the LAC MFI that aggressively pursued the SME market segment also illustrates the risks of uncontrolled growth in the microfinance industry. Poor credit appraisals and subsequent defaults were the result of the MFI's rapidly shifting focus to the SME segment while still utilizing microcredit technology and microcredit loan officers. Such cases showed clearly that rapid growth without attention to strong credit and underwriting criteria are not sustainable and can rapidly erode a MFI's equity.

Lesson 3: Safeguard against adverse government intervention by engaging proactively.

In certain cases, government intervention has also led to operational challenges for MFIs. In South Asia, political interference in one rural region where a MFI operated led to fraudulent letters being distributed among clients announcing a loan waiver program. This led to a sudden wave of defaults among customers who believed falsely that they no longer had to repay their loans. Premature or restrictive regulations can stifle innovation, especially in a nascent sector: overly prescriptive conditions on maximum loan size, interest rate restrictions, or subsidized lending programs have also hampered some of our microfinance clients from time to time.

IFC, together with other commercially-oriented donors and partners such as the Consultative Group to Assist the Poor (CGAP) – a global partnership of 34 leading organizations which are working to improve financial inclusion, has played an effective lobbying role by sharing best practices and helping to prevent market distortions.

CONCLUSION

In most of these cases, IFC responded by working with the main sponsor and other minority shareholders to effect a resolution – whether trying to make the sponsor accountable in terms of providing more resources, or changing management to avoid failure. IFC often deployed in-house technical microfinance experts to conduct on-the-ground assessments in order to fully understand where missteps had taken place, and create action plans to quickly resolve any short-term crises and prevent losses from further spiraling on a medium-term basis. Though some of these conversations were difficult, particularly working with network partners in multiple countries, the main lesson was that if the sponsors were unable to play a leading role in turning around the institutions, it was time to find a new sponsor who could. Ultimately, all was not lost as with a change in strategy, along with stronger credit procedures, many of these MFIs were able to recover in their local markets.

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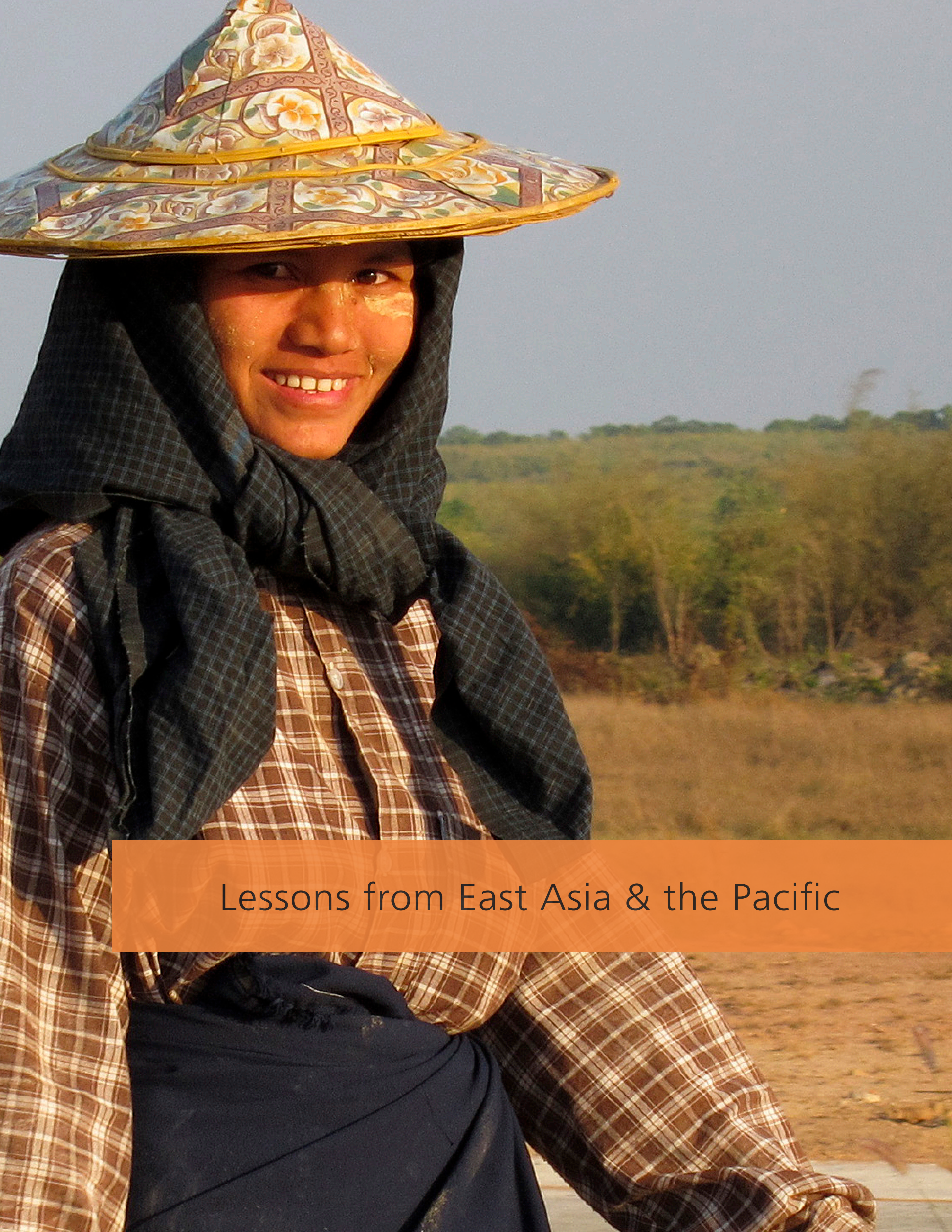

Lessons from East Asia & the Pacific

SmartLessons
real experiences, real development

Resonating to the "Kundu" Beat: Rural Banking in Papua New Guinea

Innovative solutions are helping people in rural areas gain access to basic banking services. But actually implementing those solutions and providing those services entails many challenges. Take, for example, the Electronic and Mobile Banking project in Papua New Guinea with Bank South Pacific (BSP), an IFC investee institution. The project aligns with the strategic interest in Access to Finance to support mobile banking projects across the Pacific to reach underserved segments of the population through the provision of electronic and mobile banking. The integration and collaboration of BSP with BSP Rural (its wholly-owned subsidiary) as a single bank have provided an extraordinary opportunity to offer a variety of banking options for the bank's diverse customers. This SmartLesson details the lessons learned from BSP's experiences with rural banking.

Papua New Guinea is predominantly a cash-based economy. The geography and demographics make traditional banking operations extremely challenging. For example, over 800 languages are spoken in Papua New Guinea, and 80 percent of the approximately 7 million people live in the rural areas. Only 10 percent of the total population have access to a bank account. on the other hand, about 30 percent of the people have access to mobile phones. This growth of mobile-phone reach and use has provided an opportunity to introduce mobile banking into the country, with the aim of reaching potential customers in the rural areas where there has been no access to banking. (See Box 1.)

Meanwhile, the Papua New Guinea economy continues to expand with the natural resources boom. Rural communities are slowly feeling the positive effects of this boom, and there is an increasing demand for domestic remittances from those employed to send back to their families in the villages. Domestic remittances have been a norm but are now growing, and with the growth come rising risk and cost.

Box 1: Rural Banking Innovations

The BSP Rural banking project continues to expand with innovative banking options to meet the needs of rural populations that lacked access to banking services. For example, the bank uses hand-held tablets to open and issue an instant working debit card—called the "Kundu Card"—for new rural customers when they open new bank accounts.

Also, an expanded network of rural branches, cash agents, EFTPOS[a] merchants, commodity buyers, and container branches, along with a close collaboration with local communities, has proven to be a success. Many people—and especially women—in the rural areas have signed up for new bank accounts and are using the rural banking services through BSP's "ecosystem." This growing "ecosystem" equips BSP to deliver basic banking services to its rural customers as well as offer entrepreneurial opportunities for rural businesses to act as agents and EFTPOS merchants.

a. EFTPOS = electronic funds transfer at point of sale.

Kundu drums accompany songs for many occasions, including at various ceremonies. A kundu is a hollowed-out tree trunk cut to about one meter in length and shaped. The striking surface is usually made from snake, lizard, or goanna skin stretched across one end, and resin is used to fine-tune the kundu.

In September 2010, IFC conducted a feasibility study among coffee growers in Papua New Guinea on the concept of mobile/electronic banking. The purpose of the study was to validate prior ad hoc research that had suggested that the entire coffee supply chain, from the growers to the international exporters, preferred a cashless transaction mechanism because of security risks—and that they preferred a mobile-money solution as an alternative to cash.

Based on the study's findings, IFC had discussions with BSP, the largest commercial retail bank in Papua New Guinea. BSP was keen to serve the rural population through its subsidiary, BSP Rural, to develop savings and other financial services through a mix of branch and electronic banking solutions, including mobile banking and EFTPOS terminals.

In June 2012, IFC and BSP introduced mobile banking to reach the rural population in Papua New Guinea with the BSP Rural Mobile Banking pilot project. The pilot proved successful and laid the foundation for extending banking services to new areas. At this writing, BSP Rural is continuing to expand this innovative banking solution to the rural population with a refined business model based on lessons learned. This expansion includes the introduction of hand-held tablets to open new, fully functional bank accounts with debit cards as well as mobilization of savings from new customers in rural Papua New Guinea through the BSP Rural branch and BSP agents.

As the largest bank in Papua New Guinea, BSP takes its community service obligations seriously and was committed to expand banking services to the rural population. However, expanding traditional banking into much more sparsely populated areas was not an easy or cheap option, so BSP has had to innovate. This innovative approach was critical in its establishment in the rural areas.

The rollout of the business beyond the pilot areas is continuing, together with the container branches and tablet services. As of March 31, 2013, BSP Rural had 94,894 rural customers, 9,866 EFTPOS merchants, 37 branches, 25 commodity buying points, 120 agents, and 148 trained staff. The BSP Rural customers have conducted more than $31.9 million worth of electronic transactions through EFTPOS merchants, various branches, and ATMs. The value of deposits as of March 31, 2013, was more than $6 million and is anticipated to increase as the service continues to grow.

LESSONS LEARNED

Lesson 1: The service points for deposits and withdrawals must be ubiquitous.

The physical presence of a network of agents, merchants, and rural branches in the rural areas is critical to effective provision of rural banking services. Access to banking services in Papua New Guinea is an issue because of the road system, infrastructure, security, and geography—not to mention the time and cost of traveling to a town to access banking services. Having service points closer to home and at peoples' doorsteps has been the key factor in BSP Rural's success. This convenience is particularly important for women, given the time and risk involved in traveling.

Face-to-face interaction is important in reaching more clients. Given the geographical difficulties, the key is to have a continually staffed rural branch. Otherwise, the difficulties and cost of travel would prevent customers from signing up and using the rural banking system.

Lesson 2: Community participation and trust are vital elements.

For customers in rural areas to take advantage of the opportunity to use the rural banking services, they must trust them and feel free to participate in them. This is especially important where the majority of the people are illiterate and have had bad experiences with Ponzi schemes.

To engage the community in the services, BSP recruited staff from the local communities and trained them to perform their roles in the rural branches. BSP also engaged branded agents and merchants living in the local areas. Besides building a rapport and creating trust with the community, the recruitment of local staff and branded merchants and agents from the local areas serves another important purpose: staff, merchants, and agents are part of the community and can speak to the community in their local languages, educate them about the new bank services, and answer any queries people may have regarding the services. This is important in a country such as Papua New Guinea with over 800 languages.

The branding and association with a reputable and recognized entity such as BSP are also important to customers in the rural areas, encouraging them to have the trust necessary to sign up for the services.

Lesson 3: The technology and product must be appropriate.

An important aspect of the project was to implement appropriate technology and processes. BSP initially used an SMS -based banking product, which it found to be unsuitable to the rural customer because of a combination of technical limitations and procedural obstacles that would have to be overcome to make the product convenient to new rural bank customers.

Given the limitations and challenges of SMS banking, BSP introduced the USSD protocol for its mobile banking. The USSD features—including facilitating real-time payment clearance and settlement—complemented and enhanced rural banking services. However, signing customers up with mobile handsets—and then getting them to use the system—was not feasible. Customers also generally resisted the cost of calls, and it often is too difficult to educate them over the telephone. And the concept of a call center does not work in rural settings.

Given these challenges, BSP modified the model and adopted hand-held tablets linked to a wireless card swipe. BSP Rural staff and agents use these tablets to create and open bank accounts anywhere in Papua New Guinea where there is a Digicel signal. IFC's investment in Digicel has made possible the rollout of Digicel's network coverage, which provided the foundation for the technology.

The product design—featuring instant issuance of a working bank card with new accounts—has also contributed to the success of this product. The services reduce the need to handle cash and checks, increase electronic auditing capability and oversight, and improve overall security. In conflict-affected Bougainville, the impact of the tablet and issuance of a working bank card has economically empowered women and dramatically reduced travel time, cost, and security risks for them.

Lesson 4: Liquidity management at rural branches is critical.

The rollout of business beyond the pilot areas—and the success of the project—created a liquidity problem at the rural branches. This is because customers were not saving money in the rural branches, and the demand for physical cash resulted in withdrawals that exceeded the cash available at those branches.

In response to this problem, BSP carried out a pilot program in Simbu Province to encourage small-to-medium businesses in rural areas to deposits their cash with the rural branch rather than the metro branch. The pilot has been successful and helped alleviate the shortage of cash in the rural branch. BSP is now looking to expand the program to other areas in Papua New Guinea to address the cash liquidity problem that the rural branches currently face.

Lesson 5: Technology training and financial literacy are vitally important.

For the agents and merchants, training on the use of the technology and its functionality is important to ensure that they can perform their roles and deliver the required service to the customers. The agents and merchants are not only service providers, but they also are the focal point for customer interaction. That puts them in an excellent position to educate the customers about the banking services and financial literacy.

In Papua New Guinea, where the literacy rate is low, training in financial literacy is important, to educate customers and would-be customers on the importance and value proposition of banking services and especially savings. In the rural areas, financial literacy will be the key to encourage savings, assist with liquidity management, and reduce the ever-growing demand on physical cash.

CONCLUSION

This remarkable story of the establishment and continued expansion of the BSP Rural banking project—and the issuance of Kundu Cards for rural customers who previously had no access to banking—could not be told without the unwavering commitment from the board and management of BSP. The successful BSP Rural banking model has had a positive impact on the lives of the rural population—and especially on women in the rural areas, including women public servants such as teachers and health workers in some of the remote parts of the country.

BSP Rural is taking full advantage of the existing footprints, technology platform, container branches, and marketing of the BSP Group to achieve its targets and expand its services and reach. But while the services and network continue to grow, the liquidity problems at the rural branches suggest the customers are using their Kundu Cards to make purchases and withdraw cash in their accounts without making any regular savings. The challenge for BSP going forward is to address the liquidity issue at rural branches, and one way this can be achieved is though financial literacy in the rural areas. A further challenge in the near future is to include and support micro and small businesses in those areas.

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Serving China's Frontier Regions through Sustainable, Prudent Financial Inclusion

Responsible finance—the pragmatic way forward in the global microfinance community today—is helping IFC have an impact on its clients' operations and bottom lines, as well as influence on the markets where they operate. Responsible finance brings the focus back to clients and encourages financial institutions to build client-centric operating practices that support prudent and sustainable financial growth over the long term. This Smart Lesson uses recent projects in China to show how responsible finance is breaking new ground for IFC in microfinance, enhancing IFC's relationships with its existing partners, and providing demonstration results to share with potential new partners, within the microfinance sector and beyond.

More than 600 million Chinese people have moved out of poverty over the past 30 years. From 1981 to 2008, the number of people living on the equivalent of $1.25 or less per day decreased from 835 million to 173 million. However, inequality—of income, consumption, assets, and opportunity—is increasing, with the gap between rural and urban populations wide and growing. And it is even starker at the bottom of the pyramid.

The Gini index, measuring income-distribution inequality, increased from near 0.30 in 1985 to about 0.47 in 2007—the most sustained increase in the world, placing China at the high end of income inequality among Asian countries. Although this increase has leveled off, thanks in part to more transfers of public resources to poor rural areas, other dimensions of inequality—such as asset ownership, particularly housing—continue to rise and are mirrored and exacerbated by large disparities in opportunities to access quality social services and social protection.

Over the last several years, the Chinese government has adopted many initiatives to promote financial inclusion. Since 2005, when China's central bank launched a microfinance initiative in five provinces, the Chinese microfinance market has experienced explosive growth. Over 8,000 microcredit companies now provide more than $100 billion in loans to micro, small, and medium enterprises, and these numbers are constantly increasing. Yet the majority of China's poorest, especially in rural and frontier regions, remain largely underserved, making the case for continued growth in the sector.

However, microfinance crises around the world have shown the often disastrous results of aggressive growth combined with diluted focus on clients—demonstrating the need for consumer-centric practices. The Chinese financial market is establishing ground rules for responsible finance and consumer protection to manage this rapid growth, avoid market overheating, and avert future crises. For financial institutions to effectively serve lower-income populations and assure long-term sustainability, they must "build in" responsible lending practices into operations.

A pioneer in responsible finance, IFC has worked with

A microfinance client in her shop in rural China.

the Smart Campaign, since its inception in 2011, to pilot, test, and refine client protection principles through IFC investees in India and Bosnia. IFC brought lessons learned from implementing those principles to the microfinance sector in China. To expand microfinance lending to China's poor, IFC partnered with 13 microfinance institutions with investment and advisory services and international best practices. As of May 2014, IFC's committed investment in China's microfinance sector amounted to $266 million, reaching about 700,000 microfinance customers as a whole, including in frontier, rural, and remote areas, and incentivizing microfinance institutions to implement responsible finance practices from the outset.

LESSONS LEARNED

Among IFC's partners in China, MicroCred Nanchong, CFPA (China Foundation for Poverty Alleviation) Microfinance, and Xinjiang Tianrong MCC (Micro Credit Company) are some of the fastest growing microfinance institutions operating in urban, rural, and frontier regions. Responsible finance is becoming a core part of their mission, vision, and way of doing business. The following are lessons learned through the work of these three microfinance institutions.

MICROCRED NANCHONG: LEADING THE WAY TOWARDS GREATER CLIENT AWARENESS

IFC invested $2.9 million of equity in MicroCred Holding, a global microfinance holding company with subsidiaries in Madagascar, Senegal, Nigeria, and China. MicroCred Nanchong (MC Nanchong), one of two subsidiaries of MicroCred China, provides working capital and investment capital microloans (to purchase fixed assets) ranging from RMB 5,000 to RMB 75,000 (about $800 to $12,000) to microentrepreneurs in the frontier region of Nanchong.

Today, with IFC support on responsible finance, MC Nanchong is a pioneer in the field in implementing declining interest rate balance practices and offering pricing transparency and financial awareness to its clients. MC Nanchong trains staff to inform clients about all costs, fees, terms, and conditions prior to signing a loan. This responsible finance program—reaching some 10,000 clients in Nanchong—is a first-of-its-kind client-centric financial awareness activity on responsible pricing and transparency.

Lesson 1a: Establish core responsible finance standards as a management tool to inform decisions.

MC Nanchong established core responsible finance standards and indicators—such as *percent of borrowers that never had a relationship with a financial institution before MicroCred* and *percent of borrowers with increased turnover in activity(ies) by 25 percent during the credit period*—to track the impact of its products and services on clients over time. Senior management uses this periodic analysis to 1) ensure that MC Nanchong is meeting its mission and vision; 2) understand the impact of microfinance loans for its clients; and 3) make strategic decisions on modifying or offering new products and services to better serve its client base. Understanding which products and processes are most beneficial to clients increases MC Nanchong's client base, laying the foundation for long-term institutional stability, profitability, and growth.

Lesson 1b: Conduct a widespread transparency campaign for clients to encourage responsible client decisions and avoid issues of over-consumption of credit and potential over-indebtedness.

MC Nanchong clients learn that the "flat" rate charges interest on the original loan amount, resulting in nearly double the cost of declining-balance interest. MC Nanchong also helps its clients understand the fees charged for microfinance loans from market providers. Because microfinance loans are short-term, fees of even 1 percent upfront can add double digits to the annual percentage rate. Understanding these elements allows clients to calculate and compare the true cost of using different loans. While Chinese regulation has not yet mandated this level of transparency, MC Nanchong has been a market leader in ensuring that clients have full information to make optimal decisions, thereby promoting personal financial well-being, institutional sustainability, and the health of the sector as a whole.

Lesson 1c: Train staff on the client-centric mission and vision and align staff incentives with client protection.

MC Nanchong trains staff on the importance of responsible and transparent communication with clients at each stage of the product lifecycle—originations (in marketing materials and outreach), appraisal (on pricing, rights and responsibilities), and collections (treating clients fairly and respectfully). MC Nanchong also explains to staff the negative impact of non-transparent pricing on the whole microfinance sector. When prices are unclear, microfinance institutions are vulnerable to a domino effect, where 1) consumers don't understand the full implications of products and borrow too much; 2) market competition is hindered; 3) the prospect of high profits is a strong temptation for staff who, if incentivized by volume and growth targets alone, strive for high client acquisition; 4) clients struggle to repay; 5) the institution's reputation suffers when clients are in default, and efforts to recover the loan are perceived as aggressive collection practices; and 6) governments step in with stringent regulations and caps that curb microfinance institutions' growth and profitability. MC Nanchong trains staff on its mission and vision—and the link between treating clients responsibly and long-term institutional sustainability. Staff incentives are also aligned with responsible practices and portfolio quality rather than growth targets alone.

Lesson 1d: Build client protection into audit guidelines and train auditors to monitor compliance and capture red flags, including through client interviews.

MC Nanchong auditors are trained in client protection principles and their importance to the MC mission and vision. In addition to regular audit procedures to validate consistency of data collected by loan officers and the use of loan proceeds, auditors check with clients to ensure that ethical and respectful collection practices are followed, that no items intended to meet a client's basic needs (beds, clothes, dishes, and so on) have been compromised because of the loan, and that clients have an opportunity to provide feedback and have their issues heard and resolved in a systematic way. Senior management directly reviews these audit reports to ensure that even remote branches are treating clients fairly and respectfully—avoiding risks inherent in institutional growth through locally-based staff serving low-income communities in rural, remote, and diverse geographies.

Lesson 1e: Partner with local institutions to introduce microfinance as a career path and begin to build a cadre of trained, qualified resources for the sector.

One of the biggest challenges in the microfinance sector in China is a lack of locally-trained staff to move into operational and middle management positions at microfinance institutions. To tackle this issue, MC Nanchong launched a microfinance module with Nanchong University to offer students an overview of the microfinance sector, business model, implementation challenges, and operational realities in the field. As part of the program, students follow senior MC Nanchong loan officers as they conduct client appraisals and interact with clients, providing practical know-how on working with low-income, vulnerable communities. The pilot, which was well-received by students and university staff, piqued interest in the microfinance sector. Today, with IFC support, MC Nanchong has received global recognition and is the first SMART certified microfinance institution in China.

CFPA MICROFINANCE: INFLUENCING THE MICROFINANCE SECTOR THROUGH SUSTAINABLE, RESPONSIBLE GROWTH

The China Foundation for Poverty Alleviation, established as a nongovernmental organization (NGO) in 1989, started microfinance operations in 1996. With advisory and financial support from IFC, it transformed from an NGO to a competitive and commercially sustainable microfinance institution, emerging as a market leader in the provision of microfinance and nonfinancial services to some of the poorest rural households in China. CFPA has experienced strong growth and today is the microfinance institution with the largest outreach in China, working in rural parts of over 107 counties in 16 provinces—80 percent of the country's poorest counties. It has over 200,000 clients, with a $230 million portfolio and PAR > 30 (portfolio at risk greater than 30 days) at less than 1 percent.

Lesson 2a: Deliver investment jointly with performance-based advisory services to achieve a multiplier effect toward greater financial inclusion.

In 2005–2006, when microfinance was first formally launched by China's central bank, stakeholders were not convinced that a microfinance institution could achieve commercial sustainability. In China, microfinance institutions were nascent and lacked technical experience and know-how on microfinance. In early 2008, IFC organized a visit by CFPA senior management to several microfinance institutions in neighboring Cambodia, including ACLEDA, CEB, Prasac, and Amret. Particularly impressed with the successful transformation of ACLEDA from an

NGO into a commercial bank, CFPA management decided to transform into a commercial microfinance institution.

Also in 2008, CFPA co-sponsored a workshop with IFC on "microfinance NGO transformation" for field staff and local government, to gain buy-in for the transformation. IFC staff also worked with the board to introduce international best practices and influence a responsible, sustainable approach for the microfinance institution. IFC's microfinance specialists helped the company build core processes, such as credit and risk management, for long-term institutional sustainability.

After the successful transformation, IFC made an equity investment in CFPA of about $5.80 million in 2010 and subsequently participated with the first and second capital increases of the company, for a total equity investment of about $15.65 million (19.2 percent of shares). In 2013, IFC also approved a $20 million loan to CFPA, which is successfully serving some of the poorest, most vulnerable rural populations as a market-based institution.

Lesson 2b: Introduce responsible finance at a nascent stage to build client protection in the DNA of an institution.

As part of the performance-based advisory services, IFC introduced responsible finance to CFPA and encouraged it to formalize responsible lending principles in its people, policies, procedures, and practices. Today, in addition to financial viability and performance, CFPA remains committed to responsible finance and poverty outreach with its rural, poor clients. The average loan outstanding is RMB 7000 ($1,200), one of lowest of microfinance institutions in China. Of its clients, 93 percent are women, 89 percent previously had no access to formal banking services, and 21 percent are ethnic minorities.

CFPA, which positions itself as a socially responsible enterprise dedicated to providing microcredit in poverty-stricken rural areas of China, developed a three-year (2012–2014) strategic plan on social performance and set up a social performance committee to supervise and monitor it. CFPA reports its social indicators to MIX Market and was one of the earliest microfinance institutions in China to endorse the Smart Campaign. It also communicates responsible finance practices with staff and clients through training and broad-based financial awareness, and has developed a standard procedure to effectively handle customer complaints. CFPA continues to improve its client protection practices and is one of the few microfinance institutions in China that conducts an annual customer satisfaction survey of its clients.

CFPA's solid financial and social performance has positioned it to 1) become one of the microfinance institutions in China with highest leverage (its total borrowing from commercial banks is about three times its equity value); 2) access privileged interest rates from commercial banks; 3) achieve strong client and staff loyalty; 4) increase productivity through loan officers (from 205 in 2009 to 255 in 2013); 5) attain success and recognition locally and globally through numerous awards, including the Best Performer in Responsible Finance in 2013; and 6) act as a key influencing stakeholder across the broader microfinance sector in China.

Lesson 2c: Introduce good practices and share results—for a vibrant demonstration effect.

CFPA Microfinance has been active in policy advocacy with government authorities and shared its experiences with other microfinance institutions, resulting in a strong demonstration effect. With IFC support, it launched a series of knowledge products for the sector on such topics as 1) the need for a sound regulatory environment on microfinance; 2) the difference between microfinance and SME lending; 3) international best practices on microfinance; and 4) CFPA's own responsible finance practices.

XINJIANG TIANRONG MCC: BANKING AT THE FRONTIER

Lesson 3: Leveraging existing microfinance good practices through knowledge sharing and successful South-South investments, contributes towards developing the whole sector.

Xinjiang is one of the most sparsely populated frontier regions in China and home to 47 ethnic minority groups. Although the region plays an important economic role in connecting China with Europe, its GDP per person is 20 percent lower than the country's average. In 2012, to enhance financial inclusion in Xinjiang, IFC partnered with XacBank, a successful microfinance bank in Mongolia, and invested $1.6 million to set up the greenfield microfinance institution, Xinjiang Tianrong MCC.

Along with the investment, IFC provided performance-based advisory support to develop the institution and embed responsible finance principles into its mission and operations from inception. In May 2013, Xingjiang MCC management visited CFPA to learn from the earlier advisory support provided to CFPA and its current microfinance practices. As part of the project, Xingjiang MCC also developed and submitted its long-term responsible finance strategy to IFC in December 2013. At that time, its loan portfolio included 562 loans totaling $6.5 million, double the projections for its first full year of microfinance operations. It completed its first two years of operations in September 2014.

Today, Xinjiang Tianrong MCC has successfully integrated responsible finance and client protection principles into its operations, expanded its branch network from three to four offices, and served some of the most remote, vulnerable, low-income communities in China. It is creating new opportunities for those previously without access to finance—in a responsible, transparent way.

CONCLUSION

The experiences and lessons learned from **MC Nanchong** in China are being documented for implementation across MicroCred's entire operations in other subsidiaries in Africa and Asia. **CFPA Microfinance** has a stable senior management team, the majority of whom joined before its commercial transformation. Its NGO background and commitment to responsible finance and client impact has allowed CFPA to mature into a large, commercial, sustainable institution with a strong reputation. To demonstrate its commitment to responsible finance, **Xinjiang Tianrong MCC** has appointed a social and environmental manager/coordinator. It also has plans to establish a responsible finance working group, under which a monitoring team and an implementation team will be set up to integrate responsible finance throughout the organization, building a quality institution to serve one of China's poorest rural areas.

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Lessons from Europe and Central Asia

Applying Corporate Governance to the DNA of a Transforming Microfinance Institution: Mission, Culture, and Risks

When IFC introduced advisory projects to help companies improve their corporate governance, it expected the client base to be real sector companies and regulated financial institutions. However, in Europe and Central Asia, IFC started receiving requests to help microfinance institutions run by non-governmental organizations (NGO-MFIs) develop their governance standards as they transformed into regulated for-profit entities. This SmartLesson describes how IFC responded to this demand, and sets out some lessons learned.

In 1992, through the transformation of Prodem, a Bolivian microfinance institution, BancoSol became the world's first private commercial bank devoted exclusively to microfinance, and the microfinance industry witnessed the birth of a new trend: the transformation of NGO-MFIs into regulated financial institutions. Such transformation has become a strategic objective for many NGO-MFIs around the world. In microfinance, "transformation" most commonly refers to the transfer by an "ownerless" NGO-MFI of all or part of its business to a for-profit, shareholding entity. IFC has been engaged with many such transformations globally including ACLEDA Bank in Cambodia, K Rep in Kenya and NRSP in Pakistan.

Until recently, corporate governance was of secondary interest in the transformation process, but the recent economic downturn and the risk exposure of a number of microfinance institutions have led many in the industry to consider it a primary differentiating factor between those institutions that survive crises and those that do not. The following lessons address specific risks associated with NGO-MFI transformation. (See Table 1.)

LESSONS LEARNED

*Lesson 1: **The Risk:** The institution views corporate governance as simply a "new" compliance obligation within the context of a complex institutional change process—leading to weak governance from the outset. **The Lesson:** Prepare and plan for the intervention carefully, in a timely fashion—and sensibly.*

In advising an NGO-MFI during transformation, any corporate governance team needs to conduct its intervention in the context of a wider, fast-paced, and often uncertain transaction. This requires ***allocating sufficient time to properly understand the situation,*** particularly:

• *Timing.* If the intervention comes too early, before key structural issues have been identified, advice will be at best theoretical and at worst erroneous. If too late, it may fail to take into account important governance considerations in defining the structure of the new entity.

• *Reasons for transformation.* These will affect how

Table 1: Matrix of IFC Corporate Governance (CG) Advisory Support Tools and Transformation Risks

	Tools	Lesson 1: CG Beyond Compliance	Lesson 2: Mission Preservation	Lesson 3: Facilitating Culture Change
Before intervention	**CG Offer**	Timing of submission aligned with any investment transaction and transformation calendar	Focus on maintaining/enhancing MFI mission	Focus on using CG as platform for supporting culture change
	Interview Questionnaire; Document Review	Cover reasons for transformation. Document review includes outline transaction terms	Ask interviewees to define mission of new entity	Open-ended questions on existing and expected culture
Development of CG Report	**Charter**	Based on best practice rather than minimum legal requirements. Properly reflects realities	Mission clearly stated	Defines roles of all key governance functions
	Code of Conduct	As per Charter	Values on which MFI is based, with clear reference to mission	Values include business-related as well as social/mission ones
	CG Code	As per Charter. Refers to benefits of CG "beyond compliance"	Refers to mission	Defines CG as platform for comprehensive change
	Board Rulebook	Defines role of Corporate Secretary as leadership CG function	Focus on new structure and responsibilities	Greater scrutiny over management
	Remuneration Policy	–	For executive and nonexecutive directors. Long- and short-term incentives linked to profit and social mission	Higher remuneration for non-executive directors compared to NGO. Define non-linear criteria based on attendance, membership in committees, etc.
	Director ToR	As per Charter	Refers to responsibility to maintain mission	–
	Management Contracts	As per Charter	Refers to responsibility of managers to maintain mission and to report on same	Refers to corporate values emanating from culture change. Board refers to values during selection of managers
	Employee Contracts	–	Refers to responsibility of employees to respect Codes	Refers to any Employee Share Ownership Plan
	Internal Control Policy	–	Includes mission in its section on "internal environment"	Introduces comprehensive system of internal controls
	Risk Policy	–	Includes responsible lending principles (e.g., SMART Campaign)	Covers range of risks (financial, market, legal, compliance, reputational)
	Compliance Policy	–	Includes reference to compliance with Code of Conduct and CG Code	Defines full scope of function (beyond AML/ CFT)
	Internal Audit Charter	–	–	Stronger skills mix in internal audit; move to risk-based audit
	Subscription/ Shareholders Agreement	–	Shareholders state commitment to mission	May envision managers becoming shareholders. Refer to any Employee Shareholding Ownership Plan

committed to corporate governance the transformed entity and its personnel are. Reasons vary: delivering additional services, attracting investors, enhancing legitimacy, allowing existing management and staff to become owners, and meeting regulatory requirements.

• *Ownership structure.* As an "ownerless" entity, the NGO-MFI will not be familiar with having shareholders. In some cases, the transformed entity's sole shareholder may be the NGO-MFI itself. However, certain jurisdictions may require a minimum number of shareholders, restrict foreign ownership, or require a fit-and-proper test. The team should request details of agreed transaction terms.

• *Regulatory requirements.* Advice must take into account regulations that did not apply to the NGO-MFI. The team will need a deeper understanding of local regulation than may be necessary with other interventions.

Microfinance institutions typically have limited capacity to implement all changes at once, and the team should be ready to provide advice that results in quick wins. The intervention will likely span a long time but include labor-intensive bursts with strict deadlines. The team should exercise common sense in addressing the scope and timing of the intervention. The process will require many short-term practical decisions, and these may conflict with the long-term view on the establishment of quality governance.

Throughout the process the team should continually make the corporate governance business case—through written material, presentations, and informal discussions. The team should identify quick fixes through which corporate governance could have impact. For example, early appointment of a corporate secretary as custodian of good practices could contribute to better navigation of the intervention.

*Lesson 2: **The Risk:** The NGO-MFI loses its development mission as it transforms into a for-profit entity. **The Lesson:** Strategize early ways to maintain and reinforce the mission through better governance.*

A common concern among transformed entities is that they might lose their core reason for being an NGO-MFI—to help the poorest people gain access to finance. With transformation, the initial reasons for establishment as a non-governmental organization seem to disappear: the entity becomes profit-focused, with a financial bottom line at odds with the original social one. The introduction of owners brings a new allegiance—to shareholders. This risk is exacerbated if the original NGO-MFI is diluted by the addition of new commercial partners. Through the following means, IFC can help avoid mission drift:

Robust corporate governance instruments. New structures and policies that come with the introduction of corporate governance should clearly reflect—and enhance—the original mission. The "tone at the top" requires significant attention. Detailed bylaws should clarify board, management, and staff roles and responsibilities, ensuring that those in each governance layer are clear as to their role in preserving the mission. (See Box 1.)

Box 1: SMART Campaign

A tool to embed responsible lending into the operations of transformed entities is the SMART Campaign, developed under the leadership of Accion[a] through a consultative process. Its purpose is to protect low-income clients from disadvantageous financial services and ensure excellence in service. SMART principles comprise appropriate product design and delivery, avoidance of over-indebtedness, transparent and responsible pricing, fair treatment of clients, privacy of client data, and mechanisms for complaint resolution.

IFC has assisted a number of microfinance institutions with Client Protection Certification, an independent, public certification of adherence to SMART principles, and has assisted other microfinance institutions with a detailed assessment of adherence to the principles.

a. Accion is a global nonprofit organization that supports microfinance institutions in their work to provide financial services to low-income clients.

Board's strategic oversight. NGO-MFIs are often advised to change their boards, which typically have been less focused on profit and thus considered weak in skills necessary for a regulated financial institution. While it makes sense for the transformed entity to introduce industry-relevant skills to its board, it risks losing sight of its mission or making it subsidiary to financial returns, depending on the individuals. The following actions can help preserve the original mission:

- Ensure that a number of members of the former board stay on for an agreed period to avoid abrupt, irreversible changes.

•Have at least one microfinance expert on the board.

•Develop institutional targets and an aligned remuneration policy for board and management, linked not only to financial performance but also to the development mission. (Indicators developed for tracking success should include outreach, number of rural branches, and so on.)

•Establish a board committee to monitor social performance.

No radical investor-base changes. Investors in microfinance institutions constitute a distinct investment community and are instrumental in preserving the mission. Engaging only with the commercial investor base in the early life of the transformed entity increases risk of mission drift. Ensuring that the board scrutinizes investor policy helps avoid abrupt changes to the mission through this channel.

*Lesson 3: **The Risk:** The transformed for-profit entity retains the culture of a non-governmental organization. **The Lesson:** Use corporate governance as a platform to introduce comprehensive culture change.*

When the NGO-MFI starts its life in the nonprofit framework, everyone accepts those ground rules. The situation dramatically changes with the establishment of the transformed entity, which may lead to culture clash.

Culture change usually benefits the transformed entity, helping it prosper in its new market environment. But to take advantage of its new status without lowering staff morale, the transformed entity needs to navigate culture change carefully. As with many strategic decisions, the *process* and *communication* of culture change are as important as its content.

Based on principles of transparency, integrity, responsibility, and accountability, corporate governance is well-suited as a platform for introducing culture change and ensuring a system for proper communication between stakeholders. Corporate governance can include the following to ease culture change:

Support for the board in leading culture change. Management cannot, and should not, drive change without the board. One key area of needed change is within management, where there may be inherent conflicts of interest that only the board can resolve. The board has a primary role in incorporating culture change into the transformation plan and strategies. It should lead efforts to introduce culture change through the following:

• Clear articulation of the values of the transformed entity;

• Incorporation of these values into the recruitment and evaluation of managers; and

• Building consensus in the market—and including this in strategic documents.

Alignment of interests of directors, managers, and staff with those of the transformed entity. During transformation, alignment (or lack thereof) of personal interests of key decision makers can affect the ultimate success of the new entity. Typical concerns of those affected include financial implications, personal status, recognition, social mission, and desire for control. The following are some tools to help align interests:

• Severance packages for managers who leave and remuneration packages for managers who stay—including long-term and short-term components based on financial elements (profits, relevant ratios) and nonfinancial elements (such as dissemination of new values);

• Considerations as to the price at which managers become shareholders (and alertness to concerns about enriching owners at the expense of the public good and donors); and

• Development of ESOPs (employee share ownership plans).

Priority strengthening of controls. The transformed entity will face new and complex risks; not only will management of them need to be more systematic, but also reporting to regulators and the market must be more holistic. A first step is to establish an internal control system through board-adopted policies related to key functions in the control environment, such as:

• *Risk management:* One of the most significant differences in the transformed entity's risk profile is the requirement for a more complex spread management capacity in the taking of deposits and offering of other services. Often, NGO-MFIs have only a credit risk function, and even if a risk management department exists, it will need to be revamped to respond to these new realities—and will likely require hiring external management capacity.

• *Compliance:* If a compliance function did previously exist, it would have focused mostly on AML/CFT and would not cover the full spectrum of responsibilities usually associated with compliance.

• *Internal audit:* Similarly, while the NGO-MFI may have had an internal audit function, it typically would not have the proper skills mix needed for performance of audits in a regulated financial institution. This function in the NGO-MFI also is often compliance-based and would need to be developed into a more risk-based approach.

• *Audit committee:* An independent audit committee should be established to oversee the internal controls system and report to the board, even when not legally required to do so.

CONCLUSION

Embarking on a transformation is a far-reaching institutional decision, with challenges often underestimated by the NGO-MFI. All layers of the organization need to be involved in and committed to this process, and a proper corporate governance framework should be part of it from the outset. To achieve the desired benefits, the team needs to be sensitive to the specific nature of the institution, and patient enough with the stop-and-go aspects of the process to provide hands-on implementation of corporate governance tools. We have found this approach valuable and hope our colleagues working in this area will find it helpful in focusing on the DNA of these transforming entities as they develop a governance environment conducive to enhanced outreach and impact on people's lives.

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An apple farmer in Central Asia stands by his product.

SmartLessons
real experiences, real development

Applying the Pareto Principle in the Kyrgyz Republic: Microfinance Matters for Job Creation

By increasing access to finance for micro and small enterprises, IFC helped unlock opportunities for job creation in the Kyrgyz Republic. The synergy of a two-pronged approach—improving a regulatory framework and supporting a microfinance company in expanding its outreach objectives—resulted in the successful transformation of a nongovernmental organization (NGO) into a microfinance bank. The client, Bai-Tushum, received a banking license in November 2012, becoming the first microfinance bank in the Kyrgyz Republic. This SmartLesson describes how IFC Azerbaijan and the Central Asia Micro and Responsible Finance project contributed to this progress—and applied the Pareto principle to help make it happen.

Micro, small, and medium enterprises (MSMEs) vastly contribute to the creation of jobs in any economy—rich or emerging. But to create jobs, MSMEs need access to finance. In poor countries, this remains an acute issue, because bank credit continues to be inaccessible to many entrepreneurs. In this situation, efficient and effective microfinance institutions play an important role.

To increase access to finance in the Kyrgyz Republic for MSME businessmen like Tilek Aripov (see Box 1), IFC contributed to the creation of the country's first microfinance bank. The key objective of IFC's Azerbaijan and Central Asia Micro and Responsible Finance project is to support microfinance institutions' transformation into deposit-taking institutions or even banks—to increase outreach by bringing new products such as deposits, money transfers, and cash management to more clients, thereby increasing access to finance for larger numbers of people. The project supported this objective in two ways in the Kyrgyz Republic:

1. Through capacity building, the project helped Bai-Tushum become the first deposit-taking microfinance institution in the republic in June 2011, and later improved its status by becoming the first microfinance bank in November 2012.

> *Why become a bank? We aim at responding to the growing client needs—some of them grow their business up to a size when they need bigger loans for further business expansion. In addition, it will enable us to offer services our clients need: lending, savings, money transfers, and forex [foreign exchange market] operations.*
>
> *—Gulnara Shamshieva, General Manager, Bai-Tushum and Partners*

2. Going beyond working with clients, the project supported regulatory change to legally enable transformation of microfinance institutions in the republic.

As of June 30, 2014 , Bai-Tushum had served over 45,000 clients, with loans worth $99 million and over 25,000 deposits worth $11 million. Seventy percent of the bank clientele consists of MSMEs, a driving force for job creation in the republic.

Box 1: The Success Story of Tilek Aripov

A great imbalance of social and economic development exists throughout the Kyrgyz Republic. Isfana, a town located in the south in Batken oblast and near the Tajikistan border, has few advantages. Its challenges include poor infrastructure, little or no access to finance, and high levels of poverty and unemployment. Business origination is rare—and if it does happen, it is the result of tremendous entrepreneurial talent.

One such entrepreneur is Tilek Aripov, a 42-year-old owner of a little brickyard that employs 12 permanent staff and over 70 seasonal workers (from May to September, the peak construction season). It sells 60 percent of its production to a nearby province and exports 40 percent to Tajikistan. Increasing demand for bricks in both countries eventually meant the existing brickyard facilities couldn't meet market demand.

Tilek decided to expand his business—to double the brick production by purchasing a new processing line from China. But how would he pay for it? The existing business generated only enough cash to finance working capital, not to purchase the equipment. He needed access to capital of $110,000.

Bai-Tushum microfinance company had been fast and reliable in servicing Tilek's first loan. He also valued the advice and financial coaching he received from loan officers on business planning and loan structuring. So he turned to the newly transformed Bai-Tushum and obtained the needed capital.

The new brickyard, built right before the start of the season, required Tilek to contract 10 more permanent employees and an additional 35 seasonal workers. Thus Tilek's business creates employment for 22 permanent staff and 105 seasonal workers in Isfana.

The project is improving the responsible lending practices of microfinance institutions and generally bringing about more transparent operations by cooperating with the SMART Campaign.[1] Bai-Tushum Bank became the first and so far the only bank in the Kyrgyz Republic that received "Client protection certification" international certificate officially recognized by the SMART Campaign in May 2014.

LESSONS LEARNED

Lesson 1: In applying the Pareto principle (see Box 2), aim at 20 percent of the targeted intervention in the regulatory environment to bring about 80 percent of a desired change.

According to the Kyrgyz law, microfinance institutions are permitted to transform into deposit-taking companies that, in addition to making loans, may extend their product offering with term deposits. This service is essential for very small enterprises and farmers, who might earn interest from deposit accounts where they can save their excess cash flows generated from sales or harvest seasons.

Although the regulatory framework for transformation of an NGO into a deposit-taking commercial microfinance institution existed in the Kyrgyz Republic, none of those institutions took advantage of the opportunity to offer deposit products to clients because of lack of legislative clarity and know-how—on both sides: regulators and institutions. To fill this void, ***we narrowed our focus to improving regulations only for transformation of microfinance institutions.***

The project started small, working with individual microfinance institutions, and over time it expanded to support regulatory changes. To address the lack of clarity of deposit-taking regulation for microfinance

1 The SMART Campaign provides criteria for financial institutions to set objectives to protect low-income clients from disadvantageous financial services and ensure excellence in service.

Box 2: The Pareto Principle

The Pareto principle (or the 80-20 rule) was created in 1906 by Italian economist Vilfredo Pareto to describe wealth distribution in Italy, but people also apply it in other disciplines. For example, project managers believe that 20 percent of the work (the first 10 percent and the last 10 percent) consumes 80 percent of the time and resources.

The Pareto principle says that any problem we encounter can be broken down statistically in the order of its severity or importance by the largest and smallest elements to help us understand its complexity and significance. It suggests that 80 percent of progress achieved is earned from just 20 percent of the time worked, and that 80 percent of resources spent will produce only 20 percent of the benefits. It reminds us to focus on the 20 percent that matters.

institutions, the project team—in cooperation with Mongolia Financial Regulatory Commission and Microfinance Development Fund—organized a study tour in Mongolia on microfinance-related policy. Participating in the tour were 14 policymakers from Azerbaijan, Bosnia and Herzegovina, Kazakhstan, the Kyrgyz Republic, and Tajikistan. A delegation from the Kyrgyz Republic included representatives from the legal department, non-banking organizations control division, and licensing division of the National Bank of the Kyrgyz Republic (NBKR).

The tour acquainted policymakers with international best practices and with XacBank's[2] transformation experience. After the tour, the NBKR improved the Deposit Licensing Procedures. When the procedures were officially approved, the NBKR representative (one of the delegates on the tour) visited Bai-Tushum and discussed the pros and cons of being a deposit-taking organization. This meeting eventually led Bai-Tushum to take on the challenge of deposit product introduction, correctly assuming that this would allow it to test its functional capabilities and gain credibility with the NBKR regarding compliance with prudential regulation. It took one month for the NBKR to review the application and make a favorable decision according to the procedures.

IFC's workshop in Mongolia helped us implement changes in licensing policies and procedures. We initiated a dialogue with Bai-Tushum and Partners, encouraging them to apply for a license. During the application period, we tested and streamlined deposit-taking procedures for other MFIs in the country.

—Samatbek Jumashev, Chief,
BKR Non-banking Organizations Control Division

The project targeted a series of interventions to the regulatory environment and supported the NBKR's development of the *Decree on Procedures of Transformation of a MFI into a Bank*. The head of the NBKR licensing department acknowledged during the Central Asia Microfinance Summit that drafting of the regulation was inspired by Mongolia's success in microfinance transformation. Bai-Tushum followed the decree in applying for a banking license, and on November 14, 2012, became the first microfinance institution to achieve legal transformation into a commercial bank—not only in the Kyrgyz Republic but also in the region of Central Asia.

Focusing on only a few vital areas of regulation helped us support the desired change for microfinance institution transformation. This change enabled these institutions in the Kyrgyz Republic to transform into more commercially sustainable entities (See Box 3).

Lesson 2: Often it is the final 20 percent of advisory services that will produce a targeted change for a client.

Bai-Tushum was ready for the new deposit-taking service when it received the NBKR's official permission to start it. A stakeholder engagement advisory module delivered

2 XacBank is one of Mongolia's largest banks, serving MSMEs as well as large corporations. It offers a range of inclusive banking, fair investment, and other financial products and services.

by the project provided the impetus to kick off a new product. The module included advice on promoting deposits to customers, designing communications strategies and actions, and developing internal deposit-collection policy and procedures for employees.

Bai-Tushum's deposit products were designed specifically to address the needs of low-income customers and local small businesses—in opening accounts, accruals and withdrawals, and interest rate and duration. Bai-Tushum considers a deposit business to be first an effective tool for developing a savings culture in the region and then a low-expense source of funding for its lending business.

However, the public continued to see the company as only a provider of loans. This perception hindered the launch of a piloting stage for deposit mobilization, and it was our job to help Bai-Tushum change its public image. Following our advice, the company promoted its deposit products through, for example, participating in five television programs and publishing 10 articles highlighting its deposit activities as well as its lending. As a result, the number of deposit accounts opened in selected pilot branches more than doubled, from 150 to 419, during the last two months of 2011.

The fifth component (the last 20 percent of the advisory intervention) is **stakeholder engagement**. The first four components were successful in helping the company become eligible for banking license consideration (see Box 3).

The last 20 percent became the grand finale, carrying the company through the submission of an application for a banking license in April 2012 according to the NBKR decree. Finally, on November 14, 2012, it became the first microfinance institution in Central Asia to be awarded a full banking license by the National Bank of the Kyrgyz Republic—a major step forward!

Becoming the first microfinance bank in the country will enable Bai Tushum to offer an even broader range of financial services to microentrepreneurs and low-income customers. Also, Bai Tushum's new status will help set an example for other microfinance institutions across Central Asia.

Lesson 3: A microfinance institution's legal transformation to a bank after obtaining a banking license takes it only 20 percent of the way to full operation in the banking marketplace. Integrated investment and advisory support will bring another 80 percent, to make the bank a solid credit provider to MSMEs.

After Bai-Tushum received a banking license, the company found itself competing with well-established and experienced banks for banking market share. Meanwhile, its internal structures were designed for microfinance functions only; they didn't support the bank in performing a full range banking operations. This along with a lack of banking experience and expertise made Bai-Tushum's entry into the bank arena even more challenging.

A key element of IFC's continued support during this stage of development is the broadening and scaling up of Bai-Tushum's products. We designed and negotiated with the bank an engagement to introduce SME banking, and Bai-Tushum has designed several MSME and SME loan products and piloted them in several branches. Newly developed credit methods enable the bank to measure risks during loan application by incorporating a scoring mechanism to assess a client's ability to repay a loan. This will help Bai-Tushum expand upmarket.

Simultaneously, IFC—in line with the financial markets strategy for the Kyrgyz Republic, aimed to increase access to finance for MSMEs through a long-term investment—approved an $8 million senior loan to Bai-Tushum in 2014 and a cross-currency risk-management support. This will support Bai-Tushum's strategy to scale up its

Box 3: Bai-Tushum's Successful Transformation

Bai-Tushum bank became an IFC client after signing a $1.2 million loan in 2005 and a subsequent $4 million deal in 2009 to finance micro and small entrepreneurs through individual and group lending products. In 2014, IFC approved an investment package to Bai-Tushum bank that included risk-management facilities and senior loan of $8 million to support MSMEs in the Kyrgyz Republic. IFC was engaged in the company transformation, first with the deposit-taking organization and next with the bank, through contributing to the following four components of the transformation:

Component 1: In strategic planning of the company, the project provided mentoring support to the management for producing an investor presentation for potential equity investors in 2009, moderating a shareholder seminar in August 2010, and advising on investor relations and negotiations. As a result, Bai-Tushum attracted the first equity investor to the newly registered LLC in 2011 and a year later formed a joint-stock company with two other social investors. Thus Bai-Tushum fulfilled the first two legal and regulatory requirements (the joint-stock company structure and charter capital requirements) to become eligible for a banking license.

Component 2: To strengthen Bai-Tushum's institutional structure in preparation for becoming a bank, the project provided advice for internal control and audit as well as an inventory of all business processes, which entailed development of a complete set of policies—another prerequisite for a banking license.

Component 3: To help Bai-Tushum build institutional capacity to introduce deposits and obtain a deposit-taking license prior to the banking license, the project supported the design and implementation of a stakeholder-engagement advisory module that included advice on promoting deposits to customers, designing communications strategies and actions, and developing internal deposit-collection policy and procedures for employees. The module also helped Bai-Tushum strengthen relations with the NBKR, which gradually became strongly supportive of the company's plans to become a bank.

Component 4: The project supported Bai-Tushum with an IT (information technology) audit and assessment of the budget allocated for capital investment in hardware to make full use of a newly acquired MIS (management information system), support considerable expansion, and acquire a bank license planned in 2012. The consultant's recommendations were highly valued and served as guidance during the company expansion in 2012.

Component 5: Stakeholder engagement (see Lesson 2).

As of June 30, 2014, Bai-Tushum provided loans to over 45,182 customers, an increase of 45.5 percent over the same indicator in June 30, 2013. Bai-Tushum expanded business considerably upmarket and increased the average loan size to $2,200. The value of outstanding loans is $99 million—a 24.6 percent increase over the same indicator in June 2013.

lending activity to MSMEs and stimulate competition in the banking sector. Therefore, integrated advisory and investment support will enable Bai-Tushum to expand its market and supply more credit to SMEs, which contribute to more than 40 percent of GDP and about 60 percent of employment in the republic.

Lesson 4: In spite of the Pareto principle, actively engage 100 percent of the stakeholders in the idea of a change—and you'll receive 20 percent support for the change.

Microfinance has been a hot topic of discussion at the highest level in the Kyrgyz Republic. At the Central Asian International Microfinance Summit in July 2011, the president of the country described microfinance as "very important to the Kyrgyz Republic." To build momentum, IFC created four videos, showing how microfinance is making a difference in the Europe and Central Asia region, and featured an interview with the president.

The project's contribution to the transformation of Bai-Tushum included engagement of stakeholders on the idea of transformation. We used several communications tools:

• During the first quarter of 2011, we extensively publicized the Mongolia study tour and generated over 70 media mentions of the event. This helped build momentum to make transformation possible within the regulatory environment.

• We increased the project's visibility on national and global levels. For instance, we organized and moderated the IFC microfinance institution transformation sessions during several conferences and summits.

• We kept key stakeholders updated on the transformation progress via a legal framework update, proactive investor relations, and participating in and moderating three conferences and summits in 2009–2011. During those three years, more than 240 participants—representing the microfinance community, policymakers, and donors—attended the events.

• In October 2011, we initiated production of a set of documentary videos to raise stakeholder awareness of the positive impact that microfinance has had on individuals, communities, and economies in the region.

• We engaged the highest-ranking politicians in the Kyrgyz Republic in the microfinance transformation goals.

CONCLUSION

President Roza Otunbayeva told IFC she was a "big fan" of microfinance, having seen the role it plays in tackling rural poverty, supporting the development of women, and helping her country recover from political and ethnic upheaval in 2010. She also acknowledged that the sector faces challenges.

In 2012 in the Kyrgyz Republic, as in a number of other countries, there were public reprisals against the industry because of perceived high interest rates and excessive indebtedness. There were frequent protests against the overall sector including microfinance companies, pawnshops, and private moneylenders, where borrowers had stated that suffered from the actions of creditors. In some individual cases, owners of pawnshops and microcredit companies in the south of the country were blamed in creating pyramid schemes that ruined savings and hopes. By the end of 2012, however, the crisis was over thanks to a consolidated microfinance sector effort, a stabilized political situation, and improved microfinance legislation in the country.

We in the project believe that progress in microfinance will allow the expansion of the range of products offered to populations in remote regions of the republic and stimulate job creation. And—even though we realize that 80 percent of all our work may produce only 20 percent of the results—we are committed to making that change happen.

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Approved by Natasa Goronja, Program Manager, Europe and Central Asia Micro and Responsible Finance Program.

Lessons from Latin America & the Caribbean

SmartLessons
real experiences, real development

Avoiding Altitude Sickness in the Andes of Peru: Implementing a Rural Agricultural Microcredit Product in Urban-Focused Microfinance Institutions

Altitude sickness, or "soroche," is a pathological effect on humans caused by acute exposure to low partial pressure of oxygen at high altitudes. Similarly, a loan product oriented to small farmers that is introduced in the Andes could suffer from many "illnesses." Here we propose a few "treatments" that can help smooth the path when you are bringing new financial services to rural areas.

Peru has one of the most developed microfinance industries in the world, and its microfinance business environment is ranked first in the 2012 edition of *Global Microscope on the Microfinance Business Environment.*[1] However, most of Peru's economic and microfinance development has occurred in cities and peri-urban areas. Rural households, representing a quarter of the total population, have been left behind. In fact, more than half of rural households live below the poverty line and have limited access to basic services, including financial services. Only 5 percent of rural households have a loan, compared to 21 percent of households in urban areas of Peru.

In partnership with the Canadian International Development Agency, IFC is implementing a project that promotes economic and social integration of rural populations in provinces where extractive industries operate, mainly in the highlands of Peru. The project supports microfinance institutions in launching micro agricultural loans to poor farmers in those areas. The main product is small agricultural loans that are designed to meet the financing needs of small farmers. The small farmers targeted by the project are in fragmented value chains with very limited access to formal financial services. They raise staple crops sold through local and regional markets. Productivity is low, because the farmers do not have access to modern production technologies. Their land plots are quite small (in many cases less than one hectare), and because of the landscape they tend to be on steep slopes that are difficult to access and where tractors cannot be used. That also makes it difficult for the farmers to bring their crops to market.

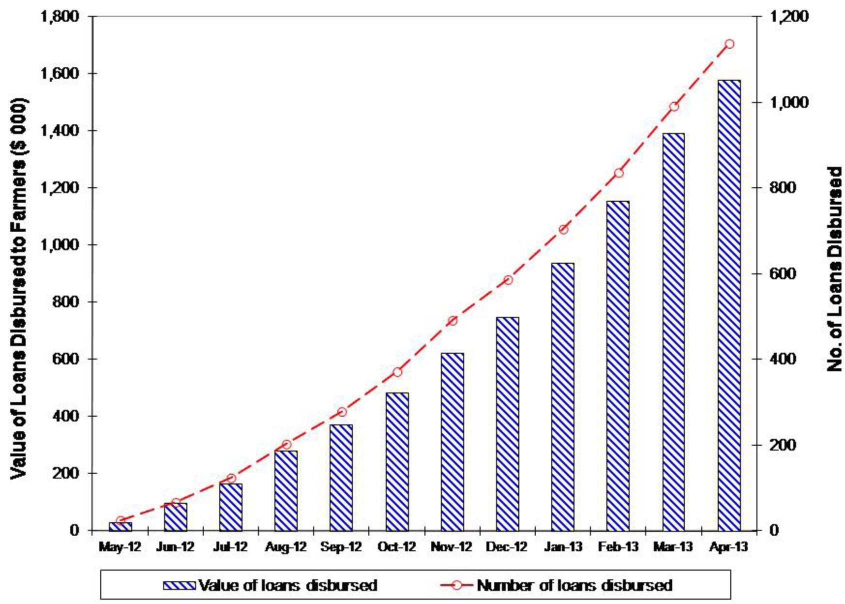
IFC is working with two leading microfinance institutions on this project and expects to work with at least one more. Combined, the two institutions have 670,000 loans outstanding that total more than $1.6 billion, a network of 248 traditional branches, and more than 6,000 employees. Each institution disburses 30,000 to 60,000 loans a month. Financiera Edyficar was the first microfinance institution to try the pilot loan project and completed it in December 2012. At this writing, the project is being tested by Caja Arequipa.[2]

As of April 2013, one year after launching the pilot, there were encouraging results: 1,100 small farmers

1 *Global Microscope on the Microfinance Business Environment* is an annual IFC/Inter-American Development Bank study that offers an in-depth analysis of the enabling environment in microfinance for countries around the world. Peru is also ranked #1 in 2013 as well.

2 Project implementation started early 2011 and continues until June 2015. The SmartLesson was written early 2013 based on the experience working with two MFI. As of August 2014, the agri-lending product has been rolled out at EDYFICAR and is going to be rolled out at Caja Arequipa soon. Additionally, one MFI is benefiting from the project and exploring the option of introducing the product.

Figure 1: Loans Disbursed to Farmers in the Highlands of Peru



in two regions in the highlands of Peru received loans totaling almost $1.6 million; and more than 20 loan officers were trained in the new method of evaluating agriculture loans (See Figure 1).

Even though we are working with highly developed and mature financial institutions, introducing a new product in a remote rural setting is very challenging. We have found that many of the lessons we learned in the process are applicable in other countries in the region and may be in other regions as well.

LESSONS LEARNED

Lesson 1: Find one institution willing to pilot an expansion in a rural area—and work hard to make it a success. Then attract others on the basis of the strong value proposition created.

Increased competition between microfinance institutions in urban areas is becoming an issue, and growth potential in existing urban markets is limited. As a consequence, the institutions are exploring new options for growth. Specifically, they are looking at product diversification and increasing their regional outreach by opening branches in rural areas and offering financial products to farmers.

However, it is one thing to consider growth into new areas and another thing altogether to embrace the changes that such growth implies. Even microfinance institutions that are interested in expansion tend to shy away from micro agricultural loans in rural areas. We found that the more the institutions understood about the realities of the highlands, the more their interest weakened.

Urban-based institutions are reluctant into expand to remote areas because 1) demand in rural areas is limited compared to demand in urban centers; 2) lending in rural regions with traditional credit methods is costly and risky because of low and highly variable average household income, as well as scattered populations and poor infrastructure; 3) all activities in rural regions are affected by significant agriculture-specific risks, namely weather, price volatility of agricultural products, and lack of knowledge about the agricultural sector; and 4) there is a greater risk in rural areas of political interference, such as debt forgiveness before elections and direct subsidies by the government. A successful pilot by a peer institution is the best way to overcome resistance.

Since IFC began this project, our team has met with 11 microfinance institutions.[3] All of them were interested in the micro agricultural loans, and in most cases discussions moved forward rapidly. But at different stages of the negotiations, many of the institutions decided not to engage or to postpone making a decision. Now that the pilot with one institution has concluded successfully and we can show some results, interest in the product is increasing and attracting the attention of the management of leading institutions in Peru and in other countries in the region.

Lesson 2: Expansion of a microfinance institution into rural areas requires a new type of loan officer, often less well-trained in finance and agriculture, but with deep roots in the local area.

It is generally thought that it is easier to train an agricultural engineer to become a loan officer than to teach the secrets of agriculture to a person with a business administration background. Hence we recommended that our two pilot microfinance institutions hire and train agriculture engineers to work as rural agricultural loan officers. But it became a challenge to find appropriate, well-educated candidates willing to live and work in rural areas. Living conditions in the "sierra" are tough, and people from the city have problems adapting.

In the end, we realized that the loan-officer profile had to be adjusted to the reality of the region, and much more flexibility was needed when selecting the candidates. For example, young people with strong personal roots in the region, who grew up in farmer families and have an understanding of the behavior of the rural population, have turned out to be excellent candidates. They understand and speak the local language and often have plans to stay in the region for personal reasons. A positive side effect is that high-value positions are created, and local people are getting opportunities for professional careers that were unthinkable a few years ago.

Lesson 3: Microfinance institutions ideally should have dedicated loan officers to test an agricultural microcredit product. If a pilot program uses nonspecialized microloan officers, the institution should modify its incentives to adequately motivate the officers to work on agricultural loans.

Experience shows that hiring loan officers to work exclusively on agricultural loans results in greater productivity than using loan officers with existing portfolios. The explanation for this difference in productivity is twofold: 1) dedicated agricultural loan officers can devote their full attention to farmer clients, whereas credit officers who simultaneously manage a mature microfinance loan portfolio have to spend time monitoring and making collections in their existing portfolio, and 2) while incentives for both types of loans are the same, agriculture financing is more complex and takes more time than the methods used for traditional loans (because farmers are more dispersed, and average amounts for agriculture loans in the highlands tend to be low).

Therefore, if a microfinance institution uses non-specialized loan officers, it is critical that it adjust its bonus system to provide adequate incentives for working on the more labor-intensive agricultural finance product.

Lesson 4: Implementation of the agricultural microcredit product may require complex and time-consuming adjustments to the loan module in the microfinance institution's core banking system. But don't wait for lengthy adaptations of IT systems before launching your project.

When designing a project, it is easy to underestimate the time needed to make adjustments to a microfinance institution's core banking system. Adequate launch of the

3 Besides the two microfinance institutions that finally engaged in the project, the team had promising talks, which have not yet resulted in projects, with CRAC Nuestra Gente, Caja Trujillo, Caja Sullana, Caja Tacna, CRAC Los Andes, CRAC Chavin, EDPYME Nueva Vision, MiBanco, and Financiera Crediscotia.

agriculture loan product methodology in bank branches requires specific adaptations to the way loans are made. For example, one of the basics of assessing the creditworthiness of farmers is to consider irregular cash flows from specific crops (instead of doing a static analysis of a typical month) and to allow irregular repayment schedules. A farmer might be able to make either one payment after harvesting a crop, for instance, or more than one payment if he or she has multiple but smaller sources of income.

To accommodate this complexity, a microfinance institution's core banking system loan module might need to be adapted, which could take one to six months, depending on such factors as the state of the existing loan module and whether the adaptation is done internally or through an external system provider. When IFC engaged with one institution in Peru, the team and the client estimated that the system adaptation could be done in one to two months and expected that loan disbursements could start in the fourth or fifth month of the project. This estimate proved to be overly optimistic, because the institution's loan module did not have the necessary capabilities. The system adaptation ended up taking six months. As a result, loan disbursements were delayed and the team had difficulty reaching project outcome targets.

Lesson 5: To reach remote rural areas, microfinance institutions must find ways to adapt their distribution strategies and use "light" branches that are smaller and offer only products needed in the rural areas. IFC should prepare the institution's management to be more flexible with its distribution channels.

Urban-based microfinance institutions have expanded into rural areas in the last 10 years by opening branches in medium-size cities with strong links to rural agricultural regions (See Box 1). Mature institutions have well-thought-through branches, with all the facilities required in urban areas. However, microfinance institutions have had difficulties adopting a lighter branch model for use in rural areas. To operate at a sustainable cost level while remaining close to clients, institutions should learn to rely more on agent networks and on basic or temporary branches such as kiosks.

Before adjusting its distribution system, the institution should conduct market research to understand local client preferences and should customize its distribution accordingly. In addition, the institution will need a strong marketing and communications strategy to promote its use of alternative channels.

Box 1: Agricultural Loan Portfolio: Hidden Risks and Missed Opportunities

Most institutions expanding into rural areas have not adjusted their credit methodology and instead only offer loans to the traditional sectors they are familiar with in urban areas: trade, services, and some small factories. Agricultural activities are usually not eligible. But in reality microentrepreneurs in rural areas have diversified businesses with different sources of income and quite complex risk profiles and financial needs. Since money is fungible, clients apply for loans by presenting the loan officer with an eligible activity—for example, a small grocery shop or transportation service firm—and also use the funds to finance their agricultural activities, which are not evaluated by the loan officer.

This practice has two negative effects: The first is hidden risk, because if the client has a problem in the agricultural activity, it will affect his or her overall repayment capacity. Second, because the loan officer only considered the eligible activities, the client's profile (and hence potential needs) are not registered and cannot be evaluated and used for cross-selling activities or any other commercial targeted campaign.

It is important to draw microfinance institutions' attention to this critical issue and create awareness of the hidden risks and the missed business opportunities they have in their loan portfolios. In some branches, 30 percent to 50 percent of their loan portfolio is affected by this phenomenon, according to interviews with loan officers.

Lesson 6: It's essential for IFC to be vigilant in its supervision and to have a product champion at the microfinance institution.

Introducing agricultural microcredit loans in remote locations requires close supervision by IFC and significant attention from the microfinance institution's management team. However, the very remoteness of the projects makes this particularly challenging. It is often difficult to provide adequate remote backstopping support to a resident advisor working in the highlands for as long as 12 to 18 months to launch a loan product.

Meanwhile, the MFI's management team does not always pay enough attention to a project taking place far from headquarters. However, management attention is critical to success, given that the project requires many adjustments at the loan officer and branch manager levels and even in some departments in the head office (mainly human resources, marketing, IT, and procurement).

Under these circumstances, IFC must take a frequent and active approach to supervision of the implementation team. In Peru, we took two actions to strengthen supervision. First, we required the team to present brief monthly reports summarizing progress in each area, and when cultural barriers arose with staff in branches, we scheduled biweekly calls with the resident consultant. Second, we conducted field visits every two or three months.

On the client's side, it is essential to have a product champion with enough seniority to ensure that the product has credibility and receives attention at headquarters. That champion also helps monitor and collect statistics about the product and can take the lead in monitoring the product once IFC leaves. This is especially true when institutions implementing the product are large and do not have enough time to closely supervise and learn from the external expertise provided by a regional specialist.

CONCLUSION

The task of introducing and expanding the micro agricultural loan product in a developed microfinance institution with an urban background involves much more than simply adding a new product to the institution's existing portfolio mix. Although an institution may have solid organizational structures, policies, and procedures, it takes time for its management to understand a new reality. An institution's strategy developed for expansion in urban areas must be modified to ensure the success of a new product in rural areas. It will be necessary to revise and fine-tune management tools that have been in place for years, such as the process used to open new branches, recruitment and selection criteria for new staff, and incentive plans for middle management and loan officers. Institutions also must adjust their targets to the new market to keep them ambitious but realistic, and they must differentiate the rural targets from the targets set for urban-based branches.

ABOUT THE AUTHORS

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Felipe Portocarrero is a Microfinance Consultant in Latin America and the Caribbean based in Lima. Before joining IFC in 2007, he was coordinator of a project funded by the Inter-American Development Bank in which the Peruvian Cajas Rurales (microfinance institutions specialized in rural credit) piloted rural microcredit.

Approved by Ghada Teima, Manager, Latin America and the Caribbean.

Client Sixta Mamani visited by a loan officer. Field visits are an essential part of the risk assessment, which is required to get a better understanding of the activities of the farmer.

SmartLessons
real experiences, real development

An Old Innovation for a New Era: Lessons Learned from Financial Cooperatives in the Latin America and the Caribbean Region

Cooperative financial institutions (cooperative banks, credit unions, and building societies) have prospered in many markets around the world and have come to play a major role in financial inclusion. According to the latest data from the World Council of Credit Unions, there are 51,000 credit unions in 100 countries, with a total of 196 million members. IFC's Financial Institutions Group team has traditionally found it difficult to engage with cooperative financial institutions because of challenges of democratic governance, low financial returns, and limited possibilities to acquire equity. However, in recent years there has been a concerted effort to develop partnerships with leading institutions in a number of markets. This SmartLesson highlights some of the experiences from IFC's engagement with cooperatives in the Latin America and the Caribbean (LAC) region.

In 1844, a group of 28 tradesmen got together in Rochdale, Lancashire, in Great Britain to discuss how the new machines of the Industrial Revolution were forcing skilled workers into unemployment and poverty. The group formed the Rochdale Society of Equitable Pioneers and met regularly for the following months, struggling to save together a total of one British pound per person ($1.55 at today's exchange rate) to serve as the capital for a store that would sell low-cost food items to the local community. This was the birth of the cooperative movement, which now involves millions of people around the world and continues to be based on the seven principles proposed by the Rochdale tradesmen (see Box 1). I was born just a few miles from Rochdale and have always been fascinated by the subject of cooperativism. This might be an old innovation, but it is still very relevant in today's economic era.

Box 1: The Rochdale Seven Principles of Cooperatives

1. Voluntary and open membership.
2. Democratic member control.
3. Member economic participation (limited return on equity; surplus to support other organizations or to be returned to the members).
4. Autonomy.
5. Education, training, and information (for members and the public about the nature of cooperation).
6. Cooperation among cooperatives.
7. Concern for the community.

Business model

Financial cooperatives' business models can vary quite dramatically from country to country. Although the cooperative-movement principles may trace their heritage back to Rochdale, financial institutions are a blend of those original principles, together with practices from local cultures that predate the international cooperative movement. Some form of rotating savings and credit associations can be found in villages and communities on every continent (such as the *esusu* system in Nigeria, and *tontines* in Cambodia).

In general, cooperative financial institutions differ markedly from the banks IFC typically invests in. For instance, they are nonprofit organizations and sometimes unregulated. The ownership structure of cooperatives is typically diverse, as they are owned by their clients with an extreme form of democratic ownership: each member of the organization has one vote, independent of the share of capital he or she owns, and some form of regular contribution to capital is levied on all members. Cooperatives tend to offer a broad range of products rather than focus on lending, as many microfinance institutions do. Profits are usually invested in growing the capital base of the institution, but over time they tend to be seen as an indicator that lending rates can be lowered and/or savings rates increased, squeezing margins.

Even though the governance structure can be a challenge, and the lack of focus on profit and growth a source of concern, there are many reasons why these institutions are interesting to IFC. Cooperative financial institutions are very close to their owners—the clients. They appreciate their financial needs and the potential of their cash flows. They also tend to play an important role in the communities they serve and understand the industries and value chains that make up the local economy. For this reason they usually do the following:

• Develop innovative financial products.

• Expand outreach by penetrating underserved regions and rural communities.

• Promote broader access to financial products, particularly for micro and small enterprises, which are typically neglected by most financial institutions.

• Form partnerships with other cooperatives and financial entities and play an important role in the growth and development of financial sectors in many countries around the world.

IFC's experience in the LAC region

Investment and Advisory Services teams are working together on a number of transactions with cooperative institutions in the Latin America and the Caribbean region. Over the last three years, IFC has invested in two wholesale banks that are owned by and fund their respective cooperative systems: Bansicredi in Brazil, and Fedecredito in El Salvador. IFC has also invested in and provides advisory services directly to Coopenae, a cooperative in Costa Rica (see Box 2). Investments in two more cooperatives in Costa Rica were recently approved by IFC investment committees (for a total of $15 million in debt), and cooperative institutions in Colombia and Paraguay are being appraised.

LESSONS LEARNED

Lesson 1: Financial cooperatives play an important role in financial sector development.

In many economies, significant proportions of the population are members of cooperatives. Cooperatives do not always provide all the financial services that individuals or companies need, and indeed they may be prohibited from doing so, as in Costa Rica, where the regulator, SUGEF (Superintendencia General de Entidades Financieras), limits cooperatives to working only with individuals and nonprofit organizations, according to the legislation (Law 7391). However, they often are clients' first choice because of pricing or their position in the community. An IFC engagement with the cooperative sector should always be considered as part of a comprehensive financial sector development strategy.

Box 2: IFC Investments in LAC Cooperatives

Sicredi is a network of Brazilian financial cooperatives present in more than 800 towns and cities—typically smaller communities in the interior of the country, where banks have little presence. In 2012, the network grew by 20 percent, closing the year with $15.7 billion of assets, equity of $2.3 billion, $10 billion of deposits, and net income of $336 million. The total membership of this cooperative system grew by 13 percent in 2012 to reach 2.3 million. The Sicredi cooperative system is the owner of a bank, Bansicredi, created in 1995, with equity of $239 million. It was the first cooperative bank in Brazil and allows the network members to access government lines of finance and the national payments platform.

Fedecredito is an integrated system that includes the federation, 48 financial cooperatives (cajas de credito), and seven workers banks. In December 2012, the system had 671,000 shareholders, a total loan portfolio of $893 million, $518 million of deposits, and equity of $246 million. In fiscal year 2012, IFC committed $30 million to the federation, backed by a securitization of remittances from migrant workers sending money from their U.S. homes to their families in El Salvador.

Coopenae is the largest regulated financial cooperative in Costa Rica. It is the sixth-largest private financial institution in assets and fifth-largest in equity and is owned by its 73,000 members. Coopenae closed 2012 with $830 million of assets, $154 million of equity, and $14 million of net income. In FY12, IFC committed a $15 million A loan, and mobilized a further $15 million from FMO.[a] In parallel, Advisory Services initiated a project with $367,324 to support Coopenae in building expertise with financial services for Costa Rican small and medium enterprises (SMEs).

a. FMO is The Netherlands Development Finance Company.

Lesson 2: Cooperatives promote outreach.

Cooperatives have proven to be extremely successful in reaching market segments that are traditionally underserved by the rest of the financial system, such as women, SMEs, and rural populations. For example, Bansicredi is the only financial institution present in 100 of the 800 Brazilian towns served by the Sicredi cooperative system. In countries with smaller institutions, it is a good idea to work with a wholesale entity or aggregator, such as Bansicredi in Brazil and Fedecredito in El Salvador. IFC can contribute to the expansion of access to financial services by supporting the growth of cooperatives and, by interacting systematically with a number of players, can be a factor in reaching IFC Development Goals targets.

Lesson 3: Cooperatives develop innovative products and services.

Because of the position that cooperatives have in their communities and the proximity to their clients, they are often innovators in product and service development. For example, cooperatives in Costa Rica intimately understand the production chain of a variety of agricultural products and thus adjust loan tenors to harvests, and payment mechanisms to client cash-flow variations. For instance, milk purchasers pay biweekly loan installments for farmers. It is also common to see cooperatives encourage savings practices by promoting accounts for children of their members. Financial cooperatives are also interested in returns on investment. Although they are essentially nonprofit entities and tend to maintain slim margins to satisfy their owners (the clients), in practice their desire to grow and offer broader product platforms provides an incentive to generate healthy returns.

Lesson 4: Different strokes for different folks.

The business model for financial sector cooperatives appears to be standard, but actually it varies significantly across countries and even within markets. It is essential to understand local legislation as well as the origins and drivers of each institution. For example, ***closed*** cooperatives act like clubs and seek to grow within a predefined client group (like IFC's own credit union, which is limited to employees). However, ***open*** cooperatives seek to capture new members and as a result have much more commercial, competitive practices, which makes them more interesting targets for IFC engagement. For instance, Coopenae began life as a cooperative for teachers but is now seeking to attract members across all segments of Costa Rican society.

Lesson 5: More complex funding options are attractive.

Financial cooperatives tend to be liquid, because they can capture member deposits quite cheaply (especially where they participate in national deposit insurance plans). This means that short-tenor debt financing usually is not attractive to such institutions. However, they are likely to be capital constrained, because their governance structure and limited returns do not attract equity investors. Therefore, subordinated debt (particularly in second-tier banks, such as Bansicredi), longer-term credit lines, structured products, and straight equity from IFC may be interesting products to propose.

Lesson 6: Examine issues of governance early in the process.

Given their typically dispersed ownership base, financial cooperatives face governance risks deriving from the separation of ownership and control. (These risks differ from those caused by concentrated ownership structures commonly found in developing countries.) It is important to study governance carefully, with the close involvement of IFC's specialists.

Though the clients are the ultimate owners, it is often in their long-term interests to implement mechanisms that effectively guarantee stability and professional management. For this reason, many cooperative systems have evolved complex checks and balances, such as the appointment of several corporate bodies (regional and delegate meetings, electoral and oversight committees), restrictions on board membership (typically allowing only eligible cooperative members to be appointed as directors), incorporation of wholesale banks run by experienced bankers (as with Bansicredi), and limits on members' withdrawal of capital (as in Costa Rica, where regulation limits it to a maximum of 10 percent a year). Caution is called for, particularly when a potential investee is not regulated.

CONCLUSION

IFC has engaged with a number of cooperative financial institutions in the LAC region and has found them to be professional, well-managed organizations, operating at the frontier of access to services in their markets. This renewed focus on cooperatives, together with innovative transactional structures, is making a significant contribution to international development goals in the region. There is an opening to build on this experience and evaluate the opportunity to support the development of cooperative sectors in many markets around the world. I encourage colleagues who have worked on transactions with similar organizations to share knowledge and continue to build on this experience.

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Lessons from the Middle East & North Africa

Managing Credit Risk in Microfinance: Challenges in the Wake of the Arab Spring

Enda Inter-Arabe (ENDA), a market-leading microfinance institution in Tunisia, was one of the first such institutions affected by a repayment crisis linked to the Arab Spring. However, rather than spiral out of control, ENDA took quick steps to limit the damage while demonstrating an unwavering commitment to its clients. Today, IFC is helping ENDA remain at the vanguard of regional microfinance institutions through the adoption of advanced risk management practices. This SmartLesson highlights the lessons learned from the crisis, explores the nuances of effective credit risk management, and shows how microfinance institutions like ENDA can remain ahead of the curve in the years ahead.

Tunisia, where a micro-entrepreneur's self-immolation in December 2010 set off the chain of events now known as the Arab Spring, was at the forefront of a wave of revolutions in the region that brought both promise (the evolution toward more democratic governance) and distress (socio-economic disruptions).

Despite the conventional wisdom that microfinance is countercyclical and typically more resilient in the face of macro-level shocks, the country's microfinance sector (the MENA region's third largest, with between 300,000 and 400,000 borrowers[1]) was affected by the economic malaise that followed the revolution. With Tunisia's economy in crisis, its leading MFI, ENDA Inter-Arabe (ENDA), began to accumulate loan delinquencies across its portfolio.

IFC is currently providing ENDA with an investment and advisory services package focused on building capacity in key areas, including nonperforming loans and risk management. This support has been timely. ENDA, which had always enjoyed exceptional portfolio quality, saw its Portfolio at Risk as of 30 Days (PAR>30) rise from 0.3% in December 2010 to over 6% by October 2011.

Box 1: Enda Inter-Arabe

Founded in 1990 as part of the international ENDA Third World network, Enda Inter-Arabe rose to become one of the largest and most successful microfinance institutions in the Arab World. In 2003, it became the first, and only, sustainable microfinance institution in Tunisia. In 2011, it achieved full autonomy when it registered as a local non-governmental organization.

ENDA offers an array of credit products as well as non-credit business development support and training aimed primarily at low-income households and female microentrepreneurs. By January 2013, ENDA had over 218,000 active clients, 68 percent of them women, and an active loan portfolio of $87 million.

During the revolution, ENDA had to temporarily close some branches, and many of its microcredit clients were deeply affected by the contraction of the economy. For example, small entrepreneurs near the Libyan border were unable to continue cross-frontier

[1] Ministre de Finance de Tunisie "Vision Concertée pour le Développement de la Microfinance," 2011

trade (commerce à valise), while much of the wider population faced difficulty as inflation rose, revenues from tourism and other key sectors declined, and households refrained from spending.

Like many MFIs, ENDA finances the majority of its credit portfolio through repayments, and thus rising delinquencies presented not only an increased credit risk but operational and liquidity risks as well. Fortunately, the people, processes, and systems that ENDA had nurtured and put in place over many years proved resilient. Furthermore, before the dust had fully settled, ENDA began working with IFC to proactively implement new measures to enhance its risk management—particularly in credit and operational risk, which historically are the most serious risk areas affecting MFIs—to minimize the likelihood of such a situation recurring and, if it did, to mitigate its severity.

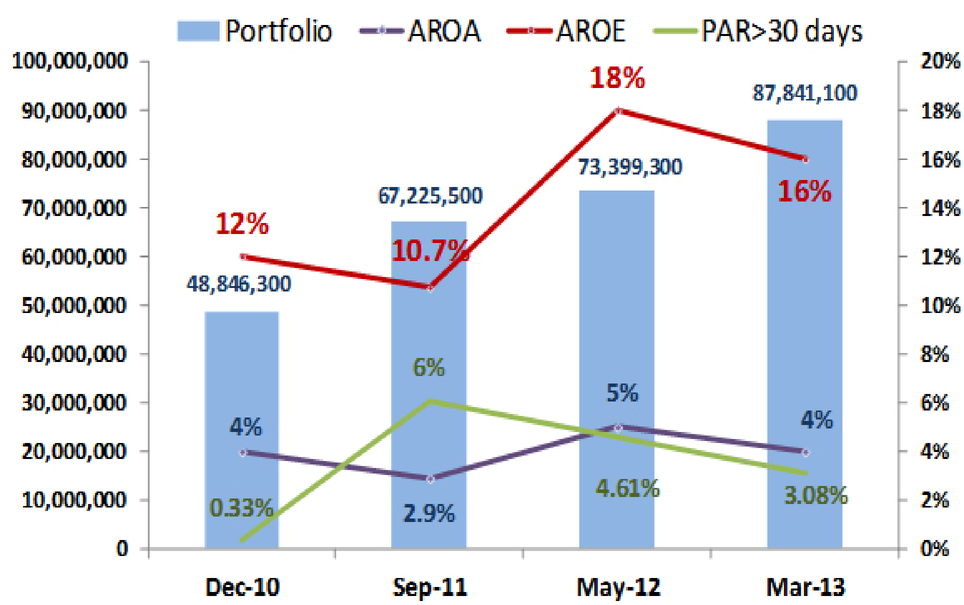
LESSONS LEARNED

Lesson 1: Stand by your clients, and they will stand by you.

As a mission-driven organization that was determined to help its clientele in a time of difficulty, ENDA did not merely adopt a reactive approach to rising delinquencies by panicking, turning off the faucet on new loans, and focusing entirely on repayment. Instead, it remained true to two tenets of (micro-) banking orthodoxy: know your client (KYC) and relationships matter. The staff held meetings with clients in all branches to better understand their problems and how best to support them.

The outcome of these meetings included the development of a new "disaster" loan product, which was made available to distressed clients at a subsidized rate, and the selective use of rescheduling and

Figure 1: ENDA Key Trends (2010–2013)



repayment grace periods. ENDA also went on the radio and television to reiterate its commitment to its clients and the fight against poverty in Tunisia. Taken together, these steps helped assuage the concerns of both clients and the broader public.

This is not to say that ENDA continued, in the aftermath of the crisis, to grow apace as it had before. Rather, it slowed its expansion and adjusted its incentive system to emphasize portfolio quality over volume. However, it did not turn away from those clients that were most in need. It continued to serve agri-entrepreneurs in at-risk rural areas, opened new branches in the south of the country, and even provided specialized services targeting refugees and returnees from Libya.

ENDA's financial partners (including IFC) likewise stood by it and continued to make available new loan facilities and support. By 2012, as its portfolio began to stabilize and improve, it even began piloting a start-up loan product for youth entrepreneurs (Bidaya) as well as exploring new channels (mobile banking) as a way to serve clients more efficiently and cost-effectively.

> *When the revolution started, in many cases, our clients protected the ENDA branch from potential looters.*
>
> *—Essma Ben Hamida,*
> *ENDA Co-founder and Executive Director*

Lesson 2: Develop a tailored recovery strategy.

A deliberate, well-tailored recovery strategy is a critical element of any effective response to rising repayment issues. ENDA quickly put in place a dedicated recovery team, organized high-profile campaigns to collect overdue amounts, and even instructed some of its call-center agents to follow up with delinquent clients by telephone. It also segmented its past-due loan portfolio, based on conversations with clients, into different categories, such as willful default (estimated at just 1% of clients) as opposed to default due to economic hardship. This allowed the staff to better target its efforts, including negotiation of new terms and/or collection of partial payments from clients. Later, ENDA further tailored its recovery strategy to: differentiate loan officers following up on loans less than 90 days overdue from recovery agents focused on loans more than 90 days late; categorize clients by relative likelihood to repay; highlight more at-risk segments of overdue loans; and understand the effect on provisioning. To assure success, these efforts were well-documented and integrated into ENDA's management information system (MIS) to enable effective monitoring and appropriate follow-up by recovery agents or supervisors.

Lesson 3: Nurture strong relationships with your staff.

Often overlooked in a crisis is the importance of the relationship between a MFI and its staff, and consequently its staff and clients. ENDA employs over 1,000 staff spread across more than 65 branches. After the revolution, many employers in Tunisia began to face more confrontational attitudes from their employees, which challenged work environments and also led to higher turnover rates. While ENDA likewise experienced this change, the strong organizational culture it had built over the years assured it the support and loyalty of its long-time staff, many of whom protected branches or volunteered to assist clients in affected areas.

However, ENDA's management also needed to take quick and decisive action with regard to its personnel. For example, it adjusted salaries to ensure employees had a stable income to offset the lower incentives that ensued from declining loan volumes. It also gave branches and staff new autonomy to resolve issues in the field, and used IFC assistance to invest in additional training on recovery strategies. And rather than give its more experienced staff the difficult task of recovering overdue loans (which they often viewed negatively), ENDA wisely shifted younger and more recently hired field employees into these roles. As ENDA fielded this new team of dedicated recovery agents (RAs), it became necessary to weigh cost against benefit. Indeed, when RAs began collecting smaller amounts than expected, ENDA reduced the fixed amount it paid RAs and increased the incentive-based portion of their monthly salaries, leading to better results. Despite challenges, ENDA's swift human resource interventions yielded significant dividends, including keeping staff morale high and improving recovery of overdue loans.

Lesson 4: Go back to basics: reinforce credit underwriting.

While much of ENDA's delinquency was linked to the revolution, coupled with Tunisia's subsequent economic slowdown and the closing of border with Libya, a close analysis of field activity revealed that staff often deviated from its standard loan appraisal and approval process. For example, loan officers often focused their analyses exclusively on a client's business and failed to factor total household income and expenses in calculating loan size or a client's ability to make monthly payments. Furthermore, it was clear that adherence to credit policy varied from branch to branch and region to region.


An entrepreneur and ENDA client.

To address these challenges, ENDA sought additional training and reinforcement of oversight mechanisms in the field to improve and standardize the loan-making and review processes. In addition, experts helped ENDA build an automated anomaly-detection system that could be linked to the MIS. The system uses a linear-regression model that detects discrepancies between financial analyses of a client (for example, summaries of business revenue and income, household income and expenses) and the loan amount requested; any anomaly will automatically trigger further analysis. Finally, to reinforce solid credit-underwriting decisions, the institution began deploying credit analysts who helped further develop a risk culture by scrutinizing specific applications.

Lesson 5: Harness data to create an early-warning system...

Relying on the portfolio-at-risk metric, a conventional but lagging indicator of microfinance portfolio quality, merely permits the assessment of risk events "after the fact." Instead, ENDA began to adopt and integrate new tools into its monthly reporting system to monitor the accumulation of credit risk before a repayment problem involving a few clients becomes a portfolio issue. These include vintage curves which graphically represent default in a given set of loans over time, allowing disbursements to be further segmented by region, product, or business unit. ENDA also has adopted the use of transition matrices which monitor arrears in a tabular format by predicting the likelihood of deterioration or improvement in a given category of arrears (30-day, 90-day). Tools of this sort, which constitute leading indicators, can be used for more accurate loan portfolio provisioning as well as to guide or monitor the effectiveness of collection and recovery strategies, and thus allow MFIs like ENDA to take proactive risk mitigation measures in a timely fashion.

Lesson 6: …and a predictive credit scoring model.

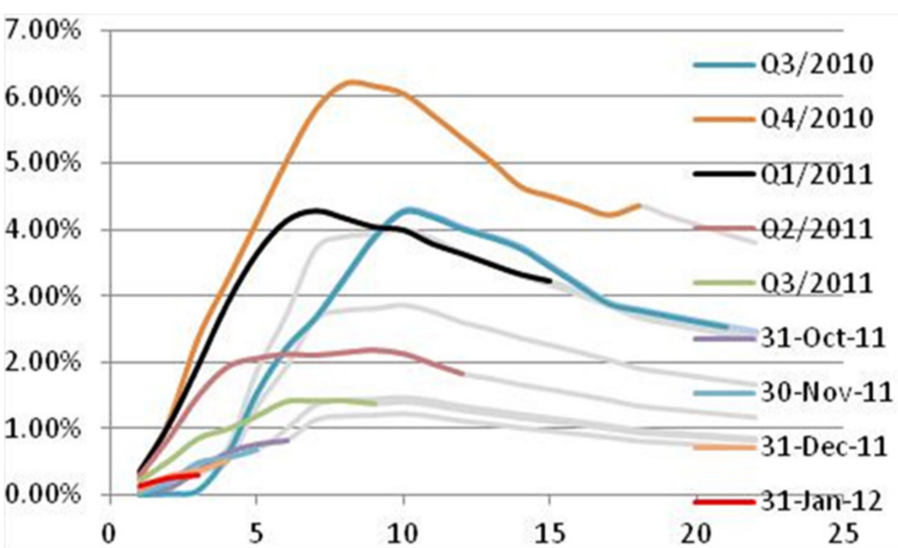
Beyond simply measuring and monitoring risk, effective risk management should help avoid or at least mitigate the key risks facing an organization. In the case of financial institutions, credit risk is usually of primary importance. Given its already extensive database of client information, ENDA was well-placed to develop a creditscoring tool that would help it analyze and approve loans with greater sophistication, and ultimately reduce losses from avoidable loan defaults.

By mid-2012, a credit risk expert was brought in to help ENDA design an initial scoring model that used predictive statistical methods to analyze the behavior of previous customers and make predictions on the relative credit risk of new clients (e.g., likelihood of default). It was prudent to pilot such a tool offline for up to a year to allow for testing and adjustments to the model. Thus far, the pilot test has shown strong results, and the tool demonstrates strong predictive ability. ENDA is currently training its staff in the implementation of the credit scoring tool, and hopes to roll it out formally by the summer of 2013. However, credit scoring should neither replace nor undermine the qualitative research typically undertaken by ENDA loan officers in the field, nor should it substitute for sound underwriting practices, adequate financial analysis, or strong customer relationships.

Lesson 7: Credit analysts under a risk management unit provide an independent view.

Taking a page from the playbook of banks and advanced MFIs (such as those in the Latin America and Caribbean region), ENDA took the difficult step of placing an independent check on its lending and commercial activity: the creation of a credit

Figure 2: ENDA Vintage Curve Analysis (2010–2011)



analyst position. In principle, a credit analyst's role is straightforward: to focus exclusively on portfolio quality by assisting with ongoing credit scoring; to further analyze loans that meet certain risk criteria; and to assess incidents and/or default patterns.

However, implementation has been challenging, and ENDA continues to face a number of key questions. One of these is how to select the right candidates. Thus far it has begun using high-performing loan officers who have aspirations for greater responsibility and who view the role of credit analyst as a step forward career-wise. A second important consideration is how many credit analysts are sufficient vis-à-vis the portfolio or staffing size, and how to quantify their contributions against the costs they incur. Furthermore, should credit analysts be based in the field or at headquarters? How should they be deployed? To whom should they report?

Risk management units typically do not insert themselves into the daily business of MFIs. They should ideally retain an independent outlook and focus on making recommendations about risk rather than getting pulled into real-time decisions typically the purview of operations staff, whose commercially-driven goals may seem at odds with their own. However, credit analysts involved in credit decisions typically do the opposite: they are incentivized to say 'no' to any borderline new loans and thus bedevil staff and managers who have their own portfolio growth targets linked to incentives. Still, these conundrums are not unusual; each MFI must find its way, taking into consideration sound practice, as well as its own unique character and risk tolerance.

CONCLUSION

Today, Tunisia and the wider region continue to suffer from political and social tension, rising unemployment, and slower economic growth, all of which present an elevated risk environment for MFIs. This is particularly relevant to the sector as the country's regulatory body for microfinance prepares to enact new legislation that may transform the sector by allowing for new commercial entrants.

Given its strong foundation and adept decision-making, ENDA has absorbed the lessons of the crisis and relatively quickly returned to sustainable growth and strong portfolio quality. It has also, with the support of IFC, set high standards among MFIs in the region in the management and handling of risk. Its success is critical: estimates put the number of micro-entrepreneurs still with limited or no access to finance in Tunisia at 1.2-1.4 million (nearly 12% of the population).

In fact, as part of its regional strategy, IFC is now providing risk management advisory support to other MFIs in the region to help them adopt and integrate advanced risk management tools and systems into their operations, measure and mitigate risks, and continue to expand outreach to low-income households in a more sustainable manner. Given its achievements, Tunisia and ENDA are well-placed to remain at the forefront of MFI developments in the MENA region.

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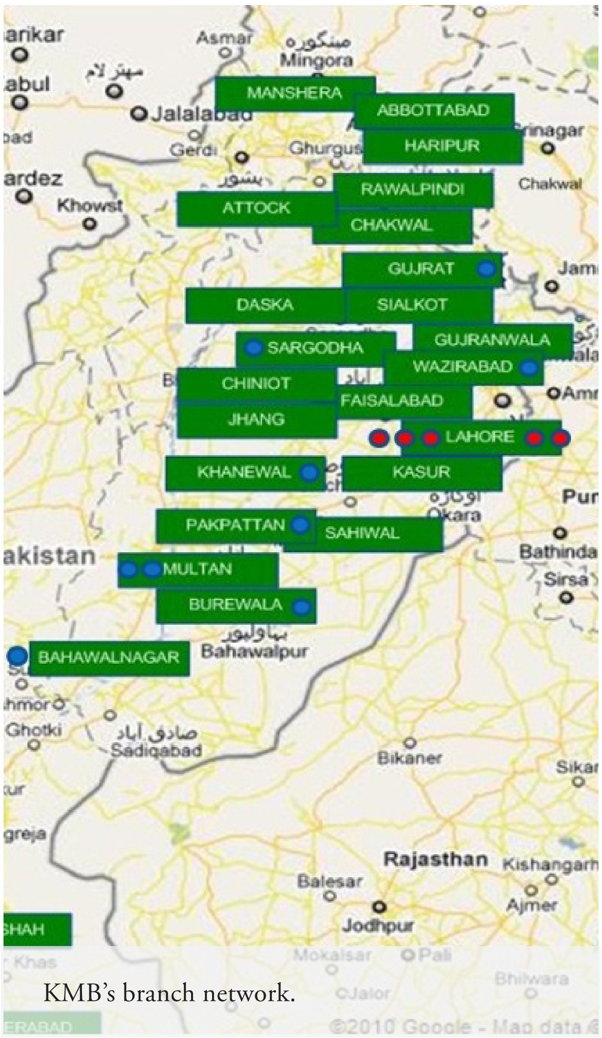
Lessons from Transformation: Recognizing When a New Strategic Investor Is the Best Way Forward in Bridging a Financing Gap

"Transformation" in the microfinance world began with the creation of BancoSol in 1992, inspiring a host of non-governmental organizations (NGOs) to become regulated financial institutions. The boons were easy to see: access to commercial capital, opportunity to exponentially increase outreach, and diversification into other financial products such as savings and payment transfers. From an industry perspective, this model meant private sector ownership and accountability from a formerly "rudderless" institution—and, ultimately, improved governance, strengthened internal control structures, and financial sustainability. And these improvements spurred strong regulatory support. Many NGOs achieved the desired objectives, but for some the journey was not without pitfalls and challenges. This SmartLesson examines the transformation and subsequent experience of one such institution, Kashf Microfinance Bank (KMB). It illustrates the challenges facing a transformed entity as well as the pivotal role that IFC can play in salvaging a deteriorating situation and turning it around for the benefit of the bank, the investors, and the sector.

Pakistan has significant potential for the enhancement of microfinance services, with an unmet demand from approximately 30 million clients with market penetration at only 9 percent. The portfolio value of the microfinance sector was $375 million (36 billion Pakistani rupees) at end-2012 and expected to reach $980 million (94 billion Pakistani rupees) by 2016. The number of active borrowers is expected to increase from 2.07 million to 3.2 million for the same period. Hence over 90 percent of the demand remains unmet. The sector comprises 10 microfinance banks, 9 specialized microfinance institutions, 5 rural support programs, and 30 other providers (NGOs, leasing companies, and so on). Approximately 56 percent of the portfolio market is controlled by microfinance banks, while 60 percent of borrowers are with non-bank microfinance institutions. With this dynamic backdrop, supporting microfinance is a priority for both IFC investment and advisory services, given Pakistan's large population, IDA status, and underdeveloped financial markets.

KMB was created through the transfer of the larger-ticket portfolio of the NGO, Kashf Foundation (KF). Following a decade of success by KF, KMB was established in June 2008 with a vision to become a leading microfinance bank by offering a diversified range of financial products and services to low-income wage earners and microentrepreneurs. The name "Kashf" means "miracle" in Urdu; the concept was modeled after Grameen Bank and aimed to encourage people to change their lives through this miracle. KF was the main sponsor, with 51 percent shareholding through a holding company, Kashf Holdings Limited (KHL). IFC held 19 percent, and Women's World Banking, Triodos, and ShoreCap held 10 percent each.



KMB's branch network.

The vision was for KMB to leverage KF's outreach and expertise and commence lending operations in November 2008. In June 2009, KMB also introduced a deposit product. It is currently present in 37 cities in Pakistan, with a network of 31 branches and 15 service centers with an outreach of 27,313 customers as of April 2013. However, the bank was unable to meet its planned targets and was acquired by Finca Microfinance Cooperatief U.A. (Finca) in May 2013. Finca took a sizable 82 percent shareholding in April 2013.

We will trace the events that led to this transformation experience, which resulted in the bank seeking a new sponsor. The analysis yields many lessons that put into context the potential pitfalls that a transformation may face and the options available to support the client while protecting IFC's position.

LESSONS LEARNED

Lesson 1: The parent entity needs to ensure that solid credit and operational procedures are passed on.

At the outset, KMB experienced some operational problems such as a deteriorating portfolio quality, staff turnover, and link between the NGO and the Bank. These problems were exacerbated by challenges that developed relative to the relationship dynamics between the management, board, and staff, which were partially responsible for the eventual resignations of the chief executive officer, the chief financial officer, and the head of risk management in 2011. This situation has improved over the years by shoring up the internal processes, and as a result, PAR improved significantly in April 2013 to just above 2 percent, albeit at the cost of important write-offs. The development impact that IFC anticipated was also below target as the average annual growth in outreach was lower than the industry average.

Some of these weaknesses could have been averted through better handholding and technical support from the NGO, which had the capacity to do so, given that it was running its own independent training programs. Initially, KMB did not have a preemptive strategy to counter some of the political influences which had weighed down the portfolio quality. The NGO had a deeper understanding of the clients as well as of the political playing field and was expected to swiftly assist with implementing a strategic plan for the credit issues as well as the external factors leading to the problems. While there was some collaboration, KF was unable to play the role required as the bank's "technical backbone."

Lesson 2: Carefully assess capital requirements—with a clear plan for how to raise additional equity if needed.

During its first year of operations, KMB became aware of a capital shortfall. It had made its initial budget projections in 2007/8, but by the time operations took off in 2009, the U.S. dollar had depreciated by 30 percent, resulting in high inflation. As a consequence, costs spiraled—something KMB had not budgeted for. Moreover, in November 2010, the central bank, State Bank of Pakistan (SBP), raised the minimum capital requirement for microfinance banks to $10.9 million (1 billion Pakistani rupees) to take effect incrementally by 2013.

The bank's shareholders looked to the holding company, KHL, to lead the effort to get it through this crisis. To avoid a situation where all shareholders looked at each other for capital to the detriment of the bank, IFC engaged with all shareholders to explain its policy of not becoming the single largest shareholder, exposure constraints, and its understanding that the sponsor shareholder is expected to take the initiative in recapitalizing the bank, should the need arise.

Conferring with the other investors brought about a consensus that KMB needed to find a deep-pocketed investor who could also provide technical guidance. As a temporary fix, IFC and other investors raised capital by way of a rights issue in September 2012, which improved the capital adequacy requirement to 28.3 percent in September 2012.

Lesson 3: IFC can leverage its global relationships to find interested investors.

KMB tried soliciting investor interest on its own at various junctures, but its efforts fell through because of the high level of risk associated with the country's overall political and macroeconomic position. IFC was able to leverage its relationship with Finca, which was already in 21 countries across Latin America, Eastern Europe, Sub-Saharan Africa, and MENA, and was looking for an entry into the South Asian microfinance market.

Finca found a good fit with KMB; the pricing was favorable, the bank already had a network of branches, the franchise was well-recognized across the country, and other shareholders—namely IFC and Triodos—were reputable development finance institutions that Finca was already involved with globally. IFC's stated intention to stay in KMB also influenced Finca's decision, because that allowed it to work with a global partner in an unfamiliar market. Other international shareholders, such as Acumen Fund, Women's World Banking, and ShoreCap, decided to sell their stakes, mainly because their investment horizons were nearing completion, among other internal factors. Although KMB had not achieved its targets on the microcredit side, it has managed to attract sizable deposits, an important and decisive factor for Finca, as KMB has no expensive commercial lines, with deposits providing ample liquidity.

Lesson 4: Advisory assistance can be beneficial only if the recipient has absorption capacity.

KMB has benefited from substantial advisory assistance from IFC and ShoreCap, amounting to about $200,000 each, which has been used for such activities as conducting a feasibility study, developing a business plan, creating an IT platform, and providing international training programs for the bank's management team. As an important part of the advisory program, IFC conducted a corporate governance assessment aimed at ensuring continuity of the board and commitment to the for-profit objectives of both KMB and KHL.

The substantial advisory assistance could have yielded better results had the bank's absorption capacity been stronger and policy application more rigorous across all areas. A more systematic and organized effort to internalize the advisory recommendations might have led to better overall indicators and avoided the heavy write-offs that became necessary. The Bank's absorptive capacity was hampered by a lack of focus on implementing the core learnings due to the pre-occupation with the capital raising exercise and the rise in outstanding dues. In hindsight, more involved oversight at the board level could have been pivotal to the success of the TA. On a positive note, however, KMB has amassed significant deposits in three years in the amount of $20.52 million, providing liquidity support. The association of the Bank's franchise with that of the well-recognized NGO contributed to success on the liability side.

Lesson 5: When the sponsor shareholder is unable to fulfill its obligations, IFC must take on the role of honest broker.

IFC actively supported the bank by encouraging all stakeholders toward the common goal of finding a strategic investor, despite initial pushback. There was intensive internal coordination within IFC that made this possible. IFC committed resources by becoming part of a strategic investor committee that held biweekly meetings to coordinate efforts and align all stakeholders. IFC also joined meetings with regulators and helped expedite the process of regulatory approvals.

It was important for IFC to articulate and demonstrate its sincerity because of its 15 percent shareholding in Finca at the global level. In a crisis situation like the one KMB faced, IFC's honest and sincere efforts needed to remain clear. It is extremely important to get all parties on the same page and to find common ground, because every shareholder has its own interests and position, which may be at cross-purposes with others, depending on the situation. Cooperation can be accomplished through frequent, intense, and candid communication with all parties, as was the case here.

CONCLUSION

Although KMB did not achieve the fundamental objectives of the transformation within the stipulated time-frame, IFC reoriented its role in the engagement, which led to the successful entry of a specialized microfinance agency. These augur well for the sector, since Finca's investment of approximately $9 million is to date the highest foreign direct investment in a microfinance bank in Pakistan. That this has been welcomed by the regulators is a testament to the stewardship of the original investors, amongst which is IFC, and heralds new opportunities for this sector, holding enormous relevance and potential.

Finca's entry was the first investment in an existing microfinance bank in Pakistan by a specialized international microfinance institution and materialized after almost two years of IFC's constant engagement with a client that other investors had metaphorically written off. Finca, which brings global expertise, an extremely high profile, and an accomplished board of microfinance professionals, is expected to review and revise KMB's business plans. IFC will remain engaged with this promising entity as KMB redefines itself in the microfinance space. This is also an opportunity to reinvigorate the Bank's operations and focus on core objectives, such as product development and outreach penetration, as it is now unfettered by capital constraints. IFC continues to remain engaged during this journey.

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Islamic SME Banking: Upscaling from Micro to SMEs in Yemen

Al Kuraimi Islamic Microfinance Bank (KIMB)—one of the fastest growing and most innovative new microfinance institutions in the Arab world—is all the more remarkable given that it operates in the fragile and conflict-affected environment that pervades Yemen today. The private sector is a key pillar of the country's development strategy, and SMEs (small and medium enterprises), a core driver of economic diversification and job creation, have become a key focus. But many SMEs lack access to finance, with banks reluctant to lend and microfinance institutions unfamiliar with this segment. To address this gap, IFC is working with KIMB, its long-term partner, to design and pilot a new SME financing product. This SmartLesson shares insights from the product design and early pilot phase that may prove useful for other regional microfinance institutions looking to enter this important space.

Despite recent progress, Yemen—one of the Arab world's poorest countries—remains in a difficult transition period. In the wake of the 2011 uprising, its economy contracted by nearly 12.7 percent and the poverty rate rose to 54.6 percent. Today, despite early signs of recovery, businesses still face challenges from poor infrastructure, frequent power cuts, petroleum shortages, and fragile security. However, Yemen's transitional government, agencies, and outside donors such as the European Union and IFC have begun supporting the development of the SME sector, which is critical to job creation and, ultimately, the nation's economic development.

Although SMEs make up nearly 96 percent of the nation's GDP, banks remain hesitant to lend to them. And the growing microfinance sector has focused almost exclusively on the microenterprise segment, with an average loan size of about $400. This has left SMEs in a broad "missing middle," forced to rely on families, moneylenders, or short-term finance options from suppliers. It has also opened the door to a large and potentially profitable SME market for financial institutions ready to take advantage of the opportunity.

Box 1: KIMB's Story

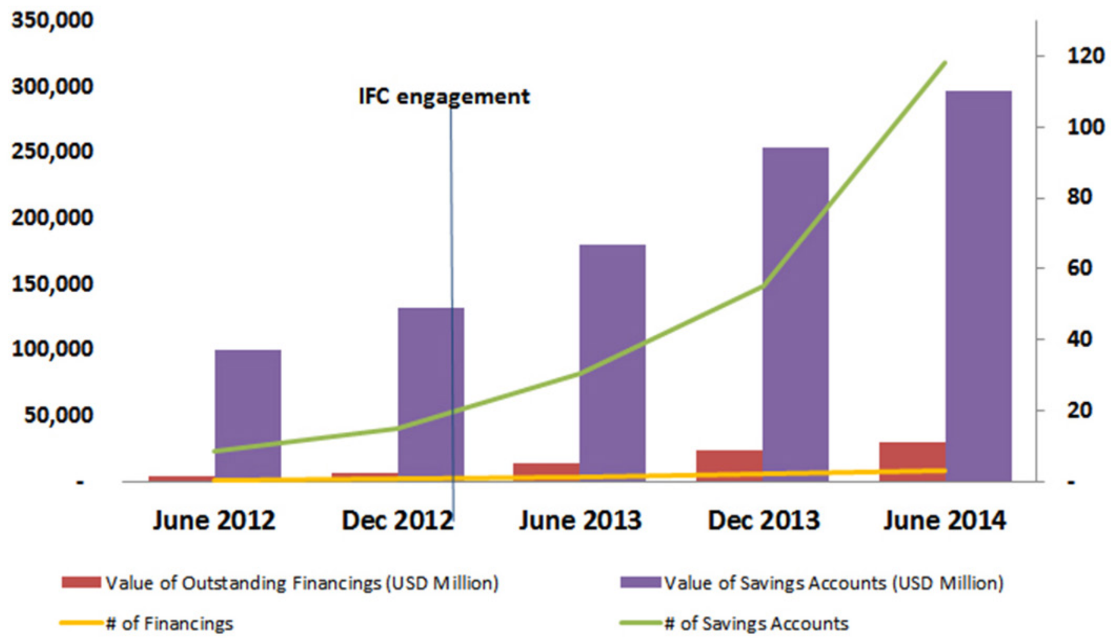
Al Kuraimi Islamic Microfinance Bank arose from a highly regarded family business that provided money transfer and exchange services since 1995 and had a large branch network. An innovative new participant in the micro and SME finance space in Yemen, KIMB received a microfinance bank license from the central bank in 2010.

After the uprising in 2011 slowed its new activities, KIMB approached IFC for help in adopting international sound practices in micro and SME banking. IFC saw an opportunity to help the bank expand access to finance in the country—sustainably and profitably. KIMB began introducing new financing (credit) and savings products more seriously. Today, it offers a range of products through an extensive network of branches and agents, as well as mobile banking.

IFC is helping one such institution, KIMB, address this gap (see Box 1).

Today, IFC supports KIMB through such capacity-building activities such as product diversification into SME and housing finance, risk management

Figure 1: KIMB Portfolio Growth from June 2012 to June 2014



and governance, strategic planning, IT (information technology), and human resources. Since the support began, the number of people opening savings accounts at the bank has taken off, and the microfinance institution has achieved an astonishing level of liquidity (see Table 1). Although KIMB has always taken a cautious and prudent approach to extending financing, as it builds capacity it has already more than tripled its financing portfolio (see Figure 1).

The Opportunity

In the large and underserved SME segment, KIMB saw an opportunity to contribute meaningfully to their country's development, as well as a means to deploy the banks excess liquidity. Inspired by successful examples of SME financing, such as ProCredit Bank, it sought IFC's global expertise to help it upscale from financing micro- and very small enterprises (VSEs), to the new frontiers of SME finance.

IFC commenced its support by assembling a team of specialists in both SME banking and microfinance and engaged a specialized consulting firm to assist with implementation. The work began in mid-2013 with a rapid market assessment to better understand both the supply side (including existing and potential competitors) and the demand: e.g., characteristics of the SME segment, including key sectors, average size (employees, turnover), as well as current financing habits, preferences and needs. While KIMB was an

Table 1: KIMB Indicators (June 2014)

Indicator	Value
No. of Financings	8,094
Value of Financings	US $11,278,900
PAR>30 days	0.40%
No. of Deposit Accounts	317,376
Value of Deposits	US $109,469,000

A new KIMB branch office in Yemen.

"early mover," other banks and MFIs were primed to enter the space.

Next came a product design phase to define the key product features, including eligibility, size, maturity, pricing, collateral, and repayment—while respecting the principles of *shariah* (Islamic finance), which are not only important to KIMB, but better reflect the market demand. KIMB started with a typical *murabaha*[1] product, financing working capital or fixed assets for existing businesses in all sectors, with amounts from $10,000 to $100,000 and terms of 12–24 months.

1 An Islamic financing structure similar to "rent to own," whereby an intermediary buys an asset/property and then agrees on a sale price (including a profit for the intermediary) that can be made through a series of installments or as a lump-sum payment.

With IFC's assistance, KIMB established a separate SME unit with a team of SME finance officers (front-line and back-office) led by an SME unit manager—reflecting the new SME business line and the differentiation necessary *within* the bank to serve this segment effectively. KIMB developed clear job descriptions, clarified reporting lines, and recruited (internally and externally) staff for these positions.

Accompanying the product development process was the design of the process flow of the new SME financing business line, ensuring that it was backed by clear policies and procedures (including *shariah* compliance). Finally, the time came to train KIMB staff and senior management on the SME financing technology—a rigorous market and financial analysis technique that is critical for determining the structure of the business customer's balance sheet and reliability of its cash flow, market size, and profitability.

Early in 2014, KIMB began pilot testing the new product in two branches in Sana'a, Yemen's capital and economic hub. It is proceeding quite cautiously as it explores the new segment, disbursing 81 loans ($1.1m) as of June 2014. However, many more are already approved and awaiting appropriate collateral from clients before disbursing. Furthermore, KIMB is tackling a larger segment of SMEs, with a greater range of financing from $5,000-$100,000 (avg. $15,000).

LESSONS LEARNED

Lesson 1: Relearning the rule of thumb: understand the local context.

Understanding (and adapting) to the local context represents a fundamental lesson that we are continually re-learning. Because of the lower income levels, an SME in Yemen (with a GDP per capita of close to $2,500) doesn't look like those operating in higher-income countries—in number of employees, average turnover, and financing needs. Also, the level of education, informality, and lack of training and support services mean SMEs in Yemen often do not have comprehensive financial records or documentation for loan officers to analyze.

Another challenge is how to manage credit risk during the underwriting process. The traditional model relies primarily on a rigorous financial analysis of the SME, together with a check of the local credit bureau. That may suffice in some countries, but in Yemen—where informal family and business relationships are central to the local economy—a detailed reputation/background check (talking to the neighbors, suppliers, and so on) is equally important in determining risk. IFC's support and quality control helped ensure consultants leveraged the best of both KIMB's screening process and their own tried and true SME lending technology.

Lesson 2: Consider the importance of segmentation.

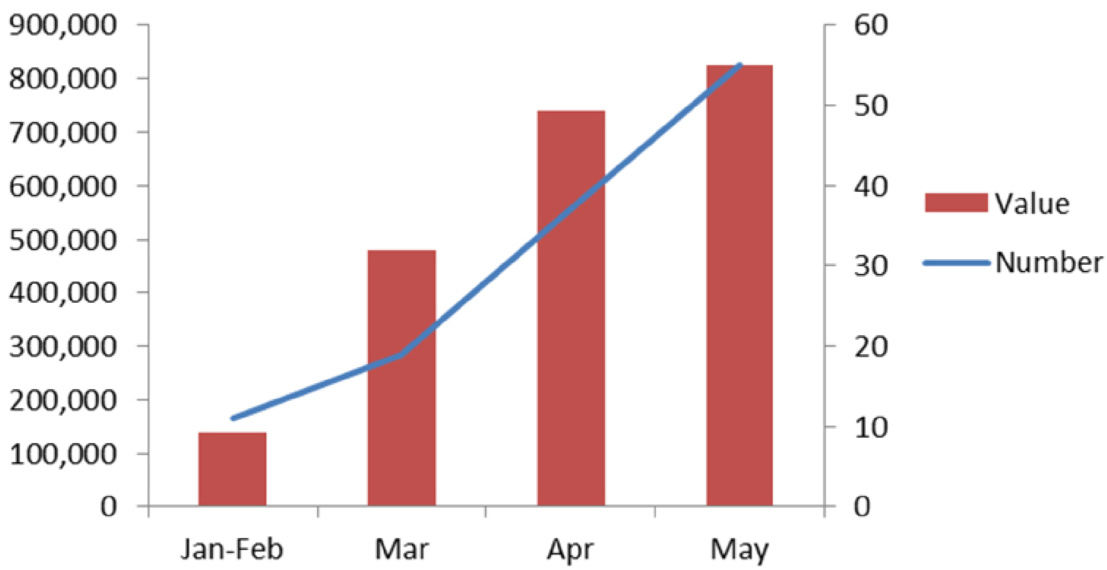
KIMB hoped to use the market assessment as clear guidance on the characteristics of the new market it was entering. Not only was the SME segment a completely new territory for the bank, but also the higher financing needs of small businesses in Yemen ($10,000 to $100,000) meant that it was putting larger amounts of its own capital (and effectively, in Islamic finance, its customers' savings) at risk. The consultants' first attempt at the market study resulted in rather generic findings — e.g. trying to define 'SME' in the Yemeni context, and quantifying the SMEs broadly by city, sector, years in business, employees, financing needs, and size.

However, IFC worked with KIMB and the consultants to go deeper into describing the different segments and sub-segments—which ones were typically more risky and which activities had stronger markets and offered more opportunities. Understanding the characteristics of different business activities and which types to target or avoid, for example, has since helped underpin a smarter client acquisition strategy by KIMB, while exposing the bank's staff to the actual risks and opportunities in the local SME segment.

Lesson 3: Start slow, make small mistakes and learn from them.

KIMB's senior management had a right to be nervous about venturing into the new frontier space of SME finance, especially since many of the staff had little formal banking training or background. Indeed, because the company's original business model consisted of offering money transfer and exchange services, it had little experience putting its own capital (and that of its depositors) at risk. An early default with a significant sum of money ($75,000 to $100,000) could sour the

Figure 2: KIMB SME Portfolio Growth Path (Early 2014)



management on this strategic entry into a potentially large and important new market.

To accommodate these concerns, IFC helped KIMB to scale back the pilot phase targets (for example, disbursing 4–5 SME financings in the first months, rather than the initial targets of 15–20). This allowed SME staff to receive proper training and coaching, rather than rushing to meet their targets in a new and unfamiliar landscape. Such a slow start also meant that any small errors or oversights were captured in credit committees *before* disbursement. Furthermore, during the initial months the SME pilot was run largely out of KIMB's head office, with substantial senior management involvement. Even when some finance officers were decentralized to the branch, all credit committees continued to take place at the head office. This allowed the bank's senior management to fully participate, remain involved, and provide effective oversight—all while giving themselves the opportunity to learn more about the business (Figure 2 illustrates llustrates early SME pilot results for early 2014).

Lesson 4: Work around the limitations of not being a full-scale bank.

As a microfinance bank, KIMB is not licensed to provide a complete array of banking services, including checking accounts and trade finance. This could pose a limitation, as when microfinance providers seek to scale up to SME lending (a customer segment with more sophisticated banking needs), its services must evolve. The institution should also begin to look beyond a single product focus to a more holistic SME *banking* approach. Furthermore, it might begin to study its customer value proposition and look for ways to better serve small business clients (while enhancing profitability) by tying SME finance in with other relevant services, including savings and checking accounts, bill or supplier payments, money transfers, and so on.

KIMB does in fact offer many of these products, but the lack of a collateral registry in the country means KIMB must ask its SME customers to "guarantee" its finance through checks obtained from *another* bank. While today KIMB is one of the few institutions offering SMEs the financing they need today, as banks monitor their more reliable SME customers, they may one day decide to serve these same businesses themselves. In the meantime, to retain a competitive foothold, KIMB is exploring different value-added services to enhance its value proposition to SMEs, including not only providing money transfer and exchange services, but also linking its clients to savings accounts and using alternate delivery channels such as its expanding agent network, ATMs, and even mobile banking.

Lesson 5: Islamic SME finance is a new frontier.

Yemen has a strongly conservative culture governed by Islamic values and with *shariah* law prevalent in the financial sector. This is particularly relevant, as low-income Muslims throughout the Arab world are often doubly-excluded from finance, because 1) most financial institutions remain inaccessible to the poor, and 2) many people either refuse or prefer not to take out loans on a commercial basis (charging interest), believing that it goes against their principles.

KIMB clients queue at a modernized bank branch office.

While some microfinance institutions and Islamic banks do provide Islamic finance to either the micro or corporate sector, IFC is helping KIMB push the boundaries further by reaching out to SMEs with *shariah*-compliant financing. KIMB has begun providing the *murabaha* form of financing to cover primarily the working capital needs of SMEs, whereby customers select the goods they wish to own, but KIMB's own staff negotiate and purchase the goods themselves before transferring them to the customer. Payments (plus markup) are then made monthly over the life of the arrangement, usually 12 months.

KIMB is also exploring a novel *revolving murabaha* product that will help small businesses with recurring working capital needs to top up their financing at any point during the year (much like a line of credit). However, it will wait before trying to test a lease-like *Ijara*[2] product for SMEs, whereby the bank finances the goods and promises to transfer ownership to the SME at the end of the term, if all of the payments have been made. To further mitigate risk in such a product, the financing amount should not cover the entire cost of the goods, but instead the SME pays a percentage up front (usually 10–30 percent). However, because there is no fixed asset registry in Yemen to formerly register ownership, there is no meaningful way to collateralize an *Ijara* transaction (for example, the asset itself), and the asset may lose value or be transferred to someone else before KIMB recovers its costs.

In Islamic finance, the more profit the bank makes, the more the depositors will gain on their saving accounts and vice versa—-an almost venture capital-type partnership between banks and their customers that represents a truly "responsible" form of finance. This, coupled with KIMB's sustainability concerns, made pricing an important discussion item during the product design phase. Both IFC and KIMB had to pay attention to details and to question consultants, whose financial projection models and assumptions were sometimes flawed. For instance, the consultants' recommendation that KIMB could afford to lower the cost of financing to SMEs, and their proposal to bring down the costs for longer-tenor financing (where risk is actually higher), did not make sense. As an early mover in the SME market space, KIMB could set the market rate and was already providing financing at a fairly low effective markup relative to its competitors.

2 An Islamic form of financing similar to conventional leasing, whereby the lessor agrees to sell the asset/property at an agreed value at the end, but the lessee is not obligated to purchase.

Another issue in Yemen was how to price on assets/amounts denominated in different currencies such as Yemeni rial, U.S. dollar or Saudi riyal, which had consequences and risks for the bank's foreign exchange position. Indeed, many customers sought financing in dollars because of a lower initial rate offered, even if they were earning income from their business in rial. Eventually KIMB adjusted the price of U.S. dollar-denominated finance to prevent currency mismatches on its balance sheet. IFC's presence helped ensure they were taking into consideration *correct* assumptions about the market (external) and the bank itself (internal) while including such items as the cost of funding, staff, and productivity in financial projections. It also ensured that a critical pricing mistake wasn't made at the outset of the SME pilot, when demonstrating the product's viability to management was key.

Lesson 6: Pilot testing, coaching and implementation support are critical.

Product design, theoretical training, and development of policies and procedures for a new SME unit are important steps in framing a bank's movement into the SME space. However, when staff actually begin analyzing SME applicants and issuing the first new loans, that's typically where the "rubber hits the road," and when sufficient training, coaching, and on-site implementation support are most critical and should be

Box 2: Key Issues for a New SME Unit

- Who should be the first point of contact for new SME clients?
- How do we analyze or cross-check sales figures from a business that has nothing documented?
- What is the role of the branch managers relative to the SME unit manager?
- Why was initial financing and customer acquisition so slow?
- When should we take the pilot into new branches?
- Who should join the credit committee, and how long should it stay in the head office?

woven tightly into any project plan for SME product development.

KIMB was no exception. Despite its rich expertise in the money transfer and exchange business, none of the staff had the SME banking background necessary to address all the challenges and special cases they initially encountered in the field. The bank's new SME financing officers faced numerous questions when analyzing the early SMEs. Its SME unit manager was likewise new to small business finance and needed strong training and even a coach to help him learn how to effectively guide his team and develop new business while controlling for risk. Meanwhile senior management could still benefit from the presence of an experienced SME manager to help them understand how to strategically roll out and oversee this new business line (see Box 2).

CONCLUSION

As Yemen struggles to emerge from internal political and social divisions, boost its economy and forge itself a new and more promising future, efforts like those of IFC and Al Kuraimi Islamic Microfinance Bank – to stimulate job creation and spur economic growth through the financing of SMEs – are increasingly critical. Indeed, we are already seeing a demonstration effect as new actors (including a greenfield microfinance bank and new private entrants) prepare to enter the micro- and small finance space, and other MFIs also move up from targeting strictly "micro" clients and begin to serve the very small or SME space.

Furthermore, the IFC-KIMB project has brought important learnings on the key challenges one faces and how best to support an institution that is planning to set up a dedicated SME unit and begin serving SMEs with appropriate products – including the unique and relevant angle of how to provide socially responsible, *Islamic* SME finance. This learning couldn't be more timely, given that today many MFIs in the MENA region (including other important IFC Advisory and Investment partners) are looking for support to upscale and serve SMEs.

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Lessons from Sub-Saharan Africa

From Micro to Small: How Do Microfinance Banks in Sub-Saharan Africa Scale Up to Small Business Lending?

You probably already know that small and medium enterprises (SMEs) play an important role in global job creation and economic growth. Since the onset of the global financial crisis and the ensuing unemployment fallout, "SME" has become a veritable buzzword, and by now most people have heard the headline statistics: in OECD countries, SMEs account for over two-thirds of formal employment, while the 2013 IFC Jobs Study and other recent World Bank research suggest that the statistic is similar—or even greater—for developing countries. Similarly, there is a growing consensus that access to finance—while certainly not the only barrier to SME growth—is a significant constraint. This SmartLesson shares some experiences of IFC's microfinance clients with SMEs.

What are SMEs? The term applies to a heterogeneous group of businesses with diverse characteristics and requirements. It is particularly difficult to define the SME market in Africa, because official definitions often focus on formal, registered businesses, while Africa's high level of private sector informality renders such a definition unusable. Other definitions, based on number of employees, annual turnover, assets, or financing needs, are also problematic or simply difficult to estimate accurately.

It is probably easiest to understand SMEs as the so-called "missing middle," occupying the space somewhere between corporations and microenterprises. While larger than a typical microbusiness, they often fail to meet one or more of the criteria for accessing traditional bank finance, such as the ability to generate formal financial statements or to provide collateral such as titles or bank deposits.

The "missing middle:" IFC's response in Africa

Given the diversity of the SME market, a single approach to financing SMEs does not suffice. Instead, IFC is closing in on the missing middle from two directions: top-down and bottom-up. From the top down, IFC already works with mainstream commercial banks to develop strategies, systems, and products to reach SMEs that traditional commercial banks would otherwise have been unable or unwilling to target.

At the same time, IFC's maturing network of specialized African microfinance institutions (many of them specialized regulated banks) are increasingly targeting the "S" of the SME spectrum as a natural extension of their core business. African SMEs share many of the characteristics of informal microenterprises, and many of the same tools and approaches used to profitably serve this market can also reach SMEs.

Within three to four years of starting operations, small businesses already become an important market for IFC's microfinance clients in Africa: SME loans (defined by IFC as any loan of $10,000 or greater) already represent more than 25 percent of the total portfolio outstanding held by IFC's African microfinance bank clients as of December 2012. This growing share is driven by new microfinance clients entering this space as well as underlying growth of approximately 60 percent for IFC microfinance clients already targeting SMEs. One client, ProCredit Bank Congo, is essentially fully dedicated to this segment, with an average loan size of about $10,000. Most important, the quality of the SME loan portfolio built by IFC's microfinance clients is excellent, with PAR>90 averaging 0.8 percent across the 10 clients now serving this segment (see Table 1).

LESSONS LEARNED

Lesson 1: SME lending departments can build on skills in microlending—but need a distinct structure and capacity building plan.

Most of IFC's African partners entering the SME segment created a specialized department with dedicated staff to serve the new segment. Generally, the SME lending department tends to be more centralized at headquarters, with oversight responsibility for SME business development carried out at the branches.

Some institutions initially hired new SME loan officers with a more traditional banking profile and higher level of education. They soon realized that because SME clientele are not reached by most traditional banks, the newly hired loan officers were unable to piece together the necessary cash flow analysis and were unwilling to work with customers outside of the office. Of the six initial SME loan officers hired by Advans Cameroun, for example, only one remains with the institution.

Instead, most institutions have taken a hybrid approach to loan officer staffing, allowing some of the better-performing microloan officers to graduate to offering SME loans. These loan officers receive additional training. Most of the institutions found homegrown talent to be much more capable of understanding the needs of SMEs and respectful of the institution's mission and credit culture, and to view the opportunity to work in this segment as an incentive for career advancement.

Lesson 2: SME loan products and operations need to be developed specifically for this segment.

All of the IFC microfinance clients surveyed adapted their policies and processes to serve SME borrowers.

Table 1: SME Lending by IFC's Microfinance Clients in Sub-Saharan Africa

Summary		2011	2012	Growth
MF clients with >$3m outstanding to SMEs		7 of 18	10 of 19	+3 clients
SME loans outstanding	#	3,684	5,905	60%
SME loan portfolio	$ million	75	129	73%
SME loans disbursed	#		7,526	
Value of SME loans disbursed	$ million	n.a.	176	n.a.
PAR>90 of SME loans	%		0.8%	

Note: Summary excludes K-Rep Bank, for which data collection was ongoing at the time of publication.

Most important, the credit and collection methods become more sophisticated and operate on a shorter turnaround time from origination to disbursement (many cite 15 days on average), and they include more urgent follow-up on delinquent loans. For example, many institutions prepare collection reports in advance of due dates to allow SME loan officers to remind borrowers, while others have a regularly updated "watch list."

According to IFC's clients, many of the key elements in the SME credit process are similar to those used for lending to microbusinesses, including regular and spot-check business visits, integrity checks, personal guarantees, and, most important, cash flow analysis of the business. However, the minimum operational track record of new SME borrowers is usually longer than that required of microbusinesses, averaging at least nine months, and the cash flow analysis for

Box 1: Advans Cameroun's Experience with SME Lending

In 2010, in its third year of operations, Advans Cameroun launched an SME loan product with loans ranging from CFA 5 million to CFA 50 million (about $10,000 to $100,000). The average loan disbursed is CFA 7.75 million ($15,500) and has an average tenor of 14 months.

In the first three years, the SME loan portfolio grew to CFA 6 billion ($12 million), with 1,077 loans outstanding as of the end of 2012. It had a major impact on the institution—accounting for 48 percent of the total loan portfolio by volume and 10 percent of the number of loans outstanding. Performance and quality of the SME loan portfolio are very good by industry standards. Although PAR>30 increased to 4.7 percent in 2012, by the end of 2013 it came down to about 3.5 percent.

To be eligible for an SME loan, a business must have annual turnover of at least CFA 100 million ($200,000), a minimum of five employees, and sufficient skills to provide historical financial information and a vision to project the business over the next 12 months. Formal financial statements are not necessary, but the relevant inputs for loan officers to piece together an income statement, balance sheet, and cash flows are required. Besides the initial eligibility criteria, the primary differentiating factor is the combined historical and projected business analysis.

A key risk the institution has identified is underfinancing or overfinancing the business. If it is underfinanced, the proprietor may need to abandon the proposed plan in favor of a less capital-intensive option that was not evaluated in the loan application process. When overfinanced, a business may move into uncharted territory, beyond the scope and capacity of the owner to manage. Overfinancing was also cited as a reason why PAR has been seen to dip after the third loan cycle in the portfolio. In these cases, there may be adverse incentives for the loan officer to increase loan size for consistently well-performing borrowers. This risk can be compounded by overly optimistic borrowers with visions of vertically integrating their core business by taking over parts of the supply chain or distribution but without the proper planning or evaluation of such expansion.

The institution has found that profitability of the SME loan portfolio is driven by revenues on larger loan sizes. However, it has also found limited, if any, cost savings on the SME loan portfolio. Loan officer productivity, as measured by SME loan portfolio per loan officer, is not much higher than for the microloan portfolio, meaning that SME officers make fewer larger loans, whereas microloan officers make many smaller loans. Overall, Advans Cameroun views the SME segment as a core part of its business model, serving the poor and underserved population in Cameroon by filling the gap between the traditional microfinance and commercial banking sectors in the country.

Box 2: SME Lending in Liberia: When Regulatory Changes Add to Risk

When AccessBank Liberia—the first microfinance bank in the country—started operations in February 2009, the business plan included SME lending as a core component of the loan portfolio and business model, which would launch in the second year of operations. However, as AccessBank prepared to launch the product, the Central Bank of Liberia introduced a new definition of SME loans, starting at $7,000, and prescribed an 18 percent declining interest rate, roughly half the rate assumed in the original business plan.

In March 2012, the bank launched the SME loan product and intentionally grew the portfolio slowly. One year after launching, the SME loan portfolio consisted of 104 loans, representing a portfolio of $1 million, or approximately 11 percent of the overall portfolio. The average loan size at disbursement is $18,000, whereas the largest single loan disbursed to date is $25,000, and the maximum loan size is $50,000. If higher interest rates were allowed in the Liberian market, the bank would target SMEs to represent 50 percent of the portfolio by volume.

As with other countries in the region, there is a high demand for SME loans in the market, but many of the traditional banks will not lend to SMEs, given the mix of low maximum interest rates, poor credit culture, and weak legal infrastructure for recourse. This combination of high demand and limited supply contributes to an elevated risk of fraud, particularly involving collusion between borrowers and loan officers. As a result, AccessBank has had to insist on tight controls and oversight of the SME loan portfolio, including the centralization of all credit decisions. This shift has also reinforced its focus on existing customers, who are already familiar with the bank's operating procedures, rather than using the new product to attract new customers.

Regarding profitability, the high cost of training loan officers capable of evaluating SMEs and managing the credit process, combined with the more competitive market for SME lending, makes margins relatively tight. Spikes in arrears or worsening portfolio quality leading to write-offs can have a direct impact on profitability in this segment, making careful and constant management of the underwriting standards essential.

SMEs tends to be both historical and projected. In addition, credit appraisals for SMEs typically incorporate credit reference checks and credit scoring tools as well as expanded use of collateral (80 percent of the microfinance banks surveyed require it from SME borrowers). The types of collateral include fixed assets, land titles, vehicles, and sometimes social collateral (for example, guarantors).

Despite detailed processes to manage risks, the evidence among IFC's existing microfinance banks tells us that portfolio quality in SME loan portfolios can be more volatile than in microloan portfolios. When these bigger loans do go into arrears, the collection process is also more complex: legal action seems to be more frequent with SME borrowers, and external debt collectors are often used for long-overdue loans. Overall, though, it is evident that IFC's microfinance clients have been able to manage these fluctuations and currently report outstanding PAR>90 figures averaging 0.8 percent at the end of 2012. To successfully run the SME lending business, it is necessary to have enough flexibility to adapt the processes and procedures rapidly and have the ability to monitor portfolio quality on a real-time basis.

Lesson 3: SMEs are attracted to full-service offerings, and they value greater flexibility.

Almost all of the IFC clients interviewed consider the provision of a package of products and services beyond credit as essential to satisfying SME customers. Non-credit products, including deposits, micro insurance, trade finance, and payment/transfer services, are taken up by SME customers, who can participate in surprisingly dispersed and complex value chains in many countries. Additionally, the fee structure and distribution channels also tend to be more favorable to the customer, including free local debit cards, reduced fees (50 percent) for international debit cards, free tokens for e-banking, and lower cashwithdrawal fees (see Box 1).

In addition to the internal factors identified above, many IFC clients cited external factors that can have an impact on the SME market. Common external factors include competitive pressure from commercial banks targeting the best customers, regulatory pressure from governments that want to prioritize the microfinance sector's services at the lower end of the market segment, and fraud, where borrowers and loan officers are complicit in distorting credit appraisals (see Box 2).

CONCLUSION

The early experiences of IFC's African microfinance partners in serving the SME segment have been positive. SME portfolios are growing consistently, with good portfolio quality, and are increasingly contributing to the institutions' sustainability. This complements IFC's downscaling efforts in the traditional commercial banking space by closing the gap between the minimum lending amount of traditional commercial banks (about $100,000) and the maximum amount of SME loans for IFC's microfinance partners ($50,000 to $100,000). At the same time, microfinance institution clients face unique risks when they start serving the SME market and will need to adapt their risk management, policies, and procedures accordingly.

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A market woman in Kinshasa depositing her daily earnings at a FINCA Express bank agent in a pharmacy next to a market.

Breaking Free of the Branch: Designing Alternative Delivery Channel Projects for Microfinance Banks in Africa

Nearly 80 percent of adults in Sub-Saharan Africa do not have an account with a formal financial institution. Despite recent well-publicized successes in increasing financial inclusion in a small number of African markets, such as Kenya, hundreds of millions of African adults still lack access to affordable financial services. In response to this need, IFC and The MasterCard Foundation partnered to introduce alternative delivery channels in IFC's key microfinance partners in Africa. Although the partnership is still at an early stage, this SmartLesson distills some general lessons from two of the first alternative delivery channel engagements. These lessons may be useful for other IFC teams in structuring such projects with microfinance clients.

During the past seven years, IFC focused mainly on closing the access gap by supporting retail microfinance banks, which provide a strong platform for increased outreach. Until now, these banks have generally replicated the traditional branch-based banking model, an approach that is inherently slow and expensive to deploy in challenging African frontier markets. To achieve the necessary transformational outreach, IFC and our microfinance clients recognize that alternative delivery channels (ADCs)—including agent and mobile banking—are potentially powerful tools to scale outreach in the face of these unique challenges. However, because of a combination of low capacity, inherent risks, and high upfront costs, most microfinance banks operating in underserved markets have not yet taken advantage of the ADC model.

In January 2012, IFC and The MasterCard Foundation launched the $37.4 million Partnership for Financial Inclusion, with the goal of bringing financial services to an estimated 5.3 million people previously without banking services in Sub-Saharan Africa—within five years. The program aims to develop sustainable microfinance business models that can deliver large-scale, low-cost banking services. To accelerate the development of low-cost mobile financial services, the program provides advisory assistance to mobile network operators, microfinance institutions, banks, and payments systems providers.[1]

Through the partnership, IFC aims to scale up eight to ten of our strongest African microfinance clients—including key partners FINCA and MicroCred—by supporting the development of innovative new products, expansion into hard-to-reach locations, especially rural areas, and the deployment of new cost-effective alternative delivery channels.

LESSONS LEARNED

Lesson 1: Upfront support is crucial for success.

The IFC Africa microfinance team intended its initial approach to microfinance channel engagements to be a relatively light-touch process: a full IFC team

1 For more information, go to www.ifc.org/financialinclusionafrica.

composed of the project leader and relevant specialists would conduct a due diligence mission and aim to get most of the way toward a detailed project implementation plan within a few days. However, the approach has changed substantially following lessons learned from our first ADC engagements under the partnership—including with FINCA DRC. After just one day of due diligence meetings with FINCA, the IFC team realized that even relatively mature microfinance clients such as FINCA DRC lack capacity when it comes to a channel project—which is understandable considering the nascent state of branchless banking globally.

Initial proposals from microfinance clients thus tend to be either 1) overly ambitious, as the client underestimates the level of resources and capacity necessary to implement a project, as with FINCA (see Box 1), or 2) overly conservative, as the client is unwilling to commit to specific targets, given a lack of direct experience with the ADC. As a result, most microfinance institutions will require substantial expert input and upfront advisory support well before beginning to draft an implementation plan. They will need assistance in defining the magnitude of the project, the broad strategic priorities, and the specific activities to be covered under the project, as well as in thinking through the practical aspects of the plan in detail.

As a result of these early lessons, IFC now uses a revised client engagement strategy for channel projects that incorporates significant early-stage advisory support: before even conducting initial due diligence, the IFC project team works with the client to complete a detailed questionnaire to help the client think through the necessary strategic, financial, and operational aspects of mobile and agent channel development—and to ultimately be more prepared to engage with the IFC team during due diligence.

Depending on client capacity, IFC may also provide

Box 1: FINCA DRC

Although FINCA DRC's alternative delivery channel strategy is ambitious, it is modest in scope compared to FINCA's initial proposal during due diligence discussions with IFC. In addition to developing an agent network, FINCA DRC's original plans included the following:

• a costly branch expansion ($200,000 per branch in infrastructure investment alone) that would almost double the physical branch infrastructure;

• a mobile banking channel, with the aim of directly integrating FINCA with the e-wallet of a mobile network operator; and

• a card-based channel—likely in partnership with a bank—to give FINCA clients access to one of the Democratic Republic of Congo's proprietary ATM networks and to allow them to transact when abroad (mainly for clients running trading businesses).

The proposal was very agressive and likely to pull FINCA DRC in too many directions. In response, IFC provided specialist consultants to work with FINCA for two weeks onsite to develop a narrower plan that would reflect FINCA's real priorities. The resulting project, with a focus on building the savings outreach and an aggressive but realistic expansion of FINCA's agent network, has thus far exceeded the initial targets. As of May 2014, FINCA already had 173 agents operational, $21 million in deposits mobilized, and 51,000 transactions processed through FINCA agents monthly. Based on this early success, FINCA DRC has committed to an ambitious new target of becoming the Democratic Republic of Congo's first true mass-market financial institution and reaching over 1 million customers within five years.

significant support—after the due diligence but before implementation—in developing the business case for the channel, including financial and operational projections. For FINCA, this involved sending a team of specialist staff and consultants for two weeks following the due diligence to develop a more prudent business case by working through the market size and client uptake assumptions, agent network rollout plan, and budget.

Lesson 2: Keep your eye on the ball.

The novelty of channel implementations can make it easy for both IFC and the client to lose sight of the ultimate goal, and technical complexities can quickly overwhelm the client and dominate the design phase of the project. In both the FINCA and MicroCred projects, the IFC team spent significant time discussing the technical questions, such as point-of-sale solutions, switches, and integration with third-party payment providers. Also, both FINCA and MicroCred initially focused heavily on the channel potential for direct revenue from fees or other charges during due diligence and follow-up discussions (see Box 2).

However, it is equally important to remember that, for microfinance banks, an alternative delivery channel is a means to an end and generally not an end in itself. While the channel itself has naturally been an area of significant focus in our discussions with clients, it is equally critical to give sufficient attention to the bank's broader business strategy—and product overhaul, if relevant.

The discussions and project implementation plan should address the following key issues: which clients the bank wants to target with the channel; what type of savings, credit, or other products it may need to add or adapt to the channel; what volume of deposits, loans, or other business it can reasonably expect to mobilize; and how to grow its business through the right mix of products, promotion, places, and field activities—so the client can realize the core business benefits of the channel. The IFC team has reinforced this message during due diligence discussions and pre-implementation advisory assistance; that's when discussions of the business case and financial projections provide a good forum for debating various scenarios and assumptions regarding the impact of the channel on the overall business of the bank.

Lesson 3: Partnership is key.

There is a reason why "partnership" is the first word in the name of the IFC-MasterCard Foundation program. As already noted, branchless banking is still relatively new territory for almost all microfinance clients, and the investment required to roll out a new channel is daunting: a $2 million to $4 million initial outlay for staff and systems is not uncommon, with more than half of this outlay coming in the form of parallel

Box 2: IFC's Channel Partnership with MicroCred in Africa

The following factors characterize the IFC-MicroCred channel partnership in Africa:

• The relationship leverages one of IFC's key greenfield network partners in Africa. MicroCred Senegal and MicroCred Madagascar, two of IFC's strongest greenfield clients, were selected through a competitive process by an IFC team composed of Advisory Services and Investment Services staff.

• In addition to support in business modeling and providing performance-based grants, IFC is delivering advisory services in the areas of strategic planning, agent network management, and network optimization.

• The partnership includes significant investment in capacity at the MicroCred Holding level—including support for a global director of channel development, who is responsible for the performance of all of the alternative delivery channels and will make lessons learned in Senegal and Madagascar available across the MicroCred network.

contributions from the client. Microfinance institution clients require a true partnership with IFC to feel comfortable undertaking a channel project, and they want to share the risk of innovation proportionally. Without some assurance of continuing support, clients are unlikely to feel comfortable committing to outcome-related targets, which can be problematic when structuring the project. Moreover, given the many uncertainties inherent in such a new area, clients expect some degree of flexibility to refine and revise their approach based on early experience and lessons.

IFC has addressed the need for unambiguous partnership and risk sharing in the structure of the project legal agreements: continuing advisory assistance in the form of a specific cooperation agreement, combined with grant support. In addition to the design phase advisory support described above, IFC commits to provide advisory services during at least the first part of the implementation phase, to support the client's testing and refining of key assumptions made during the design phase. The details of this advisory assistance are formalized in a cooperation agreement—usually at the same time as the signing of a performance-based grant agreement. With IFC's advisory support, the project and grant targets can then be amended as necessary, based on the initial results of the project to ensure realistic but sufficiently aggressive objectives.

To avoid placing undue risk on the client during the early stages of the project, the grant agreement is also structured with a significant upfront payment and with the first performance-based tranche linked to output-based targets (for example, number of agents) that the client has more control over; later tranches are more closely tied to the outcomes and impact of the project. Even mature microfinance institutions are unlikely to push ahead without some reassurance that early stumbles will not result in the withdrawal or curtailing of IFC's financial and advisory support.

The Africa microfinance team's partnerships also go beyond the individual project level. For example, based on positive initial outcomes from the partnership in the Democratic Republic of Congo and the strength of this relationship, FINCA has asked for IFC's assistance in rolling out its alternative delivery channel strategy worldwide—with additional support from IFC as a provider of advisory assistance and as a shareholder.

CONCLUSION

Although it is still early days, IFC's initial experience in supporting ADC projects with African microfinance partners has been largely positive. Nonetheless, our initial engagements in this space serve to highlight the reality that branchless channel development is new territory for both IFC and our clients—even those that are more mature and relatively sophisticated. This means IFC cannot expect our microfinance clients to hand us a fully-baked project, signed, sealed, and delivered. We are all figuring this out as we go along, and success in ADC implementation will require a true partnership to reach the mutual goal of expanding access to finance for those who are least served.

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SmartLessons
real experiences, real development

Greenfielding in Africa: A Model for Building Capacity and Scale in Nascent Markets

Sub-Saharan Africa (SSA) has the lowest level of access to finance of any region, with banking services available to only about one-quarter of the population. The banking systems are small, and the microfinance sector has been relatively slow to expand. Services are concentrated in larger urban centers, with meager service delivery in rural areas. Until a few years ago, the main providers of financial services to base-of-the-pyramid customers were credit unions, savings and loan associations, and nonprofit credit programs. Now new players include specialized greenfield microfinance institutions, downscaling pan-African commercial banks, and mobile network operators. This SmartLesson describes how the IFC Microfinance Program for Africa's greenfield model is increasing the number of commercially viable microfinance institutions in the region.

In Liberia, Sierra Leone, and the Democratic Republic of Congo, fewer than 1 percent of people have access to a bank account. Yet as these countries continue to stabilize, the demand for secure financial—particularly microfinance—services is exploding, because subsistence-level micro and small enterprises are often the only surviving businesses after a conflict. In 29 countries for which survey data are available, only 11 percent of households had access to savings accounts, as contrasted with 25 percent in other low- and middle-income countries and 90 percent in industrial countries. In Liberia, fewer than 1 percent of people have access to deposit accounts, and in the Democratic Republic of Congo it is fewer than 0.5 percent. Access to credit is even more limited.

IFC'S RESPONSE

In 2006, IFC decentralized a specialist microfinance team dedicated to expanding the Microfinance Program for Africa. To increase the number of commercially viable microfinance institutions in the region, the program works with sponsors that have demonstrated expertise in managing microfinance institutions in frontier markets. Key elements of the program include 1) designing strategic IFC-led projects with early and consistent engagement in frontier countries; 2) ensuring that projects have adequate resources to make an early-stage venture bankable in the medium term; 3) applying the greenfield model to new microfinance institutions with global standards and strong commercial orientation, targeting sustainability in three to five years and lasting impact on market development; and 4) ensuring a menu of products and channels to support extended reach and scale.

The greenfield business model expands financial services by creating a group of new "greenfield microfinance institutions" without preexisting infrastructure, staff, clients, or portfolios. In Sub-Saharan Africa, the greenfield model—where a centralized holding company provides investment and expertise for the development of commercial microfinance entities—began in 2000, when ProCredit Holding opened a bank in Mozambique. Essentially alone in pursuing this strategy, ProCredit opened a bank in Ghana in 2002, in Angola in 2004, and in the Democratic Republic of Congo in 2005. While other network operators and local institutions started nongovernmental organizations (NGOs) and cooperative microfinance entities much earlier, the greenfield model of a centralized holding company providing investment and expertise for the development of commercial microfinance entities began in earnest at the turn of the millennium.

In 2005 and 2006, Advans, Access, and MicroCred holding companies were formed with a structure similar to that of ProCredit and had collectively launched five greenfield microfinance institutions in Sub-Saharan Africa by the end of 2007. During the same period, Accion started its first greenfield microfinance institution in partnership with three commercial banks in Nigeria. Then Ecobank and Accion entered into a partnership and opened two such institutions in Ghana and Cameroon. From that point, the Access, Advans, and MicroCred networks each created roughly one new microfinance institution per year. Toward the end of the decade, ASA and BRAC from Bangladesh began establishing greenfield microfinance institutions in Africa. From late 2006 through 2012, a total of 27 additional greenfield microfinance institutions were launched (see Table 1).

The greenfield lifecycle in Sub-Saharan Africa, has three stages: 1) foundation (preparation and first year of operation), 2) institutional development (year two through financial breakeven typically in year three, four, or five), and 3) scale-up (from financial breakeven onward). Each stage is characterized by milestones related to management, product development, infrastructure build-out, outreach, funding structure, and sustainability (see Box 1).

LESSONS LEARNED

Lesson 1: Designing appropriate interventions requires early and consistent IFC engagement.

Acting early can preempt the proliferation of poor practices and provide significant first-mover advantages, such as shaping the sector with appropriate best practice models and building strong relationships with key stakeholders. IFC supported the development of the greenfield cohort in Africa by engaging directly during all stages of the institution's lifecycle. A decentralized team of investment and advisory microfinance specialists based in Africa worked closely with investors, sponsors, government, regulators, and in-country stakeholders to incrementally facilitate the program and the specific institutions created under its scope.

When deciding to intervene in Liberia, IFC learned that conventional wisdom said the market was far from ripe for a greenfield commercial microfinance bank. However, with strategic initiative funding from the Africa region, the microfinance team fielded one of the first IFC missions to Liberia to draft a feasibility study. Even though one of the largest UN military peacekeeping

Table 1: Greenfield Microfinance Institutions Created 2006–2012

	2006	2007	2008	2009	2010	2011	2012
Greenfield MFIs	7	12	18	22	27	30	31
No. of Staff	1,564	2,512	4,856	6,685	8,009	10,137	11,578
No. of Branches	37	56	261	392	514	625	701
No. of Loans Outstanding	107,887	141,231	332,349	449,973	570,017	743,640	769,199
Gross Loan Portfolio (USD mn)	57.4	94.7	144.5	203.6	285.8	409.5	527.0
No. of Deposit Accounts	220,377	317,943	595,008	780,497	1,050,087	1,574,750	1,934,855
Total Deposit Balance (USD mn)	50.7	106.7	177.9	211.6	291.3	371.8	445.5

Box 1: Greenfield Lifecycle Stages

Foundation—typically includes legal creation and partial capitalization of the new entity, shareholder negotiations, licensing process, and onsite operations preparation. Initial management—usually staff seconded from the holding company—is responsible for tailoring policies and procedures to the local market, designing and adapting products, installing an information technology (IT) system, providing physical space for branches, managing the relationship with regulatory authorities, and recruiting and training loan officers (usually 20–30). Preparation for operation usually takes four to six months from preliminary approval from the regulator, then another two to four months until the central bank inspects the institution and grants the final operating license.

Institutional development—focuses on building staff capacity and installing risk-management systems that will create the core foundation for future growth. As operations grow, there is increased institutionalization of risk management systems, such as policies and procedures for decentralized management, internal audit, cash and liquidity management, and regulatory compliance, including anti-money-laundering measures. The board's asset-liability committee becomes more active as deposits increase and begin to account for a greater portion of funds for intermediation.

Scale-up—occurs after breakeven, when the focus shifts to product diversification and delivery channel development to attract new clients, deepen existing client relationships, and gain market share. New products target secondary market segments, such as agricultural lending for rural clients. Expansion of small and medium enterprise lending can be a critical driver of profitability by offsetting the high cost of smaller microloans as institutions expand into more rural areas.

forces in the world was still on the ground, this early mission provided information about the market, costs, security, and the degree to which the economy was changing—providing information necessary for IFC to engage with potential co-investors and sponsors.

IFC's early-stage work with the Central Bank of Liberia (CBL) and the government to build confidence and establish the appropriate regulatory and supervisory framework was critical to the CBL's acceptance of the license application and laid the groundwork for a vibrant and sustainable microfinance sector. By early 2008, when AccessBank Liberia submitted its license application, UBA (a commercial bank from Nigeria) already had a provisional license, and other banks were lining up to enter the market.

Lesson 2: Accept that building from the ground up is expensive—but the impact is proportionate.

Operations in frontier markets require heavy upfront investment to compensate for a lack of physical infrastructure and capacity. The severe lack of the most basic public infrastructure, particularly for countries emerging from a conflict, forces all private sector companies to invest disproportionately in infrastructure to ensure safety and access to electricity, water, and transportation. The cost of establishing a branch in post-conflict Africa is about $300,000, roughly four times the cost in Eastern Europe. Compensating for lack of capacity can be equally costly, as years of conflict have brought education systems to a standstill and few young adults have any significant formal education. Lack of technical skills is often aggravated by social tensions from lingering divisions among communities, making extensive training and coaching of local staff critical to scaling up operations and building local management capacity.

To address these issues, greenfield projects are normally accompanied by advisory services packages. Advisory and related funding allow the introduction, application, and transfer of skills and knowledge necessary to successfully operate a commercially viable microfinance institution and enable it to internalize appropriate microfinance methodologies, social and environmental standards, internal controls, corporate governance, and so forth (see Box 2 and Table 2).

Table 2: Calculation Example

	Month 6	Month 12	Month 18	Month 24	Month 30	Month 36	Month 42	Month 48	Month 54	Month 60
Net Income for the period	386,569)	410,387)	359,666)	(178,023)	(33,527)	(26,280)	174,318	419,463	553,862	395,553
Add'l Cost to MFI if no external TA funding	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)	(500,000)				
Net Income if no external TA funding	(886,569)	(910,387)	(859,666)	(678,023)	(533,527)	(526,280)	174,318	419,463	553,862	395,553
Equity	2,974,906	3,553,198	3,510,502	3,558,164	3,839,706	4,324,016	4,480,075	5,267,880	5,284,887	6,558,059
Equity if no external TA funding	2,474,906	2,553,198	2,010,502	1,558,164	1,339,706	1,324,016	1,480,075	2,267,880	2,284,887	3,558,059
Annualized ROAE	-26.0%	-24.4%	-23.7%	-15.1%	-5.8%	-1.5%	3.6%	12.4%	19.9%	16.1%
Annualized ROAE if no external TA funding	-71.6%	-71.5%	-78.9%	-74.8%	-72.3%	-73.5%	-25.0%	33.1%	51.7%	32.6%

The actual average net income and equity positions for the greenfield cohort were used as a starting point.

The $3 million received in external grants for advisory ("TA funding" in the table) is spread evenly across the first 36 months of operations.

The remaining $1 million funded by the microfinance institution is already reflected in the average net income and equity figures.

Box 2: Impact of Advisory Services on Financial Performance

Greenfield microfinance projects generally include substantial grant funding for advisory assistance, largely because of investor constraints and because of donor and investor belief in the potential benefits of well-run and (eventually) large microfinance institutions offering a range of financial services to microenterprises, small businesses, and low-income populations in Sub-Saharan Africa. Although it is possible that these institutions may turn out to be good investments for the initial investors, it is unlikely that this will happen over any reasonable time horizon, which most investors consider to be five to eight years. Development-oriented investors may accept lower expected returns for higher expected impact, but they also have limits on how far this can be stretched.

Greenfields receive on average $3 million in external advisory-assistance grants for start-up, and they typically pay about $1 million more out of their own pocket, for a total advisory budget of $4 million. The Table 2 model illustrates what could happen if the full advisory cost were borne by the institution. It shows that typical greenfields would experience higher retained losses if paying fully for the advisory services.

The model also indicates more volatility in the return on average equity, fueled by higher initial losses and diminished equity. The time to reach the monthly breakeven point, however, remains the same, at month 42. But since the retained losses are higher and will take longer to recover, the expected return to investors is lower. Without advisory grants, the expected internal rate of return (IRR) at five years is approximately 1 percent; with advisory grants, it is about 14 percent. An IRR of 1 percent is too low for direct foreign investors (DFIs) to justify, even with an important development effect on the local market—even 14 percent is below what many DFIs and social investors consider acceptable in a region like Africa.

Lesson 3: Starting up a new institution in a nascent market will have a tremendous demonstration effect—an incredible opportunity to leapfrog older methods that have not succeeded and less formal programs that are not designed to be sustainable in the long run.

Many investors in greenfield microfinance institutions care almost as much about financial returns as about development impact. They want to see a steady progression toward financial sustainability through rising revenues, falling cost ratios, and improving margins and returns. Table 3 shows that the institutions in the cohort have sustained fairly rapid revenue growth over their first 60 months, increasing on average by $500,000 every six months and reaching $5 million by the five year anniversary. At the same time, they have pushed operating expense ratios lower.

However, despite the appearance of a stable progression toward sustainability, these institutions typically experience significant swings between profits and losses during this period.[1] Many register substantial losses over the first 24 months before achieving initial breakeven at about 24 to 36 months, but then fall back into losses for the next 6 to 12 months as they begin to assume the full cost of any additional management service contracts. Only after about 42 to 48 months do they emerge fully self-sustainable.

Greenfields also play an important role in market

1 This SmartLesson does not attempt to remove the advisory support from the figures presented, because the amount of the support is difficult to precisely quantify and attribute among different accounting periods.

Table 3: Growth of Greenfield Microfinance Institutions over Five Years

	Month 6	Month 12	Month 18	Month 24	Month 30	Month 36	Month 42	Month 48	Month 54	Month 60
Total Revenue ($ million)	0.41	0.62	0.98	1.59	1.98	2.46	2.75	4.03	4.27	5.02
# in sample	28	28	26	25	23	21	19	17	14	13
Portfolio Yield	30%	59%	55%	56%	56%	54%	54%	55%	54%	52%
# in sample	26	28	25	23	20	21	19	16	14	13
Op. Expenses / Avg Portf (%)	278%	200%	108%	82%	57%	53%	45%	38%	37%	36%
# in sample	26	28	26	24	21	21	19	16	14	13
Net Income ($ million)	(0.39)	(0.39)	(0.35)	(0.17)	0.01	(0.03)	0.17	0.42	0.55	0.40
# in sample	28	28	27	26	23	22	20	17	14	13
Net Income / Revenue (%)	-408%	-120%	-69%	-26%	-13%	-11%	-5%	10%	12%	8%
# in sample	28	28	26	25	23	21	19	17	14	13
Net Income / Avg Assets (%)	-6.7%	-12.4%	-8.8%	-4.1%	0.4%	-0.1%	1.8%	3.3%	3.8%	3.1%
	28	28	27	26	23	22	20	17	14	13
Net Income / Avg Equity (%)	-13.0%	-44.6%	-24.2%	-13.7%	-0.3%	-0.4%	-3.9%	20.0%	26.0%	18.9%
	28	28	27	26	23	22	20	17	14	13

development by demonstrating professionalism and good practices. They generally apply high standards of transparency with clients, are often active contributors to national credit reference bureaus, and sometimes advocate changes on behalf of the microfinance sector to enhance transparency, raise standards, and improve the quality of regulations. Many endorse and train their staff to practice the Client Protection Principles.[2] In the Democratic Republic of Congo, Advans and ProCredit led the way in transparency, and now two traditional commercial banks also publish their prices and terms on their websites. In Ghana, greenfield banks are seen as more open and transparent in their dealings with clients, making client-oriented material available on their websites. In Madagascar, AccèsBanque Madagascar is one of only two microfinance institutions that publish effective interest rates to their clients.

The greenfields' most significant effect is the professional development of staff, introducing human resources practices that positively affect the financial sector. Other than a few international staff, all 11,600 employees in greenfield microfinance institutions as of December 2012 are nationals. In Ghana, they employed more than 2,000 staff in 2011 (mainstream banking employed 16,000). The two greenfields in Madagascar have more than 1,000 staff—23 percent of staff in the microfinance sector and almost 19 percent of banking sector employees. Greenfield employees—typically young adults with little or no previous work experience—receive extensive training and skills development in several areas of credit and banking. Eventually, they become attractive candidates for mainstream banks, extending their skills to the larger market. These positive results to the financial sector reduce the potential market distortion from providing advisory grant funding to individual institutions.

2 The Smart Campaign website (www.smartcampaign.org) lists as endorsers Access, Accion, Advans, BRAC, FINCA, MicroCred, OI, and Swiss Microfinance Holding as well as some of their affiliates in Sub-Saharan Africa.

Greenfields typically have an intensive and systematic approach to staff selection, recruitment, and training. Staff development accounts for 3–5 percent of their operating budget—and a significant portion of the initial advisory resources. Most greenfields have company-specific training facilities with courses for induction and professional development, and they provide intensive on-the-job training—all leading to a reputation for high-quality staff development.

Lesson 4: Product and channel diversification is critical for scale.

Among microfinance institutions, greenfields tend to be at the forefront of innovation in low-income retail banking. Other financial institutions replicate their new products, credit policies, and service standards. In the Democratic Republic of Congo, ProCredit attracted large numbers of savers by introducing free savings accounts with no minimum deposit when most banks had minimum requirements of more than $1,000. Following this example, some other banks relaxed their account-opening requirements, and the number of deposit accounts in the Democratic Republic of Congo grew from 30,000 in 2005 to 1 million in 2012. Similarly, Malagasy microfinance institutions adapted their internal procedures, processes, and IT systems to keep up with the new greenfield competition, evidenced by the reduction in loan processing times from weeks to five days.

In Ghana and the Democratic Republic of Congo, greenfields were the first to introduce new technologies in banking for low-income populations. Ghana's EB-Accion, Opportunity, and ProCredit introduced ATMs (previously available only at commercial banks), and EB-Accion Ghana and Advans Ghana introduced mobile deposit collection. In the Democratic Republic of Congo, ProCredit established the first ATMs, and mainstream banks soon followed; clients now have access to point-of-sale devices at over 300 locations, facilitating the withdrawal of funds and cashless purchases.

Some greenfields have pioneered the development of financial services perceived as risky and challenging in their markets, such as microinsurance and agricultural finance. Opportunity International started an agricultural finance program in Ghana in 2010 with a pilot credit plan for cocoa farmers. It now serves 9,000 farmers and has introduced geographic information system technology to more accurately map the smallholder farmers.

CONCLUSION

Almost 15 years in the making, the greenfield microfinance model has strong foundations in Sub-Saharan Africa. Sponsors and investors of these greenfield banks did not invest and take on high levels of start-up venture risk to create a handful of boutique banks for the poor. Rather, the promise of this model lies in the ability to leverage strong foundations to serve the market and reach scale. Few commercial microfinance institutions in Africa have been able to do this through productive lending and savings products, as opposed to consumer finance. So how does this proof of concept give way to mass-market sales and shareholder returns? Three promising paths span strategies for organic growth as well as growth through partnerships and acquisitions.

Organic growth: Many greenfield banks are successfully tailoring products and services for the micro, small, and medium segments, using revenues from larger clients to subsidize smaller ones. At the same time they cultivate a pipeline of clients that will eventually grow and graduate.[3]

Partnerships often result from the emergence of alternative delivery channels and technology-based solutions that require broader collaboration between the banking and technology sectors. By expanding reach and leveraging partners' complementary core competencies, partnerships can help maximize greenfields' investment in alternative delivery channels. Regulated banks provide credit risk analysis and secure regulatory-compliant deposit management, while technology partners bring best-practice marketing, distribution, and agent network management.

Acquisition: Shareholding of greenfields has been stable, but return on equity for some is more than 25 percent, attracting greater interest from local investors, who are expected to replace foundation-stage DFIs. Sales of entire greenfield entities or networks are also possible as commercial banks seek to enter growing markets in Africa with an immediate geographic footprint, license, and skilled staff, thanks to the early success of the pioneers.

3 See SmartLesson in this publication titled: *From Micro to Small: How Do Microfinance Banks in Sub-Saharan Africa Upscale to Small Business Lending?*

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Approved by Momina Aijazuddin, Principal Investment Officer, Financial Institutions Group.

REFERENCES AND FURTHER READING

This SmartLesson draws from three previous publications:

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An AccessBank Tanzania loan officer goes over details with a client.

Lessons from South Asia

SmartLessons
real experiences, real development

Fulfilling the Housing Dreams of Microfinance Clients

Rahees Mohammed and his wife lived in a rented house in a slum and had one wish—to build a house that would be a permanent home for the whole family. Aadhar Housing Finance Private Ltd. helped Rahees realize his dream by offering a housing finance product that corresponded to his needs, preferences, and capacities. This SmartLesson, building on Aadhar's experience and that of our other housing finance clients in South Asia, provides a brief overview of the dos and don'ts for the implementation of housing finance products.

Aadhar offers housing finance loans to households earning $1,200 to $4,800 per year and with no proof of income, such as self-employed business owners like Rahees. It offers smaller loans for repairs or incremental construction as well as mortgage loans. Aadhar entered the housing finance market in 2010 with IFC's support. In addition to financial, IFC provided advisory services covering market-entry strategy and product design, sales and marketing approach, and a risk management framework. As of June 30, 2014, Aadhar's housing finance portfolio amounts to $102.5 million.

Why enter the housing microfinance business?

Housing microfinance (HMF) is a subset of microfinance and fits well into the microfinance mission. It is designed to meet the housing needs and preferences of low-income groups, especially those without access to the banking sector or formal mortgage loans. HMF is intended for low-income groups who wish to expand or improve their dwellings or to build a home in incremental steps, relying on sequential small loans. Loan sizes vary from $800 to $3,000, and the tenor ranges from 24 months to 60 months. Interest rates in India are from 22 percent to 24 percent. Microfinance institutions require collateral for loans exceeding $1,500.

Rahees Mohammed and his family enjoy their new home.

For many microfinance clients, the home is also the place of production for their micro or small business. Clients who can improve their housing conditions experience an increased quality of life and well-being and, as a result, become more productive, creative, and satisfied. Those clients who take out HMF loans are considered lower credit risks and more satisfied customers.

HMF also allows microfinance institutions to retain existing clients or attract new clients. According to anecdotal experience, about 10 percent to 20 percent of microfinance loans are used for housing. By offering HMF products, a microfinance institution improves its risk management framework (especially through diversification and better identification of risks).

Because of rising demand for housing finance in South Asia, entering this market offers an unrivaled opportunity for microfinance institutions. They are likely to benefit from enhanced profitability and sustainability of their overall operations. Key to achieving sustainable and profitable operations is having the right product and right strategy. This includes a good understanding of the difference between needs, preferences, and capacities, as well as clear market segmentation (see Figure 1).

*DO*s AND *DON'T*s FOR ENTERING THE HOUSING MICROFINANCE MARKET

The following *do*s and *don't*s for the implementation of housing finance products offer guidance for microfinance institutions that plan to develop a strategy to enter the housing finance market.

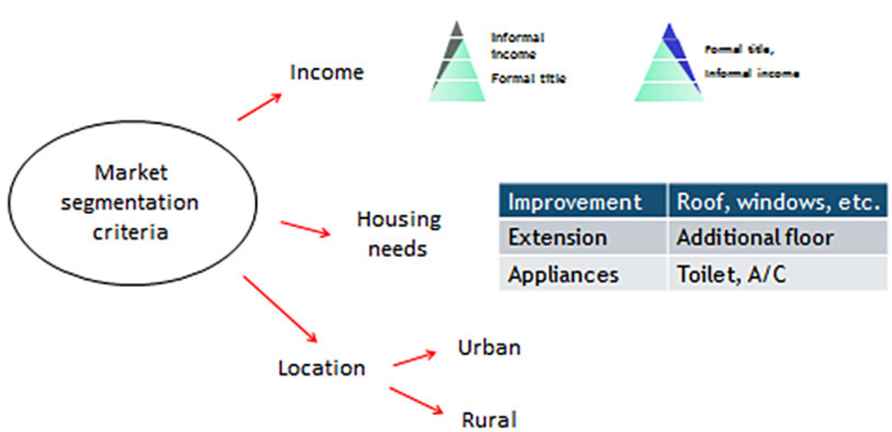
*Lesson 1: **Do** understand the demand patterns of your customers.*

Depending on the size of the housing project, the demand for financing differs. The three elements listed below influence customers' needs (improvement or extension), preferences (type of material used), and capacities (whether the work will be completed by the customer or by hired professionals):

1. *Income and title.* Microfinance clients may have a formal salary and an informal title or vice versa. To assess creditworthiness, microfinance institutions can rely on the same methods as for microfinance loans.

2. *Housing needs.* Clients may use the loan proceeds for home improvement, extension, or appliances (such as toilets).

Figure 1: Illustration of Market Segmentation



3. *Location*. Depending on where the microfinance institution operates, loan amounts may vary. They tend to be higher in urban areas than in rural areas.

Lesson 2: **Do** a detailed market assessment.

The goal of the market assessment is to identify the potential and effective demand: 1) to identify the potential target clientele, 2) to determine the potential demand and the size of the market (effective demand), and 3) to ascertain the affordability levels of the target segment. Other important aspects of the market research are a thorough assessment of the enabling environment (such as economic development, legal and institutional framework, housing sector) as well as a competitive analysis. The findings of the market research will provide the basis for the final design of the housing finance products.

Lesson 3: **Do** assess institutional readiness and capabilities.

The goal of this evaluation is to identify the necessary organizational adjustments needed within the institution and the costs of implementation. It should take into consideration the following elements:

• *Interest and willingness to expand into housing products.* To ensure sustained institutional interest, it is essential to get support from all key management, board of directors, and investors.

• *Financial and operational performance.* The institution should already have some experience with lending operations. In India, the asset base of a microfinance institution should be at least $20 million. Prior experience with individual lending products is not a requirement; it can be obtained through the launch of HMF products. In other regions, microfinance institutions have often used HMF products to offer loans to individuals. The management information system, however, should have the capacities necessary to process individual loans of longer tenor and larger ticket sizes.

• *Funding and other resources needed for pilot implementation and scale-up.* As HMF loans typically have longer tenors than microfinance loans, microfinance institutions should also have access to longer-term funding in local currency to keep asset-liability mismatches at a minimum. Also, sufficient staff resources should be available or be recruited to ensure smooth implementation. These people should have appropriate knowledge of banking and housing finance.

Lesson 4: **Do** build capacity and appropriate incentive systems for staff involved in housing.

Capacity building of existing and new staff members is critical to a successful rollout of HMF product offerings. Also, management should appoint a dedicated and fully empowered project manager ("product champion") to be in charge of the implementation process. In South Asia, microfinance institutions that have invested in appropriate capacity-building measures (particularly in individual credit assessment and basic construction and technical knowhow)—from the beginning of the implementation process—have demonstrated superior performance.

Some institutions expand the duties of staff members whose current job is handling the group lending portfolio, having them offer housing loans as well. In this case, management needs to align the incentives and targets of these twin goals appropriately.

Lesson 5: **Do** consider introducing housing support services (HSS).

HSS or construction technical assistance (CTA) services are products and services that enable households to improve their houses on their own. They can range from providing process support for registering land titles, or advice on construction and materials, to community development. There are three broad categories of these products and services:

1. *Pure technical information.* The lender provides brochures, videos, contact lists of masons, and so

on, to customers. These services can be provided by lender staff. Professional support is required to design the brochures or any other material.

2. *Professional services.* The lender provides support for the design and planning process, trainings, permit processing, and so on, possibly including visits by technical staff to the borrower's home. The lender may cover these services through a cooperation agreement with an architect or other service providers.

3. *CTA or engineering advisory.* The lender provides onsite support at the borrower's housing unit, ranging from basic (repairs) to structural work (such as masonry or plumbing). Structural work is the most intensive form of housing support services and typically requires the employment of an engineer.

In determining how to deliver housing support services, it is important to create an effective link between the provision of these services and the HMF offering. Market research should clarify whether customers would consider the availability of CTA an added benefit, which types of services they prefer, and how much they would be willing to pay for the services

Lesson 6: **Don't** underestimate the aberrations of an uncertain regulatory environment.

In countries such as India, where the regulatory framework for microfinance institutions is still unclear, implementation success could be negatively affected by ambiguous regulations and directives. Current regulations of India's central bank do not allow microfinance institutions to lend more than 30 percent of their loan book for non-income-generating loans, which includes housing finance. At present, an amendment to this rule, which envisages a relaxation of this limit, is pending approval by Parliament. It is therefore prudent to conduct a thorough review of all the laws and regulations dealing with HMF operations. This work should be covered within the market assessment.

Lesson 7: **Don't** fail to upgrade internal systems and processes.

Individual lending—and in particular housing finance—requires a clear diagnostic and an overhaul of all key internal systems and business processes. The move from joint-liability-based lending to detailed cash flow-based assessment necessitates revisiting and modifying (or establishing) the following internal business processes:

• *Technical appraisal.* Incorporate technical appraisal capabilities within the institution to improve credit appraisal, disbursements, and loan-use checks (preferably with the field-level loan officers).

• *Documentation requirements and pre-sanction process.* Understand the particulars of legal documentation for a specific geography and incorporate this learning into loan sanction and documentation requirements.

• *Loan-use checks and repayment processes.* Be sure loan-use checks (such as photographs to accompany staged disbursements for larger ticket sizes) are in place; also gear your systems for monthly repayments, as opposed to the weekly or fortnightly collections for a typical microenterprise loan.

• *Delinquency management process.* Upgrade the delinquency management process to account for longer-term housing finance loans as well as prepayment possibilities.

Lesson 8: **Don't** fail to set up robust responsible lending, customer protection, credit bureau reporting, and disclosure practices early on.

From the beginning of the implementation process, build a responsible housing finance framework, because it will result in enhanced customer awareness and consequently better risk management. To ensure robust credit appraisal and an appropriate product design, it is advisable to embed customer-centric practices across the entire business operations. Such practices include the following:

• Clear and full disclosure of housing loan terms (such as interest rate and tenor);

• Efficient grievance handling mechanism for individual lending;

• Credit bureau reporting, beyond basic compliance requirements, to aid credit assessments of clients;

• Staff trainings that incorporate ethical behavior for staff and sales agents;

• Customer-friendly collection practices, which could involve exploring electronic transfers;

• Raising awareness on documentation requirements, technical assistance, and so on.

*Lesson 9: **Do** consider scaling up the HMF offering after the pilot and some operational experience.*

Before a nationwide or statewide rollout, the HMF product offering should be tested through a pilot, and the results should be reviewed and adjustments made. According to experience in South Asia, the following areas may require modifications:

• Loan size sought by customers;

• Down payment requirements from customers to ensure their willingness to repay the loan;

• Disbursement in tranches or in one lot.

Once the pilot is completed and after a year of operations, management may consider scaling up HMF operations. Within the Indian context, there are the following models:

• Continue with HMF lending within the existing setup through organic growth;

• Act as a sourcing and collection agent for larger banks or housing finance companies (HFCs) that plan to go down-market.

• Establish a stand-alone HFC, bank, or nonbank financial institution, as specific country regulations allow.

CONCLUSION

Microfinance institutions, such as Aadhar, that have pursued a rigorous, albeit flexible, approach to the rollout of their HMF product offering have been quite successful and are today's market leaders. Thorough market research and internal capability assessment are critical success factors, and an HMF product champion ensures a smooth implementation process—so long as he or she enjoys the full support of management.

Another crucial element is a critical review of the pilot to allow for further changes, to hone the product offering and the sales and marketing approach. However, to retain a competitive edge in the microfinance institution's housing finance market, management should constantly review the performance of the HMF loan portfolio and be ready to make further adjustments.

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A client of Ujjivan Microfinance Pvt. Ltd., in New Delhi.

SmartLessons
real experiences, real development

The India Microfinance Story: Putting the Focus on Borrowers

IFC has worked on client protection issues since its first microfinance investment in the early 2000s. These activities took on a more defined shape when seeds of the Responsible Finance program were sown with the Microfinance Credit Reporting Initiative in 2009, which aimed at reducing the significant information asymmetry between microfinance borrowers and lenders by supporting increased links between microfinance institutions and credit bureaus.

This SmartLesson shares the lessons learned during the implementation of components of the Responsible Finance program of IFC's Advisory Services—and how that program is having a clear and defined impact on India's microfinance industry.

In Andhra Pradesh, high growth in the microfinance industry led to an overemphasis on the supply side, ignoring the impact on clients, and brought the sector under scrutiny with the onset of a microfinance crisis in August 2010. The state government's restrictions on new lending and recovery led to huge nonperforming loans in microfinance portfolios, and consequently bank lending to microfinance institutions plummeted across India, falling to almost zero for those with exposure in Andhra Pradesh. Microfinance operations reached a standstill, and only $835 million is estimated to have been lent to the sector in fiscal year 2012, compared to $2.38 billion during fiscal year 2011.

Given the changed circumstances, with microfinance portfolios having deteriorated across Andhra Pradesh, IFC expanded the scope of its Responsible Finance program by promoting initiatives that incorporate greater customer-centricity into operations and raising decision makers' and stakeholders' awareness of the need to effectively address the reputational issues facing the sector. The program focused on multidimensional yet interlinked interventions, pitched at different stakeholder levels, that would address the multiple challenges the industry faced. The following key project components of the program (Box 1) span sector, institutional, and client levels:

- ***The Microfinance Credit Reporting project*** promotes use of credit bureaus for decision making and links credit bureaus to microfinance institutions, the key to reducing multiple borrowing and over-indebtedness. The project design incorporates increasing awareness of end borrowers as well as a study of the impact of credit bureaus on microfinance institution borrowers' behavior and dissemination of results. The project has a database of more than 100 million client records and has received 45 million incremental inquiries to credit bureaus.

- ***The Responsible Finance Sectoral project*** works with the stakeholders at the sectoral level and aims at building the capacity of industry associations, facilitating adoption of a common code of conduct, supporting policy advocacy measures, carrying out benchmarking studies, and creating forums for stakeholders to arrive at consensus on key issues facing the sector and potential solutions. The project, with its work with the industry associations, covers more than 90 percent of the microfinance sector.

IFC also worked with SMART Campaign[1] India—at the institutional level—for the adoption of global client protection principles (CPPs) by Indian microfinance institutions. The project supports training on CPPs for microfinance institution staff and onsite assessment of the institutions, as well as guidance on appropriate product design and delivery, enhancing transparency, responsible pricing, fair and respectful treatment of clients, privacy of client data, and mechanisms for complaint resolution.

• ***The Financial Awareness program*** works on the demand side and aims to roll out an effective and sustainable financial awareness program for low-income households so that clients make informed choices about financial services—and microfinance institutions and financial institutions experience better business outcomes.

•***The Risk Management project*** contributes to strengthening risk management systems and practices in the microfinance sector in India. It aims to promote global risk management practices in Indian microfinance institutions and integrate them with responsible finance practices. On completion, it is expected to cover 28 microfinance institutions.

Box 1: Some Responsible Finance Program Milestones

• Under the Responsible Finance Sectoral initiative, IFC worked with the World Bank to bring together a core group of stakeholders to form the "Responsible Finance Forum" in 2011. One outcome was the adoption of a common approach to responsible finance through a harmonized India Microfinance Code of Conduct.

• The SMART project contributed to the development of global standards for client protection in India and completed 20 client protection assessments covering about 20 million Indian microfinance clients. IFC also helped five partners receive global Client Protection Certification, carried out eight trainings on CPPs for microfinance institutions, and conducted 10 assessor training workshops to create a pool of regional resources.

• The Risk Management project team conducted risk-management diagnostics of eight microfinance institutions and formulated a customized risk management strategy for each one. Phase 2 should reach 20 smaller microfinance institutions in low-income states. The team also conducted a series of five workshops/trainings with 210 participants from microfinance institutions, covering more than 70 percent of the Indian microfinance sector.

• IFC-supported credit bureaus, High Mark and Equifax, have a combined database of more than 100 million micro-client records, the world's largest repository of such data.

LESSONS LEARNED

Lesson 1: The microfinance crisis demanded a rapid and multi-pronged response.

Post-crisis, the need to reinforce responsible lending practices in microfinance institutions increased multifold, and it was critical for the sector to come together and propose concrete next steps to ensure adherence to responsible finance. IFC immediately took a leadership role by initiating a comprehensive effort through the Responsible Finance program. With its different project components focusing on stakeholders at sectoral, institutional, and client levels, the program quickly began to address the sector's multiple challenges.

IFC's neutral role was critical in bringing the sectoral stakeholders together to address differences and harmonize their efforts, such as in the negotiation of the Unified Code of Conduct for the sector. The individual project components, with their focused

1 Committed to embedding client protection practices into the institutional culture and operations of the microfinance industry, the SMART Campaign encompasses the following client protection principles: appropriate product design and delivery, prevention of over-indebtedness, transparency, responsible pricing, fair and respectful treatment of clients, mechanism for complaint resolution, and privacy of client data. SMART Campaign India is housed under Accion International.

deliverables, helped address such sectorwide concerns as multiple lending and client over-indebtedness. IFC's credibility in the sector, ability to mobilize strong links with stakeholders, and expertise in project delivery helped microfinance institutions develop the necessary partnerships with clients and adhere to client protection principles and codes of conduct.

Lesson 2: In project design, propose holistic solutions.

For a project to have a sustainable impact on the sector and to be appreciated by the clients, it needs to shift from a piecemeal approach to providing solutions. IFC's recognition of the need for an integrated approach to address challenges in the Indian microfinance sector guided all its interventions.

Identifying a lack of consensus in the sector on the direction to be taken post-crisis, IFC reached out first to the important stakeholders. The result was the Responsible Finance Forum, formed in 2011, and the Unified Code of Conduct for the Indian microfinance sector. To ensure integration of Code of Conduct principles into microfinance institutions' systems and processes, IFC then worked strategically with SIDBI to carry out Code of Conduct assessments, which analyzed existing systems and processes of a microfinance institution, rated its compliance with the Code of Conduct, and identified gaps in adherence to Code principles. Then the team worked with each institution to integrate CPPs into its operations. This holistic approach of working at the sectoral, institutional, and end-client levels has increased the success rate and pace of institutionalizing responsible finance practices in the Indian microfinance institutions.

One of our clients, Cashpor Microcredit (based in Uttar Pradesh) underwent CPP assessment and worked with IFC on institutionalizing client protection principles. Cashpor Microcredit is among the first microfinance institutions in the country to be certified by the SMART Campaign.

Lesson 3: Engage with key stakeholders for maximum sectoral outreach.

A multistakeholder approach is critical for a large sectoral project where it is important to holistically address the underlying gaps. The project's credibility and acceptability is heavily influenced by how successfully the team can mobilize strong links with stakeholders—to clearly gauge the stakeholders' expectations and willingness to participate in the project and take collective responsibility.

As the primary strategy, IFC successfully engaged with sectoral stakeholders such as development institutions, lenders, investors, credit bureaus, and network associations, thus ensuring that everyone was on the same platform—and lending more credibility to IFC's efforts. This stakeholder engagement resulted in a high level of participation by microfinance institutions, technical vendors, and consultants in credit bureau workshops and risk management workshops and trainings across the country. This approach generated buzz about the IFC project and made it easier to get buy-in for the project's implementation. Similarly, reaching out to key stakeholders can lead to further expansion of the project to a large number of microfinance institutions, as with SIDBI, which has seen value in the risk management initiative and will support the rollout of the risk management framework for another 15 microfinance institutions.

Lesson 4: Master the balancing act: customize content and standardize quality.

Differences in regulatory framework, operating models, and political environments make it important to customize a project to suit the local context. The key is to identify the optimal level of customization without undermining the quality of the project. This balancing act requires close collaboration with clients, consultants, and other stakeholders to determine the optimal level.

An example of the effectiveness of this approach was

Indian women go over their paperwork with a loan officer.

the customization of IFC's Global Risk Management Assessment toolkit to suit the Indian microfinance context. Recognizing that direct application of global tools and frameworks might not be effective, the project team put in extra effort through stakeholder workshops and onsite experience to customize the toolkit to include, for example, 1) measures to identify hidden group delinquency, because group lending is the common model; and 2) social performance management, considering its importance in the risk management context in India.

During implementation of the Risk Management project, the team identified the need to customize according to the scale of operations or size of clients. For instance, small institutions usually have nascent risk management systems and find it easier to integrate the project's risk management standard framework into organizational strategy and processes without huge modifications or cost implications. On the other hand, for larger microfinance institutions with better-developed systems already in place, we need to demonstrate value addition through more nuanced and system-specific recommendations.

Lesson 5: Ensure client buy-in early on.

Any new process or system involving a considerable shift from the norm requires the institutions dealing with it to be willing to change and to be supportive of the efforts to do so. So it is important for the project team to be actively involved with the client right from the design phase—and at all levels. This implies a substantial investment in time by senior management and staff across the organization.

Hence we emphasize a consultative approach, which helps in outlining priorities and concerns, thereby preventing unrealistic expectations on either side.

With one of our clients, Ujjivan Financial Services, we engaged right from the inception for the integration of client protection principles in its operations. This helped Ujjivan set up its service quality department in line with its decentralized operational structure by empowering the branch-level staff to handle client complaints and grievances. Engagement with the client from an early stage significantly improved IFC's understanding of operations and enabled us to consistently support and strengthen the organizations' efforts.

The project team also ensures the involvement of a microfinance institution's senior management right from the project design stage. For instance, under the Risk Management project, the team makes detailed presentations to the senior management on the proposed risk management framework prior to the diagnostic to understand expectations and concerns. We also send the final list of recommendations from IFC as a letter to the board for its approval. Implementation does not begin until the board approves.

CONCLUSION

Through its Responsible Finance program, IFC with its partners has helped microfinance institutions institutionalize client protection principles and codes of conduct. Across South Asia, the Access to Finance team is managing 16 microfinance institution projects with a built-in Responsible Finance component. The Indian microfinance institutions are nearly 60 percent of the banking sector's outreach to small lenders; therefore, the impact of these IFC initiatives may be felt by as many as 26 million clients.

Commitment to responsible finance requires participation from all stakeholders, and this program serves to bring them together on the same platform. It requires innovative and proactive approaches at the sectoral, institutional, and client levels. These collaborative efforts aim to build sustainable partnerships in Indian microfinance—partnerships that clearly demonstrate the social impact of the work being done and that do a better job of communicating the microfinance success story. The systematic approach this program follows has had a profound impact on the sector.

We hope these successes—and how the program addressed the challenges—can provide insights that will help those developing similar approaches in other regions. IFC's Responsible Finance advisory program can continue to be a key factor in building capacity and revamping the sector in fledgling and mature microfinance markets throughout the world. IFC is geared to play a critical role by replicating lessons learned from successful interventions globally.

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DESIGN & PRODUCTION

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PRINTING

World Bank Group Printing and Multimedia Services

Lessons Learned from 20 Years of Microfinance Projects in IFC

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SmartLessons is a World Bank Group program which enables development practitioners to share lessons learned in development operations. This collection presents first-hand and straightforward project stories with pragmatic useful analysis, written by professionals for professionals. Through the prism of their own experience—positive and negative—these authors aim to capture practical insights and lessons that could help advance development-related operations for private sector-led growth across the globe.

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