

The Microcredit Summit's Challenge:

Working Toward Institutional Financial Self-Sufficiency While Maintaining a Commitment to Serving the Poorest Families

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ABSTRACT: Institutional financial self-sufficiency (IFS) is necessary for a microfinance institution (MFI) to obtain the large amount of funds required to reach and benefit truly large numbers of the poor and poorest households. There is no necessary trade-off between serving large numbers of the poorest households and the attainment of IFS by an MFI, as proven by the case studies in this paper.

Cost-effective identification of the poor and the poorest women is essential to maximizing the effectiveness and efficiency of providing microfinance services to them. If the service is not exclusively for the poor and the poorest, it should be operated separately for them to minimize leakage to the nonpoor.

The total cost of efficient microcredit to the poor, i.e., the appropriate interest rate, will vary between 35% and 51% of their average loans outstanding, depending on the conditions under which it is provided, and on the quality of the loan portfolio.

The poorest women in Asia, Africa, and Latin America are proving that they can and will pay the required cost of this opportunity to reduce their poverty and to provide a better future for their children. This is made possible by the impressive returns to their microenterprises, averaging normally more than 100%.

Introduction

Working toward institutional financial self-sufficiency (IFS) is essential for microfinance institutions (MFIs) to reach and benefit significant numbers of the poorest households—those living in the bottom 50% of the poverty group⁴—with financial services for poverty reduction. IFS reflects an MFI’s “ability to operate at a level of profitability that allows sustained service delivery with minimum or no dependence on donor inputs” (Christen, Rhyne, Vogel, & McKean, 1995, p. vi), international agencies, or charitable organizations. We believe that only by pursuing commercially motivated, for-profit strategies will MFIs, particularly those working with the poorest, achieve our primary goal of reducing poverty among truly large numbers of the poor and poorest. The argument for IFS is well known:

As MF[I]s begin to wean themselves away from their dependence on subsidies and start to adopt the practices of good banking they will be forced to further innovate and lower costs. Not only may this ultimately mean better service for poor borrowers, but more importantly, it is argued that as MF[I]s become profitable they will be able to increasing[ly] tap into the vast ocean of private capital funding. If this happens the microfinance sector as a whole will soon be greatly leveraging the limited pool of donor funds and massively increasing the scale of outreach in ways that it is hoped could begin to make a truly significant dent on world poverty.⁵ (Conning, 1998, p. 2)

IFS is defined as the ability of an MFI to cover all actual operating expenses, as well as adjustments for inflation and subsidies, with adjusted income generated through its financial services operations. Inflation adjustments are twofold: (1) to account for the negative impact, or cost of inflation, on the value of your equity and (2) to account for the positive impact of the revaluation of nonfinancial

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assets and liabilities for the effects of inflation. Similarly, there are two types of subsidies which must be adjusted for (1) explicit subsidies to properly account for direct donations received by an MFI to cover operating expenses, and (2) implicit subsidies to account for loans received by an MFI at below market rates, and in-kind donations such as rent-free facilities, staff paid by third-parties, technical assistance, and the use of a third party infrastructure (e.g., communication facilities, etc.).⁶ In analyzing an MFI's performance, such adjustments are necessary, since MFIs often operate in highly inflationary environments and receive significant support from third parties—such as government or donors—in the form of implicit subsidies. The adjustments take this support into account and allow an MFI to understand the potential commercial viability of its financial services operations. This is done by comparing adjusted operating income to adjusted operating expenses. If the figure is greater than 1.0, we say an MFI has reached IFS. If IFS has not been achieved, the withdrawal of such “support” could ultimately result in the failure of an MFI, with potentially disastrous effects on the poor clients being served.

So MFIs wanting to reach and benefit truly large numbers should consciously work toward IFS. This does not, of course, mean that IFS should be attained at the cost of the overriding goal of poverty reduction. That would defeat the purpose for which we are working—which is not profit as an end in itself, but poverty reduction. Rather it means that IFS should be pursued at a rate that is consistent with substantial poverty reduction. Attainment of both goals must be monitored so as to ensure that IFS does not displace the more important goal of poverty reduction.

Even with this qualification, many may disagree with the need to work towards IFS. Perhaps most would argue that nongovernmental

organizations (NGOs) have important social objectives that cannot be executed in a financially sustainable manner. Requiring that an institution do so would result in goal displacement. Outreach and service to the poor and poorest are more important, some might well argue, than making profits. A major purpose of this paper is to try to convince those who want to reach and benefit truly large numbers, say at least 500,000, of the poorest households with microfinance, aim for IFS, and support, rather than displace, their efforts in poverty reduction.

The most important reason is funding. Reducing poverty significantly, that is, reaching and benefiting truly large numbers of poor and poorest households, even the 500,000 mentioned above, requires vast amounts of funds. Assuming an average loan outstanding per client of only US\$150, for example, the total annual loan fund requirement alone would be US\$75 million.⁷ Add to that the equity requirements to cover operating losses in the early years of operations and large-scale expansion, and the figure rises further. Attainment of the Microcredit Summit goal of reaching 100 million of the poorest households is estimated to cost around US\$21 billion. From where are such vast amounts of funds going to come? Not from donors, whose funds for supporting microfinance are limited, and probably not from governments either, because of competing claims on their funds: though in countries where funds are made available by governments, MFIs should take advantage of them—provided they can do so without incurring crippling interference in their operations.

Grants and soft loans have played, and continue to play, major roles in financing MFI start-ups. They are particularly useful at that early stage when equity is usually nonexistent and deficits are large. Guarantees and quasi-equity, which are themselves soft loans, can

also be of critical importance when the MFI seeks to establish relations with banks. However, grants and soft loans are always limited in supply and time-consuming to secure. For these reasons they are likely to be insufficient for financing the scaling-up of MFIs to reach truly large numbers and IFS.

In the likely event that grants and soft loans do not meet funding requirements for scaling-up, MFIs must search elsewhere. Only formal financial institutions are likely to be able to provide the vast financial resources required to reach large numbers of the poor and poorest with microfinance.⁸

If profit-oriented, formal, financial institutions are to be interested in entering business partnerships with MFIs, the latter will have to convince these institutions of the strength of the MFI's operational and financial management, in other words, that the MFIs operate as commercially minded, for-profit entities, just like the other clients of the financial institutions. In order to maximize the potential of this partnership, MFIs will have to build their equity, because it serves as a lever to obtain debt from formal financial institutions and savings deposits (where appropriate) from members. Currently, for MFIs, the most reliable long-term source of such equity is retained earnings. To build retained earnings, MFIs will have to make profits from their outreach to the poor and poorest by reaching truly large numbers. Making profits, in the medium to long term, means the attainment of a sufficient degree of IFS and reasonable adjusted, return on assets (AROA). There is no other way.

So it is not a question whether or not we need to pursue IFS so as to be able to reduce extreme poverty in a big way, but rather how best to go about it without losing sight of our overriding concern for poverty reduction. The rest of the paper focuses on this point.

Trade-off between Working with the Poorest and IFS?

A few years ago, an influential book that included case studies of 12 MFIs in Asia, Africa, and Latin America argued that MFIs working with the poorest would experience a trade-off with IFS. Specifically, it concluded that “at a given point in time [MFIs] can either go for growth and put their resources into underpinning the success of established and rapidly growing institutions, or go for poverty impact . . . and put their resources into poverty-focused operations with a higher risk of failure and a lower expected return” (Hulme & Mosley, 1996, p. 206). Lending to the poorest requires very small loans and results in a small average loan size. Achieving IFS however, the book argued, would require a much larger average loan size. The Consultative Group to Assist the Poorest (CGAP) of the World Bank publicized this argument in its Focus Note No. 5. Many practitioners of microfinance with the poor and the poorest disagreed. We felt from our experience that there was no necessary medium to long-term trade-off, for even among the poorest loan clients, average loan size tends to increase considerably over the years⁹ as clients prove their ability to repay and consequently have access to larger and/or multiple loans. Indeed, it is this “progressive” lending to large numbers of the poor and the poorest, coupled with efficiency and other initiatives at the program level, that makes the attainment of IFS possible while serving the poorest.

Despite the influence of Hulme and Mosley’s study, it is now recognized by many that the alleged trade-off is not inevitable (Christen, 1997; Christen, et al., 1995; and Gulli, 1998, p. 28). A study of 11 successful microfinance programs in three continents found that “among high-performing programs, no clear trade-off exists between reaching the very poor and reaching large numbers

of people” (Christen et al., 1995, p. viii), and concluded that their results showed that “full self-sufficiency can be achieved by institutions serving the very poor.” (Christen et al., 1995, p. 27). Thus it is not the clientele served that determines an MFI's potential for IFS, but the degree to which its financial services program is well-designed and managed.

Learning from Successful MFIs Working with the Poorest

In choosing case study MFIs for this paper, we were able to identify several in Asia, Africa, and Latin America that are working with substantial numbers of the poorest households in their countries and are also on a clear path toward institutional financial self-sufficiency. Of these, we chose one from each continent for illustrative purposes,¹⁰ as follows:

- The Center for Agriculture and Rural Development (CARD), a Grameen Bank replication/adaptation based in the Philippines;
- Credito con Education Rural (CRECER), a Freedom from Hunger Credit with Education affiliate and village-banking program based in Bolivia; and
- The Foundation for International Community Assistance (FINCA Uganda), a village banking program based in Uganda.

These case study MFIs, from three different continents, operating in three distinct environments, and employing varied lending methodologies, provide empirical evidence that the trade-off is not inevitable.

Where appropriate, we will also draw on the experience of CASH-POR Financial & Technical Services Private Limited (CFTS), which began disbursing loans in September 1997 as a fast-track commercial approach to providing microfinance services to the poor and poor-

est in India, using the Grameen Bank methodology. It has the explicit goal of maximizing outreach to the poorest women while achieving IFS within five years. The purpose of referring to CFTS, although it is still very small, is to show that IFS can be achieved relatively quickly while serving the poorest clients if it is systematically planned for and implemented from the beginning.

A brief statistical overview of the three case study MFIs is provided in Table 1; all data have been supplied directly by the case study MFIs. Given the dangers of comparing MFIs working in such different environments, we ask that readers analyze the case study MFIs on an individual basis.

Table 1. Basic Statistics of Case Study MFIs

Basic Statistics at 12/31/98 (in US\$)	CARD	CRECER	FINCA
Country of Operation	Philippines	Bolivia	Uganda
Inflation Rate	10%	4.3%	5%
Exchange Rate (end of period)	39.2 Pesos/US\$	5.7 Bol./US\$	1,370 Shil./US\$
Lending Methodology	Grameen Replicator	Village Banking	Village Banking
Gross Loan Portfolio	US\$2,115,207	2,122,011	854,044
Number of Loans Outstanding	26,691	12,892	17,225
Equity	US\$1,036,809	1,594,871	1,243,514
Operating Profit/(Loss)	US\$3,725	(49,362)	(83,538)
Total Staff	136	59	96
Operating Self-sufficiency	100.5%	93.5%	83.9%
Financial Self-sufficiency (IFS)	84.0%	78.2%	64.6%
Effective Interest Rate	42.8%	42.0%	62.3%
Administrative Efficiency	38.7%	33.7%	71.8%
Portfolio-At-Risk	.64%	2.3%	.1%

Outreach and Benefit to the Poorest

Among our case study MFIs, each is committed to working with the poor and poorest households. In figure 1 we can see that all three case studies actually are serving substantial numbers of the poorest households in their areas of operation: CARD has over 11,000, CRECER more than 6,300, and FINCA Uganda approximately 11,500.

Table 2. Outreach to the Poorest Among Case Study MFIs

As of 12/31/98	CARD	CRECER	FINCA
Active Savers	22,587	12,892	17,225
Poorest	Approx. 50%	49%	67%
Poor	Approx. 50%	34%	22%
Non-Poor	0%	17%	10%
Active Loan Clients	20,617	12,892	17,225
% Women	100%	96%	100%
Maximum First Loan Size	US\$31.1	US\$88.5	US\$73.0
Maximum Initial Loan Term	6 months	16 weeks	16 weeks
Average Loan Outstanding per Loan Client	US\$102.6	US\$164.6	US\$49.6
Average Savings Balance per Saver	US\$35.1	US\$40.6	US\$48.9
No. of Years in Operation	9	5	6

Of the three case studies, only CARD is using one of the cost-effective poverty targeting strategies outlined below (Becoming a Cost-Effective MFI, Cost-Effective Targeting). It identifies its potential clients on the ground by using the CASHPOR House Index (CHI) as adapted to conditions in south Luzon and the offshore islands in the Philippines, followed by a Net Worth test for those living in houses between four and six points on their Index. However, CARD does not subdivide its clients into poor and poorest. For purposes of this paper, CARD took two samples of 100 new clients. The clients in one of the samples had joined the Landless Peoples Association (the official name of the CARD NGO) before the CARD Bank was established in 1997, while those in the other had joined after. It was found that 53% of those who joined before CARD became a bank were living in the poorest category of houses, whereas 63% of those who entered after the bank had been established lived in the poorest houses. It would be safe to conclude, therefore, that CARD becoming a Bank has not adversely affected its outreach to the poorest, and that probably at least half of its clients were in that category when they entered the program.

In 1997, an independent impact evaluation of CARD's microfinance program for the poor was commissioned by the Grameen Trust, its main funder up until that time (Hossain & Diaz, 1997). The results showed that CARD had succeeded in reaching the poorest, since "nearly 70% of its borrowers have no access to land and have very poor housing worth less than PHP25,000 (about US\$650; note: PHP = Philippine Peso), and they received a share of loans proportional to their numbers" (Hossain & Diaz, 1997, p. 19). In addition, "The average labor productivity in enterprises financed by the loan was PHP107 per day, 34% higher than the market wage rate of PHP80 per day. The rate of return on capital was 117% compared to 46% (effective) rate of interest charged by CARD on the amount of outstanding loan. Employment, income and labor productivity increase with the number of repeat loans taken from CARD" (Hossain & Diaz, 1997, p. 20). The data show poverty was being reduced, even among many of the poorest clients.

Although CRECER does not have a specific poverty yardstick, it operates in the poorest areas of rural Bolivia. Recently, a study by Freedom From Hunger evaluated the poverty level of the clients being served by CRECER. A summary of this study concluded that "these results indicate that even within provinces with very high rates of poverty, the CRECER Credit with Education program is successfully reaching the relatively poorer households and not skewing program services to the relatively better-off in the program area" (Bresnick & MckNelly, 1999, p. 7). A comparison of CRECER participants with randomly selected nonparticipants showed no statistically significant difference in poverty status. The study therefore concludes that "given that on average 84% of the population in the 20 provinces in which CRECER is active were classified as poor, with 49% of the total population classified as 'extremely poor,' it is

likely that the CRECER clients have a similar breakdown in poverty levels” (Bresnick & MckNelly, 1999, p. 5). We do not have any impact evaluation data on CRECER, but we can assume from the small proportion (2.5%) of its portfolio that is at risk, that poverty is being reduced among its poorest clients. Otherwise, how could they repay so faithfully?

FINCA Uganda's outreach was evaluated in a recent study commissioned by the FINCA Head Office in Washington DC. It concluded that “67% of FINCA Uganda's new clients enter the program in ‘severe poverty’—i.e., with a daily per-capita income (DPCI) of less than US\$1. The average DPCI of this category was US\$0.56. A further 22% of new clients were moderately poor (DPCI of US\$1-2), with an average DPCI of US\$1.39. Finally, 10% of clients were non-poor (DPCI >US\$2+) with an average DPCI of US\$3.44.”¹¹ As in the case of CRECER, we do not have any impact evaluation data on FINCA Uganda, but can also assume from the even smaller proportion (0.1%) of its portfolio which is at risk, that poverty also is being reduced among its poorest clients.

From its beginning CFTS has identified potential clients as poor and poorest according to their score on the CASHPOR House Index (CHI), their ownership and operation of agricultural land, and their possession of large farm animals. Poor households are those with three points on the CHI, owning/operating no more than two-thirds of an acre of irrigated agricultural land and possessing large farm animals worth less than Rs.8,000 (about US\$190). The poorest households are those with two or less marks on the CHI, owning/operating no agricultural land and possessing no large farm animals. Poor households tend to live in medium-sized houses with reinforced mud walls of between five and eight feet in height and a permanent roof of used tiles. The poorest households live in small

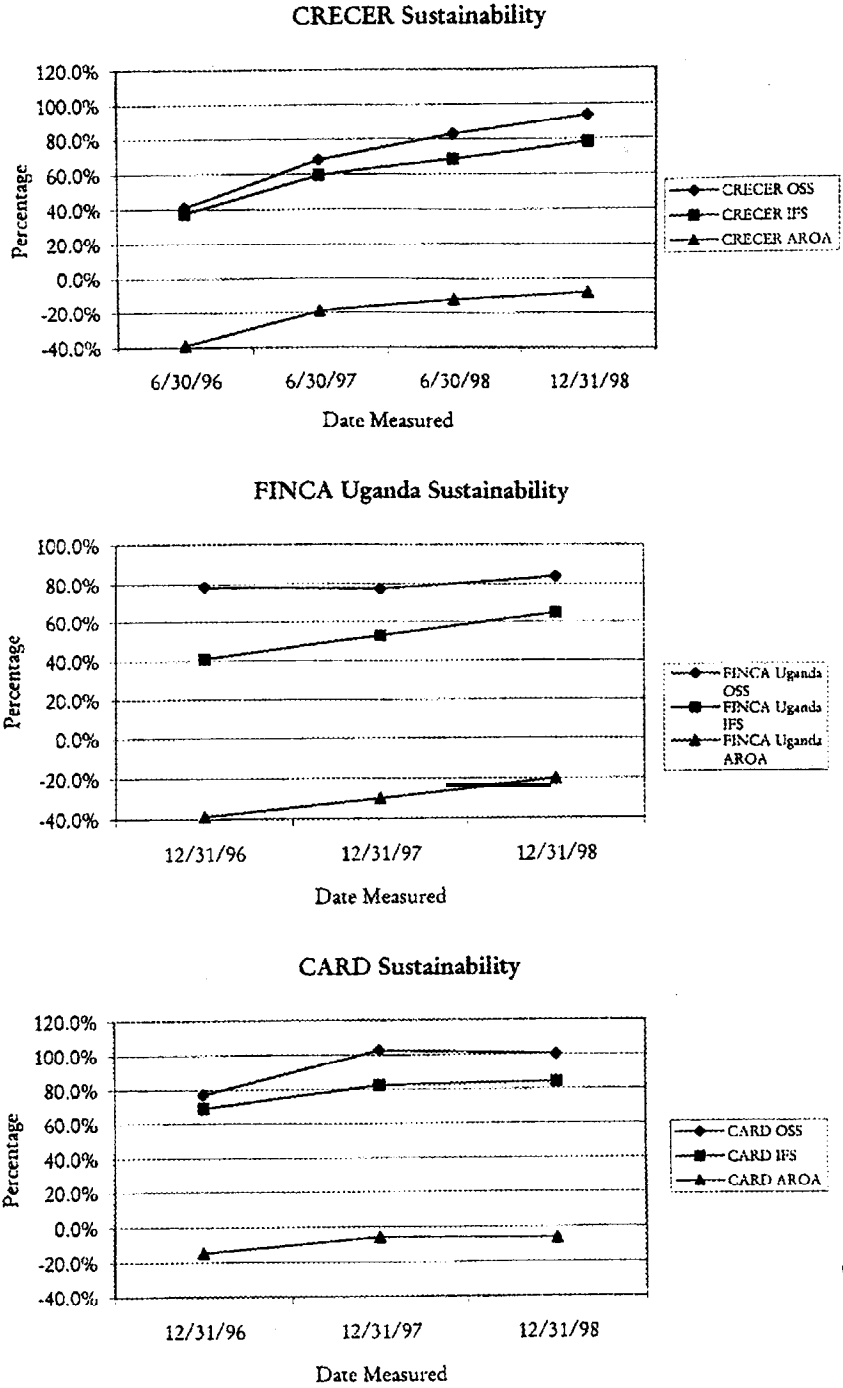
huts with mud walls of less than five feet with an impermanent roof of thatch. In retrospect, the poorest have been defined too low and have been found to make up only about 20%, instead of 50%, of the total poor. Not surprisingly, these extremely poor households are currently underrepresented among CFTS clients, all of whom are poor. As of the end of the first 1.5 years of work in Mirzapur, the poorest accounted for only 13% of the active savers. More time for demonstration will help the poorest overcome their fears, and more suitable loan products for them will be required before larger proportions of these households at the bottom of the poverty group take advantage of the financial services being offered. Probably CFTS should relax somewhat its operational definition of the poorest so that it corresponds to the bottom 50% of the poor in Mirzapur. Regardless whether or not they do this, however, the fact that they are tracking the poorest potential clients means that they will know what proportion of these clients have entered the program and will be able to approach them with more suitable loan products.

Sustainability and Profitability

While CARD serves substantial numbers of the poorest households in their areas of operation, trend analysis shows that CARD also has achieved operational self-sufficiency (OSS) for the last two years, and CRECER and FINCA Uganda are nearing that goal. The three are moving towards IFS, and Adjusted Return on Assets (AROA) is also improving, though it remains negative among all factors, since IFS has not been achieved.

While the trends for the most part are consistently improving, CARD's OSS and IFS from 12/31/97 to 12/31/98 are virtually flat, worrying any observer at first sight. However, the figure for

Figure 1



12/31/98 has been reduced by rapid expansion during that year, including the opening of three new branches. Rapid expansion, especially the opening of new branches, increases operating expenses faster than interest income because of large start-up costs

for salaries of new staff and capital expenditure to equip the branches; these are costs which are incurred well before new loan disbursements are generating much new income. The effect of such expansion therefore, is to lower OSS and IFS temporarily until the interest income in the new branches surpasses the additional expenditures that were made to generate it. Since 12/31/96, CARD's outreach has increased by 230%.

FINCA Uganda increased its outreach to the poor by an impressive 301% since 12/31/96, and for the reasons highlighted above, its OSS has leveled off during that period. It is important to note, however, that the annualized OSS on 12/31/98 of 83.9% masks the fact that in the last quarter of the year (and the first quarter of 1999), FINCA Uganda has achieved OSS, while IFS is approximately 84%¹². This is due to two factors: (1) increased interest income from new clients is offsetting the start-up costs incurred for expansion, and (2) rapid expansion of the prior years was slowed to a halt in August 1998, allowing FINCA Uganda to upgrade its management systems to accommodate its growing size. CRECER has had more modest rates of expansion than the other two programs, growing by 118% since 6/30/96, and its OSS and IFS have climbed fairly steadily.

It is clear that MFIs serving and benefiting substantial numbers of the poorest clients in their countries can be at or near operational self-sufficiency, not too far from IFS, and making progress toward both. They need not experience a trade-off between working with the poorest and reaching institutional financial sustainability. The rest of the paper shows how this is being done.

Becoming a Cost-Effective MFI

Most MFIs operate in environments where their only competitors are local moneylenders, who charge rates significantly above mar-

ket, often between 5% and 10% per month, to their clients—including the poorest. MFIs thus have much liberty in setting interest rates before they would be out-priced by local supply. Because MFIs' effective interest rates are set not by the free market forces of supply and demand, but rather by monopolistic or oligopolistic institutions, there is a grave danger that inefficiencies and delinquencies can flourish but remain hidden under “appropriate interest rates,” and that innovation can be stifled. While there is no doubt that the poorest should pay full cost for their financial services, they should not be asked to bear the burden of incompetent MFI management and inefficient operations.¹³

From this perspective, achieving IFS is a cost issue rather than a pricing issue, which is particularly relevant if an MFI is interested in serving the poorest. An article by Elisabeth Rhyne summarizing the results of the 1995 paper by Christen et al. recognizes that “undoubtedly it is more challenging to serve people with very small loans or to reach remote rural clients. However, even in relatively unfavorable settings [MFIs] had developed service delivery methods so tailored to their clientele and so efficient that clients could afford to pay the full cost of the services, making the institutions financially viable” (Rhyne, 1998, p. 6).

Because cost is the key to IFS, then an MFI must consistently evaluate whether or not it serves as many clients as possible with its resources at the lowest possible costs. In other words, does it operate efficiently? By definition, the concept of efficiency is simple: to maximize output from a set amount of inputs. In practice it is much more complex, particularly since tracking sustainability and efficiency indicators is fairly new to MFIs, and consequently industry standards, which serve as guidelines in the business world, do not yet exist.¹⁴ How efficient a microfinance institution can become

before it sacrifices the quality of its operations is not yet absolutely defined. Some guidelines are suggested later in the paper, but the only clear guiding principle is to ensure that as great a proportion of available funding as possible reaches the hands of the poorest.

The key to attaining IFS while working with substantial numbers of the poorest is, therefore, to become a cost-effective MFI. The first step in this direction is the adoption of a cost-effective poverty yardstick to identify poor and poorest households in the villages.

Cost-Effective Targeting

In order to do business with the poor and poorest, we must identify and motivate them on the ground in a cost-effective manner. This process of identification and motivation is often referred to as “targeting the poor.” Normally, the poorest will not come forward by themselves to apply for financial services, because they will not know or believe that the services are actually for them. Even when informed, many likely feel that it would be too risky for them to borrow. Only patient motivation and convincing demonstrations of neighboring poor and poorest households that do participate and benefit will encourage them to take advantage of the opportunity.

While targeting the poorest is critical to our ultimate goal of poverty reduction, if a program is not able to undertake this activity in a cost-effective manner, the potential to achieve IFS might be greatly reduced or even eliminated, jeopardizing the long-term viability of a program. Hulme and Mosley raise the concern that “targeting on the poor of credit . . . imposes costs of research (finding out who is eligible), communication with the eligible and monitoring to prevent access by the ineligible, which may if pushed too far, outweigh the benefits of poverty reduction” (Hulme & Mosley, 1996, p. 36). Fortunately, proven, cost-effective strategies have been

developed and refined which enable programs to identify the poorest while also maintaining the quality measures necessary to ensure that only the poor and poorest are admitted to the program.

While the goal of this paper is not to describe nor debate the costs and benefits of targeting strategies,¹⁵ given their acknowledged potential to reduce the ability of an MFI to achieve IFS, we believe these effects warrant a brief discussion. We are aware of two existing approaches used to target the poor and poorest that are proven and cost-effective: the CASHPOR House Index (CHI) and the Small Enterprise Foundation Participatory Wealth Ranking (PWR) system.¹⁶ The CHI uses the house and compound of the household, in place of the more traditional costly and time-consuming household interview, as crude indicators to show which nonpoor households to eliminate from initial consideration as potential members. Only after the CHI identifies potentially poor and poorest households do field staff visit house-to-house to verify the eligibility of the occupant households through a short interview that focuses on the value of their productive assets.

Instead of using the house, PWR relies on the knowledge of the villagers themselves to identify the poor and poorest among them, again eliminating the initial interview process. Villagers are called on to map the village and to rank households into groups by poverty status, and only then do field staff interview those who have been identified as eligible. On average, both methodologies take about five minutes per poor and poorest household.

The targeting method one chooses either CHI or PWR should depend on local conditions and expertise. Whichever is chosen, however, it will be cost effective because care has been put into designing both methods in order to eliminate unnecessary expenditures. Time-consuming, costly interviews used to determine house-

hold income or expenditure, which are of dubious validity and reliability anyway, are not used in the initial stages. They are replaced by a quick survey of household productive assets, which takes only about five minutes on average, and these more lengthy asset interviews are done at the final stage of targeting, only after most non-poor households have been eliminated. Because most of the households identified through the CHI and PWR turn out to be eligible, the interview doubles as the first step in motivating poor and poorest households to take advantage of the financial services being offered.

Exclusive Focus on the Poor and Poorest?

By focusing their efforts exclusively on the poor and the poorest, MFIs can use funds allocated for their use most effectively and efficiently. Given that these funds are normally limited in supply, it is vital to ensure they get into the hands of the intended beneficiaries. Leakage to the nonpoor should be minimized.

There is a counterargument, however, that, “It is scale, not exclusive focus, that determines whether significant outreach to the poor is achieved” (Christen et al., 1995, p. 24). Programs serving several strata of clients, not just the poor and the poorest, may be able to expand faster and reach larger numbers. If they do, large numbers of the poor and the poorest may benefit. Moreover, such programs have the possibility of cross-subsidizing lending to the poorest from their more profitable lending to the nonpoor, due to larger initial average loan size. Thus they could achieve IFS more rapidly.

Whether or not such mixed programs benefit large numbers of the poor and the poorest is an empirical question. If they do, they are surely welcome; but they should not, under any circumstances,

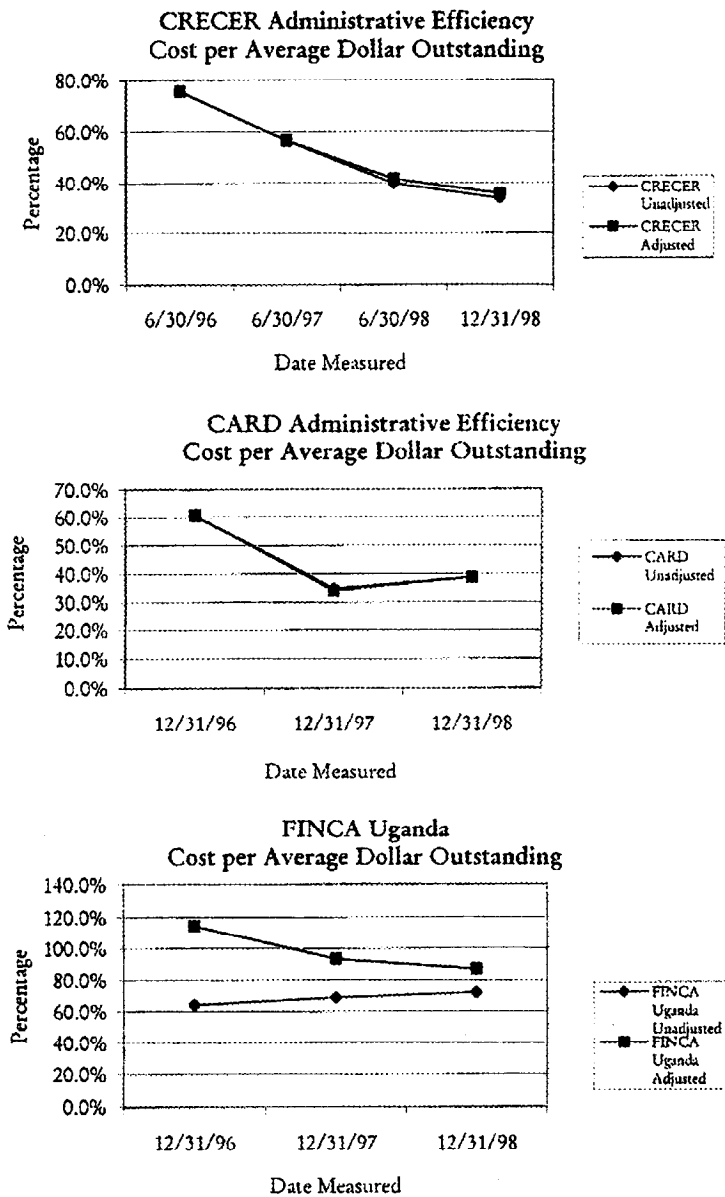
channel funds meant for the poor and poorest into the hands of the nonpoor.

Administrative Efficiency

Most managers focus heavily on one component of institutional efficiency: administrative efficiency. This figure reveals how much it costs your institution to keep one dollar¹⁷ of credit in the hands of your loan clients. Current “best practice” assumes that well-managed MFIs should be able to achieve levels of between 15% and 25%, or administrative costs of 15 to 25 cents for every dollar outstanding, regardless of the lending methodology (Christen, 1997, p. 172). Trend analysis in the figure 2 shows that none of the case studies have reached Christen’s standard, although CARD and CRECER are approaching best practice standards.

Only CRECER, however, shows a clear downward trend in administrative expense per average dollar outstanding, while the trends for FINCA Uganda and CARD are less clear. With respect to the latter two MFIs, this uncertainty is likely due to the higher rates of recent expansion of these two programs as compared to CRECER. We have seen that rapid rates of expansion, particularly in the opening of new branches, result in large increases in administrative expense before any additional loans are disbursed. Thus, administrative efficiency would fall temporarily until counteracted by an increase in loans outstanding. That being said, FINCA Uganda’s administrative efficiency ratio (unadjusted) of 71.8% is very high. This figure indicates that it is costing nearly 72 cents to get one dollar in the hands of the poor, which signals low levels of efficiency. FINCA Uganda blames this low efficiency on its rapid growth strategy, achieved through up-front investment in capacity building.

Figure 2



Field Staff Efficiency

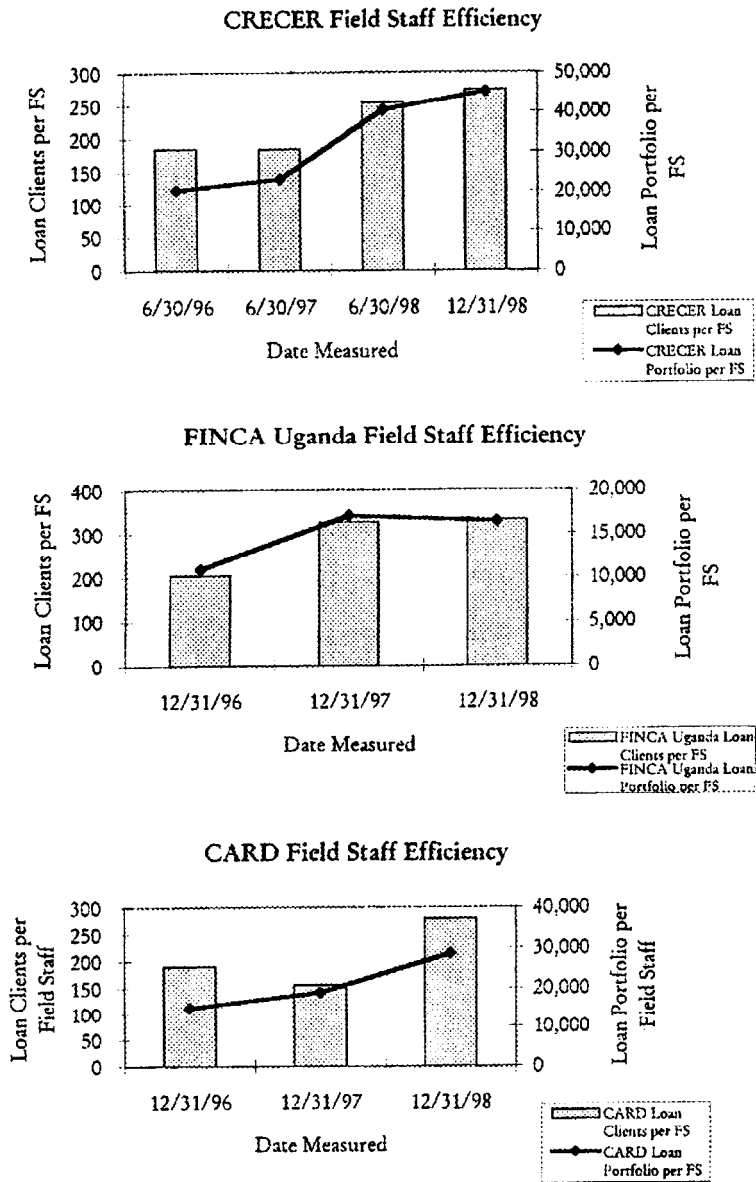
Salary and salary-related expenses represent the significant bulk, often between 50% and 70%, of total administrative costs. Field staff, sometimes referred to as “directly productive staff,” usually make up about 80% of an MFI’s total staff. Given the field staff’s disproportionate representation in the overall expense mix, managers must carefully monitor and measure field staff performance and productivity. Two basic measures are consistently employed to

monitor MFI field staff efficiency: (1) average number of active loan clients per field staff, and (2) average loan portfolio per field staff. These two measures work closely together to determine how much revenue individual field staff generate in relation to their costs. For example, if loan sizes are low, field staff will need to manage as many loan clients as possible, without sacrificing quality, in order to generate revenue.

With respect to the first measure, average number of loan clients per field staff, best practice ranges for MFIs worldwide fall between 300 and 500 clients¹⁸, regardless of the lending methodology employed (e.g., individual, solidarity group, village banking). Developing a best practice range for average loan portfolio per field staff, however, is more difficult because it relies more heavily on the lending methodology used, the level of poverty of participating borrowers, and the local operating environment (e.g., inflation). In the Grameen Bank methodology, best practice yields a loan portfolio per field staff of more than US\$25,000.

In Figure 3, we see that while CRECER has a loan client to field staff ratio of less than 300 clients, at 274, it has a high loan portfolio per field staff of more than US\$45,000, which, from an income-generating perspective, more than compensates for the lower levels of loan clients per field staff. CARD is nearing the first efficiency standard, with 279 active loan clients per field staff, and exceeds US\$25,000 loan portfolio per field staff, at US\$28,584, and seems well on track toward achieving best practice levels in the near future. FINCA Uganda, on the other hand, has the highest loan client to field-staff ratio among our case study MFIs, with 331 clients per field staff, but it falls well short in terms of loan portfolio per field staff at only US\$16,424. This reflects both the high proportion of borrowers in early loan cycles and the fact that it has the lowest

Figure 3



average loan outstanding per loan client of US\$49.60, compared to US\$102.60 and US\$164.60 for CARD and CRECER, respectively. FINCA's low average loan outstanding is credited to the large number of poorest borrowers in the program as well the requirement that borrowers must save 20% of their borrowings in each cycle. This latter policy is currently being reconsidered. If savings requirements are eased, the average loan outstanding should grow and thus

improve the loan portfolio per field staff measure as well as overall administrative efficiency.

New Management Tools for MFIs

Efficiency is a dynamic, not a static, process. Though there is a tendency to rely primarily on specific output measures—administrative expenses and field staff productivity—in order to understand the efficiency achievements of MFIs, alone they certainly do not tell the full story. Each of the MFIs analyzed in this paper have exhibited a willingness to tailor their services to their local environment and to embrace new operational and financial management techniques, which have dramatically increased their efficiency, and thus their ability to achieve IFS. They have paved the way for other MFIs working with the poor and poorest to follow this lead so that IFS becomes an achievable standard for all.

Monitoring Financial and Operational Performance: Management Information Systems¹⁹

Access to timely, accurate, and detailed information on the overall performance of an MFI is required if efficiency and IFS are to be achieved. Management information systems (MIS)—whether manual, computerized through spreadsheet, or computerized through advanced computer-programming software—must be introduced and then updated as both financial and operational management techniques become more sophisticated. Though costs are involved in developing such systems, they are absolutely required by all to reach and serve with quality large numbers of poor and poorest households.

A cost-effective MIS should generate both financial and operational information. On the financial side, full financial statements,

including the Income Statement, the Cash Flow Statement and the Balance Sheet should be prepared regularly, at least on a quarterly basis, though monthly statements would be preferable. Financial statement monitoring report formats²⁰ that facilitate the analysis of IFS and efficiency, among other important performance indicators, are now available to MFIs worldwide. As these new tools greatly enhance the ability of MFIs to monitor financial performance, they should be adopted.

On the operational side, in recent years portfolio-at-risk has replaced the repayment rate as the leading measure of loan portfolio quality, following the lead of traditional commercial banks. This relatively new and valuable measure of loan portfolio quality compares the remaining outstanding balance of loans with at least one installment overdue for a specified period (e.g., one week, one month, 90 days) to the total loan portfolio. It is an indication of the proportion of loans outstanding that may not be able to be recovered in the future. It does not replace the repayment rate (amount collected over the amount due for a specified period), a historical measure, which shows what proportion of principal and interest due during a specified period actually was collected. Portfolio-at-risk should be monitored on a weekly basis at the branch level and on a monthly basis for each field staff. In addition, the aging of arrears is done to calculate portfolio at different levels of risk (i.e., with arrears overdue for different lengths of time, e.g., number of days or weeks), and can be used also for calculating MFI-specific loan loss provisions.²¹

With such information, managers are able to make informed and timely decisions about performance, allowing for identification of areas where performance improvements must be made before small problems become crises. Without such information, and verifica-

tion of this data through both internal and external audits, MFIs will not be in a position to make decisions that can facilitate efficiency and IFS.

CRECER introduced a computerized monitoring system (through Excel spreadsheets) back in 1995, well before it became a leading topic of microfinance “best practice.” Though they are currently looking to develop and implement a more sophisticated, integrated MIS, the existing system has certainly served them well, to which its financial results attest. CRECER produces monitoring statements, including operational data and full financial statements, on a monthly basis. Results are monitored in formats (as described above) that facilitate the measurement of best practice indicators. These results are compared quarterly to planned targets for the same period, and senior managers are provided bonuses and incentives accordingly.

Over the years, CARD has also been monitoring its quarterly results through spreadsheets. Since becoming a bank in 1997, it has recognized the importance of a more sophisticated MIS and has hired a local computer-programming firm to design an integrated system for them. Meanwhile, CARD continues to monitor its performance through Excel spreadsheets in a format that facilitates their analysis of IFS, efficiency, and loan portfolio quality. Like CRECER, CARD compares actual performance to planned targets. Like the other case study MFIs, reflecting a critical theme to achieve IFS, FINCA Uganda monitors both its operational and financial performance, including the full income statement, balance sheet, and cash flow statement, on a monthly basis through Excel spreadsheets. Actual financial and operational performance is measured against planned targets during each period. Given their rapid growth over the last few years, however, the limitations of the manual system

have become obvious. In June 1999, FINCA Uganda will automate its MIS, installing a customized, off-the-shelf, loan-tracking software.

Monitoring results carefully and frequently is particularly important for new MFIs like CFTS, established with IFS as a primary goal. Through its monthly monitoring CFTS has become aware that dormancy is a problem among its active savers. Although eligible for loans, some clients do not apply for them. Because microlending is the primary means of reducing poverty, the reluctance of clients to borrow means that CFTS is not helping them much. This is not intended, however, to discount the critical contribution of savings, nor to suggest in any way that dormant clients should be required to borrow. But their failure to borrow does make it difficult for CFTS to meet its loan disbursement targets, and therefore its expected income from interest payments. Discussions with the dormant clients on their reluctance to borrow has revealed that fear of not being able to repay weekly is a major cause of their dormancy. Most dormant clients would like to borrow for income generation, but they are not confident in their ability to repay weekly and benefit from the loans. Perhaps some of these dormant clients are among those for whom microlending is not a way out of poverty; but experience has shown that others will get a good investment idea in time and benefit from it. What CFTS must do is ensure that its loan products are conducive to this.¹⁹

Business Planning to IFS

Working in tandem with a strong MIS system should be the business planning process. Historically, business planning, undertaken by all commercial ventures, has not been at the forefront of MFI management. Where such efforts have been undertaken, they have often consisted of senior managers guesstimating important figures, such

as outreach and funding requirements, in order to determine their goals for the following year. This is extremely unfortunate, because such a process ignores the underlying dynamics of an MFI's business. By undertaking the business planning process, and specifically financial modeling, managers can begin to understand how different financial and operational decisions affect various aspects of the business, and more important, the extent to which this impact is positive or negative.²²

While it was once often necessary for programs to bring in specialists to develop detailed financial models, MFI-friendly tools have recently developed detailed five-year financial forecasts.²³ One of these tools is requisite management training. With these tools, management will be able to better understand the dynamics of their business and to make the critical and often difficult decisions required to plan for efficiency and IFS. With planned targets developed that map the path to IFS, managers can compare these with actual performance so they can determine where adjustments need to be made within the organization in order to stay on track toward achieving IFS.²⁴ As indicated above, CARD and CRECER are already doing this.

In the past, neither CARD nor CRECER prepared detailed three- to five-year financial models. They did, however, develop annual operating budgets revised and updated each year based on historical performance. In the case of CRECER, this not only led to planned targets for key operational and financial data, but also to the development of full financial statements. Measuring their actual performance against these well-thought-out annual budgets allowed managers at both CARD and CRECER to make changes to their operations (or, when necessary, to the financial model) in order to meet their primary goals. Looking forward, CRECER intends to

introduce a more sophisticated planning tool. Last summer, CARD introduced and is now using CGAP's Microfin model, a sophisticated yet user-friendly financial modeling tool.

Before 1997, FINCA Uganda, like CARD and CRECER, prepared an annual operating plan and budget against which actual performance was measured. This included detailed operational and financial performance indicators, including full financial statements. In 1997, FINCA Uganda developed a three-year strategic plan, augmenting the annual operating plan and providing a medium-term forecast of the MFI's goals. In 1999, like CARD, FINCA Uganda has adopted CGAP's more sophisticated *Microfin* model.

CFTS after 1.5 Years

The basic design and path forward for CFTS were formed from the results of detailed spreadsheet modeling. Created with the dual goals of achieving IFS and rapidly expanding outreach, an optimum program size was identified—six branches to reach 18,000 poor and poorest women in the Mirzapur District of Uttar Pradesh State, India—which would allow for achievement of both goals within five years. Thus, from the outset, CFTS had clearly defined objectives, for both financial and operational achievement of which all managers are aware. Comparing these targets to actual performance will allow CFTS to consistently track where it under- and over-performs and to make the necessary changes on the road to IFS.

After 1.5 years, CFTS is basically on track for the attainment of its goals of providing financial services to 18,000 poor households (with the poorest at least proportionately covered) and thereby attaining institutional financial self-sufficiency in five years. This is shown in Table 3.

Table 3. CFTS' Achievement of Key Targets in the Business Plan as of End Year 1.5

Performance Indicator	Actual Performance	Planned Target	% Achievement
Active Savers	2,433	2,318	105%
Active Loan Clients	1,819	2,021	90%
Total Loans Disbursed	US\$93,790	US\$97,039	97%
Total Loans Outstanding	US\$57,434	US\$60,716	95%

With plus or minus 10% of planned targets considered to be good performance, CFTS can be said to have performed well on all four key indicators. Achievement on active loan clients, however, just barely made it into the acceptable range and is still some cause for concern. Overall, however, these results show that IFS can be systematically planned for and implemented, while still keeping a focus on the poorest. These results also illustrate the importance of being able to evaluate actual achievement as related to planned targets.

Maintaining Loan Portfolio Quality: Client Incentives

In the face of progressive lending, and thus a growing loan portfolio, as well as expanding numbers of loan clients, innovations in maintaining loan portfolio quality can be referred to as client incentives. As argued earlier, progressive lending, which provides for increasing maximum loan sizes as borrowers progress from one loan cycle to another, is critical for both poverty reduction and the attainment of IFS, because it allows for important economies of scale. But if the quality of the growing loan portfolio is not maintained, the net result to the MFI could be negative, and in a worst case, disastrous.

In addition to the “carrot” of progressive lending, an innovative “stick” has been introduced at some MFIs. Both CARD and CFTS link the maximum loan size of subsequent lending cycles to repayment performance in the existing cycle. In other words, the subsequent loan size declines by a predetermined amount for each

dropped repayment; after a certain number of dropped repayments, four in the case of CARD and five for CFTS, the borrower is no longer eligible for a subsequent loan. CARD adds a further twist to this formula by linking subsequent loan size to attendance as well; one absence (or two late arrivals) is equivalent to one dropped installment. CFTS delays subsequent loan disbursement by one week for every absence from or tardiness at weekly meetings. Not only does this allow CARD and CFTS to track those borrowers who may have trouble repaying subsequent loans, it also reduces the amount at risk in those loans. At the same time, credit discipline is strengthened.

CRECER uses progressive lending as its primary incentive to induce their members to repay, though they also include its health and nutrition education services as further client incentives. On strong repayment performance and solid self-management, CRECER also provides members at the beginning of the fourth loan cycle with the option to increase their loan term from four to six months, with biweekly rather than weekly repayment. Management is also considering offering preferred rates in the future—like any other bank—to its stronger clients, but will await achievement of IFS.

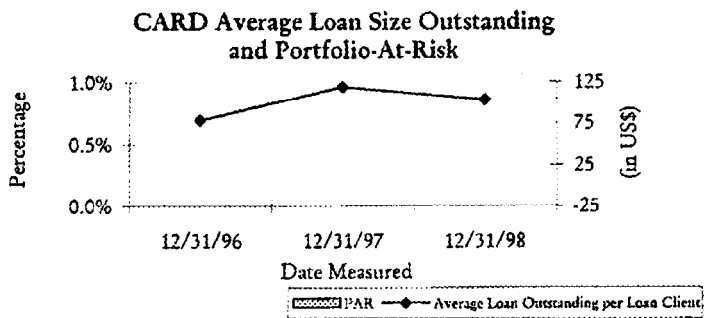
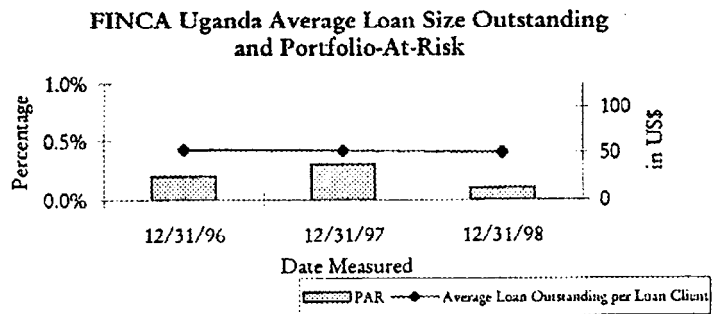
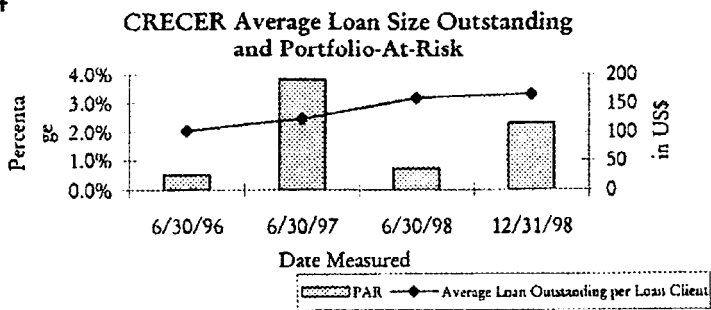
Like CRECER, FINCA Uganda uses progressive lending as its primary incentive for repayment.

The following trend analysis shows the progressive lending among the three case studies and compares this to loan portfolio quality, as measured by portfolio-at-risk:

Of the case studies, both CRECER and CARD have shown significant increases in average loan size outstanding per loan client over the short period being measured: CRECER from just over US\$100 at 6/30/96 to nearly US\$165 at 12/31/98, and CARD from US\$78 to US\$103 during that same period. However, FINCA Uganda's aver-

age loan outstanding has stayed basically flat at around US\$50. These differences are inversely associated with the rates of growth of the three MFIs since 12/31/96, in terms of the number of clients served. FINCA Uganda has grown over 300% since then, CARD 230%, and CRECER more modestly at 118%. As highlighted in the discussion of field staff efficiency, in the case of FINCA Uganda, many early cycle borrowers take smaller loans and thus draw the average figures down, resulting in a flat average loans size outstanding. That being said, in the face of increasing loan size outstanding and client growth, all programs have been able to maintain strong loan portfolio quality, as measured by portfolio-at-risk. Only CRE-

Figure 4



CER, at 2.3%, but still within reasonable best practice ranges, is above 1%. These MFIs, particularly FINCA Uganda and CARD, will have to continue to focus on increasing the average loan size outstanding. Without progressive lending, their progress in reducing poverty will be slow, as will be their attainment of IFS.

Staff Incentives

As highlighted in the discussion of field staff efficiency, salary and salary-related expenses represent more than half of the total administrative expenses in nearly all MFIs worldwide. In order to stay on track to achieve IFS, staff must perform as productively and efficiently as possible, while still maintaining the quality of their work. Motivation of staff through incentives is a practice frequently employed in the business world. Many innovative MFIs are now experimenting with staff incentives that link a percentage of the field staff's total compensation to predetermined performance targets tailored to the realities of microfinance, and are finding increasingly positive results.

CARD and CFTS both actively employ staff incentives in their MFIs. Those incentives targeted at field staff focus on two key areas. First, incentives are linked to bringing new members into the program, particularly relevant if the MFI has just been established or is expanding. Second, in order to discourage the approval of high-risk members,²⁵ staff are also rewarded for high loan portfolio quality, as measured by low portfolio-at-risk, and can be penalized in the event the portfolio-at-risk of the clients for whom they are responsible remains high for prolonged periods of time. Thus, in addition to encouraging greater labor productivity, staff incentives also reinforce the critical importance of strong portfolio quality management.

CRECER provides similar incentives to its field staff, zonal coordinators, and regional administrators. The incentives are related to the number of borrowers (not necessarily new borrowers), the total loan portfolio, and percent delinquency. Because it is a credit with education program, incentives are also provided for the number of learning sessions and the quality of learning sessions facilitated, as measured by a monthly evaluation of each field staff's performance as a learning session facilitator.

FINCA Uganda introduced incentives for its field staff in late 1996. The program is based on three pillars, differing somewhat from those described above. First, incentives are linked to the repayment performance (measured by the repayment rate of amount collected divided by the amount due) of a field staff's clients during any given month. Second, FINCA Uganda compensates field staff according to the gross loan portfolio managed (adjusted for arrears). Finally, to encourage field staff to turn the loan portfolio over quickly, thus improving annual yields, there is a "Week 17 Recapitalization" incentive. With a loan term of 16 weeks, this incentive provides a set of cash benefits to those field staff who are able to receive client loan applications in Week 16 and then disburse the new loan in Week 17, meaning that funds do not linger unproductively in low interest bearing bank accounts. Unlike the other case study MFIs, FINCA Uganda sets an eligibility requirement for field staff to be able to participate in the incentive scheme. Specifically, field staff must have an average of 30 clients per village banking group before qualifying. While this incentive scheme has served them well, FINCA Uganda is seeking to simplify the process. The new scheme, to be introduced this year, will be based entirely on the loan portfolio (adjusted for arrears) managed by the field staff, and is thus indirectly based on the assumption of a certain yield level from the

portfolio and the income required for the institution to meet its IFS goals. Where field staff can surpass the portfolio requirements, the incentive payment will be a portion of the additional income earned by FINCA.

CFTS has innovated further on the incentive structure for field staff. It provides differing rewards for bringing the poorest versus the poor households into the program. In fact, the compensation is 33% more for recruiting the poorest.

CARD has been a leader among CASHPOR Grameen Bank replications in providing incentives for its field staff to increase their productivity. For example, it pioneered “fast-track” promotion for new field staff. Those on the first three-month basic training can be promoted to probationary status after two months if they have recruited and trained at least 20 “quality members” (i.e., clients who have passed the Group Recognition Test). The target for probationary field staff is 60 quality members in six months, but they are confirmed as a member of CARD staff as soon as they reach probationary status. CFTS has used the fast-track confirmation in Mirzapur, India with good results in terms of group formation and staff satisfaction.

CRECER goes beyond the other case studies in its economic incentive structure for senior managers. On a quarterly basis, actual results are compared to planned targets for the period, and regional administrators are provided bonuses accordingly.

Know What Clients Want: Customizing Financial Products

Underlying the strategy for achievement of IFS is the implicit assumption that an MFI can attract new clients and maintain the commitment and participation of existing clients. Financial prod-

ucts being offered, including both loans and savings products, must be designed especially to meet the needs of the poorest women. The first loan must be small enough to be easily repayable in frequent, small installments, but not so small as to be insufficient for generating additional income quickly. Study of local income-generating activities of the poor and poorest women will reveal a suitable band and term for first loans. In Asia, the principal amount will typically range from US\$25 to US\$75 and the term from six months to one year. Subsequent loan and savings products of the MFI must be designed to facilitate a rise out of poverty.²⁶ Subsequent loan size must increase with the demand from clients and their (increasing) ability to repay. Not all clients will progress at the same speed. There should be different loan and savings products for clients of differing abilities and with different demands. The overall result, however, will be an increase in average loans outstanding and average savings balances as time passes. This offers the prospect of increased profits and income to the poor and poorest women and a steady growth in depth of outreach to the poorest. It also provides the conditions for the attainment of financial self-sufficiency by the MFIs serving the poorest and attractive profits to the banks that provide bulk loans to them.²⁷

These general guidelines, however, sometimes do not fit closely with the reality of the operating environment. MFIs committed to working with the poorest must be flexible in designing their credit and savings products.

CARD discovered very early in its adaptation that a one-year first loan term, like that of the Grameen Bank of Bangladesh, was not suitable for most of its clients, who were involved in tertiary activities, like petty trading, which has shorter business cycles. It reduced the term of its first loan to six months. In recent years,

CARD has also introduced new loan products, such as the Multipurpose Loan Product, available to clients for any purpose after six months of membership in an amount up to PHP5,000 (approximately US\$132). This product is intended to discourage clients from turning to the traditional moneylender in times of trouble, as they had been doing, and it has become popular. CARD has also recently introduced the CARD Loan Accelerated Program (CLAP) for those very successful members who have been with the program for many years. Qualifying members are given an identification number that allows them to draw on an overdraft account based on the needs of their business. Such members are still required to attend weekly center meetings.

CRECER, unlike the other case study MFIs, operates in a highly competitive environment. While CRECER has avoided some of this competition by targeting the poor and poorest rural and semirural households (often not the primary target group for the majority of MFIs operating in Bolivia), they still must operate efficiently, maintain competitive interest rates, and provide services that their clients consider attractive compared to those of other MFIs. This is where credit with education comes in. It integrates the weekly credit delivery service at the village level with health, nutrition, family planning, and better business education services. While this definitely adds to the cost of the program, it is clear from the efficiency and sustainability measures provided above that the services can be delivered competitively. Recent innovations include community-based distribution of contraceptives, including condoms and vaginal tablets, as a for-profit venture. CRECER also works closely with NGOs and the government's health representatives to provide discounted health services—including referrals—to its clients.

Since commencing operations six years ago, FINCA Uganda has not introduced any new loan products, and this is recognized as a limitation of the program; ordinary credit will not keep FINCA Uganda competitive in the future. As a result, focus groups with borrowers have been held recently to receive their input on potential new loan products. Currently, the head office is also carrying out a marketing study. Although new loan products have not been introduced, FINCA Uganda has added peripheral products for its clients, including credit, life, and disability insurance. It is also exploring options for introducing health insurance to their clients. At CFTS, loan products were redesigned after six months of field-work when the one-year income-generating loan of Rs.2000 was found to be too rigid for client requirements. Recognizing this, a workshop was held with the center chiefs, the elected leaders of each village-based center, after which the now popular, shorter-term, smaller, petty trading loans were introduced. At the same workshop, management was told that some clients on one-year term loans needed more capital during the year. As a result, two additional types of loans were hammered out and introduced: (1) the Additional Balance-Based Loan (ABBL), allowing clients who did not borrow the maximum for their loan cycle (but have a perfect repayment record) to borrow the balance, and (2) the Additional Savings-Based Loan (ABSL), allowing those who did borrow the maximum (and who have perfect repayment records) to take an additional loan after six months in an amount up to 50 times their running average weekly voluntary savings. The response has been positive.

Efficiency is Not Easy

What has just been written on the attainment of administrative and field staff efficiency targets is not intended to give the false impres-

sion that it is easy. As of December 31, 1998, none of the three case study MFIs had attained all the target efficiency levels. CRECER's administrative efficiency of 33.7% is nearing the upper level of the target range of 15% to 25% and appears on track to attain it, but CARD (at 38.7% and with no clear downward trend) and FINCA Uganda (at over 71.8% and with no clear downward trend) are not near nor clearly on track to achieve the target.

With respect to field staff efficiency, only FINCA Uganda has exceeded the minimum best practice target of 300 loan clients per field staff target, at 331, but CARD and CRECER, at 279 and 274 loan clients per field staff, respectively, are close to the minimum target and show a clear trend toward achieving it. The minimum average loan outstanding per field staff of US\$25,000 has been surpassed by both CRECER, at US\$45,149, and CARD, at US\$28,584. FINCA Uganda is well below the target, at US\$16,424, and appears to have leveled off. As discussed above, however, FINCA Uganda is currently reconsidering a savings policy, which would restrict loan size; a change in the policy should improve this efficiency measure. With respect to portfolio-at-risk, which is a measure of the efficiency of loan recovery, all three case studies are performing extremely well; CRECER reports the highest level of portfolio-at-risk of 2.3%, well within the acceptable band of 0% to 10%.

There is a lesson to be learned here. Even though our case study MFIs illustrate that there is no necessary trade-off between attainment of IFS and serving large numbers of poor and poorest households, they also show that there is still much room for improving efficiency—even among top-performing MFIs. CARD, CRECER, and FINCA Uganda will have to work harder to raise their efficiency to levels required for IFS, particularly as the threat of competition, which would drive interest rates down, looms over MFIs. The good

news is that tools and training necessary for improving efficiency levels, as outlined above, are available today to all practitioners. These must be taken advantage of as we seek to achieve our primary goal of poverty reduction.²⁸

Efficiency and Expansion of Outreach: a Paradox

Administrative efficiency tends to decline initially as expansion of outreach takes place, if the expansion involves opening new branches and/or hiring trainee staff. The main reasons for this are (1) the up-front costs of opening new branches, (2) the fact that new field staff have to be trained (and thus paid), often for many months, before they become productive, and (3) that following the staff's training, it takes time for productivity in bringing clients into the MFI to reach levels of experienced field staff. In our experience, it often takes more than five years for new field staff to meet the target of 300 clients and US\$25,000 in loan outstanding. It is only after three to four years that a new staff member should be earning enough interest income from the loan portfolio they manage to cover their salary.

There is no running away from the fact that expansion of outreach to the poor will require the opening of new branches and the hiring and training of new field staff. Both administrative and field staff efficiency levels will drop as soon as the new field staff are included in the MFI's ongoing performance evaluation. It will take considerable time for the economies of scale that eventually come about from expansion of outreach to be achieved. So rapidly expanding MFIs will not be able to meet the levels of efficiency that allow for achievement of IFS in a reasonable time-frame, and thus allow for receiving funding from commercial banks or taking savings from the general public. Rapidly expanding MFIs will show increasing

losses until the expansion levels-off and then begin to enjoy economies of scale.

There is definitely a trade-off between expansion of outreach and achieving IFS, as long as the expansion involves the opening of new branches and the hiring and training of new field staff. The decline in financial sustainability that accompanies rapid expansion of outreach makes the ongoing financing of that expansion difficult. This difficulty can be called the “paradox of poverty reduction through microfinance”: expansion of outreach is necessary for more poverty reduction, but the expansion itself lowers IFS, which, in turn, makes commercial financing of the expansion more difficult, if not impossible.

Breaking the Paradox

Strategic planning and financial modelling can help to break the paradox. The maximum period that social investors and donors will wait for IFS is thought to be about five years. So, based on realistic assumptions concerning client build-up, loan products, average loan sizes by cycle, repayment rates, repeat loan rates, savings products and savings mobilisation, staff salaries and allowances, other administrative costs, the cost of funds, likely leverage ratios, and the cost of additional capital, we can use financial modelling to calculate the number of clients that can be served and the appropriate interest rate to be charged to allow for IFS and the covering of all accumulated losses within five years. If the poor can pay the required interest rate, then MFIs can do business with them. In the case of CFTS, modelling told MFIs that the appropriate interest rate would be 20% (flat), and it is doing business with the poorest at that rate.

To attract sufficient funding to implement the Five-Year Business Plan, the plan should be promoted as a “package financing” to IFS.

If social investors and donors can provide grants and soft loans, contingent on the attainment of planned annual performance targets, to finance the operating deficits prior to IFS, then commercial banks should be willing to provide the required onlending funds at commercial rates. Thus the paradox can be broken.

Can the Poorest Afford Microcredit?

As defined previously, an “appropriate” interest rate is one that will allow an MFI to cover all its adjusted operating costs from its adjusted operating income within a reasonable period of time. Four to five years is thought to be the maximum time available because the patience of donors/investors providing grants and other subsidized funding is not likely to extend beyond that. As a cost plus measure (designed to cover costs and provide a reasonable profit) in its most fundamental state, an appropriate interest rate will be determined primarily by how efficiently the organization is able to operate its business. But that is not to discount the critical importance of the final component in calculating appropriate interest rates: profit, as measured by the capitalization rate. Without profit, continuation of IFS will be impossible. Earning a profit allows MFIs to build their equity—a source of funding—in order to expand their outreach to the poor and poorest. And as the equity position grows, the MFI will then be able to further leverage funds by raising debt or taking deposits from clients (or the general public if the MFI is regulated) and increase outreach even further, driving the program toward IFS and beyond.

Setting appropriate interest rates is therefore a matter of estimating unit costs of administration, loan loss, funds, and capital. A good set of guidelines is found in CGAP Occasional Paper No. 1. This paper notes that “the annualized effective interest rate (R)

charged on loans will be a function of five elements, each expressed as a percentage of average outstanding loan portfolio: administrative expenses (AE), loan losses (LL), the cost of funds (CF), the desired capitalization rate (K), and investment income (II)” (Rosenburg, 1996, p. 1):

$$R = [(AE + LL + CF + K) / (1 - LL)] - II$$

Typical ranges for MFIs in Asia on these items are shown in Table 4.

Based on the above formula, this means that appropriate interest rates for MFIs that work with the poor in Asia range between 35% and 51% per annum.

A note of caution should be added here. For all the reasons outlined above, achieving IFS is of critical importance to MFIs if they seek to expand outreach to large numbers of poor households. However, because MFIs work with the poor and poorest, a balance must be struck when setting an appropriate interest rate. This balance lies between early achievement of IFS and the institutional benefits this brings, and keeping the interest rate charged to clients manageable for them. This means that the interest rate must not be so high as to rule out adequate profitability on the main income-generating activities open to the poor; that is to say, the pace of

Table 4. Setting Appropriate Interest Rates in Asia

	Administrative Expense	Loan Losses	Cost of Funds	Desired Capitalization Rate	Investment Income
Range	15% to 25%	2%	12% to 15%	8% to 10%	2%

planned achievement of IFS for an MFI must be consistent with the attainment of the overriding goal of poverty reduction. Most important, an impossible burden must not be placed on the shoulders of the early clients.²⁹

Gap Analysis—Ensuring an MFI Receives the Income It Expects

Setting an appropriate interest rate is a key step in getting on the path toward IFS, but ensuring that the loan portfolio and assets yield the expected rate of return is another challenge.³⁰ Up to this point in the paper we have focused on managing expenses as a way to increase efficiency. However three tools are available to measure efficiency in managing income. In other words, is an MFI generating the expected level of income from the loan portfolio, as measured by the appropriate interest rate? If this is the case, it can be assured of overall strong management. If not, regardless of how well the MFI manages its costs, it will be very difficult to achieve IFS.

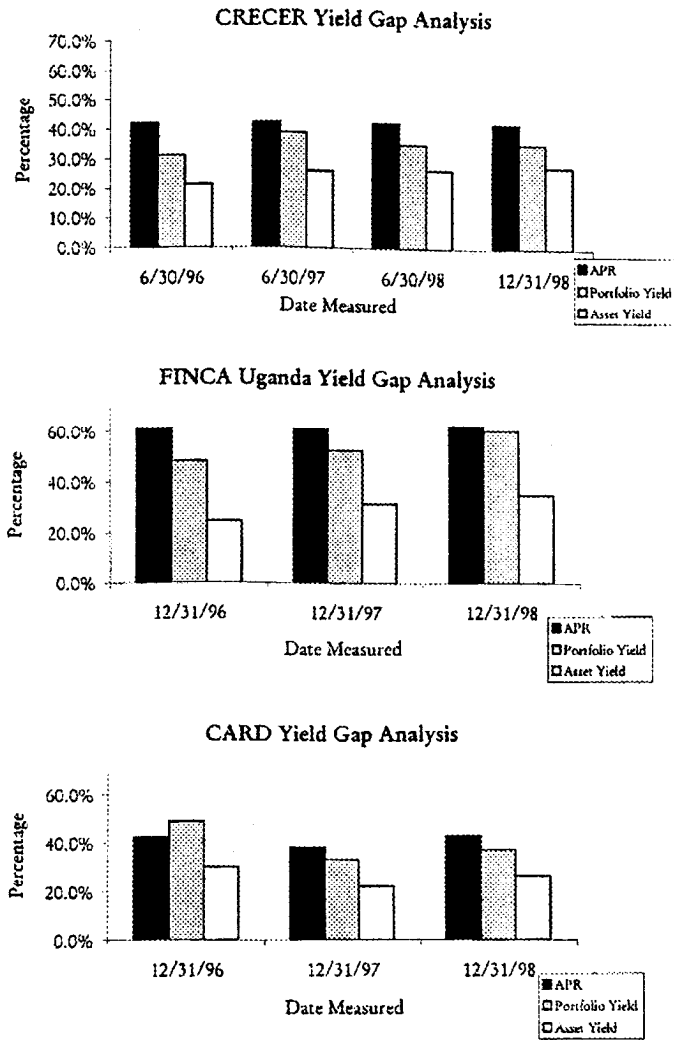
The best way to measure income efficiency is to compare annual effective interest rate, also known as the Annual Percentage Rate (APR), the total cost the borrower must pay for credit services in a year, with the actual portfolio yield. The portfolio yield attempts to measure how well an MFI is collecting from its clients by comparing interest and fees received from loan clients during a specific period of time (up to one year) to the average loan portfolio for the same period. Differences between the APR and the portfolio yield can imply poor loan portfolio quality or difficulty in collecting interest. Particularly for MFIs with loan cycles of less than one year, any differences can also imply slow administrative roll-over of the lending product(s), due to increasing dormancy among clients on subsequent loans, among other factors, or inefficient management techniques leading to delays in subsequent loan disbursements. Taking the gap analysis one step further, an MFI should also compare interest and fee income received from loan clients during a specific period of time (up to one year) to the average total assets for the

same period, referred to as the asset yield. The difference between the portfolio yield and the asset yield indicates how well an MFI has invested its other funds, those not out in the hands of the borrowers via loans and those in income producing activities. For example, are other funds being kept in non-interest bearing bank accounts, or have they been placed in interest-bearing investments such as cash deposits (CDs) or savings accounts. A large difference between the best portfolio and asset yields can indicate that assets other than loans are not being managed properly.

The best-managed MFIs will show very little difference between each of these measurement tools. Institutions with moderate to large differences will note that administrative changes may be necessary—of which they may already be aware, based on their cost management techniques. Tracking efficiency in managing both expenses and income allows an MFI to ensure that it does not stray from the path toward IFS.

The annualized effective interest rates, portfolio yields, and asset yields of our case study MFIs are shown in figure 5. Here we see that of the three, FINCA Uganda has the smallest gap between the APR and the loan yield, with a spread of approximately 1.8% at 12/31/98. This dramatic reduction in the gap reflects FINCA Uganda's specific efforts to improve turnover of its loan portfolio by introducing the "Week 17 Recapitalization" incentive to field staff, described in the Staff Incentive section above. However, the difference between FINCA Uganda's loan portfolio and asset yields was the largest among our case study MFIs, a spread of 25.2%, reflecting high liquidity at FINCA Uganda. As of 12/31/98, nearly 34% of FINCA Uganda's total assets were held in cash and cash equivalents; as FINCA Uganda gets this money into the hands of the poor, the gap should shrink. CARD's yield gap at 12/31/98 was

Figure 5



approximately 5.6%, which it credits to dormancy among general loan and other basic loan products, which has, in turn, slowed turnover of the loan portfolio. While improvements can be made in financial efficiency, particularly at CARD, both MFIs are performing well.

CRECER's yield gap³¹, of approximately 47%, however is not acceptable and needs to be addressed by management immediately. As loan portfolio quality is very strong, as measured by portfolio-at-risk at 12/31/98 of 2.3%, the dramatic gap is likely caused by an extremely slow turnover of CRECER's 16-week loans. CRECER should consider introducing a staff incentive, as FINCA Uganda has

done, to encourage rapid portfolio turnover, among other potential initiatives to reduce the gap. Of course, the intention is not to force the poor to borrow if they are not prepared to do so.

Based on this analysis, FINCA Uganda will not be able to consider lowering its high effective interest rate of 62.3% until it can be sure that its low administrative efficiency of 71.8% can improve substantially. Given CARD's current administrative efficiency of 38.7%, there appears to be no case for reducing its effective interest rate of 42.8%. The situation with CRECER, charging the highest APR among our case study MFIs at 82.4%, is different. CRECER is the lowest cost program among our case study MFIs, with administrative efficiency of 33.7% and institutional efficiency (which includes interest expenses and loan losses) of 38.4%. Thus, even with its low portfolio yield of 35.4%, it is nearly able to cover all its costs! Once CRECER improves loan portfolio yield, thus reducing its yield gap, it should re-evaluate the interest rate it charges to its borrowers; we are sure they would not want their borrowers bearing this cost.

Can the Poorest Pay Appropriate Interest Rates?

This is a sensitive issue. Politicians are fond of defending the poor and poorest by insisting that interest rates charged to them on loans should be subsidized and low. It is now known that subsidized credit rarely gets into the hands of those for whom it was announced, yet politicians persist. In several countries, governments still cap interest rates on small loans in the mistaken belief that it helps the poor and poorest. In fact, such an action has the opposite and unintended result of depriving them of access to any credit at all, because the scarce, subsidized credit is taken by those

with more influence and better connections than the poor and poorest at the local level.

NGOs and companies that offer sustainable financial services directly to the poor and poorest at appropriate interest rates are, ironically, in constant danger of being accused of usury by politicians, bureaucrats, and intellectuals—but notably, not by their clients. It is necessary to defuse the issue.

In microfinance, as it is known, loans are small. Even relatively high interest rates on them still result in relatively small (in amount payable) installments, especially if these are paid frequently, say weekly. For example, a PHP2,000 loan for hog fattening at CARD, payable over six months, will require weekly installments of PHP88 (about US\$2.32), of which PHP8 (about US\$0.21) will be for interest. Two piglets will be purchased at around PHP1000 each. After about six months, the fattened (mainly on household scraps, vegetables planted in the house garden for that purpose, and commercial feed supplement) pigs can be sold for about PHP4,000 each, giving an attractive lump-sum return and net profit estimated at around 100% on average. Weekly repayment is made from the household cash flow, which payment sometimes requires its members to tighten their belts. Here is a classic form of savings based on self-denial for future gain.

For households too poor to tighten their belts, loan activities like petty trading or small shop-keeping that result in the quick and frequent generation of additional income are more appropriate. To minimize the repayment burden, such loans can be for small amounts. For example, petty trading of bangles and cosmetics by poor women at CFTS India requires a working capital of only about Rs.1,000 (about US\$24; note Rs. = Indian rupies). If this is borrowed at an interest rate of 20% (flat) for a term of 20 weeks, with princi-

pal and interest repaid in equal amounts weekly, then the required weekly repayment is Rs.60 (about US\$1.42), of which Rs.50 (US\$1.18) is principal and Rs.10 (US\$0.24) interest. Usually the women sell house-to-house and village-to-village, carrying their wares in a basket on their heads, and working six days a week, grossing about Rs.100 a day or 600 per week, of which about Rs.120 (about US\$2.83) are net profit, half of which goes for repayment.

For larger loan amounts, the weekly repayments can be kept small and manageable by lengthening the loan term. In India, a popular loan activity among the poor is the purchase of a moderately yielding, say three kilo per day, milch buffalo, which can be purchased pregnant for around Rs.6,000 (about US\$150). If a loan of the whole amount is made available for that purpose to a very poor woman at 20% interest (flat), with an effective rate of around 40%, on a declining annual rest for a term of two years with 100 equal weekly installments of principal and interest, each payment would amount to $[(6000 + (6000 \times 0.2)) + (3000 + (3000 \times 0.2))] = 7,800/100 = \text{Rs.}78$ (just under US\$2)]. The three kilos of milk could be sold daily for approximately Rs.12 per kilo. This means that the weekly repayment money of Rs.78 could be earned in two to three days, leaving the income from the other four to five days to reduce the poverty of the household. The risk of the buffalo dying can be covered by livestock insurance at a premium of four rupees per week, or Rs.100 per year. Over the two-year period, the total cost would be Rs.160, which could be paid from the sale of the milk. However, because the buffalo will produce milk for only about nine out of twelve months, the clients have to save or engage in some other income-generating effort for the remaining three months. To fill the gap, clients in India purchase a second buffalo as soon as they can. With two milch buffalo they can have a good, steady income throughout

the year, with which they can pull themselves and their families out of poverty within a few years. A good example of this can be seen at the SHARE (Society for Helping Awaken the Rural Poor through Education) branch in Dachepalli, Gunter District, Andhra Pradesh, where more than half of the loans disbursed over the past five years have been for milch buffalo, and many of the original clients are now living in large concrete houses of their own design.

The examples above hint at a second important factor that makes it possible for the poor and the poorest to pay appropriate interest rates. The returns to capital in their microenterprises tend to average more than 100%. This was the finding of a recent, careful impact-evaluation study of CARD done by Mahabub Hossain.³² Returns to capital in his random sample of clients averaged 117%. As CARD's effective interest rate on loans to clients is approximately 39% per annum, this leaves, on average, 78% in the hands of clients to reduce their poverty. It can, of course, be argued that if CARD's interest rate were significantly lower, its clients could come out of poverty faster. But from where would they get their loans? If CARD does not charge an appropriate interest rate, it may not be able, in the short-term and long-term, to earn a profit, thus making it dependent on donor and government largesse. In a worst case scenario, it might no longer be able to meet the financial needs of its clients. There is no certainty that another MFI would not fill the gap. The only alternative for the moderately poor and poorest may then be the traditional moneylender. A recent study of the returns to capital in microenterprises in India and Kenya (Harper, 1998) found the returns to be even higher on average than Hossain and Diaz found at CARD.

The consistent, near perfect repayment rates, which are characteristic of MFIs around the world, are empirical evidence that the mod-

erately poor and poorest can pay appropriate interest rates charged by efficient microfinance institutions. Working in an area of India where repayment of IRDP loans is said to have been less than 10%, CFTS has been able to collect 97% of weekly repayments due since it began operations 18 months ago; and SHARE in Andhra Pradesh, India has been recording perfect repayment performance since it started. CARD has maintained near perfect repayment for years, with about half of its clients coming from the poorest category. CRECER and FINCA Uganda have had the same experience while dealing with substantial numbers of the poorest. It is our impression that if anything, the poorest clients have a higher repayment rate than the poor clients. Probable reasons are the strength of the desire of the poorest women to rise out of poverty and provide a better life for their children, as well as their relative lack of alternatives for earning cash income.

The 16 CASHPOR-member MFIs, who together had US\$34 million in loans outstanding to over 200,000 poor and poorest households throughout Asia at the end of 1998, had a combined portfolio-at-risk of only 1.13%. The millions of weekly payments made in full and on time that lie behind that figure are eloquent evidence of the ability of the poor and the poorest to pay appropriate interest rates for their financial services.³³

So it is clear that the poor and the poorest can pay much higher effective interest rates on loans for income generation than has been presumed by many.

What about Savings?

Very little has been said in this paper about the tedious topic of savings. Few other issues in microfinance have sparked so much debate or aroused such emotions. Our relative silence on savings is not

meant to deny the importance of promoting the practice among the poor, on which most microfinance practitioners agree.

Savings are needed to provide a safety net for the poor so that in times of emergency (e.g., food shortage or illness) they have funds to meet their needs and to smooth deficit months so that they do not have to turn to exploitative moneylenders. Appropriate savings facilities are of particular importance to poor women who need a secure place to keep surplus funds, but also a place to which they themselves have easy access. Weekly meetings of an MFI with its clients in their villages provide the opportunity to supply such savings services. Through these services, clients can also build up their savings so as to be able to purchase the productive assets that can make their progress out of poverty sustainable, or to perform important social obligations. There is no doubt about the importance of savings to the poor.

Most MFIs also recognize the importance of savings for the institution and its business. Client savings, if partially blocked, can reduce the risk of lending to the poor. More important, savings can be a relatively cheap source of funds for MFIs, because interest rates that have to be paid to attract savings are usually less than those that have to be paid to borrow funds commercially.

Major differences exist among MFIs, however, on the relative emphasis to be given to savings as compared to credit as tools for poverty-reduction, and on the timing of the emphasis. These differences are illustrated by the three case studies in this paper. CARD, being a Grameen Bank replication/adaptation, gives primary emphasis to credit and only secondary attention to savings. Only small amounts of compulsory savings are required for the Group Fund to make clients eligible for much larger loans to finance income generation, the amount of which is not related to the

amount saved. As its clients progress, however, CARD increases the amount of compulsory group savings and promotes individual, voluntary savings. FINCA Uganda and CRECER, using the village banking approach, on the other hand, put primary emphasis on savings. Only after saving regularly for several months does a poor household become eligible for a loan, and the maximum that can be borrowed is restricted, at least in the case of FINCA Uganda, by times the amount saved.

The three case studies differ, as expected, in their average client savings balance, CARD having the lowest at US\$35 (even after nine years), followed by CRECER at US\$41 (five years) and FINCA Uganda at US\$49 (six years). We are surprised, however, to find that CRECER has the lowest savings to outstanding loans ratio at 25%, compared to CARD at 38% and FINCA Uganda at 99%. Notice that the ranking of the MFIs in terms of average loan outstanding is the reverse, CRECER having the highest at US\$165, followed by CARD at US\$103, and FINCA Uganda at only US\$50. FINCA Uganda's strict linking of loan amounts to savings may have limited the amounts that could be borrowed by the poor.

In addition to these differences among MFIs in terms of relative emphasis on credit and savings as instruments for poverty-reduction and their timing, there are major moral and legal issues involved with savings. The moral issue has to do with the need for adequate protection of the savings of the poor, and the legal issue revolves around the responsibility that governments usually take, through their central banks or other regulatory agencies, to provide this protection. As a result, NGO-based MFIs usually cannot legally mobilize deposits, even from their clients, not to mention from the public. However, many governments and regulators close their eyes to NGO-MFIs mobilizing deposits from their members, because they

realize that most are sincerely trying to help the poor. But, the question whether there is adequate protection for the deposits of the poor remains. And the possibility of legal action against deposit-taking NGOs is always there. Ultimately, such protection can come only from the capital adequacy of an MFI, but NGOs do not usually have any equity. For this reason, the amount of savings MFIs can mobilize will, and should be, restricted. So if NGO-MFIs want to offer progressive lending to large numbers of poor households, savings cannot be expected to be their major source of funds nor of institutional financial self-sufficiency. Savings could still be an important source of funds, however, and should not be neglected. Once an MFI becomes financially self-sufficient and builds up its equity through retained earnings, mobilizing deposits from the public could become its major source of funds for further poverty reduction.

Conclusion and Recommendations

Large numbers of the poorest households in Asia and growing numbers in Africa and Latin America are already being provided with financial services in a sustainable way. A close look at the case study MFIs has shown not only that this is being done, but also how to go about it. The key is increasing cost effectiveness so that the appropriate interest rate to the poor and the poorest can be minimized. Comparison with CFTS has revealed how this can be systematically planned and implemented in order to reduce significantly the period of time required to attain IFS, by maximizing the scope and depth of outreach to the poor and the poorest—provided adequate funding is available for a financial break-even for the MFI.

The key steps to increasing institutional efficiency are 1) cost-effective targeting, 2) maximizing both institutional and field staff

efficiency through management information systems, formal business planning, maintenance of loan portfolio quality with client incentives, and staff incentives, and 3) customizing financial products.

Once an MFI has planned for high levels of efficiency and managed its costs in such a way as to achieve those goals, the next step is to charge an appropriate interest rate and ensure that the rate is yielded by its portfolio.

Mainstreaming

For mainstreaming to occur in some of the poorest countries, key policy changes will have to take place. First, interest rate caps on loans to the poor and poorest must be removed where they still exist. Second, a suitable legal identity for providing microfinance to the poor and poorest (perhaps exclusively, to minimize leakage to the nonpoor) has to be created and provided with a regulatory system to support the overriding objective of reducing poverty by providing microfinance to the poor and poorest.

Attitudes also must change. Concerns remain within the microfinance community, and perhaps elsewhere, that IFS is not an achievable goal for many MFIs—particularly those which began as NGOs. Our case study MFIs provide empirical evidence that this is not true. Many NGO managers came into microfinance because of the promise it had shown through the success of the Grameen Bank of Bangladesh and other similar microcredit innovators, for large-scale reduction of poverty. Many are gradually transforming their multi-program NGOs into de facto financial institutions because microfinance has become their most effective program for poverty reduction. They are retraining to become competent managers of their microfinance institutions. Their motivation and job satisfaction do not come from banking per se, but from seeing with their

own eyes the increasing numbers of poor women lifting their families out of poverty and providing better lives for their children through the opportunities provided by the microfinance that the NGOs have delivered. It is hard to imagine a higher level of job satisfaction than is obtainable through providing microfinance to the poor and poorest in an efficient and financially sustainable way.

We hope that this paper has removed much of the mystique that has surrounded OSS, IFS, and AROA, and shown them to be attainable by MFIs managed by normal human beings who are motivated to reduce poverty through the provision of microfinance to the poor and the poorest, and who will take the trouble to learn how to do it in an efficient and financially sustainable way.

Leveraging

MFIs, provided with the suitable legal identity mentioned above, should begin to establish track records with commercial banks in their countries as soon as possible. Guarantee funds and quasi-equity in the form of subordinated soft loans provided by responsive donors or government agencies could help initially attract the banks. Once a relationship is established, however, the reliability of the loan recovery and the soundness of the financial management of the MFIs will determine to what degree to which banks are allowed to leverage their equity to obtain the huge amount of funds required to reach and benefit truly large numbers of the poorest households. Five-year business plans and effective monitoring of them, which show an MFI is on track to achieve planned targets, can attract the interest of banks even before an MFI begins to make profits. Although only 18 months old, CFTS has received credit lines from a commercial bank, the Oriental Bank of Commerce, at a market rate of 14.8% per annum: and from an apex bank, the Small

Industries Development Bank of India (SIDBI), at a near market rate of 11% per annum, because CFTS has an attractive business plan and can show that it is meeting its targets. Both banks are financing CFTS as a financial intermediary with the poor. Each bank has been given a 10% margin of the sanctioned amount in the form of a fixed deposit, and both have accepted loans with the poor as security. A rating by an independent microfinance institution rating agency that gave CFTS “alpha minus” status, meaning “recommended because of reasonable security and good systems,” was helpful in securing the line of credit from SIDBI.

Franchising to the Poor and the Poorest

To maximize their benefits to the poor and the poorest, MFIs could be sold³⁴ (franchised) to their clients once they attain IFS. In this way, the poor and the poorest would be able to enjoy some of the profits of their being provided with financial services. Also, this should remove any remaining concern about charging them “high” interest rates. Finally, it would free the franchiser to establish more franchises to reach and benefit more of the poor and poorest households, although it would have to ensure that quality was maintained in the franchises according to the franchise agreement. In this way, truly large numbers could be reached and assisted out of poverty.

Notes

1. For the purpose of this paper, the 1997 Microcredit Summit, and the Summit’s nine-year fulfillment campaign, any reference to microcredit should be understood to refer to programs that provide credit for self-employment and other financial and business services (including savings and technical assistance) to very poor persons.
2. We would like to thank the Microcredit Summit for inviting us to write this paper and for extending full cooperation in the process. Rob Gailey of the Secretariat deserves special mention for his hard work on our behalf.

The commitment of our case study MFIs to providing requested information in a timely and accurate manner, particularly given their commitments in the field, was very much appreciated. We would specifically like to thank Dolores Torres, Robert Ridgley, Stuart Bresnick, Barbara McKnelly, John Hatch, Michael McCord, and Paul Ssegawa. Valuable comments were received from a large number of readers to whom an earlier draft was circulated by the Summit Secretariat. Particularly valuable comments were received from Sam Daley-Harris, Alex Counts, Charles Waterfield, Howard Brady, Gary Woller, Bill Gheen, and Hartmut Schneider. We thank all commentators for the time they have taken out of their busy schedules. We have done our best to incorporate your suggestions, and feel the paper is much stronger because of them. Helen Todd proofread the final draft and made valuable suggestions. Nevertheless, we take final responsibility for what we have written. Comments are welcomed by both authors, whose e-mail addresses are as follows: gibbons@pc.jaring.my and jmeehan@asiaonline.net.

4. Here we follow the Microcredit Summit definition of the “poorest” families as those who live in households with incomes that place them in the bottom 50% of the poverty group as defined officially in each country. Households in the top 50% of a country’s poverty group are termed “poor.”
5. Jonathan Conning (1998, p.2), referring to Christen, 1997; Microfinance Network, 1998; and Otero & Rhyne, 1994.
6. The inflation and subsidy adjustments are calculated based on the method outlined in Chapter 2, “Evaluating MFI Financial Sustainability,” of Christen’s *Banking Services for the Poor: Managing for Financial Success*.
7. This is a very simplified assumption, which does not address the maintenance of principal value against inflation, among other considerations.
8. In some cases, apparently unlimited amounts of subsidized funds for on-lending to the poor may be available in the form of refinancing as “priority sector lending” from central or apex banks. The conditions required to obtain such funding, however, are likely to be similar to those for receiving commercial funding from formal financial institutions. Moreover, such subsidized lending may not be sustainable in poor economies.
9. A rejoinder was submitted to CGAP for publication, but rejected on grounds that many other contributions awaited publication that had to be dealt with first, before a “new issue” could be published. See Gibbons (1998) “Can the ‘Core Poor’ Benefit from Microcredit” in CASHPOR’s newsletter *Credit for the Poor*, Issue No. 20.

10. We have been asked why we did not choose better-known MFIs, like BancoSol, K-Rep, BRI, and Grameen Bank as case studies. The first three, BancoSol, K-Rep, and BRI, do not meet one of our key selection criteria: working with a substantial number of the poorest in their countries. The Grameen Bank, of course, has many clients among the poorest households in Bangladesh, but we thought our case would be stronger if demonstrated with a replication/adaptation. In this way we can avoid the sui generis argument.
11. E-mail communication from John Hatch, Founder and Director of Research, FINCA, March 8, 1999.
12. The figures quoted here are quarterly figures.
13. It is important to note that as the competitive environment among MFIs increases worldwide, as is currently being experienced in Bangladesh and many parts of Latin America, MFIs will be forced to reduce interest rates in order to retain their clients and remain competitive. Under such conditions, the impact on the long-term viability of inefficient and poorly managed institutions would be devastating.
14. Increasingly, efforts are being made globally to compile comparable operational and financial data on MFIs. One of the most comprehensive examples of this so far is the Microbanking Bulletin, produced originally by the Microfinance Program at the Economics Institute, Boulder, CO, and now by Calmeadow, which is distributed biannually. Efforts to develop rating agencies for MFIs, such as Private Sector Initiatives and EDA Rural Systems, and independently developed analyses, such as ACCION's CAMEL, will also contribute to these efforts going forward.
15. A separate paper at the Microcredit Summit Campaign's 1999 Meeting of Councils in Abidjan will address this topic in significant detail.
16. For more information, please refer to the manual *Cost-Effective Targeting: Two Tools to Identify the Poor* by David Gibbons and Anton Simanowitz with Ben Nkuna. CASHPOR: Seremban, Malaysia (Fax(606)7642307 & e-mail: gibbons@pc.jaring.my)
17. Any local currency unit can be included here. In cases where 1 unit of a currency is not a meaningful measure, 100 units or 1000 units (a multiple of ten) can be used.
18. E-mail communication from Chuck Waterfield, March 26, 1999.
19. For more details, please refer to the CGAP's *Handbook for Management Information Systems for Microfinance Institutions*, February 1998, prepared by Nick Ramsing and Chuck Waterfield.
20. See the final version of the CGAP's *Format for the Appraisal of Microfinance*

Institutions (1997), the SEEP Network's paper *Financial Ratio Analysis for Microfinance Institutions* (1995), and CASHPOR's recently revised manual *Tracking Financial and Operational Performance* (1999).

21. For guidelines on calculating portfolio-at-risk and using it to determine the appropriate loan loss provision, see CGAP (1997) and Christen (1997).
22. This is understood by changing assumptions such as amount of funding, administrative costs, etc. to gauge their impact on other key indicators, such as efficiency, OSS, and IFS. This is often called variance or sensitivity analysis.
23. See, for example, the new CGAP *Business Planning and Financial Modeling for Microfinance Institutions: A Handbook*, (November 1998), prepared by Tony Sheldon and Chuck Waterfield.
24. The 5-Year Business Plan is not, of course, fixed for a period of five years. It will have to be updated and amended several times in light of varying actual experience during the period. The updated financial model will show the likely impact of such changes on the triple goals of maximizing the delivery of financial services to the poor in an efficient and financially sustainable way.
25. "High risk" would be the nonpoor, or those known in the village not to be trustworthy in matters of money.
26. This is earning enough additional income to put the household above the official poverty-line income.
27. For fuller development of this point, see Gibbons (1998b).
28. The authors are grateful to Ismail Serageldin, vice president of the World Bank, for ensuring that this section and the following two sections were included in the paper.
29. We are grateful to Huguette Labelle, president of the Canadian International Development Agency, for bringing this danger to our attention.
30. We are grateful to Howard Brady of Global Partnerships in Seattle for specifically recommending this analysis be included here. It has greatly added to the strength of the paper.
31. For the version of this paper presented at the Microcredit Summit Meeting of Councils in Abidjan in June 1999, an incorrect figure of 42%, representing CRECER's APR, was reported to us. This version of the paper includes the corrected figure of 82.4%. The Gap Analysis section has been adjusted accordingly.
32. Director of the Social Science Division at the International Institute for Rice Research (IRRI), Los Banos, Philippines. (Hossain & Diaz, 1997)

33. We have been informed of a Tagalog saying among the poor in the Philippines: “In extreme need, one will hold on even to the sharp edge of a knife.” But we do not think it is relevant to microcredit for the poor. What is convincing about the near perfect repayment rates in microfinance for the poor is their persistence over decades, which can be taken as evidence that they are benefiting from the opportunity. Otherwise, how would they be able to repay in full so consistently?
34. The Grameen Bank, which is majority-owned by its clients, shows that this is possible.

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