WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

The Agence française de développement (AFD) has been supporting a large number of microfinance institutions since 1990. FINCA Perú is a non-profit association that successfully combines additional non-financial services with its microfinance loan activity. In this article, Philippe Serres (AFD) and Iris Lanao Flores (FINCA Perú) analyze the impact this diversification of services has had on profitability, after comparing the different management methods of microfinance institutions.

# Microfinance and non-financial services: an impossible marriage?

*Microfinance institutions (MFIs) can - in addition to their classic products - develop non-financial services: vocational training, technical assistance, agricultural or health education. The comparative assessment of five Latin American MFIs (including FINCA Peru) shows that performance varies depending on how non-financial services are integrated into usual activities, but that this diversification is possible and even seems to make a great improvement to the quality of the portfolio. However, the choice of the integration model ("linked", "parallel" or "unified") and its implementation must be carefully tailored to the context.*

**By Iris Lanao Flores,** ***CEO of FINCA Peru,***
**and Philippe Serres,** ***Project Officer at Agence française de développement***

Like many other development instruments, microfinance has generated various debates about its capacity to fight poverty. Many practitioners argue that microfinance *per se* needs to be combined with other actions to effectively improve the living conditions of its beneficiaries. Based on this principle, a number of microfinance institutions (MFIs) with a strong pro-poor positioning promoted the idea of comprehensive microfinance services (Hickson, 1999). Under this approach, MFIs provide beneficiaries with financial services (credit, savings, insurance) along with non-financial services (primarily education, but also health services, practical training, and technical assistance). These aim at improving the borrowers' capacities to develop sustainable income-generating activities.

This approach has been challenged by other practitioners. Arguments include MFIs' lack of skills or lack of a mandate to provide non-financial services. Such services may divert the attention away from the financial services and send contradicting messages to clients (especially if they are free of charge). Non-financial services may also impede MFIs' ability to reach financial self-sufficiency, as they generate high costs that add to the already expensive microfinance operations.

However, some successful models, including CRECER in Bolivia, the Pro Mujer network in Latin America, FINCA Peru, BRAC Bangladesh and ASA India, show that institutions can be sustainable while combining financial and non-financial services in highly competitive environments. What is the real impact of non-financial services on MFIs' performance, especially their financial and operational results? This article will briefly address these issues through a review of the existing delivery models, a performance benchmarking exercise based on Latin American MFIs, an attempt to identify the performance factors and a focus on one particular provider that puts the double bottom line high on the agenda: FINCA Peru.

## Various models, various results

There are three main models of integration of non-financial services with microfinance, leading to different results in terms of performance and management: the linked, the parallel and the unified models. In the linked model, services are provided by two independent organizations. The MFI does not directly provide non-financial services but establishes a partnership with another entity to do so. This may be very appropriate for schemes including specialized non-financial skills that cannot be found within the MFI, like health services or technical assistance for agriculture. This model also allows to know the exact cost of non-financial services and to decide how to better handle it. However, one of its weaknesses is that the MFI has little control on the quality of its partner's services.

The parallel model is often applied by multiservice organizations, as opposed to fully-fledged MFIs. Here, financial and non-financial services are offered by the same organization under different programs and are managed by separate, specialized personnel who share the same brand. For example, FUNDAP in Guatemala, or Interactuar in Colombia, have strong training and microcredit programs, provided by different departments to clients who are not necessarily beneficiaries of both services. This model allows to employ spe-

[1] *www.freedomfromhunger.org*
[2] *The MIX is the leading provider of business information and data services for the microfinance industry (www.themix.org).*

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cialized staff and to have direct control on each program. However, managing each program separately generates a significant financial and administrative burden on the organization. Also, the comprehensive approach is not really implemented since financial and non-financial services are offered to different beneficiaries.

The unified model seeks complementarity between financial and non-financial services by embedding them in a hybrid product to be provided by the same staff. In this scheme, unlike the two other models, non-financial services are generally compulsory for the beneficiary of financial services. Services usually involve education activities, which occur during regular group meetings. A well-known example is the *Credit with Education* model developed by Freedom From Hunger[1]. It is based upon a village banking methodology, whereby groups of 15 to 25 women meet every week to receive financial services from a loan officer, who then gives a 10 to 20 minutes education session on issues such as health, nutrition, business and financial literacy. If well integrated, this model can be cheaper for MFIs than the two others: apart from management costs (for training materials, training of trainers, etc.) it only requires extra time at the end of each meeting. However, measuring this extra cost is challenging, since all services are provided by the same staff.

## Looking at the numbers

The table below compares the performance of five major Latin American MFIs with a strong non-financial services component to peer groups in Latin America and throughout the world reported by The Microfinance Information Exchange (The MIX)[2].

The five non-financial service MFIs analyzed report diverse operating expense ratios, ranging from 21% to 58%, but always higher than their peers in Latin America (19.5%). The larger non-financial service MFIs (CRECER, Pro Mujer Bolivia, Pro Mujer Peru) have an operating expense ratio quite similar to that of MFIs using the village banking methodology (25.4%). However, the smaller FINCA Peru and Pro Mujer Nicaragua have a much higher operating expense ratio than MFIs using the village banking methodology (48.3% and 38.0% respectively). Given that the MFIs using the village banking methodology have a small outstanding portfolio (3.8 M USD), quite comparable to the outstanding portfolio of FINCA Peru (2.7 M USD) and Pro Mujer Nicaragua (5.1 M USD), one can state that overall, MFIs providing non-financial services face a heavier cost structure. Some studies have intended to look closer at the cost of non-financial products. Freedom From Hunger has made an interesting valuation of the extra cost of the Credit with Education model (Dickey *et alii*, 1999). The study shows that this extra cost is less than 10% of the total costs of the MFI, with lower cost rates as the program matures.

In order to cover the costs of delivering non-financial services, MFIs tend to charge higher interest rates. Indeed, the five non-financial service MFIs boast a higher yield on portfolio (good estimate of their actual interest rate) than their peer groups. Consequently, they report solid profitability ratios, with a ROA ranging from 6% to 16%, while the ROAs of their peers do not exceed 2%. Such strong profitability may mean that these MFIs want to self-finance themselves, since it is particularly difficult for them, at least initially, to negotiate loans from local commercial banks. They initiate operations as NGOs and their evolution from a grants-based structure to a commercial funds-based structure is often problematic. In any case, such high profitability raises the question of the right balance between the delivery of non-financial services and interest rates. Are clients really ready to pay more for non-financial services? If not, are they given the chance not to pay for non-financial services?

In terms of operational performance, non-financial services MFIs clearly have a much better portfolio quality than their peers. With the remarkable exception of Pro Mujer Nicaragua, which has suffered from the 2008 crisis of the microfinance sector in Nicaragua, all non-financial service MFIs show an excellent portfolio quality, with portfolios at risk at 30 days (PAR 30) lower than 1%. As a reference, the peer groups have all a PAR 30 higher than 2.0%.

## What lies behind good financial and operational performance?

As a whole, the analysis of different MFIs' performances shows that sustainability and delivery of non-financial services are not incompatible: they may generate higher operating costs, but these are compensated by higher portfolio yields. The cost of non-financial services will be highly dependent on how streamlined they are with the regular fi-

**Iris Lanao Flores**
FINCA Peru

Iris Lanao Flores is CEO of FINCA Peru. She is also involved in a number of national and international networks and regularly intervenes on practices and issues that are specific to the methodology of village banking. Iris Lanao Flores holds a Masters Degree in Latin American Development from Stanford University and a Masters Degree in Operational Research from the London School of Economics.

**Philippe Serres**
Agence française de développement

Philippe Serres is a Microfinance Investment Officer at AFD and has ten years of experience in development and microfinance. After a short experience in the British NGO ActionAid, he worked for two years at the European Commission Delegation in Peru as a project officer. Back to Europe, he worked for six years in the microfinance rating agency Planet Rating as Network Director. Philippe has conducted more than 50 ratings of MFIs throughout the world. He joined AFD in 2008. Philippe graduated from the Institute of Political Studies of Paris (Sciences-Po) and holds a Masters Degree in Development Studies from the London School of Economics

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nancial services of the institution. In that sense the unified model seems more cost-effective. For MFIs that are starting a program of this nature, the initial costs of training staff, of bringing technical assistance to implement the model and of integrating the courses within the meetings, will be much higher than for institutions where the non-financial services are already a fully-fledged component of the operational structure. The case of CRECER, one of the oldest Credit with Education programs, with diminishing operating costs and education representing only 7% of its total costs, is emblematic.

Regarding portfolio quality, a number of factors explain why MFIs proposing non-financial services show relatively good results:
• Portfolio monitoring is very tight, involving regular weekly or bi-weekly meetings with the loan officers, during which both financial and non-financial services are delivered.
• Eligibility for credit services of each borrower is based on community selection. Peer pressure is exercised all along the credit cycle to ensure repayments, and in some cases it can lead to the exclusion of defaulting borrowers.
• Health, business and financial education services improve the living conditions of clients, hence their capacity to repay loans and access other financial services.
• Non-financial services can lead to increased loyalty of clients.

Overall, the review suggests that implementing non-financial services along with typical microfinance services is possible and can even lead to sustainability, good portfolio quality, while achieving the primary goal of fighting against poverty. Choosing the right delivery model, integrating it in the most cost-effective way with financial products, adjusting pricing and training staff are prerequisites for a successful comprehensive scheme. All MFIs may not be interested in developing non-financial products. But those which support this approach have a legitimate reason to do it as long as they respect some basic implementation rules. ●

## The case of FINCA Peru

Today, FINCA Peru serves 12,276 clients with a loan portfolio of 2.7 M USD and is particularly active in the least developed regions of Peru. It is a small but very reputable MFI in the country, with a strong commitment to serving poor populations by providing microfinance and social services.

Since its inception in 1993, FINCA Peru has promoted a range of social services along with credit, to suit each type of clients. FINCA Peru was the pioneer in Peru of the village banking methodology, educating women, strengthening links among them and promoting savings mobilization. Non-financial services embedded in microfinance include personal development, leadership skills, financial and social literacy and health.

Education is the key element of FINCA Peru's non-financial services, and aims at turning people into actors of their own development. Training sessions range from the explanation of the loan product characteristics to the means of improving small businesses.

Non-financial services also increase clients' loyalty. Healthy and educated clients are more willing to repay their loans, even when interest rates are higher. As of December 2008, FINCA Peru's retention rate is 72.6% and its PAR 30 has always been under 1%.

Owing to the social, geographical and business diversity of FINCA Peru's clients, the institution has entered partnerships to develop tailored solutions for specific financial and social requirements. This approach avoids the time and monetary costs of developing specific in-house expertise. Indeed, establishing alliances has allowed FINCA Peru to leverage the knowledge and experience of other organizations. For instance, FINCA Peru co-operates with public and private organizations on health training programs, which are conducted by health care professionals, while loan officers provide adequate information on preventive health measures to their clients. Similarly, through alliances with specialized partners in agriculture, FINCA Peru was able to offer both financial and non-financial services to small farmers that required both working capital and technical assistance.

Partnerships with market studies and/or research organizations have also enabled impact studies on non-financial products that are both difficult and expensive to perform for FINCA Peru.

MFIs offering non-financial services can also lever their geographic positioning and the possibility to run community group meetings in order to build stronger communities and thereby enhance the self-esteem of vulnerable borrowers. As such FINCA Peru can be considered as a developer of stronger local communities, which are then able to establish links with other communities without external assistance.

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## Benchmarking on Latin American MFIs providing non-financial services

| *Institutions* | *CRECER Bolivia 2008** | *Pro Mujer Bolivia 2008** | *Pro Mujer Nicaragua 2008** | *Pro Mujer Peru 2008** | *FINCA Peru 2008** | *Latin America 2007*** | *Village Banking 2007**** | *All MFIs 2007**** |
|---|---|---|---|---|---|---|---|---|
| Financial products | Village Banking | Village Banking | Village Banking | Village Banking | Village Banking, group lending | NA | NA | NA |
| Non-financial products | Training on business, health and personal development | Health assistance, training on business development and sanitation | Health assistance, training on business development and sanitation | Health assistance, training on business development and sanitation | Training on business development | NA | NA | NA |
| Outstanding portfolio (USD) | 37,143,879 | 27,812,930 | 5,109,398 | 12,964,008 | 2,745,594 | 6,638,122 | 3,861,404 | 6,897,451 |
| Number of borrowers | 100,387 | 87,626 | 26,365 | 49,308 | 12,276 | 11,682 | 17,694 | 11,041 |
| Average loan outstanding per borrower (USD) | 370 | 317 | 194 | 263 | 224 | 743 | 186 | 520 |
| Yield on portfolio | 38.6% | 37.2% | 47.5% | 51.0% | 66.5% | 31.7% | 32.9% | 29.9% |
| Operating expense ratio (Operating expenses/ outstanding portfolio) | 21.5% | 22.5% | 38.0% | 25.8% | 48.3% | 19.5% | 25.4% | 19.2% |
| Loan officers productivity (active borrowers/loan officer) | 480 | 440 | 463 | 394 | 261 | 230 | 277 | 209 |
| Portfolio at risk > 30 days | 0.6% | 0.8% | 5.8% | 0.0% | 0.6% | 3.2% | 2.2% | 2.7% |
| ROA | 9.0% | 7.4% | 6.2% | 16.4% | 9.3% | 1.7% | 0.8% | 0.6% |

** www.mixmarket.org, ** MIX (2008), *** 2007 Annual MFI Benchmarks; www.themix.org*

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