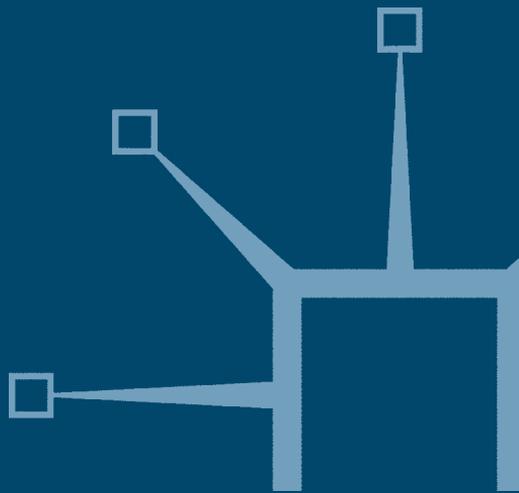


palgrave
macmillan

Microfinance

Mario La Torre and Gianfranco A. Vento



Microfinance

Palgrave Macmillan Studies in Banking and Financial Institutions

Series Editor: **Professor Philip Molyneux**

The Palgrave Macmillan Studies in Banking and Financial Institutions will be international in orientation and include studies of banking within particular countries or regions, and studies of particular themes such as Corporate Banking, Risk Management, Mergers and Acquisitions, etc. The books will be focused upon research and practice, and include up-to-date and innovative studies on contemporary topics in banking that will have global impact and influence.

Titles include:

Yener Altunbas, Blaise Gadanecz and Alper Kara

SYNDICATED LOANS

A Hybrid of Relationship Lending and Publicly Traded Debt

Santiago Carbó, Edward P.M. Gardener and Philip Molyneux

FINANCIAL EXCLUSION

Franco Fiordelisi and Philip Molyneux

SHAREHOLDER VALUE IN BANKING

Munawar Iqbal and Philip Molyneux

THIRTY YEARS OF ISLAMIC BANKING

History, Performance and Prospects

Mario La Torre and Gianfranco A. Vento

MICROFINANCE

Philip Molyneux and Munawar Iqbal

BANKING AND FINANCIAL SYSTEMS IN THE ARAB WORLD

Andrea Schertler

THE VENTURE CAPITAL INDUSTRY IN EUROPE

Alfred Slager

THE INTERNATIONALIZATION OF BANKS

Patterns, Strategies and Performance

Palgrave Macmillan Studies in Banking and Financial Institutions

Series Standing Order ISBN 1-4039-4872-0

You can receive future titles in this series as they are published by placing a standing order. Please contact your bookseller or, in case of difficulty, write to us at the address below with your name and address, the title of the series and one of the ISBNs quoted above.

Customer Services Department, Macmillan Distribution Ltd, Houndmills, Basingstoke, Hampshire RG21 6XS, England

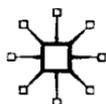
Microfinance

Mario La Torre

and

Gianfranco A. Vento

With contributions from Monica M. Ortolani, Silvia Trezza and Marco Tutino



© Mario La Torre and Gianfranco A. Vento 2006

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No paragraph of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, 90 Tottenham Court Road, London W1T 4LP.

Any person who does any unauthorised act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The authors have asserted their rights to be identified as the authors of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published in 2006 by
PALGRAVE MACMILLAN
Houndmills, Basingstoke, Hampshire RG21 6XS and
175 Fifth Avenue, New York, N.Y. 10010
Companies and representatives throughout the world

PALGRAVE MACMILLAN is the global academic imprint of the Palgrave Macmillan division of St. Martin's Press, LLC and of Palgrave Macmillan Ltd. Macmillan® is a registered trademark in the United States, United Kingdom and other countries. Palgrave is a registered trademark in the European Union and other countries.

ISBN-13: 978-1-4039-9789-0 hardback
ISBN-10: 1-4039-9789-6 hardback

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

La Torre, Mario.

Microfinance / Mario La Torre and Gianfranco A. Vento; with contributions from Monica Ortolani, Silvia Trezza, and Marco Tutino. p. cm.—(Palgrave Macmillan studies in banking and financial institutions)

Includes bibliographical references and index.

ISBN 1-4039-9789-6 (cloth)

1. Microfinance. I. Vento, Gianfranco A., 1975- II. Title. III. Series.

HG178.3.L3 2006

332—dc22

2006043257

10 9 8 7 6 5 4 3 2 1
15 14 13 12 11 10 09 08 07 06

Printed and bound in Great Britain by
Antony Rowe Ltd, Chippenham and Eastbourne

*Immo non perditurus: eo loco sit donatio undi repeti non debeat,
reddi posit. (Seneca, De vita beata, xxiv, 2)*

This page intentionally left blank

Contents

<i>List of Tables</i>	x
<i>List of Figures</i>	xi
<i>List of Boxes</i>	xii
<i>Preface and Acknowledgements</i>	xiii
<i>Notes on the Contributors</i>	xiv
<i>Introduction</i>	xvi
Mario La Torre	
1 A New Conception of Microfinance	1
<i>Mario La Torre</i>	
1.1 Introduction	1
1.2 The nature of microfinance: microfinance vs microcredit	2
1.3 The demand for microfinance	3
1.4 The supply of microfinance	5
1.5 Products and services in microfinance	8
1.6 A new taxonomy for microfinance	9
1.7 Microfinance and ethical finance	11
1.8 Conclusion	18
2 Products and Services in Modern Microfinance	20
<i>Silvia Trezza</i>	
2.1 Introduction	20
2.2 Financial services	21
2.3 Product development process	31
2.4 Non financial services: minimalist vs integrated approach	34
2.5 New frontiers in microfinance services	35
2.6 Conclusion	36

3	The Main Features of Microcredit	38
	<i>Gianfranco Vento</i>	
3.1	Introduction	38
3.2	The screening of beneficiaries	39
3.3	The nature of financed assets	41
3.4	Distinguishing features of microcredits	42
3.5	Collateral policies	44
3.6	Interest rates in microcredit	50
3.7	Conclusion	53
4	Sustainability and Outreach: the Goals of Microfinance	54
	<i>Gianfranco Vento</i>	
4.1	Introduction	54
4.2	Sustainability and outreach	55
4.3	Sustainability: how to reach it	59
4.4	Outreach: how to select the beneficiaries	62
4.5	The microfinance dilemma: sustainability vs outreach	64
4.6	The policies for improving sustainability	66
4.7	Conclusion	69
5	Risk Management in Microfinance	71
	<i>Mario La Torre</i>	
5.1	Introduction	71
5.2	A taxonomy of risks for microfinance	72
5.3	The business risk	73
5.4	Financial risks	75
5.5	Process risks	89
5.6	Conclusion	91
6	Monitoring the Microfinance Processes	93
	<i>Monica M. Ortolani</i>	
6.1	Introduction	93
6.2	Reasons for a process approach	94
6.3	Microfinance processes	95
6.4	The process of microcredit	98
6.5	Process-related risks	102
6.6	Control typologies	105

6.7	The incentive system	108
6.8	Conclusion	110
7	Microfinance Performance	112
	<i>Marco Tutino</i>	
7.1	Introduction	112
7.2	Performance analysis	113
7.3	Performance evaluation model for microfinance project	116
7.4	Performance evaluation models for MFIs	120
7.5	Conclusion	130
8	The Role of Regulation	132
	<i>Gianfranco Vento</i>	
8.1	Introduction	132
8.2	Regulation, supervision and microfinance	133
8.3	Determinants for regulating microfinance	134
8.4	Key variables for microfinance regulation	138
8.5	Which instruments to adopt	144
8.6	Conclusion	149
9	The Road Ahead: A Platform for Microfinance	151
	<i>Mario La Torre</i>	
9.1	Introduction	151
9.2	The features of modern microfinance	151
9.3	The microfinance platform: actors and functions	153
9.4	Conclusion	157
	<i>Notes</i>	158
	<i>Bibliography</i>	160
	<i>Index</i>	171

List of Tables

2.1	Financial needs and products in modern microfinance	22
2.2	Main features of microcredit	23
3.1	Main credit risk mitigation strategies	49
3.2	Three main elements in interest rates determination	52
6.1	Control typology – control instruments	106
6.2	Matrix incentives/beneficiaries	108
6.3	Typologies of incentives	110
7.1	Portfolio at risk (2004)	126
8.1	The goals of supervision in traditional financing and in microfinance	135
8.2	Key variables for regulation of MFIs	139
8.3	Key variables and instruments for regulating MFIs	147

List of Figures

1.1	The standard microcredit structure	2
1.2	Types of microfinance beneficiaries	5
1.3	Types of microfinance institutions	6
1.4	Microfinance products and services	9
1.5	A taxonomy for a modern microfinance	10
1.6	Types of ethical finance	12
1.7	Activities and agents of ethical finance	13
1.8	Variables of ethics in finance	14
1.9	Variables of ethics in microfinance	17
2.1	Group loans vs individual loans	24
2.2	Product development process	33
3.1	Use of SPV in microcredit	47
3.2	Use of segregated assets in microcredit	48
4.1	Different levels of microfinance sustainability	55
4.2	Substantial financial sustainability	56
4.3	Dimensions of microfinance outreach	58
4.4	Four degrees of sustainability for MFIs	60
5.1	Risks in microfinance	73
5.2	Business risk	74
5.3	Liquidity risk: a single project approach	78
5.4	Liquidity risk for MFIs	79
5.5	Credit risk determinants and effects	84
5.6	Credit risk management	87
5.7	Market risks	88
5.8	Process risks	90
6.1	MFIs' processes	96
6.2	Traditional credit process vs. microcredit process	99
9.1	Microfinance platform	154

List of Boxes

2.1	Fundusz Mikro's experience	27
2.2	Buro Tangail's 'Contractual Saving Agreement'	29
2.3	FINCA International's insurance products	31
3.1	Calculating interest rates	52
7.1	Cost composition indicators	117
7.2	Personnel productivity indicators	117
7.3	Cash flow indicators	118
7.4	Portfolio profitability indicators	118
7.5	Portfolio quality indicators	119
7.6	Outreach indicators	119
7.7	Subsidies dependence indicators	120
7.8	Most common models of performance evaluation for MFIs	121
7.9	Personnel productivity indicators	123
7.10	Operating efficiency indicators	124
7.11	Portfolio quality indicators	125
7.12	Loan loss indicators	126
7.13	Profitability indicators	127
7.14	Self-sufficiency indicators	128
7.15	Leverage and financial structure indicators	128
7.16	Accounting adjustments	129
8.1	Regulated MFIs: a taxonomy of Peruvian institutions	146

Preface and Acknowledgements

This book presents a current analysis of the financial aspects of microfinance. It is unique in that it utilizes a banking risk-management approach to address the financial management of microfinance institutions and projects. This work has been possible owing to the specific expertise of each of the authors. The book is the result of contributions from different researchers from the Microfinance Research Group of the Banking Department of the University of Rome 'La Sapienza', coordinated by Professor Mario La Torre. The Group has a long history of collaboration with many Italian NGOs that promote microfinance programmes around the world. Moreover, the Group has been heavily involved in the activities of the Italian National Committee for '2005: the International Year of Microcredit' – proclaimed by the United Nations – and adopted by the Italian Ministry of Foreign Affairs.

For this book, Professor La Torre has coordinated the contributions of a team of four researchers specialized in banking and financial management (Monica Ortolani, Silvia Trezza, and Gianfranco Vento – University of Rome 'La Sapienza' – and Marco Tutino – University of Rome III), which collectively has significant experience in microfinance.

The operational experience in microfinance, combined with the theoretical and managerial expertise in the banking field has allowed the authors to develop a microfinance handbook which approaches microfinance financial management with the same instruments adopted by traditional banks, without compromising the particular nature of microfinance. We believe that this effort will assist microfinance management while offering support to microfinance practitioners in developing financial strategies with a scientific approach, without complicating the practice of microfinance itself.

We would like to thank the members of the Italian National Committee for '2005: the International Year of Microcredit'.

Finally, thanks to Nicola Allan, Jami Hubbard and Tommaso Caselli, our English proof-readers.

MARIO LA TORRE
GIANFRANCO A. VENTO

Notes on the Contributors

Mario La Torre is Full Professor in Banking and Finance and Director of the MA course in Film Art Management at the University of Rome 'La Sapienza'. His main area of research is on the financial management and financial innovation of the banking and financial services industry and he has published widely in this area. Main texts include: *Securitisation and Banks*; *Postbank in Italy*; and *Mergers & Acquisitions in Banking*. Recent articles concern microfinance: 'Modern microfinance: the role of banks'; 'Ethical Finance and Microfinance'. Professor La Torre has acted as a consultant to various banks, public institutions and consulting firms. He has directed the Research Group of the Italian National Committee for '2005: International Year of Microcredit'. He is on the Scientific Board of various NGOs and Financial Institutions operating in the microfinance sector.

Monica M. Ortolani is currently a PhD student in Banking and Finance at University of Rome 'La Sapienza'. She has been a member of different research groups for the Italian National Committee for '2005: International Year of Microcredit'. After working in Total Quality Management for a banking consulting company, she is now working in internal control systems for a banking consultant. Her current research includes: microfinance; banks' internal control systems and risk management; she is the author of several articles in top academic journals.

Silvia Trezza is currently a PhD student with grant research in Banking and Finance at the University of Rome 'La Sapienza'. She has been a member of different research groups for the Italian National Committee for the '2005: International Year of Microcredit'. Current research includes, microfinance, credit risk management and credit risk mitigation.

Marco Tutino (MA, PhD) is currently lecturer in Business Administration at the University of Rome III. He has been a member of different research groups of the Italian National Committee for '2005: International Year of Microcredit'. His main research interest relates to corporate strategy, performance measurement, business evaluation and finance. His research has been published by Italian academic journals.

Gianfranco A. Vento (MSc, PhD) is post-doctoral scholar in Microfinance at the University of Rome 'La Sapienza'. He has been member of different research groups for the Italian National Committee for

'2005: International Year of Microcredit'. He has followed several micro-finance projects in developing countries for an Italian NGO. He used to be an analyst in the Banking Supervision Department at the Bank of Italy. His main research interest relates to the money market and micro-finance. His research has been published by leading Italian academic journals. He is the author of *Interbank Market and Eurosystem*.

Introduction

Mario La Torre

This book is not a macroeconomic study for policy-makers; it is not a survey of best practices in microfinance; it is not a guide for practitioners and donors. Instead, it is a tool for individuals interested in analysing microfinance using a banking managerial approach modified for the specificities of microfinance.

Microfinance literature has been characterized by different trends over the past decades. In the early 1980s, microcredit and microfinance arose as alternatives to traditional development policies. Economists and policy-makers have tried to examine, both in theory and in practice, the impact of microfinance on socioeconomic policies for developing countries. This has inspired a great number of studies, mainly focused on the macroeconomic effects of microfinance and impact studies dedicated to different countries, sectors or types of beneficiaries. For years the macroeconomic approach has been basically the only view-point presented in microfinance literature. During those early years, the need to explore and to diffuse knowledge and information about microfinance globally has resulted in a focus on the most significant experiences. There have been countless publications detailing success stories from various countries and promoted by different institutions which have been and which remain in fashion. Further, the diffusion of these success stories as examples or models for future programmes has encouraged a new trend of *best practice literature*.

From the very beginning, microcredit and microfinance have been studied mostly from a macroeconomic and operational point of view. This book, however, follows a different trajectory – microeconomic from the managerial perspective. Modern microfinance has expanded its functions compared with the very first *microcredit* experiences. New trends have dramatically altered microfinance features, in terms of beneficiaries, products and the institutions involved. Microfinance is no longer just a financial technique principally offered by the non-profit sector as part of development programmes to sustain the poor in developing countries. It has become something more. The modern microfinance market is characterized by a complex demand for financial

and technical services, and a complex supply, owing to a growing interaction and interest on the part of institutional donors, the non-profit sector and the financial markets.

Fluctuations in microfinance supply and demand have shifted the attention of researchers and practitioners towards alternative and innovative management tools for microfinance. This trend has given birth to a new series of studies, principally focused on the performance of microfinance programmes and microfinance institutions (MFIs). In turn, this has spurred the creation of microeconomic literature for microfinance. The microeconomic approach analyses, mostly, the trade-off between financial performance and the ethical goals implicit in every microfinance initiative. From this perspective, specific accountancy rules and standards have been implemented and different models for financial performance analysis have been evolved.

This book goes one step further: it takes microfinance into the field of risk management. Therefore, the main objective of this text is to extend the risk management approach used by traditional banks to encompass microfinance as well. This kind of analysis simultaneously offers a great advantage and carries a great risk: on the one hand, it can help MFIs to attain higher levels of efficiency. On the other hand, it can cause a drift from the original spirit of microfinance, which is based on having a flexible organizational structure, easy procedures and informal relationships.

For these reasons the authors of this book have put substantial effort into analysing the fundamentals of banking management, which could also apply to microfinance, and which could be particularly useful to microfinance practitioners who aim to collaborate with banks and financial intermediaries, as well as to informal and formal MFIs. We have thus adopted the standard risk management approach utilized by banks, adapting it accordingly to the exigencies of the microfinance process. The main aspects of risk management have been considered, with the exclusion of risk-measuring models. The different steps of the microfinance process, combined with the different areas of risk, have been identified using a risk management approach. From this vantage point, the accounting and financial performance analysis become tools of risk management. Thus, performance indicators provide information that may identify potential or existing problems related to specific types of risk. This diagnosis can lead to preventive changes in risk management for those specific problem areas, which in turn may improve financial performance. This book illustrates how to measure performance, and how to identify and manage microfinance risks in order to improve financial performance. Good risk management means good

performance and good performance, in the long term, means sustainability. In microfinance good performance is usually ensured by lowering the funding costs, or by charging higher fees for services. The vast majority of sustainable MFIs obtain large amounts in grants and soft loans and apply interest rates and fees that are much higher than the market rate. Most of the time increased attention to risk management can help reduce financial and operational costs by lowering the probability of substandard portfolio performance. Risk management is, thus, a prerequisite for independence from subsidies and for a more accurate pricing policy. From this perspective, risk management offers the added benefit of fostering sustainability without compromising outreach.

This book is composed of nine chapters. The first step has been to clarify the realm of modern microfinance. Chapter 1 offers a new taxonomy for microfinance in the light of the recent and future changes in the supply and demand of the microfinance market. This classification considers two main microfinance trends: international microfinance for development policies and domestic microfinance for industrialized countries.

Chapters 2 and 3 outline the main features of microfinance products, from a technical and strategic point of view. Knowledge of financial products available on the market is essential for the implementation of efficient microfinance strategies. It makes it possible to better tailor the supply to the specific target of beneficiaries served; it makes it easier to manage the risk of the MFI's portfolio. From this perspective, traditional and new products, both for individual clients and for MFIs themselves are analysed.

Before entering the core story of risk management (Chapter 5), we analysed the dichotomy that distinguishes microfinance from traditional finance, and which dramatically affects microfinance management. Chapter 4 describes the concepts of sustainability and outreach, illustrating the relationship between them and identifying the key strategies to better combine positive financial performance with ethical and social goals.

Chapter 5 enters into the field of microfinance risk management. Here, a taxonomy of microfinance risks is proposed; business, financial and process risks are explained, both with reference to their determinants and to management policies that can be implemented. Each risk is analysed considering both a single project approach and a portfolio approach.

Chapters 6 and 7 concern two main tools for risk management: process monitoring and financial performance analysis. Process monitoring is

one of the major weaknesses of MFIs, particularly for informal and semiformal MFIs. Chapter 6 describes how MFIs should design their processes, distinguishing different phases and identifying various areas of responsibility, and specifically how to implement a monitoring system. Chapter 7 describes the main issues concerning performance analysis in microfinance, offers a description of the main standards developed at the international level and proposes a new model of performance analysis, both for single microfinance programmes and for MFIs.

Chapter 8 considers two key variables for risk management: regulation and supervision. This subject matter mainly affects formal MFIs that must respect capital ratios imposed by regulatory authorities, and that must take into account the effect of capital requirements on their financial performance. The chapter also outlines the main problems concerning regulating the microfinance market and it can be a useful guide for those countries that are in the process of implementing or adopting microfinance regulatory standards.

Finally, Chapter 9 illustrates a possible future scenario for the microfinance market. This future includes the idea of projecting a microfinance financial platform strictly related to microfinance risk management and performance. Modern microfinance should be characterized by a greater cooperation among international donors and governmental bodies, both national and local, financial intermediaries and MFIs themselves. Each one of these actors can play an important role in fostering the efficiency and the efficacy of microfinance initiatives, as well as in supporting ethical sustainability. This effort must be coordinated and rationalized within a microfinance network that identifies roles and responsibilities of each actor corresponding with their skills and institutional objectives.