HORUS Development Finance

Achieving Systemic Impact

Long Term Trends in Microfinance and Sector consolidation

National Bank of Cambodia

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Plan

- Long term trends
  - From experimentation to industry
  - From microcredit to microfinance
  - Linking with local and international capital markets
  - Markets for microcredit do have limits

- Need for sector consolidation:
  - Acquisition by banks
  - Mergers of MFIs

From experimentation to industry (1)

- 70s to the 90s:
  - Experimentation in microcredit
  - Time of charismatic leaders from the north or the south,
  - Low income clients and MSMEs are good risks provided adequate methods are used.
  - 90s: the fundamentals of microfinance have been experimented, documented and are disseminated.
- Early 2000s:
  - « mass distribution », « industrialisation », « professionalisation »:
  - Need to call in private funds: development of specialised microfinance funds, rating….
  - Time for major players with know-how and funds, from « north », (ProcCredit, Accion, Opportunity international, Advans, Access) and « south » (BRAC, Grameen, ACLEDA, XAC… which replicate or aim at replicating models

From experimentation to industry (2)

- Since 2005:
  - Outreach increases rapidly,
  - Products and services are diversified,
  - Investment in new technologies:
    - MIS to cope with large clientele and diversified products and services
    - M-Banking: to reduce the cost of services and facilitate outreach
  - Economic and social impact of MFIs becomes significant in some countries.

From Microcredit to Microfinance (1)

- Origins of microfinance are two folds : Savings first (Credit Unions) and Credit first (microcredit approach, Grameen style)
- Credit Unions:
  - Savings first, hot money, and collective risk management to lending within the local association or cooperative
  - Fundamentally a « social and political movement » more than « financial innovation »
  - Have failed to master the credit methodology.
- Microcredit approach:
  - To simplify: Grameen solidarity credit
  - Insist on the capacity of poor to create their own activity, provided they receive a small credit
  - Some difficulties to move from a credit only to a bank like institution with credit, deposit and transfer payments.

From microcredit to microfinance (2)

- Microcredit has developed very rapidly in some countries
  - Morocco, Benin, Cambodia, Bangladesh, Pakistan… (mostly solidarity credit)
  - Afghanistan (solidarity and individual credit
  - Eastern Europe (mostly individual credit)

- But MSMEs need diversified products and services, which are not or inefficiently provided by mainstream financial institutions :
  - Credit: group, individual, short term/medium term, larger amounts
  - Deposit or savings accounts
  - Cash management: local and international transfers, payment means

- Emphasis is not on product specialization (credit only) but on:
  - serving a specific clientele (MSMEs) and
  - providing all services needed by this clientele.

Linking with financial markets (1)

- Strong growth of loan outstanding:
  - Donors and NGO cannot provide enough funds
  - MFIs need to be linked to the financial sector:
    - Locally: borrowing from banks, issue securities
    - Internationally: DFIs and microfinance funds.
- But, to be in a position to raise private commercial funds, MFIs must:
  - Be incorporated as private companies, with strong shareholders able to commit significant level of equity;
  - Follow best practices: governance, management, internal control system, MIS, information dissemination and reporting,
  - Be evaluated (rated)

Linking with financial markets (2)

- DFIs and CGAP have played a leading role in forstering this move:
  - DFIs: by being the first lenders, supporting the setting up of microfinance funds (KfW, FMO, IFC...
  - CGAP: promoting transformation into private companies, developing international standards for reporting, rating funds, MIS fund…
- International microfinance funds have developed extremely rapidly since 2005:
  - they specialize: equity holding companies, private equity, debt funds
  - They adjust to MFIs' needs:
    - lending terms (up to 5 years)
    - Lending in local currency: dedicated donors funds at market conditions; TCX (hedging exchange risk on large number of countries and volume=
  - Structured funds (EFSE): core equity, mezzanine, senor debt

Linking with financial markets (3)

- National financial system are slow to provide the required financing, even when the financial sector is liquid, except in a few countries (Morocco):
- Consequence:
  - Difficulties for MFIs to borrow in local currencies;
  - Lack of integration of the national financial systems
  - Slower development of MFIs.
  - MFIs need to collect deposit (short term and savings).
  - MFIs need also to provide transfer services
  - Regulation are sometimes slow to adjust to these needs

Markets for microcredit do have limits (1)

- Microfinance and growth:
  - Management and staff have strong motivation for growth and size, which is a measure for success and strength.
  - Limits to growth are not considered very seriously: in many countries the sum of all MFIs business plan is clearly not feasible and may lead to a sector crash.
  - Markets have limits
  - Need for credit bureaus
- Example : Benin,
  - small African country:
  - Strong microfinance sector including one very large Credit Union (350,000 members), three large NGOs and a private company.
  - Sector growth was fuelled by massive refinancing by DFIs and funds.
  - a slight economic downturn revealed clients’ excessive indebtedness and MFIS fragility; arrears went up went up significantly
  - Sector turned from strong growth to negative growth.
  - Large loan loss provisions in 2006 and MFIs are displaying deficits
  - Consolidation is needed but may take some time. .

The Need for Sector Consolidation (1)

- Each country can have a limited number of performing MFIs or microfinance banks. Minimal size is required
  - to achieve economy of scale in providing services to a large clientele over the entire country
  - To have the internal know-how capacity to diversify products and services, and capacity to distribute them at low costs.
  - To attract and keep high quality specialized staff, especially in support functions.
  - To invest in new technologies (MIS, M-Banking, Internet) which are or will be necessary for proper management, client satisfaction, efficiency and competitivity.

- Consolidation of the sector around a few large professional MFIs and microfinance banks will happen is in many countries.

The Need for Sector Consolidation (2)

- Consolidation of the sector can be achieved in two ways:
  - Acquisition of MFIs by commercial banks
  - Mergers of MFIs
- Acquisition by commercial banks:
  - This may contribute to increase rapidly financial inclusion, if the MFI clientele can benefit from some of the product and services provided by the bank
  - It will contribute to create a few leading MFIs benefiting from financial backing of banks

Sector Consolidation : Mergers

- Motivation for mergers of MFIs
  - Reaching economy of scales
  - Building stronger institution: improved and diversified products; management systems, technology…
  - Better access to capital: equity and debt
  - Reduce competition, when market is saturated

- Experience shows that mergers are difficult and happen mainly when:
  - MFIs are small, have not reached sustainability and are under the authority of one or two international sponsor which direct(s) the operations
  - They are "obliged" to do so because they lack access to capital (equity or debt), they need to change of legal status;
  - Managements are supporting the move, ie they have understood that they will gain from merger.

Sector Consolidation : Mergers (2)

- There are few examples of voluntary mergers:
  - Armenia: CRS and Save the Children
    - Same size but small (1600 clients each
    - Not sustainable
    - Need access to capital and grant
    - Success because strong complementarities
  - Mongolia :
    - XAC: much larger, microfinance and several region including capital region
    - GE: much smaller, SME lending, and only one region:
  - Haiti:
    - Fonkose (local institution) and MEDA (Canada)
    - Limited size (16,000 clients together
    - Share mission and vision; previous cooperation
    - Success because of common vision and improved access to finance.
- Mergers are often dictated by necessity (especially regulation)
  - Nigeria: presently many MFIs (or community banks) are merging because the Central Bank has increased the minimal capital requirement. The consolidation of the sector is encouraged, if not caused by the central bank.