FINANCIAL VIABILITY AND SUSTAINABILITY OF MICROFINANCE: THE FINANCIAL SYSTEMS APPROACH

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A striking feature of financial markets in the last two decades has been the rapid expansion of microfinance services. The Asian Development Bank has defined microfinance as "the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their micro enterprises."(ADB 2000)

Microfinance - credit and savings - enable people to begin or expand micro enterprises or other income generating opportunities and provides poor people an opportunity to accumulate their small savings safely. It is a means of providing finance in small quantities, at reasonable cost and on conditions that are both convenient and suitable for the enterprises they undertake. The objective of microfinance institutions (MFI) is to combine the functional features and strengths of informal lending with the strengths and sustainability of institutional finance. Microfinance is a means of strengthening incomes of the poor, enhancing their self-reliance, improving employment opportunities, reducing gender inequality and eliminating the feeling of social exclusion. Micro financial services have succeeded in empowering poor communities around the world though its impact on the poorest of the poor appears limited still.

A large proportion of population in developing countries ekes out an existence by undertaking very small informal enterprises. This is so in both urban and rural communities. These micro enterprises could be small manufactures, trading activities or service enterprises. These enterprises are very small, often risky and undertaken by persons whose main asset is their labour. Consequently, financial institutions like banks are reluctant to lend to them. They have been considered "unbankable" by banks. The survival of this vast number of enterprises depends on finance from outside the formal banking system. Most such finance is for their working capital. A wide range of informal lenders - from professional money lenders, itinerant traders, boutique keepers to the more prosperous neighbours, relatives, friends and landlords*, inter alia* provided finance to them. Microfinance provides a means of meeting this need more effectively and at lesser cost to the poor.

There have been broadly two approaches to microfinance. One views microfinance as basically a charitable exercise to assist the poor by providing financial services, mainly credit at low or no interest cost. One can appreciate the 'goodness' characterising this approach. The second approach is that of providing financial services at costs that would ensure that the costs of operations of the microfinance operations would be covered. A vital ingredient of this approach is the setting of interest rates such that the income of the enterprise would be covered. This approach has come to be termed the financial systems approach.

If microfinance institutions are to play a significant role in poverty reduction then they must reach large numbers of clients. Expansion in outreach is vital in order to provide large numbers of very poor people financial services. For MFIs to reach large numbers they must expand their services. The most successful examples of large-scale outreach have been accomplished through specialized financial institutions that have operated on the basis of commercialization of microfinance.

For financial viability an organization must cover its operational costs as well as the cost of its funds, including the cost of borrowing from banks and payment for of interest to depositors. Once a microfinance organization is financially self-sufficient, it can also fund its activities with capital from financial institutions such as commercial banks, making it independent of donor or government subsidies. Being financially self-sufficient is the only way for financial institutions to grow.

The financial systems approach is imperative in as far as most microfinance organisations are concerned as the outreach of the charitable approach is not likely to be adequately widespread to reach an adequate number of the poor and therefore to make a dent on the alleviation of poverty of the multitude. It is now widely recognised that this approach is the only means by which microfinance could be broad based and effective. This paper discusses the principles and practice of the financial systems approach.

Financial viability is a key issue in microfinance. The conventional wisdom was that lending for micro enterprises and the poor was not profitable. The higher administration costs of such lending, the presumption of high rates of default and the policy of low interest rates for such borrowing, it was contended, would not enable MFIs to run on commercial profit making lines or break even. The implication of this is that a continuous flow of donor funds would be required to sustain micro enterprise credit. A further implication is that the prospect of expanding the coverage and credit for micro enterprises would be severely limited, as it was dependent on a continued availability of charitable funds.

This paper discusses why the financial systems approach to microfinance is needed in order to develop a viable and sustainable system whose outreach and depth would ensure that microfinance plays a vital role in employment generation and poverty reduction, two of its avowed objectives.

Financial Systems Approach

What do we mean by financial viability and sustainability? Financial viability means that year-on-year out a microfinance institution (MFI) should generate an adequate income to cover its financial and all other costs, including provision for bad debts. A MFI whose income is continuously inadequate to cover the costs of operations, costs of finance, and the provision for bad debts, would be eroding its capital base, unless there is a continuous flow of funds from outside to offset the erosion in capital. This means that MFIs incomes must be equal to or greater than its total costs.

Since a MFI's income is primarily interest income, the interest income derived from its lending must be adequate to meet all its costs. We can express these ideas more precisely in the following equations:

For financial viability:

$Y > C$

$C = f + a + t + L$

Where Y = Income, C = Total cost, a = Administration costs, f = Financial costs, t= transactions costs and L = Loan loss provisioning.

What are the factors that determine financial viability? The above formulation answers that question. Each of the constituents requires to be discussed to understand their significance.

On the income side, interest income is the main source. There may be other sources such as investment incomes, rents or returns from other services. Yet these are generally of lesser significance than interest income for MFIs. Therefore the most important factor is the rates of interest for on lending. If the rate of interest does not reflect the cost of funds, administration and transaction costs of lending and the loan loss provisioning, then the costs of the MFI is likely to be higher than its income. In most cases financial viability can be achieved only when interest rates reflect costs. This issue is therefore discussed in detail in the next section.

However, interest rates are not the only determinants of viability. The factors on the expenditure side are also of consequence. In fact the costs determine the realistic rate of interest that should be charged. Operational efficiency and low administration costs have an important bearing. These factors affect the non-financial costs of MFIs and can be a sizeable part of a MFI's expenditure. It is vital that MFIs do not incur heavy overhead costs like high rentals or costs of building or pay high salaries to their staff. The financial viability of MFIs can be compromised by high overhead expenditures, which have little relationship to the scale of operations of the MFI or its interest income. The Association for Social Advancement (ASA) a leading microfinance organisation in Bangladesh is an excellent example of low cost microfinance administration (Fernando and Meyer 2002). Every effort is made to be thrifty and prudent in reducing administrative expenditure by conservation of electricity, recycling of paper and the very simplistic style of operations.

As indicated in the equation above, there are three kinds of costs that the MFI has to cover in providing financial services. The first two, the cost of the money (f) that it lends and the cost of loan defaults or loan loss provisioning (L), are more or less proportional to the amount lent and there are no economies of scale. They do not vary with size of loan. The financial costs of the funds borrowed are the same percentage of the loan whether the amount is Rs.500 or Rs.5000. It would be a percentage of the loan amount.

In contrast, the third category of cost, transaction costs, varies with the size of loan. It is not proportional to the amount lent. The transaction cost of a loan is not directly proportional to the loan amount. Very often the transaction costs of a small loan is not very much different from the transaction costs of a larger loan as they both require about the same amount of time for meeting with the borrower to process the loan and ensure repayment. In fact at times it may even cost more if the follow-up and supervision of loan use monitoring is regular. The transactions cost of small loans is larger in terms of the loan amount and therefore the interest rate would require to reflect the higher transaction costs. That is why the interest rates of viable MFIs are not necessarily low.

Successful microfinance operations have been characterized by committed and dedicated staff. This is especially so with the pioneer, Grameen Bank. It is vital that workers in MFIs have a dedication and commitment to the objectives of microfinance. Their salaries may be lower but their rewards must include a satisfaction derived by doing socially useful work. Operational efficiency implies that staff is deployed effectively and the functions expected of them are performed efficiently. If the operational efficiency is low it would result in poor quality lending, larger defaults and ultimately higher costs and lower incomes for the MFI.

Operational efficiency is of paramount significance as it has a direct bearing on the quality of lending and the rate of default. In turn the rate of default is the single most important factor in costs, as an increase in the default rate would require a more than commensurate increase in interest rate to ensure an adequate income. The interest rate has to be enhanced considerably to offset the amount of default, other costs remaining the same. (Hulme and Mosley 1996, CGAP 1996). Financial viability is therefore significantly determined by administrative efficiency influencing the rate of defaults. Administration expenditure should be not merely contained but be cost-effective. A curtailment of expenditure by paying low salaries and recruiting poor quality staff or unsatisfactory working conditions may reduce costs but increase inefficiency. Cost effectiveness rather than reduction of costs is the important principle.

Financial viability could be adversely affected by other objectives, such as greater outreach, as well. Though the usual caution is that an increased outreach to the poorest would increase financial risks, there are even greater threats to financial viability when MFIs extend to new areas, where their local knowledge of the borrowers are much less and the staff are either less skilled or less motivated to administer microfinances. Poorer infrastructure and marketability of goods and services could also have an important bearing on the rate of defaults (Sanderatne 2002).

It may be difficult for a MFI to reach financial viability quickly. It has therefore been suggested that a MFI could achieve financial viability in three stages or levels. At the first stage, the fixed costs of the MFI and the costs of administering credit would have to be met by a 'subsidy' or grant. At the second stage, the MFI would cover its administration costs but not the full financial costs and loss provisioning. It is only in the third stage that it would achieve full self sufficiency. This implies that MFI's be subsidized to an extent till the scale of operations, skills, information base and its monitoring systems are put in place and are effective. The start-off period would be subsidized, but in the long run the MFI would be able to generate at least a small surplus.

Interest Rates

The all important and most controversial issue is that of interest rates. The relationship between interest rates and financial viability was discussed in the previous section. Interest rates are discussed here mainly from the point of view of the principles which should guide the on lending interest rates of MFIs.

The "poverty alleviation" approach to lending for small farmers and rural needs was based on the premise that these borrowers were too poor to obtain credit at market rates. Therefore, the provision of cheap credit, which meant subsidized finance, was the objective of most lending schemes. While it was mostly government's which could provide finances for such subsidized lending, some well meaning NGOs too began limited credit operations in villages and among poor communities at low interest rates.

There were many deficiencies in such lending. Repayment rates were low, unintended beneficiaries were large, the funds were often not used for the purposes for which they were given. The total outreach of such credit was not significant. Analysts, especially of the Ohio School of thought, contended that the subsidized interest rates were largely responsible for these deficiencies. (Adams, Graham and Von Pischke 1984).

When interest rates are subsidized, microfinance organizations remain dependent for outside funds. A policy of lending at less than the total cost of funds means that these MFIs would never become sustainable financial intermediaries. Although this aspect is connected with the issue of viability discussed in the previous section, the issue highlighted here is that even if the MFI continues in operation by a continuous flow of outside funds, it will not be financially sustainable institution, unless the interest rate covers costs in the medium or long run.

There is evidence to suggest that when a credit scheme or a credit organization disburses cheap credit, the borrowers perceive the credit to be a grant or gift rather than a repayable loan (Sanderatne 2002 chapters 9 and 10). This attitudinal approach undermines the credit culture of the organization leading to higher loan delinquency. This in turn affects the financial viability and sustainability of the lending organization. (Sanderatne 1978).

Those arguing for cheap and subsidized credit for micro enterprises base their case on two pivotal issues. First, that small enterprises cannot afford market interest rates and second, that the poorest of the poor and the really small micro enterprises would not be reached when the cost of finance is high.

In fact, small enterprises, as well as the poorest, borrow at high interest rates from informal lenders and do repay their loans. Therefore, the ground situation is that micro enterprises can and do borrow at much higher rates than those offered by commercial banks to their clientele. It has also been demonstrated that the interest cost is a small proportion of total costs of borrowing from formal sources, as micro enterprises have to incur additional transaction costs to borrow funds from institutions. These additional costs increase the total costs of borrowing from institutional sources. Therefore the actual costs of borrowing is much higher than the nominal interest rate. Further, the total costs of borrowing by micro enterprises is often a small proportion of their total costs of production. (Adams, Graham and Von Pischke 1984).

What micro enterprises require are easy access, repayability on conditions suited to their enterprise, flexibility on repayment conditions when necessary and finance for a multiplicity of purposes, including consumption needs. The issue of interest rates pales into insignificance in comparison to the provision of these facilities. MFIs have tended not to reach the poorest of the poor as the interest rates charged are inadequate to cover the administration costs and risks of lending to the poorest. (Hulme and Mosley 1996).

There is evidence that when credit is given at low rates, the better off members of the community and even the officers of the MFI and their kith and kin would siphon off credit for other investments. Cheap credit provides an incentive for borrowing by unintended beneficiaries and the objectives of microcredit are undermined (Adams *et al*., 1984). However others have pointed out that MFIs could design their programmes to ensure that credit is not utilised by unintended beneficiaries. (Johnson and Rogaly 1997, Gulli 1998, Hulme and Mosley 1996).

Low interest rates have an added disadvantage for the mobilisation of savings. Since the savings deposit rate has to be lower than the on-lending rate, a MFI which gives credit at a low rate would be offering a low savings deposit rate too. This would reduce its capacity for the mobilisation of savings from its community, especially if the deposit rate is below the inflation rate; in which case the saver gets a negative real interest rate. Yet a MFI may be able to mobilize savings even at a negative rate as many savers may be interest insensitive and more concerned about the safety of their deposits rather than the yield. (Rutherford, 1999). Nevertheless a higher savings deposit rate should strengthen the savings mobilisation potential of MFIs. And this is possible only if on-lending rates too are high. There are three considerations which should temper this discussion.

First, the arguments against subsidized lending rates should not be interpreted to mean that MFI's are justified in charging very high interest rates. The reasons for higher interest margins above the financial costs are the higher administration and transaction costs owing to small loans being more costly to administer, higher costs of accessibility of borrowers and closer monitoring of loans. The higher risk and possibility of high defaults could also add to costs. Yet all these costs could be reduced over time by improved practices, higher accountability of borrowers, improved information and reduced moral hazards and improved operational efficiency. Therefore, especially in the long run, MFIs should attempt to cut their margins and reduce their rates of interest. On-lending interest rates could also be reduced if MFIs are able to source funds more cheaply. With a greater reliance on savings mobilized by the MFI itself, lending rates could be reduced; both due to reduced costs of mobilisation of funds and risk reduced asset based lending. The objective of MFIs should be to lend as cheaply as its financial viability permits by reducing its costs of operations.

Second, the case against subsidized interest rates should not be interpreted to mean that if MFIs do not lend at subsidized rates, the financial viability and sustainability of the MFI is assured and its objectives achieved. This is similar to the macro-economic argument that is often made that if you get prices right, other things would fall into place. Just as much as there is no automatic resolution of all economic problems by getting prices right, MFI objectives will not be necessarily achieved by merely getting the interest rate correct. The other issues discussed in this paper are as significant for the success and sustainability of MFIs, as interest rates.

The third aspect in the author's view is that there is a case for subsidized interest rates as a temporary phase. This is where the initial costs of administration are so high that if these have to be incorporated in the on- lending rate, it would be too high. In such situations the MFI may have to suffer a loss for a time and even erode its capital base, but view this as a temporary phenomenon. Ultimately the administration costs would have to be brought down and the interest rate charged could be such that there is a profit which could offset the initial losses. Such a strategy is not the adoption of a policy of subsidized credit, but a policy of coping with the costs of setting up a new organization and overcoming the financial difficulties of the gestation period. Initial losses are a normal feature of business enterprises which ultimately turn out to be very profitable. Similarly, an initial phase of losses or subsidisation of MFIs should be expected. It is in the long run that interest rates would require to be covered all costs. Some researchers, who have advocated unsubsidised interest rates, admit to the need for a subsidy of other costs for an initial period of operation.

It is necessary to clarify that financial viability does not mean that a MFI depends on its own funds. A MFI could be financially viable although it borrows funds, provided it obtains a profit from on-lending their funds. This is the essence of financial intermediation.

Conversely the fact that a MFI does not obtain funds from outside does not necessarily mean that it is financially viable as it could be incurring continuous deficits and eroding its capital. Such a financially non-viable MFI is not sustainable, unless a fresh contribution of capital is made.

Financial viability is also significant to a financial intermediary as its capacity for sourcing funds from outside is enhanced. Its capacity for financial leverage increases as its profitability increases. A financially viable MFI could leverage funds which would be a multiple of the increase in its own funds. This would in turn increase its capacity to expand the scale of its operations. A US AID study argues that:

Once an institution demonstrates that it is secure and profitable, whatever its type, it can gain wider access to commercial funding sources. Such institutions can fund their loan portfolio fully in commercial financial markets, either by capturing individual savings deposits or by attracting investors through the assurance of debt securities. (Christen, Rhyne, Vogel and McKean 1995, 17)

Conclusion

The case for realistic interest rates is not readily recognized. In fact many still argue that the poor are too poor to pay market interest rates and should be provided with credit at low interest rates as they would be unable to repay loans obtained at high interest rates. This argument goes against the experience of MFIs. Besides, the poor do in fact borrow at very high interest rates from professional money lenders and repay loans. This is due to their needs, on the one hand, and the fact that small sums of money used in small enterprises give high returns.

The argument for realistic interest rates outlined above should not be interpreted to mean high interest rates of the professional money lenders. Money lenders often charge interest rates of between 10 and 20 percent per month that are, when annualized, between 120 to 240 percent per year. In contrast, the Grameen Bank charges 2 percent per week that is 104 percent per year.

The preceding argument was that for MFIs to maintain and increase its services over time, they should charge interest rates that are adequate enough to cover the cost of their lending. If they do not charge interest rates that cover their costs they would lose money and their activities will contract rather than expand, unless there are fresh infusions of money from foreign or domestic donors or governments. The problem is that donor and government money is not enough to expand microfinance to meet the large and expansive demand for such services. On the other hand, commercial borrowing can meet the expanding demand for credit. However MFIs can resort to commercial borrowing only when they are profitable and sustainable. It is only when they are profitable that they are deemed creditworthy to attract large volume of funds from commercial sources.

The preceding argument has been appropriately summarised in these words by CGAP as follows:

Lending programs that continually subsidize their borrowers will de-capitalize themselves unless they continue to receive new subsidies from donors or governments. By contrast, MFIs who charge their clients enough to cover all the loan costs can attract funding from commercial sources and are capable of exponential growth without relying on scarce and uncertain subsidies as funding sources. MFIs have to charge rates that are higher than normal banking rates to keep the service available, but even these rates are far below what poor people routinely pay to village money-lenders and other informal sources, whose percentage interest rates routinely rise into the hundreds and even the thousands. (CGAP, "Why MFI's Charge High Interest Rates", in Building Financial Systems for the Poor).

There has been a significant expansion of microfinance in Sri Lanka in the last three decades. Yet the outreach and penetration is still inadequate to meet a substantial amount of the financial needs of the poor and the self-employable. One of the foremost reasons for this is that there is inadequate appreciation of the need to adopt a financial systems approach and expand microfinance services through its commercialisation.

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