Grameen Trust, a not-for-profit organization created to promote awareness and action for the elimination of poverty and hunger.

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GRAMEEN DIALOGUE

Newsletter Published by the Grameen Trust, Bangladesh

July, 2001

A New Financing Strategy For Scaling-Up Microfinance For The Poor

David Gibbons

Effective microfinance services to reach significant numbers of poor households throughout Asia, will have to be largely corporatized and privatized. NGOs that are providing some microfinance services and government sponsored microfinance programs of all kinds, will not be able to handle the gargantuan task between themselves. Moreover banks will not willingly make available to such programs the massive amounts of funds required. Only well-managed, financially-sound and privately-owned microfinance companies will be able to access their required funds.

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Fast-Track Break-even

It takes too long for most GB type microfinance institutions (MFIs) to break-even financially, often 10 years or more. Essentially, this is because they are not able to attract sufficient funding to grow at anything near an optimal rate. Accumulated deficits increase, negative equity (technical bankruptcy) is experienced and further mobilization of large amounts of funds becomes impossible. So the MFIs muddle on, increasing their outreach to the poor when they can access funds, and inch toward operational self-sufficiencty.

There is an alternative. A "fast-track" approach to institutional financial break-even within 4 to 5 years, through maximizing outreach to the poor, can be taken, if adequate funding is available. Quasi-equity funding, that is soft loans repayable in local currency, with terms of 8 to 10 years and grace periods of 6 to 8 years, that enable their repayment out of profits, and that are legally subordinated to other debt, can cover the inevitable accumulated operating deficits prior to break-even. It will keep the MFIs solvent and leverage, at near-market and market rates, the increasing amounts of on lending funds that will be required.

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Towards A More Appropriate Legal Framework

While some Central Banks throughout Asia, including the *Banko Sentral na Philippinas*, have recognized the potential of new generation microfinance for widespread reduction of poverty in their countries, none have fully acknowledged the unconventional nature of microfinance for the poor i.e. unsecured loans with near-perfect repayment rates, but a shortage of conventional equity. Nor have they fully facilitated the vital role that private sector microfinance companies could play in poverty-reduction. Microfinance for the poor should not be forced into the Procrustean bed of conventional banking regulations, like for example requiring MFIs to become banks. They do not need to be banks to do microfinance with the poor; they need their own set of enabling and suitable prudential norms and regulations.

Capital Inadequacy

Initially these microfinance companies for the poor (MFCPs) will have difficulty in attracting private investment. Primarily this is because investors don't yet see microfinance with the poor as a potentially profitable enterprise. Indeed some still believe it to be immoral to make money in doing business with the poor. This will change when the number of companies making reasonable profits in this business increases. **Meanwhile, however, the shortage of conventional equity creates two major, interrelated**

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A New Financing Strategy For Scaling-Up Microfinance For The Poor

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\problems for microfinance companies: slower than optimal rates of growth due to shortage of funds, and large operational deficits prior to institutional financial break even, which itself is delayed by the less than optimal growth rates. The resulting negative equity further frightens off potential investors and makes banks, including development banks, reluctant to lend to microfinance companies, even at market rates.

CASHPOR Financial & Technical Services Ltd (CFTS) commenced operations in Mirzapur, Uttar Pradesh, India, in Sept. 1997, to prove that with adequate financing an MFCP could break-even financially within 5 years, by providing quality financial services to about 20,000 poor households at the district level. CFTS has met its business plan targets for fiscal 00/01. Three and a half years later, with 10,613 active loan clients (97% of target), Rupees 30.1 million loans outstanding (102% of target) and only 1.284% portfolio at risk (slightly better than the 1.5% target), the company is projected to break-even financially within one year, that is, by end March 2002. At that time, four and a half years from start-up, it will be providing financial services to more than 20,000 poor households in Mirzapur District. Thereafter efforts will be made to transform CFTS Mirzapur into a community-owned financial institution for the poor, by offering shares to its clients.[1]

How Was CFTS Financed?

CFTS was not able to attract much conventional equity nor, indeed, much grant funding. However, it has been able to attract sufficient amounts of other types of funding, particularly longer-term soft loans and shorter-term near-commercial loans. Initial start-up funding for CFTS was provided by conventional equity, actually share application money from CASHPOR Technical Services Sdn Bhd, an associated company of CASHPOR Inc, based in Malaysia. A large soft loan from the **Grameen Trust** of Bangladesh, however, provided most of the funds for training of field staff and establishing branches as well as for initial loan capital. A small grant from a private Indian company helped with the preliminary operating expenses. Next, in Year 2, came a soft loan from the **Calvert Social Investment Foundation USA** which was used for operating expenses. The **Small Industries Development Bank of India (SIDBI)** started providing near commercial funding for on lending (at 11% pa, compared to a prime lending rate of 12%) in Year 2, and has supplied additional amounts each year, as the demand for our loan products has increased. In Year 3, **Friends of Women's World Banking (FWWB)** began supplying commercial funding (at 14% pa) for on lending. Currently it is considering our application for a second loan. The **Grameen Foundation USA** provided a soft loan of about Rupees 10 million for on lending in Year 4, and currently is considering our application for additional funding.

Re-arranging this funding conceptually by type and use, gives the following interesting picture:

(In million Indian Rupees)

No.	Type	Amount	%	Use
1	Equity and grants	4.583	6.6	Preliminary expenses and operations
2	Soft loans	28.864	41.3	Operations and on lending
3	Near-commercial loans	31.5	45	On lending
4	Commercial loans	5.0	7.1	On lending
	Total	69.947	100	

Important observations on the actual funding of CFTS to-date are:

- **the relative unimportance of conventional equity and grant funding**, accounting for only 6.6% of total funding over the three and one-half year period;
- the **critical importance of medium to long-term soft loans**, being 41.3% of total funding and covering operating deficits as **quasi-equity;**
- the **virtual equal importance of near commercial loans for on lending** and
- the **relative unimportance of commercial loans.** The accumulated deficit of CFTS as of end Sept. 2000 was Rupees 12.2 million, which is less than half of our soft loans that are designed to cover it. The projected accumulated deficit for the end of the current fiscal, which will be its highest prior to break-even, is about Rupees 17 million. Therefore, it is expected that the same funding strategy will see CFTS through to operational self-sufficiency within one more year, i.e., by end March 2002 and enable it to cover its accumulated deficits by the end of the next fiscal year. For on lending funds after institutional financial break-even, however, CFTS will have to seek an increasing proportion of funds at commercial rates from banks.

Toward A New Financing Strategy

Based on its experience in India, CASHPOR is formulating a new financing strategy for its member MFIs,

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[1] CASHPOR is planning to "franchise" its microfinance methodology for poverty-reduction to other poor districts throughout the Hindi heartland. Its ability to do this, and therefore, its ultimate impact on poverty in India, will depend primarily on the financial resources that it can attract. Our experience in eastern UP has shown us that human resources are not a constraint in India. Training of new field staff in microfinance is necessary of course, but it is mostly on-the-job in existing branches, and can be co-ordinated with the human resource requirements of the planned franchising. Training for senior staff in financial management will have to go hand-in-hand, but it is already available at various institutions in India and elsewhere, for the small numbers of personnel that will be involved.

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to operational and full financial self-sufficiency through maximizing their outreach to the poor. It identifies the funding requirements of MFIs according to their stage of development, and suggests the types and possible sources of funding that could meet the needs. It is hoped that member MFIs will build this strategy into their business plans; and that funders will play their appropriate roles, so that microfinance can achieve its great potential for significant reduction of poverty throughout Asia.

Suggested Types of MFI Funding

Stage of Development of an MFI				
Type of Expenditure	**Start-up**	**Year 3 to 5**	**Operational Self-sufficiency**	**Fill Self-sufficiency**
Operating	1. Equity 2. Grants	1. Quasi-Equity	1. Interest Income	1. Interest Income
On lending	1. Grants 2. Quasi-Equity	1. Quasi-Equity 2. Savings 3. Near Market Rate Loans	1. Savings 2. Near Market Rate Loans 3. Guarantee Funds 4. Market Rate Loans	1. Savings 2. Market Rate Loans 3. Retained Earnings

Grants from donors must be sought to cover the heavy, up-front costs of training and motorizing field staff and establishing branches, as well as the development costs of group formation. Supplying such grants to MFI start-ups is a particularly suitable role for bi-lateral donors and development foundations. However, donors may find the sum involved, around US$250,000 over three to four years, too small to process. This may point to a role for MFI wholesalers to package start-ups in a particular country, so that donors would be able to process one big loan, instead of several smaller ones.[2] If equity and grants are not sufficient to cover on lending as well as operating expenses, then quasi-equity in the form of 7 to 9 year term soft loans, with grace periods of 5 to 7 years, at interest rates of 2 to 5%, and repayable in local currency, should be sought to cover the balance. These soft loans should be legally subordinate to current loans.

Importance of Quasi-Equity

Medium to long-term, soft loans that are legally subordinated to current debt and are not callable, can be called quasi-equity, because they are designed to be repaid out of profits after institutional financial break-even. In concept, they are similar to equity provided in the form of medium to long term redeemable preferred shares. **Quasi-equity is vital to the financing of MFIs working with the poor because normally they will not be able to attract enough conventional equity or grants to cover all of their development costs and operating deficits prior to break-even. If the quasi-equity can cover up to half of these essential expenditures, then the MFI may not experience negative equity, and it should be able to attract an increasing amount of on lending funds in the form of loans from domestic development banks, at near-market rates.** This is important because much of the quasi-equity may have to cover essential development costs and operating deficits, and will not be available for on lending. Of course, the interest rate charged by the MFI to its clients will have to be sufficient to cover the cost of funds, as well as other essential operating costs.

Only a few organizations are supplying quasi-equity to GB-type MFIs. The Grameen Trust of Bangladesh was a pioneer of this kind of funding; but its impact has been restricted by limiting the proportion that can be spent on development costs and operating deficits to 40% of the total funding. Development banks, like SIDBI in India, have begun financing MFI capacity-building with quasi-equity. The Grameen Foundation USA is financing some MFI capacity-building with quasi-equity. Much more of such funding should be made available to well-managed MFIs that are on-track with their business plans toward operational self-sufficiency. It is most appropriate during years 3 to 5 in the development of an MFI, and also most needed then as initial equity and grants are likely to have been exhausted by development costs and deficits. Development foundations and Trusts, national and international, as well as national-level microfinance funds should give priority to such funding, as the primary goal of many of these organizations is social development. Development banks also should provide some quasi-equity, along with their semi- and near-commercial loans to MFIs.

Don't Forget Savings

Where savings facilities can be provided legally to microfinance clients, they can be a relatively cheap source of funds for MFIs, enabling them to bring down their average cost of funds. However, microfinance companies may not be permitted to mobilize savings until they can meet minimum capital requirements laid down by monetary authorities.

Development Banks, Microfinance Funds and Finally, Commercial Banks

The main role for quasi-equity is to cover essential development costs, e.g., staff training and group formation costs, that cannot be covered with conventional equity or grants. Some quasi-equity may be left over for on lending, but usually it will not be much. By the third year the on lending requirements of an MFI will have become large. National-level Microfinance Funds and Development Banks can play a vital role at this time by providing on lending funds at semi- or near-market rates. Not only will this help growing MFIs to source the funds required to meet their business plan targets for loans outstanding and interest income, but also it will help the MFI to build the capacity to pay higher, more realistic, interest rates for their funds. This should enable them to borrow the increasing amounts that they will require to finance their expansion toward opera-

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[2] I am grateful to Stav Zotalis of AUSAID for this point.

New Technology for Poverty Alleviation:
Rural Phones Service Is Profitable In Poor Countries

In poor countries, most people, in all about half the world's population-still live in rural areas. Village phone service is rare, Internet service non-existent and poverty widespread. In Bangladesh, for example, 90 percent of the country's 68,000 villages have no phone service of any kind and average annual income is less than $ 200 per person. It might not sound like a promising commercial telecom market, but appearances can be deceiving.

Since 1997, **Grameen Phone** has provided commercial cellular services in Bangladesh, operating primarily in urban areas. A subsidiary, working with the micro-finance organization Grameen Bank, now provides cellular phone service in rural areas via local entrepreneurs, usually women. Each local entrepreneur owns and operates a cell phone that typically serves an entire village. Villagers pay for phone calls in cash, by the minute. Grameen Bank helps by lending the entrepreneur money to buy the phone and collecting payments from them for phone usage on behalf of **Grameen Phone.**

These shared access village phones are very profitable, generating revenues that now average $1,200 per year per phone, more than three times as much as the company's urban phones. Each phone serves an average of nearly 70 customers - in effect, tapping the buying power of a whole village. Per phone revenues have more that doubled in two years of service. A study by the Canadian International Development Agency shows that the village phones also have a big social impact. For villages, access to phones often substitutes for a trip to Bangladesh's capital Dhaka, that could take days and cost many times as much as the call. Villagers also use phones to find out current market prices for their crops, arrange remittances from family members working abroad, and obtain urgent medical help.

If it works in Bangladesh, how about in rural areas elsewhere? If phone and perhaps Internet services can be provided profitably to rural communities through shared access, then opening up such regions to commercial telecom competition may be an effective way of stimulating rural development and providing significant social and economic benefits to impoverished areas. The business opportunity also seems large enough to stimulate private investments, becoming the phone company and the Internet service provider for nearly half of humanity.

Expanding Micro finance -With Digital Technologies

Micro loans in their modern form were pioneered by the Grameen Bank to provide a source of credit for poor people in Bangladesh. Today more than 1,000 micro finance institutions offer micro loans between $150 and $ 500 to five million clients in poor rural communities or urban slums spread across Africa, Asia and Latin America. Yet relatively few poor people have access to micro loans, only about five percent of an estimated 500 million potential borrowers worldwide. Major reasons are inefficient practices and the resulting high costs of processing loans and keeping records. Few if any micro finance institutions are profitable, so they cannot tap banks or capital.

What may change this picture is the advent of digital tools to automate transactions and increase efficiencies. Imagine a loan officer travelling from village to village equipped with mobile data entry device similar to that used by FedEx delivery personnel transmitting loan data over wireless and a central computer. Micro finance institution operating in Mexico are now testing the palm pilots equipped with simple accounting software for their loan office and many such groups are introducing computerized accounting systems.

PRIDE AFRICA operates in six East African countries where half the population subsists on less than $1 a day. PRIDE link a base of 100,000 clients to financial services information, and markets. It has developed its own banking software to manage micro loans and small savings accounts and to automate administrative tasks. The group is now experimenting with magnetic cards and information kiosks that allow even illiterate clients to access their accounts and check loan balances while cutting costs. PRIDE software will enable it to bundle together loans from tens of thousand of its clients and resell them to commercial banks, opening up capital markets to finance expansion.

PRIDE Founder Jonathan Campaign points out that micro finance can benefit from the same emerging Internet based technologies that are forcing retail bankers everywhere to rethink their business model. These include tools like data mining, customer service and support software, and customer relationship management applications. PRIDE, for example, hopes to work with partners to build an Internet based virtual "back-office" and provide tools that are easier for poor clients to use, all with the intent of making access to financial services as widespread as the traditional African drum.

Extracted from the ***Business week****, December 18, 2000.*

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For further expansion, and to make a significant impact on poverty in their country, MFIs ultimately will have to access on lending funds from commercial banks. Initially, banks will see microfinance with the poor as a high risk business, because they will doubt the ability of the poor to repay, and because most microfinance loans will be unsecured. **Guarantee Funds** can play a critical role in bringing well-performing MFIs and commercial banks together by guaranteeing to the bank a sizeable proportion of the repayment of the MFIs, thereby reducing the risks of the banks.

Minimum Standards for MFCPs

Funders of MFPCs will expect efficient provision of financial services to the poor, and effectiveness in poverty-reduction. Minimum standards for operational and financial performance of MFCPs need to be established; and funders should make their continued participation contingent upon reasonable adherence to these standards.

DEVELOPMENT ALTERNATIVES

The monthly newsletter on issues of sustainable development.

Contents

The views expressed in the articles in this newsletter are those of the authors and not necessarily those of Development Alternatives.

Owner, printer and publisher: Dr. Ashok Khosla on behalf of Development Alternatives. (Special Correspondents: Ambika Sharma and Vivek Kumar).

Published from B-32 Tara Crescent Qutab Institutional Area, New Delhi - 110 016

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Printed at AR Printing Services, 2009 Pilanji, Kotla Mubarak Pur, New Delhi - 110 003

Price: Rs.20.00

Editorial

Making Development a Good Business

Ashok Khosla

There are, in India today, some 700 million people outside the mainstream economy – twice as many as inhabited the entire subcontinent at the time of Independence.

Clearly, if present trends continue, it will be some time before the trickle down theorized by economists reaches the poor. A length of time that neither our polities nor our ecologies — let alone our moral conscience as a nation — can hope to survive.

The eradication of poverty needs different approaches. First, of course, it needs some deep structural changes in society: grassroots democracy, land reform, access to livelihood resources and fulfillment of everyone's right to reasonable education and health care. Such change is worth the strongest struggle on the part of every citizen, but the opposition to it from the rich and powerful means that it will be gained only over the long haul. In the meantime, it is also worth mounting an attack on poverty within the existing systems, highly resistant to change though they may be, to remove at least the most extreme forms of inequity.

To do this, technology and the marketplace must be subverted to the cause of what Mahatma Gandhi called antydaya – "putting the last first" – mainly by creating the conditions which generate jobs and livelihoods that will enable the mass of people to position themselves in society to start asserting their rights and getting them. The instruments needed to achieve this are far more sophisticated and complex than any available today. And, that means we need the highest levels of innovation and implementation– which in turn requires the very best in creativity and management expertise.

But, herein lies a fundamental contradiction.

After all, the very best in creativity and management expertise comes at a price – a price today determined by the interplay of economic forces in the so called global economy. Mechanical engineers, software designers and MBAs are, nowadays, commonly starting their careers with salaries approaching 30,000 US Dollars a year, even in an economy like India's; and double that for overseas assignments. The cost of the office space, computers, equipment, air conditioners, cars, travel and other operational expenses they need is comparable to and sometimes higher than in the industrialized countries. And these are the kinds of costs faced by any meaningful initiative to create sustainable livelihoods.

In the industrialized economy, the prices commanded by the outputs of activities based on such costs can easily be paid by the customer, who also earns comparable incomes – that after all, is the basis of the closed loop of household incomes and corporate expenditures that is explained in Chapter One of every economics textbook.

But in a rural economy like that of India, the customer earns less than two dollars a day.

Clearly, there exists a massive disjoint between the cost of the goods and services needed by the poor and the prices they can pay for them. One solution lies in creating standardized products and high volume sales – a state that takes time to build up to. The second solution lies in subsidizing the one time cost of research, startup and operationalizing a business so that the customer faces only the downstream recurring costs of production and distribution – probably the only type of subsidy that can be justified on any ground.

Both solutions need public resources for the capital investments so that the incremental costs of each unit of product or service can be brought down to a level that is affordable to the buying public. And they need private sector inputs, too: operational financing, efficiency and the ability to deliver results.

This is why Development Alternatives and its affiliates such as TARA and TARAhaat have found it necessary to mix the public and the private, a pure anathema in conventional institutional design. The breakthrough lies in clearly separating the objectives, which are social, environmental and developmental, from the strategies and methods used to achieve them, which are purely business. And that means we need sources of capital that can accept longer time horizons for achieving profitability and possibly lower profits than are usually available in the market. Clearly, in the early stages of such development ventures, financing of this type is more likely to come from public agencies and development banks than it is from venture capitalists – unless they are unusually visionary and can see the value of the social benefits now and the larger returns to come later. ❑