

SUSTAINABLE BANKING with the POOR

MICROFINANCE

HANDBOOK

An Institutional and Financial Perspective

Joanna Ledgerwood

THE WORLD BANK

WASHINGTON, D.C.



Contents

Foreword xv

Preface xvi

Introduction 1

PART I—ISSUES TO CONSIDER WHEN PROVIDING MICROFINANCE 9

Chapter 1 Understanding the Country Context	11
Suppliers of Financial Intermediation Services	12
Existing Microfinance Providers	14
What Role Do Donors Play in Microfinance?	16
Financial Sector Policies and Legal Enforcement	17
Interest Rate Policies	18
Government Mandates for Sectoral Credit Allocations	19
Legal Enforcement of Financial Contracts	19
Financial Sector Regulation and Supervision	20
When Should MFIs Be Subject to Regulation?	21
Considerations When Regulating MFIs	23
Country Approaches to Regulating MFIs	25
Economic and Social Policy Environment	26
Economic and Political Stability	26
Poverty Levels	28
Investment in Infrastructure and Human Resource Development	28
Government View of the Microenterprise Sector	29
Appendix 1. Risks in the Microfinance Industry	30
Sources and Further Reading	31
Chapter 2 The Target Market and Impact Analysis	33
Objectives of the Microfinance Institution	33
Direct and Indirect Targeting	34
The Importance of Adequate Cash Flow and the Capacity to Service Debt	35

Minimal Equity Requirement	36
Moral Hazard	36
Market Size	36
Identifying the Target Market	37
Characteristics of the Population Group	37
Types of Microenterprises	42
Impact Analysis	46
Kinds of Impacts	47
What Kinds of Impacts Have We Seen with Microfinance?	48
Impact Proxies	49
Client-Oriented Impact Analysis	49
When Should Impact Be Assessed?	52
Methods of Impact Assessment	53
Fundamental Characteristics of Qualitative Approaches	53
Fundamental Characteristics of Quantitative Approaches	54
Comparisons of Quantitative and Qualitative Approaches	56
Integrating Methodologies	56
The Choice of Unit of Analysis	56
Appendix 1. Quantitative Impact Assessment	58
Sources and Further Reading	59

Chapter 3 Products and Services 63

The Systems Framework	64
Microfinance Institutions—Minimalist or Integrated?	65
Financial Intermediation	66
Credit	66
Savings	71
Insurance	74
Credit Cards and Smart Cards	74
Payment Services	75
Social Intermediation	76
Enterprise Development Services	78
Social Services	81
Appendix 1. Microfinance Approaches	82
Appendix 2. Matching Enterprise Development Services to Demand	86
Sources and Further Reading	90

Chapter 4 The Institution 93

The Importance of Institutions	93
Attributes of a Good Institution	94
The Importance of Partner Institutions	94
Institutional Types	97
Formal Financial Institutions	97
Semiformal Financial Institutions	101
Informal Financial Providers	104

Institutional Growth and Transformation	106
Expansion Within an Existing Structure	106
Creating an Apex Institution	106
Creating a Formal Financial Intermediary	109
Governance and Ownership	110
Accessing Capital Markets	113
Institutional Capacity Building	117
Appendix 1. MFI Operational Review	118
Appendix 2. Manual for Elaboration of a Business Plan	123
Sources and Further Reading	128

PART II—DESIGNING AND MONITORING FINANCIAL PRODUCTS AND SERVICES **131**

Chapter 5 Designing Lending Products **133**

Cash Patterns, Loan Terms, and Payment Frequency	133
Client Cash Patterns and Loan Amounts	133
How Does the Loan Term Affect the Borrower's Ability to Repay?	134
Frequency of Loan Payments	136
Working Capital and Fixed Asset Loans	136
Loan Collateral	137
Collateral Substitutes	137
Alternative Forms of Collateral	138
Loan Pricing	138
Calculating Interest Rates	140
How Do Fees or Service Charges Affect the Borrower and the MFI?	142
Cross-Subsidization of Loans	143
Calculating Effective Rates	143
Estimating the Effective Rate	144
Calculating the Effective Interest Rate with Compulsory Savings or Other Loan Variables	146
Calculating the Effective Interest Rate with Varying Cash Flows	147
How Does the Effective Cost for the Borrower Differ from the Effective Yield to the Lender?	148
Appendix 1. How Can an MFI Set a Sustainable Rate on Its Loans?	149
Appendix 2. Calculating an Effective Interest Rate Using the Internal Rate of Return Method	150
Appendix 3. Calculating the Effective Rate with Varying Cash Flows	152
Sources and Further Reading	153

Chapter 6 Designing Savings Products **155**

Demand for Savings Services	156
Is There an Enabling Environment?	157
Legal Requirements for Offering Voluntary Savings Services	157
Deposit Insurance	158
Does the MFI Have the Necessary Institutional Capacity to Mobilize Savings?	160
Ownership and Governance	160
Organizational Structure	160
Human Resources	161
Marketing	162
Infrastructure	163

Security and Internal Controls	163
Management Information Systems	163
Risk Management and Treasury	163
Sequencing the Introduction of Savings Services	164
Types of Savings Products for Microentrepreneurs	164
Liquid Accounts	165
Semiliquid Accounts	165
Fixed-Term Deposits	166
Costs of Mobilizing Voluntary Savings	166
Pricing Savings Products	167
Sources and Further Reading	168
Chapter 7 Management Information Systems	169
An Overview of Issues Related to Management Information Systems	170
Three Areas of Management Information Systems	171
Accounting Systems	171
Credit and Savings Monitoring Systems	172
Client Impact Tracking Systems	178
Installing a Management Information System	178
Institutional Assessment	178
Configuration	178
Software Modifications	179
Testing	179
Data Transfer	179
Training	180
Parallel Operations	180
Ongoing Support and Maintenance	180
Appendix 1. Overview of Commercial Management Information System Software Packages	180
Appendix 2. Criteria for Evaluating Loan Tracking Software	183
Sources and Further Reading	183
PART III—MEASURING PERFORMANCE AND MANAGING VIABILITY	185
Chapter 8 Adjusting Financial Statements	187
Accounting Adjustments	188
Accounting for Loan Losses	188
Accounting for Depreciation of Fixed Assets	192
Accounting for Accrued Interest and Accrued Interest Expense	193
Adjusting for Subsidies and Inflation	194
Accounting for Subsidies	195
Accounting for Inflation	197
Restating Financial Statements in Constant Currency Terms	199
Appendix 1. Sample Financial Statements Adjusted for Subsidies	200
Appendix 2. Sample Financial Statements Adjusted for Inflation	202
Sources and Further Reading	204

Chapter 9 Performance Indicators	205
Portfolio Quality	206
Repayment Rates	206
Portfolio Quality Ratios	207
Loan Loss Ratios	211
Productivity and Efficiency Ratios	212
Productivity Ratios	212
Efficiency Ratios	213
Financial Viability	215
Financial <i>Spread</i>	216
Two Levels of Self-Sufficiency	216
Subsidy Dependence Index	218
Profitability Ratios	220
Return on Assets Ratio	221
Return on Business Ratio	222
Return on Equity Ratio	223
Leverage and Capital Adequacy	223
Leverage	224
Capital Adequacy Standards	224
Scale and Depth of Outreach Indicators	225
Performance Standards and Variations	227
Appendix 1. Sample Balance Sheet	233
Appendix 2. Sample Income Statement	234
Appendix 3. Sample Portfolio Report	235
Appendix 4. Adjusted Sample Financial Statements (Combined)	236
Appendix 5. Analyzing an MFI's Return on Assets	238
Sources and Further Reading	241
Chapter 10 Performance Management	243
Delinquency Management	243
The Effect of Delinquency on an MFI's Profitability	244
Controlling Delinquency	245
Rescheduling or Refinancing Loans	246
Productivity and Efficiency Management	248
Improving Staff Productivity	248
Managing Costs	251
Risk Management	254
Asset and Liability Management	254
Operating Risk Management	258
Appendix 1. Gap Analysis	260
Sources and Further Reading	261
GLOSSARY	263
INDEX	271