MAKING MICROFINANCE WORK
Managing for Improved Performance

Craig Churchill and Cheryl Frankiewicz

International Labour Office - Geneva
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- MicroSave
- SEEP Network
- USAID
- World Bank

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This course has been tested with over two hundred microfinance managers and two dozen trainers in Uganda, Zambia, Zimbabwe, Macedonia, Kosovo, Albania and Viet Nam, many of whom have provided useful feedback and suggestions on the content of this manual and the course delivery. While too many to name individually, you know who you are and we thank you whole-heartedly for your assistance.

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Craig Churchill
Social Finance Programme

Cheryl Frankiewicz
Independent Consultant
Foreword

This is a management course. It is not intended to make anyone an expert at anything. Instead it provides a broad overview, covering most key issues that are relevant for microfinance managers. Individually, many of the topics in this book could be addressed in a one- or two-week course—for example, MicroSave has a six-day course on market research, while this book covers that material in just 15 pages. This course provides managers with a valuable introduction to the key management issues with which they need to be familiar and assists them in identifying areas that they would like to explore in more detail in the future.

This course also exposes managers to microfinance experiences from around the world. Managers often get stuck in a rut, bogged down with their day-to-day responsibilities, unable to see the forest through the trees. This course gets them out of their offices and challenges them to consider alternative approaches and question their assumptions.

Much of the material in the training manual has been adapted from existing resources. Consequently, this book is an indispensable resource that brings together lessons from numerous microfinance institutions (MFIs) operating in a range of environments. The experiences are presented clearly and concisely so that the information is readily accessible to time-constrained managers. Even though the book is useful on its own, it is even more valuable when digested through the two-week training, which gives participants an opportunity to practice with numerous tools and resources, and to consider dozens of additional case studies.

Why the ILO?

The International Labour Organization is a specialized agency of the United Nations that promotes social justice and internationally recognized human and labour rights. The ILO has a unique tripartite structure, with workers and employers participating as equal partners with governments in its governance. The ILO formulates international labour standards in the form of Conventions and Recommendations setting minimum standards of basic labour rights: freedom of association, the right to organize, collective bargaining, the abolition of forced labour and child labour, equality of opportunity and treatment, and other standards regulating conditions across the entire spectrum of work-related issues.

To assist governments and social partners in applying the Conventions and Recommendations, the ILO provides technical assistance in a number of fields, including: vocational training, employment policy, labour administration, industrial relations, management development, cooperatives, social security, and occupational safety and health.

This course brings together two areas of ILO expertise and concern: management and microfinance. The ILO has a long history of involvement in improving management practices, as this is an important strategy for improving labour relations and working conditions. In addition, the ILO is keen to promote employment, including self-employment, while ensuring that workers and their families have sufficient social protection. Microfinance is therefore an important strategy for the ILO, as financial services for the poor contribute to both employment creation and social protection objectives. This management course is a nat-
ural complement to other training packages created by the Social Finance Programme and ITCILO, including leasing, microinsurance and guarantee funds.

**Intended Audience**

The course is designed for middle and senior managers in microfinance institutions. In rapidly growing organizations in a relatively young industry, microfinance managers are often promoted into management positions without sufficient training. They are forced to learn on the job, through trial and error. This course is intended to help microfinance managers, new and old, to better understand their jobs and to obtain additional tools and resources to manage for improved performance.

**Overview of the Course**

This book contains 24 modules organized into five parts:

**I. Introduction to microfinance management.** The introductory part covers four topics that essentially address different aspects of the course title: *Making Microfinance Work: Managing for Improved Performance*. Module 1 describes the managers' mandate, including the four functions of management, different management styles and the characteristics of effective managers. Module 2 tackles the microfinance thread, briefly introducing the range of financial services that are relevant to the low-income market. The rest of the section sets the stage and context for improving performance. Module 3 considers the formal, semi-formal and informal institutional options through which microfinance can be delivered. It highlights that managers can choose to transition from one institutional type to another, or partner with other types to accomplish goals and overcome environmental challenges. Module 4 considers the MFI's strategic direction, including the critical issues of vision, mission, values and objectives that collectively define the performance that managers should seek to achieve.

**II. Markets and marketing.** With the second set of modules, the manual begins to introduce tools and strategies that managers can use to improve performance. Microfinance begins and ends with the client. MFIs will not be able to meet their goals without identifying an appropriate target market (Module 5), and developing and delivering products to meet the market's needs (Module 6). Module 7 helps managers communicate the value embodied in their products and services. To further promote a customer orientation, Module 8 offers practical guidance for providing outstanding customer service and Module 9 guides readers to the ultimate objective: customer loyalty.

**III. Managing risks.** While delivering valuable products that stimulate loyalty, managers need to ensure that they are enduring a tolerable level of risk. Module 10 introduces a risk framework to holistically evaluate the risks to which MFIs might be vulnerable, as well as a system for managing those risks. Module 11 discusses strategies to prevent delinquency from occurring and, if it does occur, to rectify the situation. Using a similar prevention and detection approach, Module 12 provides guidance on managing staff fraud and security risks. Module 13, the last in this part, introduces strategies for managing external risks that an MFI cannot control, but for which it needs to prepare.
IV. Organizational architecture. A microfinance institution needs to be built in the same way an architect designs and constructs a building. It needs a plan that combines the design of the organization with the people who flesh out that structure, while considering how they interact with each other and with those outside the organization. This manual uses the metaphor of an organization's architecture to describe three issues that should be addressed collectively when striving to improve performance: how to enhance human resource management (Module 14); how to proactively shape the institutional culture (Module 15); and how to design an effective organizational structure (Module 16). Tying these three topics together, Module 17 explores the use of organizational architecture to manage growth.

V. Towards greater efficiency and productivity. The last part introduces various strategies for enhancing efficiency and productivity in an effort to minimize the trade-offs that MFIs invariably face as they try to provide valuable financial services over the long term. After introducing the concepts and measurements of efficiency and productivity (Module 18), this section examines the enhancement strategies of performance incentives (Module 19), new technologies (Module 20), and change management (Module 21). To further enhance efficiency, Module 22 describes techniques for allocating costs and determining prices, and Module 23 illustrates the importance of plans, budgets and reports. Module 24 revisits the manager's mandate presented in the first module, considers the challenges that managers might experience as they endeavour to fulfil that mandate, and summarizes the tools presented in this book that can help them to overcome those challenges.

While this manual covers a wide range of topics, there are still a few key management issues that are not addressed, including financial management and accounting, resource mobilization, and the systems side of managing information. These are omitted because they are more technical topics for which a brief overview would perhaps be more confusing than helpful.

By covering so many topics in a relatively short publication, this book runs the risk of leaving some readers wanting for more detail. Consequently each chapter concludes with a list of additional reading material, much of which is available on the Internet, where curious managers can explore topics in more depth.
# Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ABA</td>
<td>Alexandria Business Association (Egypt)</td>
</tr>
<tr>
<td>ABC</td>
<td>Activity-based costing</td>
</tr>
<tr>
<td>ABCD</td>
<td>Anticipate objections, benefitize, categorize, develop plans</td>
</tr>
<tr>
<td>ACB</td>
<td>Akiba Commercial Bank (Tanzania)</td>
</tr>
<tr>
<td>ACLEDA</td>
<td>Association of Cambodian Local Economic Development Agencies</td>
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<tr>
<td>ACP</td>
<td>Acción Communitaria del Perú</td>
</tr>
<tr>
<td>ADEMI</td>
<td>Asociación para el Desarrollo de Microempresas (Dominican Republic)</td>
</tr>
<tr>
<td>AE</td>
<td>Administrative expense rate</td>
</tr>
<tr>
<td>AFMIN</td>
<td>Africa Microfinance Network</td>
</tr>
<tr>
<td>AGFUND</td>
<td>Arab Gulf Programme for United Nations Development Organizations</td>
</tr>
<tr>
<td>AIDS</td>
<td>Acquired Immunodeficiency Syndrome</td>
</tr>
<tr>
<td>AIMS</td>
<td>Assessing the impact of microenterprise services</td>
</tr>
<tr>
<td>AMFIU</td>
<td>Association of Microfinance Institutions of Uganda</td>
</tr>
<tr>
<td>AROA</td>
<td>Adjusted return on assets</td>
</tr>
<tr>
<td>ASA</td>
<td>Association for Social Advancement (Bangladesh)</td>
</tr>
<tr>
<td>ASA</td>
<td>Activists for Social Alternatives (India)</td>
</tr>
<tr>
<td>ASCA</td>
<td>Accumulating savings and credit association</td>
</tr>
<tr>
<td>ATH</td>
<td>A Toda Hora</td>
</tr>
<tr>
<td>ATM</td>
<td>Automatic teller machines</td>
</tr>
<tr>
<td>BAAC</td>
<td>The Bank for Agriculture and Agricultural Cooperatives (Thailand)</td>
</tr>
<tr>
<td>BASIX</td>
<td>Bharatiya Samruddhi Finance Ltd. (India)</td>
</tr>
<tr>
<td>BCS</td>
<td>Banco Caja Social (Colombia)</td>
</tr>
<tr>
<td>BDS</td>
<td>Business Development Services</td>
</tr>
<tr>
<td>BEME</td>
<td>Banestado Microempresa (Chile)</td>
</tr>
<tr>
<td>BRI</td>
<td>Bank Rakyat Indonesia</td>
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<tr>
<td>BURO</td>
<td>Bangladesh Unemployed Rehabilitation Organization</td>
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<tr>
<td>CA</td>
<td>Cost allocation</td>
</tr>
<tr>
<td>CAMEL</td>
<td>Capital adequacy, Asset quality, Management, Earnings, and Liquidity management</td>
</tr>
<tr>
<td>CARD</td>
<td>Centre for Agricultural Research and Development (Philippines)</td>
</tr>
<tr>
<td>CARD MRI</td>
<td>CARD Mutually Reinforcing Institutions (Philippines)</td>
</tr>
<tr>
<td>CARE</td>
<td>Cooperative for Assistance and Relief Everywhere, Inc.</td>
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</table>
CD  Certificate of deposit
CEO  Chief executive officer
CEP  Capital Aid Fund for the Employment of the Poor (Viet Nam)
CF   Cost of funds rate
CFC  Commercial finance company
CFS  Community financial services
CGAP Consultative Group to Assist the Poorest
CMAC Cajas Municipales de Ahorro y Crédito (Peru)
COFIDE Corporación Financiera de Desarrollo (Peru)
CRIF Community Reinvestment Fund
CRS  Catholic Relief Services
EBRD European Bank for Reconstruction and Development
EDPYME Entidades de Desarrollo para la Pequeña y Microempresa (Peru)
EG   Enterprise group
ESOP Employee stock ownership programme
FFP  Private financial funds (Bolivia)
FGD  Focus group discussion
FINCA Foundation for International Community Assistance
FOCCAS Foundation for Credit and Community Assistance (Uganda)
FS   Financial services
FSA  Financial service association
FSS  Financial self-sufficiency
FUCAC Federación Uruguaya de Cooperativas de Ahorro y Créditos (Uruguay)
FUNDES Fundación para el Desarrollo Sostenible (Colombia)
GNP  Gross national product
HIV  Human immunodeficiency virus
HR   Human resources
HRM  Human resource management
ID   Identification
IFC  International Finance Corporation
II   Investment income
ILO  International Labour Organization
ISO  The International Organization for Standardization
IVR  Interactive voice response
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>K</td>
<td>Capitalization rate</td>
</tr>
<tr>
<td>KBS</td>
<td>Krishna Bhima Samruddi (India)</td>
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<tr>
<td>KPOSB</td>
<td>Kenya Post Office Savings Bank</td>
</tr>
<tr>
<td>LIF</td>
<td>Loan insurance fund</td>
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<tr>
<td>LIP</td>
<td>Local Initiatives Project</td>
</tr>
<tr>
<td>LL</td>
<td>Loan loss rate</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Mergers and acquisitions</td>
</tr>
<tr>
<td>MBB</td>
<td>MicroBanking Bulletin</td>
</tr>
<tr>
<td>MBP</td>
<td>Microenterprise Best Practices</td>
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<tr>
<td>MCO</td>
<td>Microcredit organization</td>
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<tr>
<td>M-CRIL</td>
<td>Micro-Credit Ratings and Guarantees India Ltd</td>
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<tr>
<td>MDI</td>
<td>Micro deposit-taking institution (Uganda)</td>
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<tr>
<td>MEB</td>
<td>Microenterprise Bank (Kosovo)</td>
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<tr>
<td>MEDA</td>
<td>Mennonite Economic Development Associates</td>
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<tr>
<td>MFI</td>
<td>Microfinance institution</td>
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<tr>
<td>MIS</td>
<td>Management Information Systems</td>
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<tr>
<td>MSCT</td>
<td>Micro Savings and Credit Trust</td>
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<tr>
<td>MIX</td>
<td>Microfinance Information eXchange</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non-bank financial institution</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-governmental organization</td>
</tr>
<tr>
<td>NMB</td>
<td>National Microfinance Bank (Tanzania)</td>
</tr>
<tr>
<td>OD</td>
<td>Organizational development</td>
</tr>
<tr>
<td>PDA</td>
<td>Personal digital assistants</td>
</tr>
<tr>
<td>OE</td>
<td>Operating expense</td>
</tr>
<tr>
<td>OSS</td>
<td>Operational self-sufficiency</td>
</tr>
<tr>
<td>PAR</td>
<td>Portfolio at risk</td>
</tr>
<tr>
<td>PARMEC</td>
<td>Projet d'Appui à la Réglementation des Mutuelles d'Épargne et de Crédit</td>
</tr>
<tr>
<td>PIN</td>
<td>Personal identification number</td>
</tr>
<tr>
<td>PKSF</td>
<td>Rural Employment Support Foundation (Bangladesh)</td>
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<tr>
<td>PMT</td>
<td>Performance monitoring tool</td>
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<tr>
<td>POS</td>
<td>Point-of-sale</td>
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<tr>
<td>PR</td>
<td>Public relations</td>
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<tr>
<td>PRA</td>
<td>Participatory rural appraisal</td>
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<tr>
<td>PRIDE</td>
<td>Promotion of Rural Initiatives and Development Enterprises</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>PRODEM</td>
<td>Fundación para la Promoción y Desarrollo de la Microempresa (Bolivia)</td>
</tr>
<tr>
<td>PRONAFIM</td>
<td>Programa Nacional de Financiamiento al Microempresario (Mexico)</td>
</tr>
<tr>
<td>R</td>
<td>Effective interest rate</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and development</td>
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<tr>
<td>RBP</td>
<td>Rural Bank of Panabo (Philippines)</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on assets</td>
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<tr>
<td>ROE</td>
<td>Return on equity</td>
</tr>
<tr>
<td>ROSCA</td>
<td>Rotating savings and credit association</td>
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<tr>
<td>RTS</td>
<td>Remote transaction system</td>
</tr>
<tr>
<td>SATM</td>
<td>Smart automatic teller machines</td>
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<tr>
<td>SEEP</td>
<td>Small Enterprise Education Programme</td>
</tr>
<tr>
<td>SEF</td>
<td>Small Enterprise Foundation (South Africa)</td>
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<tr>
<td>SHG</td>
<td>Self-help groups</td>
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<tr>
<td>SKS</td>
<td>Swayam Krishi Sangam (India)</td>
</tr>
<tr>
<td>SMART</td>
<td>Specific, measurable, achievable, realistic and time-bound</td>
</tr>
<tr>
<td>SMS</td>
<td>Short message service</td>
</tr>
<tr>
<td>SWOT</td>
<td>Strengths, weaknesses, opportunities, threats</td>
</tr>
<tr>
<td>TPB</td>
<td>Tanzania Postal Bank</td>
</tr>
<tr>
<td>TQM</td>
<td>Total quality management</td>
</tr>
<tr>
<td>UMU</td>
<td>Uganda Microfinance Union</td>
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<tr>
<td>UN</td>
<td>United Nations</td>
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<tr>
<td>US$</td>
<td>United States dollar</td>
</tr>
<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
</tr>
<tr>
<td>USP</td>
<td>Unique selling proposition</td>
</tr>
<tr>
<td>VIP</td>
<td>Very important person</td>
</tr>
<tr>
<td>WOCCU</td>
<td>World Council of Credit Unions</td>
</tr>
<tr>
<td>WWB</td>
<td>Women's World Banking</td>
</tr>
<tr>
<td>XAC</td>
<td>Golden Fund for Development (Mongolia)</td>
</tr>
</tbody>
</table>
Introduction to Microfinance Management
The Manager's Mandate

On any given business day, a typical microfinance manager spends his or her time performing a wide variety of activities: speaking with customers; preparing reports; supervising, coaching and disciplining employees; making decisions; answering phone calls and letters; attending meetings; selling services; signing paperwork; gathering information and so on. This wide range of activities easily clouds managers' understanding about what their job actually is.

As long as managers remain unclear about their roles and responsibilities, their ability to seek out and effectively apply tools and strategies for improving performance will be limited. Thus, this first module clarifies what the manager's mandate is and what makes individuals effective in carrying out that mandate. It provides a framework through which managers can identify how to do their job better than they do today. The module addresses four themes:

1. What is management?
2. The four functions of management
3. Management styles
4. What makes a manager effective?

1.1 What is Management?

There are many definitions of management, but one of the clearest and most relevant in the context of microfinance is the following:

\[
\text{Management} = \text{The process of getting things done efficiently and effectively with and through other people}
\]

There are two important components to this definition: first, "getting activities completed" and second, working "with and through other people." What distinguishes managers is not how hard they work or even the type of work they do, but rather, whether or not they produce results. As for the second part, to get things done microfinance managers must interact, communicate and collaborate with a host of different parties, including customers, peers, subordinates, supervisors, partners and suppliers.

A manager's job, in brief, is to deliver performance. The kind of performance required will vary depending on institutional goals, owners' expectations, environmental conditions and much more. Yet every manager is tasked with delivering a particular set of results and he or she will be assessed on the extent to which those results are achieved. Managers seeking to improve performance — be it their own, the performance of their unit, or the performance of an entire institution — should ensure there is clarity about the expected results before trying to figure out how to achieve them.
1.2 The Four Functions of a Manager

Managers achieve their mandate by fulfilling four main functions: planning, organizing, leading and controlling.

The Planning Function

Effective management begins with effective planning. Planning is what enables a manager to make sure that the right things get done. It involves:

- Assessing the current situation and determining what the future situation should be
- Identifying what must happen to create the desired future scenario
- Setting objectives and targets
- Defining activities and timelines
- Agreeing on measurement indicators

In sum, planning is all about setting goals and deciding how best to achieve them. There are many types of plans — budgets, strategic plans, business plans, operating plans, monthly cash flow forecasts, etc. (see Module 23) — which are developed at a variety of levels with different time horizons. In general, the further up the organizational chart managers are located, the further into the future they will plan. However, planning is part of every manager’s job. Even if managers lack authority to make “high-level” decisions, they should contribute to those decisions and take responsibility for defining how their team will help achieve the institution’s objectives.

As long as an institution remains small and employees have close and frequent contact with each other, the planning function is relatively easy. It becomes more complex — and much more important — as institutions grow. In larger microfinance institutions (MFIs), staff know fewer of their colleagues and little about the work that they do. In such an environment, planning becomes critical to effectively coordinate the activities, timing, strategies and decisions of various parts of the institution. In large organizations, planning ensures that desired results are produced not only by individuals or individual units, but also by the institution as a whole.

The Organizing Function

In their capacity as organizers, managers must ensure that the financial, physical and human resources necessary for the success of a plan are in the right place, at the right time, in the right quantity, and are being used efficiently. They must allocate tasks to individuals or groups in a way that aligns the job to be done with the skills required to do the job. They must also coordinate the implementation of tasks so that related activities proceed at a common pace and are synchronized.

Managers have to make sure that everyone who reports to them understands their role and the importance of their role to the overall success of the institution. They have to delegate with clear instructions and appropriate guidance. Within the organizing function, one of the most important responsibilities of a manager is the establishment and maintenance of clear and appropriate communication channels, not only within the unit being managed, but also
Box 1.1 The Roles of a Manager

Another way of looking at managerial responsibilities is to consider the roles that a manager must play. These have been classified into the three categories by Mintzberg in his 1973 publication, *The Nature of Managerial Work*:

**Interpersonal roles**
- **Figurehead**: carrying out ceremonial duties such as welcoming visitors or presenting awards.
- **Leader**: involved in training, counselling, and motivating staff.
- **Liaison**: with customers, suppliers and others outside the organization.

**Information roles**
- **Monitor**: gathering information by listening, reading, attending meetings, and being visually aware.
- **Disseminator** of information, particularly to the unit’s personnel.
- **Representative**: concerned with ensuring that higher management, other departments, and those outside the organization are fully informed about the department for which the manager is responsible.

**Decision making roles**
- **Analyst**: of issues and problems to ensure that the correct decisions are made.
- **Entrepreneur**: taking risks and initiating change.
- **Disturbance handler**: dealing with unexpected events and their effects.
- **Resource allocator**: ensures that the unit’s resources are distributed so that the tasks are efficiently and effectively achieved.
- **Negotiator**: ensures that dealings with others do not disadvantage the unit.
- **Arbitrator**: concerned with identifying and settling conflict.

with other units and with higher levels of management. Good communication is vital in creating productive linkages between goals, tasks and people. Indeed, coordinating healthy relationships among individuals and teams is perhaps the most important organizing responsibility managers possess. The checklist in Box 1.2 summarizes issues that branch managers should consider as they strive to improve their organizing responsibilities.

**The Leadership Function**

In fulfilling the leadership function, a manager helps to ensure that other people get the right things done. After all, managers are not managers if they attempt to do everything by themselves. Effective managers will provide appropriate direction and motivate others on their
Box 1.2 Questions for Branch Managers as They Organize

- Is your team prepared to implement its part of the institution’s plan?
- Have you agreed on the best time to deliver and will you be able to deliver on time?
- Are other departments or units ready for what your team will deliver?
- Are your employees appropriately trained?
- Are they motivated to carry out the tasks at hand?
- Do they have the equipment and tools they need?
- Does every member of your team have more than one channel for communicating with you?
- Do all staff have a copy of the current organizational chart? Does the chart clearly illustrate the relationships between individuals and functions?
- Does each person have a clearly written current job description? Does it define accurately all work responsibilities?
- Have you created clear lines of authority and information within your unit? Does everyone know to whom they are responsible and how information should flow?
- Do all employees have a copy of the institution’s policies and procedures? Have these been recently reviewed?
- Do you delegate authority to subordinates on the basis of results expected of them?

team so that everyone contributes to the achievement of expected results. Managers do this by:

- Articulating an inspiring vision
- Setting an example
- Setting priorities
- Coaching, advising and encouraging employees in their activities
- Establishing clear guidelines, expectations and policies
- Creating an environment in which others can thrive
- Helping people adapt and change
- Displaying innovative thinking and problem solving
- Promoting team spirit

Every manager has a leadership function (see Box 1.3). After all, no matter how talented and motivated employees are, they still need guidance as to how they can best contribute to achieving institutional goals. They will certainly appreciate regular injections of energy to help them maintain momentum and push themselves to even greater heights.
Box 1.3 Leader, Manager, Supervisor: Three Roles Everyone Responsible for a Group Must Fill

Leadership, management, and supervision are not about what you are. They're about your behaviour and your roles. All of the writing about the distinctions between managers and leaders, about whether one is better than the other, about whether we need both, and about whether organizations need more or less of one or the other entirely miss the point.

The first time that you become responsible for the performance of a group, your life changes. When you were an individual contributor, you had pretty much complete control over what to do in order to achieve better results. Once you become responsible for a group of people and their performance, that control disappears and is replaced with influence.

In fact, the higher you move up your organization's structure, the less power you have (in the sense of the ability to directly create results) and the more influence you have. That means that what you do and say has more impact because people pay more attention to it. You're also responsible for other people's performance in three distinct ways. Those ways are your leadership role, your management role, and your supervisory role.

**Supervision** is probably the easiest to understand. In supervision, you deal with individuals and with tasks. No matter what level of your organization you are, you will have some supervision work to do. You will have people directly responsible to you and you will talk directly about what they are going to do and how they are going to do it. That's supervision.

In your **management** role, you'll deal with groups and priorities. You'll handle things like scheduling problems and how to allocate scarce resources to the projects you need to complete. Your planning perspective will be tactical. (You will seek) to achieve objectives that support overall organizational goals within a defined portion of the organization.

Now we come to **leadership**, a term that's taken on almost mystical connotations in the last 20 years. Leadership, and your leadership role, is about purpose and direction. In your leadership role you deal with strategic issues. Strategic issues are the ones that affect the whole organization. If you happen to be at the top of the organization, that means the whole organization. But, if you head up a smaller sub unit, like a division or office, strategy is what you do that affects your entire sub unit.

As you move up the organizational hierarchy, you're likely to have a greater proportion of your time devoted to your leadership role and a lesser proportion to your supervisory and management roles. But, no matter where you are, if you're responsible for a group, you're responsible for leadership, management, and supervision.

There's one more key point here. You don't get a choice about whether you're a leader or not. You're a leader because that's what the people who work for you expect you to be. They will look to you for purpose and direction. They'll also expect you to be a manager, and a supervisor. They'll expect you to sort out priorities from among many competing ones. They'll expect you to give direction in how they'll perform their tasks. The trick is to figure out where the mix of roles is for you and then develop the tools and techniques that you're going to need to fill those roles effectively.

*Source: Adapted from Bock, 2003.*
The Control Function

The fourth function of management is the control function, which is sometimes referred to as the supervisory function. Within this area, managers are responsible for:

- Keeping an eye on things
- Making sure everything is going according to the plan
- Measuring results
- Comparing actual results to expected results
- Taking corrective action as necessary to bring results closer in line with expectations
- Reporting in a way that helps others keep track of performance

The use of the word “control” can be misleading as a descriptor for this function. Many managers make the mistake of thinking that their job is to control their staff — to make sure that they come to work on time and do not leave early, that everyone’s paperwork is completed properly, that all staff comply with rules and regulations, etc. There are two main problems with this approach: first, controlling managers will demotivate their staff; and second, controlling managers can only oversee a limited number of people.

As explained in Section IV of this manual, MFIs need managers who are facilitators, who oversee teams of workers who are largely self-managed, so that management ratios can increase (and thus administrative costs decrease), so that staff can be retained and their productivity can be maximized. Trying to control people in the same way that a puppeteer controls his puppets may result in short-term goal achievement, but can never create an environment in which people want to contribute their ideas and energy and be the best that they can be.

The control function, therefore, is aimed at making sure that the manager’s mandate is met — that desired results are actually achieved — and not at dominating or manipulating subordinates. It is concerned with the monitoring of staff welfare and performance, as well as loan repayment and the number of clients, and changes in the competitive environment.

1.3 Management Styles

Just as managers take different approaches to the control function, so too can they take different approaches to the other functions of management. These different approaches are management styles, and the business management literature identifies six of them: autocratic, charismatic, bureaucratic, democratic, laissez-faire, and supportive.

No one style is better than the rest, but each has its strengths and weaknesses, as shown in Table 1.1. Some are more appropriate in a given environment than others, for example:

- A more directive approach is required when subordinates are themselves authoritarian or when institutional policies and procedures are ambiguous.
- A supportive, nurturing style works best when the work is frustrating or repetitive, and therefore employees need a sustaining human touch.
- Participatory leadership works best when tasks are ambiguous and employees need to work autonomously.
- In a crisis situation, a strong leader is needed to guide an organization out of the problem; it is not the ideal situation for a participatory style.

### Table 1.1 Management Styles

<table>
<thead>
<tr>
<th>Style</th>
<th>Description</th>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Autocratic</td>
<td>Strong, results-driven authority who makes things happen</td>
<td>Speedy decision-making, delivers stated results</td>
<td>Staff turnover, succession is difficult</td>
</tr>
<tr>
<td>Charismatic</td>
<td>A leader by example with a dynamic personality</td>
<td>Inspired, motivated staff who love their working environment</td>
<td>Lack of discipline and focus, expectations may not be realistic, succession can be difficult</td>
</tr>
<tr>
<td>Bureaucratic</td>
<td>Follows the rules and ensures that others do also</td>
<td>Low risk, reduces ambiguity, avoids favoritism</td>
<td>Lacks creativity, not entrepreneurial</td>
</tr>
<tr>
<td>Democratic</td>
<td>Actively involves subordinates in decision making process</td>
<td>Highly participatory, facilitates succession</td>
<td>Time consuming, process-rather than results-oriented</td>
</tr>
<tr>
<td>Laissez-faire</td>
<td>Gives staff total freedom to achieve results</td>
<td>Allows staff initiative and creativity</td>
<td>High risk because signals of non-performance come late</td>
</tr>
<tr>
<td>Supportive</td>
<td>Assists staff emotionally and professionally</td>
<td>Motivated staff who are constantly developing</td>
<td>Institutional results can be compromised in favour of personal needs</td>
</tr>
</tbody>
</table>

Furthermore, different people will respond better to different approaches. As Fuchs (2001) wrote in Changing Ladders, “Every person you manage will present you with a different set of circumstances, opportunities, and challenges. It’s important to understand what motivates a person and then act accordingly. Truly effective managers engage with each team member in a manner unique to that individual. You do not need to develop a completely different style or tempo for each person, but you do need to understand that what works for some will not work for others. How you speak, respond, and use body language will send an important message to your team members, so always be cognizant of who they are as individuals and notice what approach works best when you try to engage them.”

Interestingly, men and women managers tend to have different management styles, although the differences are not as striking as one might expect. According to research by Eagly and Johnson (1990), women managers were more likely to adopt a democratic or participatory style than their male counterparts, who tend to be more authoritative or directive. Ironically, the participatory approach to leadership is the one most favoured by management gurus, most of whom are men!

In carrying out their mandate, managers need to pay attention to management style. Clearly, they should aim to be flexible and develop the ability to adopt different styles when the situation warrants it. They should recognize that men and women tend to respond differently to different styles, and adjust their approach accordingly. They should also be aware of their dominant management style, the one they tend to use more than others, so as to protect themselves against its weaknesses.
1.4 What Makes a Manager Effective?

As the discussion of management styles suggests, there is no universal definition of what constitutes good management. Managers with extremely different styles and methods are considered effective. So what accounts for their success? One school of thought hypothesized that success comes from possessing particular skill sets or characteristics. Scholars developed long lists of traits of effective managers (e.g., see Box 1.4), but not all successful managers exhibited the same traits. Thus, the lists offered limited guidance with respect to which skills a manager must develop to be effective.

Comparing the different lists that came out of the traits-based research, however, there are two traits that are rarely absent – the ability to communicate and the ability to delegate. These two traits are discussed further below.

Box 1.4 Characteristics of Effective Managers

- Intelligent
- Confident
- Integrity
- Sociable
- Positive outlook
- Good judgment
- Creative
- Organized
- Willing to learn
- Solves problems
- Delegates
- Focused
- Persuasive
- Decisive
- Determined
- Encouraging
- Shrewd
- Cross-functional
- Fair
- Efficient
- Goal-oriented
- Facilitates
- Communicates
- Attentive
- “Includes” not “excludes”
- Consistent
- Sincere
- Courageous
- Calm
- Enthusiastic
- Responsive
- Realistic

Communication

Communication skills can take many forms. A manager might be particularly good at listening, making persuasive arguments, providing constructive criticism in a motivating way, or simply making others feel comfortable sharing their ideas and opinions. Most importantly, the ability to help information flow in a way that produces results is crucial to success.

None of the four functions of the manager can be effectively carried out without good communication. For example, managers cannot lead anyone anywhere by simply setting a strategic direction. They must also convey that direction to the people with and through whom they work. A similar relationship exists with the other three functions as well. In fact, communication is the glue that binds the four management functions together and, as such, it is an indispensable tool for improving performance (see Figure 1.1).
The manager’s responsibility for facilitating communication cannot be underestimated. Not only must managers be able to personally convey information, but they must also establish clear channels through which others can productively communicate. They must keep information flowing so that those who provide it and those who act on it understand the impact of their contributions.

As shown in Figure 1.2, the basic communications process consists of six parts: the sender, the message, the channel, the receiver, the feedback and the context. Complicated communication may involve multiple senders, messages, channels or receivers, but the basic process is the same. Communication breakdowns can happen anywhere along the way – the message might be poorly written; it could be sent at a bad time or with the wrong tone of voice; it could be misinterpreted by the receiver; it might not even arrive.

**Figure 1.2 The Communications Process**

Source: Fowler, 1995
Dividing the communication process into these six parts can make it easier for managers to identify opportunities to strengthen communication within their unit, department or institution. For example:

- They can develop their own ability or the ability of others in their span of control to send, design, receive (i.e., listen to) and respond to messages. Indeed, it is particularly helpful if professional development plans for all staff address this issue, perhaps through mentoring or other training opportunities.

- They can ensure that efficient communication channels are clearly designated and that alternatives exist in the event that the preferred channel is not functioning as it should. For example, many MFI branches rely on weekly meetings as their primary communication channel, but what happens if the manager or staff members are absent on that day?

- They can identify and remove (or minimize) barriers to communication which may exist in the working environment. The frantic pace at which many MFIs operate can be a significant communication barrier, with interruptions from clients or the telephone. To overcome this problem, many managers hold bilateral or team meetings before or after regular hours.

- They can encourage effective feedback, both by example and through policies and procedures. For example, microfinance managers can use team meetings to develop a joint response to new policy recommendations from the head office, instead of just a forum for communicating the new policies to staff.

This last point is particularly important because feedback is the only way that the senders of information can know if their message was effectively received. It is also a valuable means of improving communication in the future, since it can identify underlying tensions, confusion, or sources of distortion. In addition, hearing others' responses can provide managers with a new perspective and ideas about how to proceed in the future in order to achieve better results. Table 1.2 provides a few specific suggestions for facilitating more effective communication at each stage of the process.
Table 1.2 Making Communication More Effective

| 1. Sending information | • Establish your credibility as a knowledgeable source of information  
| | • Clearly state why the information being sent is important  
| | • Know your audience and consider the perspective (e.g., assumptions, attitudes, culture) with which that audience is likely to interpret your information  
| | • Ask the listener for confirmation; do not assume that the message you sent will be received, or that it will be received as you intended it  
| | • Be direct, honest, respectful  
| 2. Designing the message | • Plan more than just the subject content; choose the words, tone and packaging carefully  
| | • Keep it as short as possible  
| | • Review the message before sending to eliminate errors and ambiguity  
| | • Check that the information in the message is clearly organized  
| | • Attach an appropriate level of priority to the content  
| | • Consider carefully whether you want to ask open or closed questions  
| 3. Selecting a channel | • Ensure multiple communication channels exist and are functioning  
| | • For each communication, consciously choose the channel that will be most strategic for delivering a particular message to a particular audience  
| | • Check that everyone in your span of control knows what communication channels are available and which should be used when (e.g., what kind of information should be sent via memo vs. email vs. in person)  
| | • Use more than one channel for important communication  
| 4. Receiving information | • Develop listening skills (your own and those of your staff)  
| | • Demonstrate effective listening skills (so that others can learn from and be encouraged by your example)  
| | • Request clarification if a message is vague, if it contains inconsistencies, if important details are missing, or if you see the potential for multiple interpretations of the content  
| | • Let the sender know you received his or her message; for important messages or agreements do so in writing  
| | • Ask for confirmation, e.g., “Did you say that we should...?”  
| 5. Obtaining useful feedback | • Pay attention to both verbal and non-verbal reactions to the information communicated  
| | • Seek out feedback if none is automatically given  
| | • Request confirmation of next steps and acceptance of responsibility  
| | • Respond to feedback in a productive manner (it encourages more feedback in the future)  
| | • Keep an open mind and listen fully before responding  
| | • Conduct occasional internal communication audits; check to make sure information is flowing easily and remove blockages as necessary  
| 6. Improving the context within which information flows | • Create a culture that values communication  
| | • Be careful not to send too much information too fast  
| | • Give (and request) background to understand the context in which information is being sent or decisions made  
| | • Build policies/habits of documenting important decisions and commitments in writing – this clarifies and confirms as well as facilitates follow up  
| | • Choose an appropriate time and place to communicate; aim for minimal distraction  

12
Delegation

A manager’s ability to get things done with and through other people is what defines his or her success. If results are only generated by the manager’s own contributions, then that manager is not being effective.

As discussed above, managers could get other people to do things by simply ordering them to do so, but this management style is suboptimal for microfinance. To succeed, MFI managers need to create teams of highly productive, loyal and motivated employees who can make decisions in the field without constant input from management and are keen to contribute their ideas and expertise to help achieve the institution’s goals. In this kind of environment, it is critical to delegate in a way that empowers staff.

Effective delegation allows staff to use and develop their skills and knowledge to the full potential. It is primarily about entrusting authority to others so they can act independently and assume responsibility with the manager for certain tasks. If something goes wrong, the manager remains responsible. Thus, the key is to delegate in such a way that things get done but do not go (badly) wrong.

To delegate effectively, a manager must ensure three things:

1. Those who are assuming responsibility must understand what needs to be accomplished and in what order of priority.
2. The delegates have the authority to make it happen.
3. They know how to do what needs to be done by when.

Accomplishing this will require effort in all four functions of management. Listed below are recommendations for action within each function that can assist managers to improve the quality of their delegation.

Planning

In the planning process, the first step is to agree with delegates on a reporting schedule, resource availability and criteria of success at the outset.

Second, managers should delegate gradually. If delegates are given a task with which they cannot cope, the task will not get done and staff could become severely demotivated. Start with something small that leads to some development, then another small task which builds upon the first. For example, perhaps loan officers can help each other with delinquency management before the branch manager gets involved. Each delegated task should have enough complexity to stretch staff, but only a little.

Lastly, do not expect perfection. Recognize that a delegated job does not have to be done as well as or in exactly the same way as the manager could have done it. It should be done as well as necessary. When delegating a task, be sure to agree upon the standards by which the outcome will be judged.

This section is adapted from:

Organizing

When organizing, managers need to take a long-term perspective on deciding what to delegate. Ultimately, managers should delegate as much as possible to develop their staff to be as good as the managers are now (see Box 1.5).

**Box 1.5 Deciding What to Delegate**

- Start by identifying the activities you used to do before you were promoted. If you were able to do them when you were in a more junior position, someone who is more junior than you should be able to do them now.
- Tasks in which you have experience will be the easiest for you to explain to others. Use your experience to ensure that the task is done well, rather than to actually perform the task yourself.
- Delegate tasks in which your employees have more experience. This does not mean that you relinquish responsibility because they are expert, but it does mean that the initial decision should be theirs. Make sure that they spend some time explaining their decisions so that you learn their criteria.
- Delegate decisions that are of importance to staff, but establish the boundaries of those decisions so that you can live with the outcome.
- Do not delegate personnel functions such as motivation, training, team-building, praising, reprimanding, performance reviews and promotion. Delegation is a mechanism for giving you more time to fulfill those critical leadership functions, not less.

*Source: Adapted from Blair, 2006.*

Delegation also involves facilitating access to information. To achieve the tasks which have been given to them, delegates must either possess sufficient knowledge already, or they must know where to get it. For example, branch managers should ensure that loan officers feel comfortable coming to them or, if others hold the necessary knowledge, that they are prepared and willing to receive the loan officers’ requests for information. Success also depends on regular communication, for example through progress reports.

Consider distributing the more mundane tasks as evenly as possible, and sprinkle the more exciting ones as widely. Be careful to delegate not only the performance of the task but also its ownership. Task delegation, rather than task assignment, is what enables innovation. Be sure to convey that the task may be changed, developed or upgraded as necessary or desirable.

Leading

When delegating, avoid making decisions that delegates can make themselves. The whole idea is for others to learn to take over, so encourage them to do so. If managers train their staff to apply the same criteria as they would themselves (by example and full explanations), then delegates will exercise control on the managers’ behalf. For example, in some MFIs, branch managers do not necessarily have to approve all loans in their branches – just the ones above a certain loan size. If it is in line with the MFI’s internal control polices, per-
haps smaller loans can be approved by other loan officers. In busy branches, this can enhance productivity since managers cannot be in several places at once.

Managers need to recognize that mistakes will happen. With appropriate monitoring, managers should be able to catch them before they are catastrophic; if not, then the failure is theirs. If something goes wrong — e.g., if loan officer approved loans start going bad — managers should encourage the person or team to whom they delegated the decision to fix the problem (with the appropriate guidance) and allow everyone to learn from the experience.

If delegates have done something wrong, carefully explaining what they have done wrong and why it is wrong will facilitate staff development. If they have done something well, congratulate them. This builds pride and self-esteem and can motivate future performance. If modifications might be made to improve the quality of the result, suggest them, but allow the delegates to make the decision about implementation. Unless a manager's solution has significant merits over that of staff, she should accept the staff solution. It costs her little, yet rewards staff greatly.

For delegation to work effectively, managers need to cultivate a culture in which staff look for and anticipate problems. Never criticize staff for finding an error, only for not having safeguards in place. Praise those who spot and deal with errors promptly and wisely rather than punishing them for causing them. Emphasis should be on the testing and monitoring of ideas.

Controlling

The controlling function in the delegation process is quite delicate. Managers need to avoid undermining the delegates' authority, yet they have to guard against abuses since the manager is ultimately responsible for the output of the delegates. Only by keeping an eye on how delegates are doing can managers feel confident that positive results will be achieved, and confident that internal control policies are being maintained. Monitoring through a system of pre-planned encounters is much more productive than surprising delegates with requests for progress reports or constantly watching over their shoulder.

If a mistake is made, analyse the cause so that everyone understands the event or circumstance which led to the error. Make sure those involved understand the problem, feel confident enough to resume and implement some procedure to prevent recurrence.

Challenges to Effectiveness

The ability to produce results is, by definition, the most important characteristic of an effective manager. According to Lencioni (1998), this trait is not only about making things happen, but also avoiding temptations that get in the way of producing results. Lencioni identifies five temptations in particular that managers should avoid:

1. Choosing to protect one's ego, status or career instead of taking an action or decision that would produce results.
2. Not holding colleagues or subordinates accountable because of a desire to be liked.
3. Wanting to be "right" so badly that actions and decisions are delayed until complete information is in hand.
4. Allowing the fear of conflict or the desire for constant harmony to restrict productive conflict.
5. Wanting to be seen as invulnerable; discouraging others from challenging one’s ideas, preventing the foundation of trust from being built.

Facing and overcoming such temptations is a challenge for any manager, but it can be particularly challenging for new managers. As Fuchs (2001) notes, the shift from being a credit officer, teller or technology specialist to a manager “…is not just a step up the organizational ladder, but a jump to an entirely new ladder in terms of skills, motivations, perspectives, responsibilities, and impact on the organization.”

New managers must learn how to lead; how to see beyond their own area of expertise to understand the larger organizational picture; how to motivate others to work effectively both as a team and individually; how to communicate critical information clearly, succinctly, and in a timely way; how to respond quickly and decisively to changing situations as well as to others’ ideas and needs; how to find recognition in the context of their team’s accomplishments and not compete with the team for praise or visibility. They must start performing immediately, even though their level of confidence may be low, they are concerned about their reputation, they want very badly to get things right and they do not want to alienate colleagues who were not promoted.

To help make new managers more effective, senior managers might find the following suggestions useful:

- Just because an employee was a strong individual contributor does not mean that he or she will easily and quickly excel in a management position.
- Most new managers worry about whether they are doing the right things and how they will know if they have done a good job. Senior managers can reduce this anxiety and help new managers make the adjustment away from recognition for individual accomplishments to recognition for team accomplishments by providing frequent feedback that will help them improve their performance as managers and gain confidence in the contribution they are making in their new role.
- Close mentoring during the transition to management can make a critical difference in helping thought processes evolve and avoiding potential problems that could undermine their confidence or credibility.
- Encourage new managers to take decisions with whatever information is available and allow productive failures. New managers need to gain experience as quickly as possible to build confidence in their ability to make good decisions. In general, they will learn more from failing than they will from succeeding. Senior managers should be patient and help them analyse the effectiveness of their decisions rather than criticize them for making the wrong one.
- It is important to recognize that the responsibility for acquiring and developing the skills of new managers lies both with new managers and with their supervisors. An investment of time by the supervisor in collaborating on a skills development plan with specific goals and timelines can avoid problems that might otherwise arise from a lack of mentoring and coaching.
Main Messages

1. Management is the process of getting things done efficiently and effectively with and through other people.

2. Managers achieve their mandate by fulfilling four main functions: planning, organizing, leading and controlling.

3. The control function is not about controlling staff; it is about controlling progress towards results.

4. Different situations and people will warrant the use of different management styles.

5. The ability to help information flow in a way that produces results is crucial to being an effective manager.

Recommended readings:

Financial Services and the Poor

Making Microfinance Work: Managing for Improved Performance marries two main issues: management and microfinance. By describing the manager’s mandate, Module 1 introduces half of the content of this manual. This module deals with the second half.

Microfinance is the provision of financial services to the poor on a sustainable basis. It embodies, like few other development strategies, a viable combination of equity and efficiency because access to financial services both protects and empowers the poor by giving them choices. However, most financial institutions are not poverty oriented. They do not have a social mission. What distinguishes microfinance from conventional finance is the aim to serve poor people — and generally people outside the reach of the formal financial market — without perpetual subsidies.

This chapter covers the following four topics:

1. The diverse financial service needs of the poor
2. The purposes for which financial services can be used
3. The challenges of balancing sustainability and outreach
4. A conceptual framework for thinking about outreach

2.1 Diverse Financial Services

Microfinance is commonly associated with small, working capital loans that are invested in microenterprises or income-generating activities. While microenterprise loans are certainly an important part of the microfinance menu of services, Box 2.1 illustrates that low-income persons need a range of financial services.

Credit is not sufficient as a development tool. Not everyone in a poor community is an entrepreneur, yet those without a business still need financial services. Even those who are entrepreneurs do not want to be in perpetual debt. Perhaps more critically, loans to persons who do not have the means to repay will make them worse off, not better.

Table 2.1 summarizes typical financial services used by, or at least available to, middle- and upper-income households in most countries. Low-income people have roughly the same financial services needs as everyone else, but they just need them designed and delivered in a way that meets their particular characteristics, such as: sporadic or unpredictable income, weeks or months with a negative cash flow, vulnerability to risks, and possibly situated in difficult to reach locations with limited infrastructure.
Box 2.1 Diverse Financial Services

When Prudence’s father died, she needed to raise US$200 to ship his body back to their village and pay for an appropriate burial ceremony.

The costs of “free” primary schooling seem to keep going up. Janice is not sure how she is going to find enough money for the supplies, uniforms and fees to send her three children to school.

Van’s father still lives in the village but now he is too old to work. Van has been encouraging him to come and live with her family, but he does not want to be in the city. She needs to send him some money every month to ensure that he can afford to eat.

The leaks in Nidhi’s roof are getting worse. Every time it rains, she has to bring out the buckets to catch the water. She desperately needs new thatching before her children fall ill.

Daniel’s old plough ox died after 12 years of faithful service. Unfortunately, Daniel had not planned for this eventuality, and now he doesn’t know how he will replace the beast with the planting season approaching.

Jarot’s neighbour has finally agreed to sell him the adjoining plot that they have been discussing for years, but only if he can make a full payment in cash by the end of the week.

The painkillers prescribed by the doctor cost Yvonne US$5 per week. She cannot afford that, but without them the pain is too great to work.

Maria set aside a little money every week in a jar under her house. Although she hadn’t decided what she would use her nest egg for, it gave her an extra sense of security. At least it did until last week when she realized that the jar had been emptied – her savings were gone.

Table 2.1 Categories and Purposes of Financial Services

<table>
<thead>
<tr>
<th>Category</th>
<th>Purpose</th>
<th>Financial Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Payments Management</td>
<td>Bill paying, remittances, keeping money safe</td>
<td>• Wire transfers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Money orders</td>
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<tr>
<td></td>
<td></td>
<td>• Banking accounts</td>
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<tr>
<td>2) Cash Flow Management</td>
<td>Income and consumption smoothing</td>
<td>• Liquid savings</td>
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<tr>
<td></td>
<td></td>
<td>• Consumption credit</td>
</tr>
<tr>
<td>3) Investment Management</td>
<td>Maintain and grow purchasing power of savings and other assets</td>
<td>• Term deposits and CDs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Mutual investment funds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Loans for purchase of housing and other assets</td>
</tr>
<tr>
<td>4) Business Services</td>
<td>Assist small business with financial needs</td>
<td>• Business loans</td>
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<td>• Payroll services</td>
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<tr>
<td></td>
<td></td>
<td>• Business insurance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Venture capital</td>
</tr>
<tr>
<td>5) Risk Management</td>
<td>Reduce vulnerability to economic stresses</td>
<td>• Targeted savings</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Emergency credit</td>
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<td>• Insurance</td>
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</table>
Without access to institutional financial services, the poor have to rely on informal sources, such as friends and family, savings and credit associations like ROSCAs and ASCAs, money-lenders and informal deposit collectors, and savings in kind. These informal financial services have many attributes that are appropriate for the target market. They tend to be easily accessible, require minimal or no paperwork, and can be quickly available — in fact, microfinance institutions can learn a lot by studying the positive characteristics of informal financial service providers. But some are fraught with disadvantages — including high cost, poor quality or undependable availability — which can exacerbate the vulnerability of low-income households.

By providing a range of financial services, MFIs have the opportunity to benefit their customers and themselves. If the MFI can provide better quality products, clients can reduce their reliance on informal sources, particularly those with unfavourable characteristics. The poor may also be able to access services that are unavailable from informal sources.

The benefits to the MFI include:

- **Serving a broader market:** By becoming a financial institution that serves low-income communities, rather than only providing credit to entrepreneurs, the MFI broadens its outreach and assists customers who were not interested in microenterprise loans.

- **Diversifying risks:** Offering credit for a range of purposes, such as housing or education, could avoid the concentration risk that comes with just lending to microenterprises. The prospect of accessing additional loan products can also be used as an incentive for clients to repay — for example, if borrowers maintain a good credit record then they become eligible for an emergency loan product. When borrowers have incentives to repay, lenders face lower loan losses.

- **Diversifying income sources:** An MFI that offers fee-for-service products, like remittances or insurance (when serving as an insurance agent), can generate revenues without assuming additional risks.

- **Diversifying funding sources:** By providing savings facilities to the broader community, an MFI might be able to amass sufficient resources to fund its loan portfolio.

- **Lowering acquisition costs:** By offering multiple products to one customer, an MFI can spread that client's acquisition costs over different products through cross-selling.

- **Enhancing loyalty:** The cross-selling of multiple products to one consumer strengthens the relationship between the MFI and the client.

- **Achieving greater impact:** Microfinance institutions typically try to achieve a social mission, such as reducing poverty or promoting economic development. A diverse product menu can make it possible for an MFI to achieve greater impact than through microcredit alone.
2.2 Typical Microfinance Products

Despite these benefits, not all MFIs offer a range of financial services. The regulatory environment may prevent MFIs from offering some services, such as savings or insurance for example. Institutions may not have the infrastructure or the capacity to provide some services, such as remittances. MFIs may not offer long-term loans because they do not have access to long-term sources of capital. An MFI's board may prefer that the organization focuses on a few core services so that it can do those extremely well rather than providing lots of services in a mediocre way.

Even though few MFIs offer all of these services, a scan across the microfinance industry reveals a set of products and services that can be found in most countries, if not one institution.

**Income-generating loans.** The most common microfinance product, and the one offered first by many MFIs, is an income-generating or microenterprise loan. The intention behind offering these loans is that practitioners assumed that credit was a missing ingredient for development. If the self-employed in the informal economy had access to investment capital, they could put it to productive use that would generate a return for themselves and for the financial service provider. Microfinance institutions use innovative product design and delivery techniques to overcome the challenges of serving the low-income market, including group loans with social guarantees and incrementally increasing loan sizes based on the borrower’s repayment history. Today, many MFIs offer a range of enterprise loans, including both group and individual products, for working capital and fixed assets.

**Emergency or consumption loans.** Recognizing that their customers need credit for other purposes, many MFIs also offer small, immediately available loans to assist clients to cope with unexpected expenses. Generally secured through group guarantees, pawn items, or simply the borrower’s credit history, these loans can be used for other purposes as well, including business opportunities, school fees or general consumption purposes.

**Housing loans.** This relatively new microfinance product assists low-income households to make incremental improvements to their dwelling. Still following the common microfinance practice of offering relatively small loans for short terms, borrowers usually take out a one-to three-year loan to build a room or upgrade the roof, and then once that loan is repaid they may borrow again to build or improve another part of the house.

**Leasing.** Another less common microfinance product is a financial lease that allows clients to purchase (or use) assets without a major down payment and without additional collateral. Since the financial institution retains ownership of the asset until the end of the lease term, the assessment process can be simple. In addition, the value of the asset and the lease term can be larger and longer, respectively, than the size and term of most microenterprise loans without increasing risk to the leasor.

**Savings.** Often referred to as the forgotten half of microfinance, the demand for savings products in many environments is even greater than the demand for credit. Unfortunately, however, the regulatory environment in many jurisdictions prevents many MFIs from mobilizing deposits. Deposit-taking MFIs typically offer savings products that respond to savers’ needs for liquidity. If people need access to their savings, then the MFI provides a demand
deposit or passbook savings account. If clients would rather not touch their money, then contractual savings or a fixed deposit account are more appropriate. Indeed, most savers want both options.

**Insurance.** For years, many MFIs have offered basic credit life insurance to repay the outstanding loan balance if borrowers die, but recently there has been a growing interest in using insurance more effectively to help clients and their families to manage risks, including death, disability, illness and property loss. Most microfinance institutions recognize that insurance is a fundamentally different business from savings and credit, and that the best way to offer insurance to their clients is in partnership with formal insurance companies.

**Payment services.** Some microfinance institutions have started offering money transfer services so that their clients can send or receive money from persons in other countries or in other parts of their own country. The most familiar type of payment service is a migrant worker remittance, whereby someone goes to work in another country and sends money home to family members. Remittances are particularly interesting for microfinance if they can be linked with another financial service. For example, remittances can be used to repay home loans or to deposit funds in a contractual savings account for school fees. MFIs that offer payment services usually do so in partnership with international money transfer companies like Western Union or Moneygram.

**Non-financial services.** Since they are generally serving low-income households, including some that are quite vulnerable, MFIs may combine financial and non-financial services to have a greater impact and to reduce the risk of lending to the poor. These non-financial services typically take three different forms: 1) social intermediation such as group formation and financial education to prepare clients to access the financial services; 2) business development services such as mentoring and market linkages to strengthen the operations of the borrower’s enterprise; and 3) using the meetings of savings and credit groups to provide social services, such as basic health care, family planning and adult literacy. Some MFIs cover the costs of these non-financial services out of their interest revenues, although in other cases the non-financial services are subsidized or provided by another organization.

Taken all together, these microfinance products and services promise to assist the poor to attain four main socio-economic improvements:

- **Job creation:** Business loans and leasing products facilitate small investments in micro and small enterprises that allow entrepreneurs to create and sustain jobs, for themselves and others.
- **Asset building:** Long-term savings products, housing loans, some insurance policies and even remittances can assist low-income households to build assets.
- **Poverty reduction:** Savings, emergency loans and insurance products stabilize income levels, smooth consumption, and reduce the vulnerability of people living near the subsistence level.
- **Empowerment:** Microfinance delivery techniques can develop a sense of responsibility and leadership, strengthen social capital, empower the poor, especially women, and create a building block for collective action. Combining financial and non-financial services can enhance this empowerment effect.
2.3 Outreach and Sustainability

The process of providing these diverse services to the poor in a sustainable manner requires a fusion between social and commercial objectives. On the one hand, MFIs are striving to *alleviate poverty*; on the other hand, they are trying to *generate a surplus* that will allow them to attract additional capital and reach more people. This union creates a perpetual tension: Should we strive to reach greater numbers of people, poorer people, or generate a larger surplus? How much can the poor really afford to pay for our services?

There are no easy answers to these questions. At the end of the day, microfinance will always involve trade-offs. The challenge to MFIs is to find ways of minimizing them. As Elisabeth Rhyne (1998) writes:

For well-performing institutions there was no correlation between the poverty level of clients...and the financial viability of the institution. Undoubtedly it is more challenging to serve people with very small loans or to reach remote rural clients. However, even in relatively unfavourable settings these institutions had developed service delivery methods so tailored to their clientele and so efficient that clients could afford to pay the full cost of the services, making the institutions financially viable.

In other words, if MFIs can do a better job, if they can improve performance, they will not have to make such difficult choices.

2.4 Six Degrees of Outreach

Another big thinker in the microfinance community, Mark Schreiner (2002), suggests that the duality between the poverty approach and the self-sustainability approach is perhaps too simplistic. He proposes a more complex analytical framework that considers six aspects of outreach: 1) worth to clients, 2) cost to clients, 3) depth, 4) breadth, 5) length, and 6) scope.
Schreiner's approach is a compelling way for microfinance managers to consider which dimensions are most important for their MFI and for their customers.

1. **Worth to Clients.** For clients, worth of outreach reflects their willingness to pay. Worth hinges on the design of the loan or savings product, as well as on the clients' preferences, constraints and opportunities. For example, a loan of US$100 is worth little to a farmer who wants US$1,000 to drill a well. For loans, worth increases as the terms of the contract more closely match borrower demand. For deposits, worth increases with the interest rate, and with the ease of access to the savings product, for example when withdrawals are convenient and unlimited.

2. **Cost to Clients.** Cost of outreach is the sum of explicit costs, such as the interest rate and fees, and the transaction costs. Transaction costs include both opportunity costs (e.g., the time spent sitting in group meetings) and indirect expenses such as transport, documents, and taxes needed to access a loan or use a savings service. Too often, microfinance discussions about costs focus on the price of the financial service and overlook the transaction costs.\(^1\)

3. **Depth.** Depth of outreach generally refers to the poverty level of an MFI's clients. Measuring depth directly through income or wealth is difficult, but simple proxies exist to measure it indirectly, for example: location (rural is preferred), sex (women are preferred), education (less is preferred), ethnicity (minorities are preferred), housing (small, flimsy houses are preferred), access to public services (lack of access is preferred), and loan size (smaller is preferred).

4. **Breadth.** Breadth of outreach is the number of clients. Breadth matters because of budget constraints; the wants and needs of the poor exceed the resources earmarked for them. One of the more challenging questions for microfinance practitioners to consider is whether they would be able to reach more very poor people (depth) if they serve a broader market (including persons who are not poor), or if they focus on serving the poor exclusively.

5. **Length.** Length of outreach is essentially the sustainability of the microfinance institution. If an MFI can provide financial services for a long period of time, then it meets the length criterion. But length is difficult to measure because it occurs in the future. The profitability of an organization is one proxy for length because, in the absence of guaranteed donations, profits suggest an ability to survive even if donors leave.

6. **Scope.** Scope of outreach reflects the variety of financial services an MFI offers. Scope includes a diversity of products, such as those described in Section 2.2, as well as greater options within a product line, for example group and individual loans, or loans for short and long terms.

Despite the additional complexity, this analytical framework cannot avoid trade-offs. In fact, it illustrates the intricacy of the trade-offs themselves. Each aspect of outreach depends on the other five. For example, the provision of additional products (scope) could threaten sustainability (length) if the organization is not prepared to manage the additional responsibilities. MFIs that strive to grow exponentially (breadth) might have to do so at the expense of

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\(^1\) In fact, ACCION estimates that the price of the loan represents between 0.4 and 4 per cent of the total borrowing costs to the client (Castello, Stearns and Christen 1991).
serving the poor (depth), at least in the short term, since the easiest-to-reach customers are usually not the poorest. An MFI might increase the flexibility of its loan products to make them more useful to clients (worth), but doing so might necessitate higher interest rates (cost). And so on.

Schreiner (2002) notes that the social benefits of microfinance depend on all six dimensions — worth, cost, depth, breadth, length and scope — but the greatest of these is length. The debate between impact and sustainability hinges on the effect of length on the other five aspects. More length requires more profit, and profits affect all aspects of outreach. Only by achieving high degrees of profitability (length) can MFIs have access to the funds they need to serve large numbers (breadth) of poor people (depth) with diverse (scope) and quality services (worth) at a reasonable price (cost).

For microfinance managers, this analysis essentially reaches the same conclusion as Rhyne (1998): the best way to maximize all six dimensions of outreach is through better performance.

Main Messages

1. Credit is not sufficient as a development tool; low-income persons need a range of financial services.
2. MFIs cannot have lasting outreach without sustainability.
3. Managers need to know their organization’s outreach priorities so they can strive to improve performance in the areas that matter most.
4. To provide a menu of valuable products to more clients — including poorer clients — for the long-term, MFIs have to improve their performance.

Recommended readings:


Microfinance Products


3 Institutional Options

The microfinance field is diverse and in constant evolution. Although the term microcredit has been around for 25 years, it initially referred only to externally initiated lending schemes implemented by nongovernmental organizations (NGOs). Today, microfinance involves a wide range of ownership and governance structures, sources of capital, levels of external regulation, motivations, possible services and degrees of success.

This module examines different types of microfinance institutions and explores the key advantages, disadvantages and implications of each. The analysis provides insights into which institutional type is appropriate for an organization given its mission and operating environment. Some MFIs may have little choice with respect to their legal status; some may decide that their institutional type needs to change for performance to improve; others may be content to remain as they are. Yet all managers can benefit from improved knowledge of the institutional options, since this information can influence strategies for competing and/or collaborating with other organizations.

This module addresses the following four areas:
1. A typology of microfinance institutions
2. The implications of institutional type
3. Moving from one institutional type to another
4. Combining institutional types

3.1 A Typology of Microfinance Institutions

An analysis of the financial landscape reveals three main types of microfinance service providers: formal, semiformal and informal. The primary distinction between them is the degree to which they are overseen by external organizations. **Formal financial institutions** are subject not only to general laws, but also to specific regulation and supervision by the Central Bank, Ministry of Finance or an agency thereof. **Semiformal institutions** are registered entities subject to all relevant general laws, but not usually subject to oversight by a banking or finance authority. In other words, they are authorized by governments, but are monitored by their board of directors, a federation, or other stakeholders. **Informal service providers** are typically not registered or recognized by government bodies and are monitored only by their members or the community they serve (Ledgerwood, 1998, p. 97).
Within these broad categories, there are different kinds of institutions, distinguished on the basis of legal status, ownership or governance structure, sources of capital, and outreach. This typology is described in Table 3.1 and in the text that follows.

### Table 3.1 Three Main Types of Microfinance Service Providers

<table>
<thead>
<tr>
<th>Formal</th>
<th>Semiformal</th>
<th>Informal</th>
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<tbody>
<tr>
<td>Commercial banks</td>
<td>NGOs</td>
<td>Village banks</td>
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<tr>
<td>Development banks</td>
<td>Credit unions</td>
<td>Self-help groups</td>
</tr>
<tr>
<td>Savings banks</td>
<td>Savings and credit cooperatives</td>
<td>Financial Service Associations (FSAs)</td>
</tr>
<tr>
<td>Non-bank financial institutions</td>
<td>Private companies</td>
<td>ROSCAs</td>
</tr>
<tr>
<td>Finance companies</td>
<td></td>
<td>ASCAs</td>
</tr>
<tr>
<td>Leasing companies</td>
<td></td>
<td>Burial societies</td>
</tr>
<tr>
<td>Insurance companies</td>
<td></td>
<td>Pawn shops</td>
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<td></td>
<td></td>
<td>Individual moneylenders</td>
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</tbody>
</table>

### Formal Financial Institutions

The most recent entrants into microfinance, formal financial institutions represent a variety of objectives, experiences and approaches. They may be publicly or privately owned, savings or credit-focused, serve a large or small population, in rural or urban areas. All are regulated, most are profitable, and nearly all are financed by deposits, commercial debt and/or private equity. There are four types of institutions to consider in this category: 1) private commercial banks; 2) development banks; 3) savings banks; and 4) non-bank financial institutions (NBFIs).

**Private commercial banks.** Most commercial banks have little experience or interest in providing financial services to poor persons. However, that is beginning to change as banks adopt three different approaches to microfinance:

- **Downscalers.** Some traditional banks have developed products or created subsidiaries to serve low-income communities. Downscalers get involved in microfinance for different reasons. Large mainstream banks, in which microfinance is a small activity, are generally motivated by a desire for a good public image. Smaller banks may see low-end clients as an attractive market niche. Some banks are being pushed down market by stiff competition for traditional banking clients, while others enter microfinance as a public relations strategy to stave off, or to respond to, political pressure.

- **Upscalers.** When the Bolivian NGO, PRODEM, created BancoSol in 1992, it became the first private commercial bank in the world dedicated solely to microfinance. Many other NGOs have since pursued a similar strategy. In general, microfinance NGOs transform themselves into commercial banks for two related reasons: 1) to leverage private capital that will enable them to increase their outreach dramatically; and 2) to provide financial services, especially savings, that an NGO cannot offer.

- **Microfinance banks.** In a strategy developed by the German consulting firm IPC, some banks, particularly in Eastern Europe and Central Asia, have been started from scratch to serve the micro and small enterprise market. This greenfield approach has been embraced...
by numerous development investment funds, such as the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).

Downscalers typically enjoy efficiency advantages, including the ability to rely on existing infrastructure as necessary, more stable sources of low-cost financing, and experience in financial markets. Yet downscalers also have disadvantages, such as the bias of a traditional banking culture, a lack of expertise in the microfinance market, and slow decision-making.

The greenfield approach of the microfinance banks is intended to take advantage of being a commercial bank without having to deal with the historical baggage that both NGOs and traditional banks must cope with as they transform or move downmarket.

**Table 3.2 Examples of Private Commercial Banks that Offer Microfinance**

<table>
<thead>
<tr>
<th>Downscalers</th>
<th>Upscalers</th>
<th>Microfinance banks</th>
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<tbody>
<tr>
<td>• Sogebank, Haiti</td>
<td>• Mibanco (formerly ACP), Peru</td>
<td>• Micro Enterprise Bank (MEB), Kosovo</td>
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<td>• Equity Building Society, Kenya</td>
<td>• K-Rep Bank, Kenya</td>
<td>• NovoBanco, Mozambique</td>
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<td>• Banco del Pacifico, Ecuador</td>
<td>• CARD Rural Bank, Philippines</td>
<td>• ProCredit Bank, throughout Eastern Europe and Central Asia</td>
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<tr>
<td>• Kingdom Bank, Zimbabwe</td>
<td>• ACLEDA Bank, Cambodia</td>
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<tr>
<td>• FINADEV, Benin</td>
<td>• BancoADEMI, Dominican Republic</td>
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<tr>
<td>• Bandesarrollo, Chile</td>
<td>• Nirdhan Utthan Bank, Nepal</td>
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<td>• Hatton National Bank, Sri Lanka</td>
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**State-owned commercial and development banks.** State-owned development banks were established in many countries to provide subsidized credit to farmers through extensive branch networks. Poor performance bankrupted most banks and many were closed, but some governments have sought to transform their development banks into commercial entities that provide financial services to underserved rural areas.

For years, BRI was the only successfully transformed rural development bank to provide microfinance, but several other banks have recently transformed including BEME in Chile and the National Microfinance Bank in the United Republic of Tanzania. Other banks, such as Banco do Nordeste in Brazil and Co-operative Bank of Kenya are now in the planning or pilot stages of microfinance operations.

Development banks that enter the microfinance scene have three competitive advantages: 1) an extensive branch network that offers immediate channels for market penetration; 2) the ability to offer payment services and savings (with implicit or explicit government guarantees); and 3) access to the resources needed for transformation. When these advantages are combined with good management and microfinance expertise, the results can be dramatic. During the pilot microlending phase at Banco do Nordeste, 20,000 borrowers received loans in the first 12 months, possibly doubling the number of micro-borrowers in the country.

If development banks “get it right”, they can be formidable competitors, but “getting it right” is not easy. Transforming these banks involves overcoming a corporate culture that is antithetical to microfinance. State-owned banks are known for low productivity, a lack of incentives and accountability for performance, and political interference. Thorough management change and major staff retraining is required to turn things around, and the success of such expensive pro-
cesses is far from assured. Even if these banks successfully implement microfinance operations, their ownership and governance structures represent ongoing challenges.

**Savings banks.** The legal status and ownership of savings banks varies. Some, such as the municipal banks (CMACs) in Peru, were set up and owned by municipalities; others, such as the rural banks in Ghana, are simply small local banks owned by local people. As the name indicates, savings banks tend to emphasize savings mobilization. Their main strength is that they are decentralized, rooted in the local community and interested in serving local businesses.

Another variation is the post office savings bank, which operates through the counters of post offices, and therefore, has a large network of outlets. These banks generally do not offer credit, but take deposits and provide money transfer services. A surplus of deposits is normally invested in government securities or simply transferred to the treasury. These banks have great potential given their comparatively low transaction costs and accessibility. Unfortunately, most post office savings banks are in poor shape, both financially and operationally (Ledgerwood, 1998, p. 98).

Most struggle with many of the same governance and culture challenges as state-owned development banks, yet some are working hard to change. MicroSave’s Action Research Partners, Kenya Post Office Savings Bank (KPOSB) and Tanzania Postal Bank (TPB) have made major changes in recent years including the launch of new products and the restructuring of core processes; both banks are currently in the process of re-branding.

**Non-bank financial institutions.** In some countries, new regulations have been established to create NBFIs that specialize in microfinance. These regulations take different legal forms and names, but they were set up to enable MFIs to become regulated financial intermediaries without having to meet commercial bank requirements. Examples include the private financial funds (FFPs) in Bolivia, the micro deposit-taking institutions (MDIs) in Uganda, and the EDPYMEs in Peru. Private shareholders, which typically see their investment in social terms rather than as an opportunity to maximize financial returns, own this new breed of MFI. These shareholders include development corporations, private foundations, microfinance investment funds and socially responsible individuals.

Besides these new legal forms, some MFIs operate as formal financial institutions by assuming an existing non-bank legal identity. Compartamos in Mexico, Financiera Calpiá in El Salvador and FINSOL in Honduras, for example, have registered as finance companies or financieras. Traditionally, finance companies are associated with consumer credit and instalment contracts, and are typically not allowed to mobilize savings. In some countries, their form is being adapted to provide a regulated vehicle for microfinance with lower barriers to entry than a commercial bank. This poses both an opportunity and a challenge for MFIs, as explored in Box 3.1.
Both consumer lenders and microfinance programmes need to achieve high volumes, feature quick loan processing, and charge the higher interest rates that very small loans require. Both target households at the low end of the socio-economic spectrum. It is no wonder that many consumer lenders have started to move into microfinance. If an institution is successful at consumer lending, it already has many of the competencies needed to succeed in microfinance. However, consumer credit and microfinance have fundamentally different approaches to lending.

Consumer credit involves making small loans to salaried persons, which are secured by an agreement with the borrower’s employer. As long as the borrower remains employed, the lender can be sure of repayment through the garnishing of wages. Frequently, automatic payment mechanisms are set up. Salary-based lending is much more straightforward than lending to people in the informal economy. Consumer credit companies do not require loan officers who are trained at assessing client enterprises for creditworthiness and repayment capacity. Their employees are essentially loan processing clerks. Moreover, as consumer companies have a straightforward method of securing repayment, they do not offer the mix of incentives for repayment that microfinance programmes must create, (e.g., group lending and prompt payment incentives).

At a minimum, consumer lenders challenge microfinance providers because some informal sector households have one or more members with salaried employment. These household members may become conduits for credit which is actually used for enterprise development. Around the world, wherever consumer lenders are aggressively expanding, they may bite into the potential market for microfinance services without even targeting the informal market.

Because of the routine nature of consumer lending, such lenders have developed streamlined ways of doing business that allow them to quickly process an astonishingly large number of loans. For example, a Bolivian finance company made loans to 82,000 consumers during its first 18 months of business, which is almost as many customers as BancoSol served during its first ten years of operation.

One particular problem that consumer credit poses for microfinance is the clash of credit cultures. With access to salaries as a relatively easy recourse, consumer lenders are more relaxed than microenterprise lenders about late payments. In fact, if penalties are charged, delinquency can actually increase returns for consumer lenders. Thus, consumer lenders comfortably maintain relatively high delinquency rates in their portfolios. Microfinance lenders may find that consumer lenders undermine the credit culture among their own clients.

Consumer credit also challenges microfinance programmes to be clear about their image and objectives as institutions committed to improving their clients’ lives. Coming from a purely commercial background and often operating at the edges of the financial system, consumer lenders are sometimes seen as unscrupulous operators. Popular distrust of consumer lenders may focus on the high interest rates charged or on the means by which loans are secured. Often these rates are as high as microfinance rates, although the cost structure of the finance companies is much lower. Microfinance institutions that wish to distance themselves from potential criticism may insist that they are ultimately altruistic, yet they also feature high interest rates and stringent practices for securing repayment. Some MFI networks, such as SEEP and ACCION, have launched consumer protection initiatives to help demonstrate that they do, indeed, hold themselves to a higher set of standards.

Source: Adapted from Rhyne and Christen, 1999.
Leasing and insurance companies fall into a category of their own, since they exist to provide a financial service, yet they typically are not retail financial intermediaries — they do not mobilize saving deposits and then redistribute those resources as credit. Leasing and insurance companies usually operate under distinct regulation which may prevent other institutional types from engaging in these activities. Thus, when leasing or insurance companies enter microfinance, it is usually through a partnership with another type of institution which does offer microcredit and/or microsavings services and wants to extend additional financial services to its clients.

Semi-formal Financial Institutions

Semi-formal financial institutions are registered entities subject to general laws, but not subject to oversight by a banking or finance authority. The two main types of institutions in this category are credit unions and microfinance NGOs, although private companies that provide short-term credit, cheque cashing services or money transfer facilities also compete with the semi-formal MFIs.

Credit unions. Financial cooperatives are identified by many names, including credit unions, savings and loan cooperatives, and mutuelles. Together, these institutions play a significant role in the provision of financial services to the poor and, in many countries, reach more customers than other MFIs. Financial cooperatives are operated based on cooperative principles and have the following key characteristics:

- **Savings-driven.** Credit unions usually have many more depositors than borrowers, and most of their capital is self-generated from member shares and deposits. As long as members maintain confidence in their institution, the financial base is reasonably stable. Access to external sources of capital varies, but where it exists it is sometimes destabilizing.

- **Membership** is usually based on a common bond among members, often through the workplace or the community. Because of the common bond boundaries, outreach for individual credit unions is limited, ranging from a hundred to a few thousand members.

- **Ownership and governance.** The members are the owners of the institution, with each member having the right to one vote. The board of directors is drawn from the members themselves, and members volunteer or are elected for these positions.

- **Regulation.** Credit unions usually fall under general regulations for cooperatives and are rarely subject to banking laws. Where they are regulated by a Central Bank, they can be considered as formal, rather than semi-formal, financial institutions.

Some credit unions have achieved impressive financial results; others are weak and prone to failure. A relationship with a strong tertiary association often makes the difference. These apex organizations represent the credit unions at a national or regional level, provide training and technical assistance, and act as a central deposit and inter-lending facility.

Financial cooperatives can have trouble if they are too large for members to know each other or if members do not regularly change their roles from net depositors to net borrowers and vice versa. In such situations, a structural conflict often arises between borrowers (who prefer low interest rates and little pressure for repayment) and depositors (who prefer high interest and a cautious application of their deposits) (Ledgerwood 1998, pp. 102-103). Difficulties also
arise if credit union members do not adequately understand their governance responsibilities or do not have adequate systems to facilitate accountability.

**Microfinance NGOs.** The NGO structure is the most recognized type of microfinance institution. Because microfinance NGOs usually receive donor funding, they are regularly scrutinized and documented to justify the use of public money. A scan through the microfinance literature therefore finds NGOs over-represented. Some provide only financial services; others provide financial services integrated with non-financial ones, such as business skill development, health care or education.

NGOs tend to have a powerful social mission and are strong with respect to their depth of outreach and, to a lesser extent, innovation. At the forefront of microfinance industry in the 1980s and early 1990s, NGOs continue to search for ways to reach communities that do not yet have access to quality financial services.

Microfinance NGOs are less strong in other aspects of outreach, notably breadth, scope, length and cost. They tend to peak at around 20,000 borrowers, but most have yet to reach this size and are unable to benefit from economies of scale. To pay for this inefficiency, they often charge high interest rates. In general, they are credit-driven institutions; their legal status prohibits them from offering voluntary savings. Their ownership structure makes it difficult for them to raise capital from non-donor sources. Some NGOs are profitable, but most rely on donor subsidies.

**Informal Microfinance Service Providers**

Informal microfinance service providers are typically beyond the purview of the government and are monitored only by their members. In general, they can be classified into three categories: 1) indigenous groups, such as ROSCAs, ASCAs and burial societies; 2) externally promoted self-help groups, such as village banks, financial service associations (FSAs), and managed ASCAs; and 3) private entrepreneurs, namely individual moneylenders and pawn shops. What makes these groups particularly interesting for managers of formal and semi-formal MFIs is the potential for learning from and/or partnering with entities that are serving markets that MFIs want to reach (see Box 3.2).
Box 3.2 Learning from Informal Insurance Providers in South Africa

One of the most significant trends that has emerged in the research and development of new financial services for the poor is the examination of how the informal sector operates to try and develop products and institutions modeled on those that exist in the informal sector. In South Africa, there are two main types of informal insurance schemes. The first type operates on a for-profit basis. This type of scheme is typically run by the owners of funeral parlours who sell insurance as a means of selling their relatively expensive products to low-income households. The funeral parlours administrate their own informal insurance products. The second type of informal insurance is a not-for-profit scheme that shares many of the features of ROSCAs. These schemes are typically formed by people who live in the same neighbourhood and are run according to rules agreed upon by the members. They differ from most ROSCAs in that the pot of funds does not automatically rotate but is allocated on the basis of a particular unforeseen event, such as the death of a household member. Neither of these schemes is registered with the state. Perhaps in part because of this, the workings of informal funeral insurers have barely been documented even though, in some townships, they cover more people than formal insurers. Their methods and techniques are now being adopted by formal insurance providers, who aim to compete for the low-income market.

Source: Adapted from Roth, 2000.

Rotating savings and credit associations (ROSCAs). These are financial associations organized and overseen by their members. Usually small (between five and 50 members) and primarily female, ROSCAs do not involve outside financial intermediaries. Members meet periodically and contribute a fixed amount to a group fund, which is awarded to one member at the end of each meeting via a lottery or a bidding system. This process is repeated during subsequent meetings until every member has had an opportunity to collect the fund once.

ROSCAs do not charge or pay interest. They offer little flexibility, since the payout is a defined amount that can only be obtained on the singular occasion when one “wins” the fund. However, they are simple to operate and it is relatively easy to hold members accountable for funds. They also offer a degree of flexibility in the sense that they can be started and stopped according to the needs of members.

Accumulating Savings and Credit Associations (ASCAs). Like ROSCAs, these are financial associations with approximately 30 members, primarily women, who organize and oversee their own operations. As the name suggests, the cash that flows through an ASCA can accumulate, rather than be liquidated at each meeting as in a ROSCA. Every member makes regular deposits (although in some ASCAs, members are allowed to vary those deposits both across time and between members), and some members borrow from the fund that builds up, while others choose not to. If the fund is too small to attract a borrower, it must be stored temporarily. These characteristics make the ASCA more flexible, but also more complex and more risky than the ROSCA (Rutherford, 1999, p. 28).

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2 ROSCAs are commonly referred to as merry-go-rounds, but are also known as chit funds in India, susu or tontines in West Africa, dyo in the Republic of Korea, pasamante in Bolivia, chetu in Sri Lanka and ekub in Ethiopia.
Burial societies and stokvels. A burial society is set up by a community to assist members during bereavement. It can consist of a few households living together in a small town or can include several thousands of people from different neighbourhoods in a large city. The society drafts a constitution stating how it will operate, how much and when members must contribute, who can participate, and for whom and when benefits can be realized. Payments are flexible and can be made monthly or weekly, but if a member is not up to date with payments, benefits may not be paid out in the event of a death in the household. Resources are usually kept in bank accounts and are easily accessible. Some burial societies lend out the money they collect in order to generate additional resources. Stokvels are similar to burial societies, but can be used to serve other needs, such as paying school fees or covering food insecurity when money is scarce. The main disadvantage of both stokvels and burial societies is the risk of fraud. Sometimes leaders steal the accumulated funds and flee (Moyo et al, 2002, pp. 9-10).

Self-help groups (SHGs). Unlike ROSCAs, other informal microfinance organizations charge interest on loans and pay interest on deposits (or dividends to shareholders). They are also more capable of providing loans when members need them and in more flexible amounts. Most have been promoted at some point in time by an external entity.

In general, SHGs are informal groups of between 20 and 100 members who save on a regular basis and make loans to each other, and sometimes to others in the community. They are typically trained in such areas as record keeping, savings mobilization and lending practices. The external entity may also make loans to the group, or help it link up with a more formal financial institution, first by opening a savings account, and later by taking a loan (see Box 3.3). Once the linkage with a formal financial institution is made, the external initiating entity may remain involved, assisting the members to manage their affairs and possibly promoting higher-level clusters and federations of SHGs, or it may withdraw and work with other groups.

Box 3.3 SHGs in India

Self-help groups are very well known in India where they were initiated by NGOs in the mid-1980s and are used for financial intermediation both by commercial banks and by MFIs. As of April 2001, some 285,000 SHGs had taken loans from 41 Indian commercial banks, 166 regional rural banks and 111 cooperative banks. The average loan per group was about Rs 18,000, and the average loan per member was Rs 1,100, or just under US$25. Given the average membership of approximately seventeen people per group, this means that about four and a half million people in India have access to formal savings facilities and loans through their SHG membership.

Source: Adapted from Harper, 2002.
There are several variations on the self-help group theme. The most well-known include the following:

- **In the original village banking model**, NGO field agents helped self-selected groups of women elect leaders and develop by-laws, and then trained them to manage their own financial transactions. During required weekly meetings, the village bank disbursed loans, collected loan repayments and savings, recorded transactions, and decided how to invest their savings. Village banks began their lending activities by borrowing money from the NGO and on-lending the funds to its members under standardized conditions. The expectation was that a village bank would accumulate sufficient savings to capitalize its portfolio and become autonomous. Today the village banking model has evolved in such different ways that it no longer constitutes a single model.

- **Financial services associations** resemble village banks without the link to external loans. The model emphasizes equity, rather than savings, as the main financing mechanism. Community members buy shares in the FSA, which cannot be withdrawn but can be sold to willing buyers and may appreciate as retained earnings enhance the association's value. Shareholders elect a board, which employs a locally recruited manager and cashier. Only shareholders can use the FSA's services. Members can borrow based on their shareholding — usually up to a multiple of three times shares — and can purchase shares as and when they wish. The original expectation was that FSAs would become self-sustaining, but this is only proving possible in a few cases. The turnover of board members and managers creates a constant demand for training and the need for ongoing supervision of their activities. The external promoters of FSAs are now examining models of providing affordable support through management contracts or a federation.

- **In the managed ASCAs**, management services are provided to savings and credit groups for a fee. The ASCA manager, a local individual or service provider, charges a management fee based on the size of the fund. Managers visit the groups once a month and help them run their operations. The costs of this model are kept low because the managers use public transport, rent modest offices and employ staff with basic education. As a result, many organizations managing ASCAs are financially sustainable. The challenge for this model is to increase the breadth of outreach, since the model is locally based and ASCA managers have not developed systems for replication.

### 3.2 Implications of Institutional Type

These various microfinance entities have strengths and weaknesses relative to each other, as summarized in Table 3.3 and described below.
### Table 3.3 Advantages and Disadvantages of the Main Institutional Types

<table>
<thead>
<tr>
<th></th>
<th>Formal microfinance institutions</th>
<th>Semi-formal microfinance institutions</th>
<th>Informal microfinance groups</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Length</strong></td>
<td>Owners tend to be driven by profits, creating incentives to increase efficiencies and lower costs.</td>
<td>Semi-formal institutions can focus on serving poorer markets since profit maximization is less of a concern. Subsidies help cover the cost of reaching difficult and expensive markets.</td>
<td>Services are typically less expensive than alternatives.</td>
</tr>
<tr>
<td><strong>Scope</strong></td>
<td>Regulated status is often a prerequisite for offering highly valued savings services.</td>
<td>Sometimes highly innovative; semi-formal MFIs are not constrained by regulations; can access funds and technical assistance for experimentation.</td>
<td>Can reach remote areas. Generally these groups reach women who may not be comfortable interacting with formal institutions.</td>
</tr>
<tr>
<td><strong>Breadth</strong></td>
<td>Greater potential to access commercial equity or loans, and to mobilize savings, to finance large-scale growth. Able to serve more people and to offer larger loans as clients grow.</td>
<td>Can upgrade staff and systems, which makes it possible to offer customized services.</td>
<td>The promotion of village banks or self-help groups can achieve significant scale with relatively little overhead costs.</td>
</tr>
<tr>
<td><strong>Worth</strong></td>
<td>Can upgrade staff and systems, which makes it possible to offer customized services.</td>
<td>Services are usually accessible, near the target market’s home or workplace.</td>
<td>Free of regulation and an MFI superstructure, groups can experiment with new products.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Worth</strong>: Interest income remains with the group; products can be adapted to members’ needs if groups have sufficient capacity.</td>
</tr>
<tr>
<td><strong>Constraints, limitations, challenges</strong></td>
<td>Interest rate ceilings can inhibit sustainability.</td>
<td>Without access to commercial equity or loans, capital may be insufficient to serve significant numbers.</td>
<td>Donor support may be required to promote and train groups; without ongoing external support, group longevity often is limited; groups are vulnerable to covariant risks.</td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td>Formal requirements may increase costs to clients if regulations demand more systems, staff time, reserves or taxes.</td>
<td>Semi-formal MFIs usually do not have the legal status to offer savings accounts or remittances.</td>
<td>Flexibility and range of products may be severely limited by organizational capacity.</td>
</tr>
<tr>
<td><strong>Depth</strong></td>
<td>Higher costs and a wider range of services may limit deep outreach. If the financial institution has for-profit owners, they may steer it upmarket.</td>
<td>MFIs may not be transparent and the board may not provide sufficient oversight. Organizational stability is usually linked to a few key staff.</td>
<td>Without linkages, the amount of group savings limits the number of borrowers.</td>
</tr>
<tr>
<td><strong>Scope</strong></td>
<td>Innovation of products may be curtailed if regulations restrict products and delivery systems.</td>
<td>Subsidies can be unreliable and often require burdensome reporting requirements.</td>
<td></td>
</tr>
<tr>
<td><strong>Worth</strong></td>
<td>Not usually located in close proximity to the micro market.</td>
<td>Without pressure on the bottom line, semi-formal MFIs can be inefficient.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Adapted from Churchill, Hirschland and Painter, 2002.
**Formal Microfinance Institutions**

Formal institutions offer four clear advantages for providing financial services to the poor:

- **Access to capital.** A formal institution can finance its loan portfolio with commercial equity, loans or deposits. Access to these funding sources is a prerequisite for large-scale growth. As shown in Table 3.4, banks have a much larger asset base than other MFIs and this is financed entirely from commercial sources. Non-bank financial institutions, although they have started microfinance relatively recently, have the next largest asset base.

- **Savings services.** Most formal institutions can provide savings and other services that semi-formal institutions cannot offer. This expanded product menu increases the scope and worth of formal financial institutions.

- **Quality systems.** To meet regulatory requirements and the demands of managing multiple products, formal institutions typically upgrade their staff and systems. These upgrades can enable institutions to excel relative to other MFIs in terms of efficiency and strong management.

- **Stability.** Because they are regulated and subject to numerous reporting, risk management and governance requirements, formal microfinance institutions tend to be more stable and offer a less risky option to savers, in particular.

Because of these advantages, formal MFIs can achieve greater impact than other types of institutions in nearly all six aspects of outreach. They can serve a larger number of clients (breadth), offer a better variety (scope) and more flexible services (worth), with greater efficiency (cost) and stability (length).

The greatest disadvantage for formal institutions is the challenge of reaching the very poor. As shown in Table 3.4, formal financial institutions tend to reach a lower percentage of female borrowers and have a higher average loan balance than NGOs. Deep outreach can suffer in formal institutions as owners look for more profitable results and move upmarket. Regulatory requirements may stifle innovation. A regulated financial institution also typically incurs additional costs — such as more robust security and management information systems, staff functions required by regulators, and staff training — that add administrative expenses. Even with these more stringent requirements and robust systems, formal microfinance institutions do at times collapse, so length is hardly guaranteed.

**Semi-formal Microfinance Institutions**

The implications of a semi-formal institutional type are less clear than those of the other two categories. In general, their main strength is their ability and motivation to achieve deep outreach. Microfinance NGOs, in particular, often receive subsidies to experiment and to reach unserved markets. As shown in Table 3.4, NGOs reach the largest percentage of women, with the lowest average loan balance per borrower and, by far, the lowest average loan balance as a percentage of GNP per capita.

Credit unions and cooperatives, while reaching less deeply into the market, are adept at savings mobilization and are much more efficient than other types of institutions. Their ability to capture savings gives them an important source of financing — they are second only to banks in their ability to leverage their equity, whereas NGOs are quite underleveraged.
Table 3.4 Comparative Performance of MFIs by Type of Institution

<table>
<thead>
<tr>
<th></th>
<th>Banks (n=12)</th>
<th>Credit Unions (n=20)</th>
<th>NGOs (n=62)</th>
<th>NBFI (n=29)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Institutional characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets (US$ '000)</td>
<td>54,685</td>
<td>7,653</td>
<td>4,728</td>
<td>11,360</td>
</tr>
<tr>
<td>Number of offices</td>
<td>51</td>
<td>5</td>
<td>22</td>
<td>21</td>
</tr>
<tr>
<td>Number of personnel</td>
<td>543</td>
<td>57</td>
<td>85</td>
<td>137</td>
</tr>
<tr>
<td><strong>Outreach</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross loan portfolio (US$ '000)</td>
<td>38,580</td>
<td>7,655</td>
<td>3,379</td>
<td>8,119</td>
</tr>
<tr>
<td>Number of active borrowers</td>
<td>70,444</td>
<td>4,135</td>
<td>13,001</td>
<td>21,547</td>
</tr>
<tr>
<td>Female borrowers (%)</td>
<td>50.0</td>
<td>43.9</td>
<td>73.6</td>
<td>65.3</td>
</tr>
<tr>
<td>Average loan balance per borrower (US$)</td>
<td>594</td>
<td>1,526</td>
<td>335</td>
<td>560</td>
</tr>
<tr>
<td>Average loan balance per borrower/ GNP per capita (%)</td>
<td>80.8</td>
<td>116.4</td>
<td>36.1</td>
<td>61.8</td>
</tr>
<tr>
<td>Number of voluntary savers</td>
<td>44,747</td>
<td>13,078</td>
<td>372</td>
<td>3,847</td>
</tr>
<tr>
<td>Amount of voluntary savings (US$ '000)</td>
<td>29,085</td>
<td>4,019</td>
<td>0.8</td>
<td>2,383</td>
</tr>
<tr>
<td>Average savings balance per saver (US$)</td>
<td>474</td>
<td>428</td>
<td>9</td>
<td>2,096</td>
</tr>
<tr>
<td><strong>Financial performance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial self-sufficiency (%)</td>
<td>110</td>
<td>106</td>
<td>104</td>
<td>103</td>
</tr>
<tr>
<td>Adjusted return on equity (%)</td>
<td>16.6</td>
<td>2.4</td>
<td>0.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Yield (%)</td>
<td>35.3</td>
<td>21.5</td>
<td>39.9</td>
<td>37.1</td>
</tr>
<tr>
<td><strong>Risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portfolio at risk &gt; 30 days (%)</td>
<td>4.0</td>
<td>5.2</td>
<td>1.8</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Efficiency and productivity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expense / loan portfolio (%)</td>
<td>25.5</td>
<td>14.1</td>
<td>36.9</td>
<td>34.5</td>
</tr>
<tr>
<td>Borrowers per staff member</td>
<td>123</td>
<td>77</td>
<td>154</td>
<td>130</td>
</tr>
<tr>
<td>Voluntary savers per staff member</td>
<td>91</td>
<td>298</td>
<td>4</td>
<td>17</td>
</tr>
</tbody>
</table>

Note: This chart compares MFIs' performance according to the charter under which they are registered. It reflects average performance in each institutional category. All monetary figures are given in US$. Averages are calculated on the basis of values between the 2nd and 9th deciles.


Semi-formal institutions also have well-recognized drawbacks. Large scale can be restricted. Both NGOs and financial cooperatives find it difficult to finance growth, and if they did have the capital they might not have the capacity to manage growth. The common bond nature of cooperatives also limits their scale. Semi-formal microfinance institutions tend to be weak in terms of scope, especially NGOs. They either lack the legal authority to provide certain products, or their attention to market research and product development is weak. Historically, there has been a strong temptation to supply the community with a basic product or set of
products that were successful elsewhere, rather than designing services to meet the needs of the local market.

**Informal Microfinance Groups**

Informal microfinance groups have low costs and the potential for deep outreach — they may be the only means of extending financial services to remote areas. Such groups, however, can only provide limited services and have a significant challenge achieving sustainability. They are vulnerable to fraud and mismanagement, and they may not endure after the promoting agency has withdrawn. The original village-banking model evolved away from autonomous banks, in part because of the high dissolution rate of “graduated banks”.

Savings-led or equity-based groups that are truly member owned are probably stronger than credit-led groups. Because they use their own funds for on-lending, they are more concerned about loan repayment than they might be if the funds came from an external source. Without external capital, however, the loan portfolio will be constrained. In addition, their reliance on local funds to capitalize the loan portfolio creates a covariant risk — if several members experience a common emergency, they may need their savings at the same time and cause a liquidity crisis.

Another drawback is that autonomous groups may not provide members with significant worth or scope. The range and quality of services are limited by the group’s management capacity. Except where they hire a bookkeeper or manager, savings are largely illiquid. On the other hand, members do not have to pay high interest rates to outsiders to receive these services. All revenues return to their group. Furthermore, community-managed organizations can have a social value beyond their utility as a delivery system for savings services. By running these schemes, members often develop skills and confidence.

### 3.3 Moving from One Institutional Type to Another

Given the benefits of formalization — in terms of scope, scale and length — many MFIs consider transformation as a strategy for improving performance. ROSCAs sometimes transform into village banks; village banks sometimes transform into credit unions. The most well-known and highest impact transformation is from an NGO into a regulated financial institution. By formalizing, MFIs can raise capital from a wider range of sources, increase their ability to leverage their equity base, and create a more stable and dependable funding base. Regulatory requirements and private investors bring improved governance, tighter controls and greater operating efficiency.

Of course, these benefits come at a cost. Transformation can be quite expensive. NGOs that have created regulated institutions have spent anywhere from a few hundred thousand to a couple of million dollars on the process. Transformation requires a great deal of commitment from staff at all levels and significant investments of time, energy and human resources.

The decision to transform into a regulated institution will be heavily influenced by an MFI’s mission and values, the competitive landscape, the institutional options available, and the legal and regulatory environment. To consider whether a business case can be made for transformation, MFIs may want to consider the questions in Box 3.4.
3.4 Combining Institutional Types

Box 3.4 To Transform or Not to Transform? That is the Question!

- Does an appropriate legal structure exist into which the MFI can transform, or will it need to work with the supervisory agency to enact special legislation for institutions providing microfinance services?
- Will regulations make it difficult to deliver services when and where the MFI’s clients can take advantage of them? For example, will there be restrictions on branch locations or operating hours?
- Will the costs of regulatory compliance make it prohibitively expensive to serve the MFI’s market?
- Are minimum capital, risk-weighting, provisioning and loan documentation requirements appropriate for microfinance?
- Will transformation inhibit the MFI’s ability to charge appropriate interest rates?
- Does the organization want to continue to access donor resources for research and development or to deepen outreach? How reliable will future donor funding be?
- Are investors interested in making investments into a regulated financial institution?
- Can the MFI reach large numbers of low-income persons without formalizing?
- Will transformation enable the MFI to increase the value it provides to customers through a wider product menu or more secure services?
- Is transformation compatible with the MFI’s mission?
- What effect will transformation have on the institutional culture and corporate image?
- To what extent would regulations limit the institution’s ability to innovate?
- Will transformation improve the institution’s competitive position or weaken it?
- Can the anticipated benefits associated with transformation be achieved in the current political and economic environment? What are the long-term implications of integration into the formal financial system?
- Does the MFI have the capacity to meet the requirements of transformation? If not, what would it take to build that capacity?
- Is the macroeconomic environment sufficiently stable?

Given the disadvantages of transformation, it is necessary to also consider other alternatives. An increasingly effective option for improving performance involves combining different institutional types. During the last decade, innovative MFIs have shown that linkages between institutions can provide some of the same benefits as transformation — in terms of scope, scale and access to capital — with, in some cases, even greater benefits in terms of depth, worth and cost. Linkages can enable institutions to overcome an internal weakness or an external constraint more quickly, with fewer resources, and with greater flexibility than transformation. Several examples are briefly described below.
Mergers and acquisitions. In a competitive marketplace, mergers and acquisitions can be an effective strategy for building stronger institutions (see Box 3.5). MFIs with different competitive advantages or geographic outreach can join together to capture more market share and to offer more attractive services to clients. For example, once MEDA (an NGO) had proven the viability of individual lending in two regions of Tanzania, it chose to transfer its portfolio to the National Microfinance Bank (NMB) — a state-owned bank with the largest branch network in the country — instead of transforming its operations into an independent, regulated institution. This acquisition had the dual benefit of giving clients access to NMB's massive network and services, and helping NMB develop the know-how and operational base from which to roll out microlending activities nationwide.

Box 3.5 Successful Mergers in Bosnia and Herzegovina

The Local Initiatives Project (LIP) was designed in 1996 as part of the assistance provided by the World Bank for the post-war recovery and economic reconstruction of Bosnia and Herzegovina (B&H). During that year, agreements were signed with 17 NGOs that had been providing microcredit services to receive loan funds for credit operations, grants for operational expenses, and technical assistance. Following the project's 1998 mid-term audit, it was concluded that most of the partners had viable portfolios and good repayment levels, but some would not be able to survive on a long-term basis without additional subsidies. On the basis of these findings, LIP management decided not to renew contracts with nine organizations.

The organizations that failed to get renewed funding began merger negotiations with the eight organizations that succeeded. Two institutions were ultimately closed, two chose to operate independently, and five ended up merging with one of the funded institutions. The actual process of merging was more of a takeover than a true merger since the acquiring organizations in almost all cases assumed not only staff, portfolio and other assets, but also the merging organization's debt. Ninety per cent of these funds were repaid after one year. All eight organizations that received renewed funding, including those that absorbed other organizations, are now registered in accordance with the Law on Microcredit Organizations (MCO) that was adopted in June 2000. Seven of the eight organizations have reached full financial sustainability.

Source: Adapted from McCarter, 2002.

MFIs and private companies. Microfinance institutions can partner with other companies to provide financial services that the MFI cannot offer on its own due to regulatory or capacity reasons. Many MFIs have relationships with Western Union, MoneyGram and other wire transfer agencies to enable their clients to accept and send remittances. This service is particularly interesting when it is linked with a savings or credit product offered by the MFI, such as relying on a regular remittance stream to repay a housing loan. Some MFIs also partner with insurance or leasing companies.

MFIs and BDS providers. The providers of business development services are natural partners for MFIs. Organizations that provide financial services to the low-income market generally recognize that many customers could benefit from additional business skills, technical
training, market linkages and the like. But MFIs are often reluctant to offer non-financial services themselves, since this expertise may be beyond their core competencies. Consequently, partnerships with agriculture extension agents or training centres often create a win-win-win arrangement for the MFI, the BDS provider and the customers.

**Apex institutions.** Some MFIs, particularly those partnering with international NGOs, have chosen to create an apex institution as a means of managing growth and accessing additional funding. An apex is a legally registered wholesale institution that provides financial, management, and other services to MFIs, such as:

- conducting market research or product development;
- providing technical assistance for improving operations, including the development of management information systems and training courses;
- acting as an advocate in policy dialogues for MFIs.

Apex institutions can be member-based or externally owned and operated; they can even own shares in their member institutions. For example, Catholic Relief Services (CRS) supported the establishment of the Small Enterprise Development Company, Ltd., a finance company in Thailand. This company provides financial intermediation and institutional strengthening services to CRS’s counterpart MFIs implementing the village bank methodology (Ledgerwood, 1998, pp. 106-108).

**Holding companies.** This combination of institutional types has been used within the microfinance industry to enable microfinance NGOs to create regulated MFIs and retain both influence and ownership in the new institution while carrying on with other non-profit activities. The holding company exists simply to own and control other companies, which can be registered as different legal entities with different institutional types.

K-Rep Group Limited in Kenya operates like a holding company with ownership in three subsidiaries: K-Rep Advisory Services, which provides fee-based training and advisory services; K-Rep Bank Limited, the microfinance bank created out of the original NGO’s microfinance portfolio; and K-Rep Development Agency, the research and development arm of the Group. The Group is managed through an Executive Management Committee, but all subsidiary entities have a separate board and management structure.

In the Philippines, CARD Mutually Reinforcing Institutions (CARD MRI) is another example of an institution that is structured like a holding company; it has a bank, an NGO and an insurance company as subsidiaries (see Figure 3.1). The CARD MRI Board of Advisors is a three-member body whose main task is to ensure policy and operating coordination between the three subsidiaries. The Board of Advisors consists of the Managing Director of CARD MRI, and one member each from CARD NGO and CARD Bank with alternates from each institution. Although each subsidiary has its own Board of Directors, consisting primarily of clients or members, this Board of Advisors provides guidance to the directors of each institution.
Figure 3.1 CARD Mutually Reinforcing Institutions

**NGOs and the postal system.** A promising model is emerging in Africa where poverty-focused microfinance institutions are linking with the postal system. Because working with the postal system does not require an NGO to hire additional staff, it is a relatively low-cost delivery method. The Small Enterprise Foundation (SEF) in South Africa’s Northern Province has undertaken this strategy with good results. MEDNET, a World Vision affiliate in Uganda, is also negotiating an agreement that would enable the post offices to disburse as well as collect funds. While both SEF and MEDNET are semiformal credit NGOs, by partnering with formal financial institutions they may achieve groundbreaking results in terms of deep, sustainable outreach in hard-to-reach rural areas.

**NGOs and financial cooperatives.** Another promising approach is the grafting of village banking activities onto existing credit unions. Some credit unions are well suited to offer village banking services because of their member-oriented mission, which often includes social welfare goals. Credit unions also have a long history of member education that predisposes them to group lending.

Freedom from Hunger, a US-based NGO, promotes this grafting strategy because it is much less expensive and quicker to scale up than creating new MFIs. It spent US$6.4 million in grants and technical assistance to enable two microfinance NGOs in Bolivia and Uganda to reach 30,000 women — or US$211 per client. By comparison, it spent only US$700,000 to assist two credit union federations in Mali to reach 36,000 women — or US$20 per client. The cooperatives also reached those clients in half the time, with greater financial self-sufficiency, than did the NGOs.
Self-help groups, NGOs and banks. Self-help groups (SHGs) can also be linked to commercial banks. Under this bank-linkage model, an NGO provides training to assist a self-help group to borrow from a bank. To do this, the promoting agency must convince the bank of the viability of the linkage and assist the SHGs to meet the commercial bank’s requirements. Once SHGs have learned how to access the bank, and some confidence in the relationship has been built on both sides, the NGO can withdraw, leaving a sustainable financial services relationship in its wake.

This bank linkage model is most prevalent in India (see Box 3.3), but it is now emerging in other parts of the world. In Tanzania, for example, the ILO has facilitated a relationship between Akiba Commercial Bank (ACB) and women stone crushers and tea harvesters in a project designed to reduce child labour. An NGO working with the ILO mobilizes the groups, trains them in such areas as leadership and problem solving, and then introduces them to ACB. ACB trains the group to process loan requests, which will be passed to the bank for final approval. ACB does not need to maintain staff in the areas where the groups operate; it simply sends a loan officer to the group meetings once per month to disburse new loans and receive loan payments. ACB plans to use these groups as the foundation for a new branch opening in the region.

3.5 Conclusion

Every MFI — no matter what its institutional type — has numerous institutional options for improving its outreach. It can make more efficient use of resources within its current structure; it can change institutional types; or it can combine its resources with those of another institution on a long- or short-term, formal or informal basis. Each option offers benefits and poses challenges. With mergers and acquisitions, for example, a major challenge is ensuring the compatibility of the institutions being combined in terms of governance, culture and systems. For holding companies, there are regulatory and governance-related issues due to the intertwined ownership arrangements inherent in the model. For partnerships, the critical challenge is to craft a relationship that provides sufficient benefits to all concerned so that each partner finds it in its self interest to maintain the partnership.

The most appropriate choice for an institution today will depend on many factors, including the institutional options and partnerships available, the legal and regulatory environment, current internal capacity and, of course, the MFI’s plans for the future. What may have been appropriate in the past will not necessarily be appropriate — much less ideal — for achieving the institution’s goals in the years to come.
Main Messages

1. Institutions of varying types can deliver microfinance services successfully.
2. Each institutional type has strengths and weaknesses. Being aware of yours can help you plan for the future.
3. Periodically question whether your current institutional type is the right one for the future. What may have been appropriate in the past may not be appropriate given trends in the internal and external environment.
4. By partnering with another institutional type, you can compensate for the weaknesses or disadvantages of your own institutional type.
5. Transformation is one option but not the only option. Given the disadvantages of transformation, it is important to consider other alternatives as well.

Case Study: MiBanco, Peru

The fundamental problem, and the most important challenge, in the microfinance industry is to fill the enormous gap between the demand for microfinance and the supply of such services on a sustainable basis. This is universal. Even in countries where the supply has grown rapidly over the last decade, such as Bangladesh and Bolivia, a wide gap remains. This is why MFIs, such as MiBanco, that grow rapidly and profitably are important.

MiBanco (“my bank”) grew from the NGO Acción Comunitaria del Perú (ACP), started with assistance from ACCION International in 1969 by a group of local business people who wanted to create development opportunities for low-income Peruvians. ACP began microlending operations in 1982. Like most microcredit NGOs in the region, ACP focused on urban areas with large populations of low-income households living in shanty towns and earning their living through a range of microenterprises.

During the first three years of microcredit activities, ACP’s growth was lacklustre. However, in 1986, its outreach increased rapidly and in 1987 its loan disbursements peaked at US$5.8 million. Then a sharp deterioration of macroeconomic conditions, particularly hyperinflation, had a devastating effect on all financial institutions in Peru. ACP had to close two of its four branches in 1988. In 1989, it disbursed only US$700,000 to 9,000 clients – far below the level of its 1987 operations.

Portfolio quality also deteriorated. The portfolio at risk (PAR) over 30 days reached 9 per cent in 1990 and then increased to a crippling 16 per cent in 1991, even though total borrowers in 1990 and 1991 were only about 3,000 and 2,200, respectively. In 1992, ACP managed to lower its PAR substantially as macroeconomic conditions began stabilizing. Then ACP entered a rapid growth path. Using both group and individual lending, annual disbursements increased more than fourfold from US$5.3 million in 1994 to US$65.5 million in 1997. ACP’s loan portfolio of US$2.3 million at the end of 1994 grew to US$12.6 million by the end of 1997. Because ACP provided only working capital loans, it could focus on this single product and increase the number of clients rapidly.

There were at least three remarkable features of ACP’s growth during 1994–97.
1. This growth was achieved while maintaining a reasonably good level of portfolio quality. PAR over 30 days was consistently below 5 per cent during 1994–95. Although it rose to about 7.5 per cent in 1996, ACP managed to bring it down to 5 per cent by the end of 1997.

2. ACP maintained its focus on the target market. Its average outstanding loan balance remained fairly consistent, around US$350 or 15 per cent of GDP per capita. About 61 per cent of the clients were women.

3. Neither rapid growth nor its focus on the low end of the market deterred ACP from being profitable. One of the most profitable MFIs in the region, in 1995, ACP generated a massive 83.5 per cent return on equity (ROE). In 1996 and 1997, its ROE was 46.6 per cent and 30.1 per cent, respectively.

To sustain this growth, ACP needed to access more funds. As an NGO, ACP could not borrow from COFIDE, a second tier, state-owned financial institution. The ability to leverage funds in the debt market was also limited. Nor could it access the capital markets or mobilize public deposits legally. To remove these hurdles, ACP considered transforming itself into a financiera, a regulated finance company for which only US$3.0 million was required as minimum capital. When the Banking Superintendency established a new NBFI category in 1994 to encourage NGOs to create regulated financial institutions, ACP studied the feasibility of transforming to an EDPYME. ACP’s formal proposal to establish an EDPYME was approved by the Banking Superintendency in October 1996.

In the meantime, in a public address in July 1996, President Fujimori challenged the Peruvian financial industry to establish a bank to serve microentrepreneurs. In February 1997, when the President attended the Micro Credit Summit in Washington D.C., he announced his commitment to create a microfinance bank in Peru. Instead of testing the waters as an EDPYME, ACP decided to seize the political opportunity and create a bank on the condition that it would be owned 100 per cent by the private sector.

With technical assistance from ACCION International, ACP submitted a concept paper to the Government to transform ACP into a bank, drawing on PRODEM’s experience in Bolivia. ACP’s subsequent feasibility study was approved by the Banking Superintendency in November 1997.

On 4 May 1998, Mibanco opened its doors to the public as a commercial microfinance bank, owned by five investors who came forward with initial equity capital of US$14.0 million. ACP became the majority owner, with 60 per cent of the total shares. The other shareholders included two social investors (ProFund and the ACCION Gateway Fund) and two commercial banks. This ownership has since undergone changes, but Mibanco is still owned largely by social investors.

After the transformation, Mibanco experienced another surge of exponential growth. During 1999–2002, Mibanco’s total assets increased by 252 per cent and its loan portfolio grew by 379 per cent. The number of borrowers more than doubled, from 41,344 at the end of 1999 to 99,121 at the end of 2002.

An analysis of Mibanco’s poverty outreach seems to suggest that Mibanco has actually deepened its poverty outreach after transformation, contrary to conventional wisdom. Although the average active loan balance has increased to over US$900 or 46 per cent of GPD per capita, and the proportion of women has decreased slightly to 57 per cent, at the end of July 2001 about 21 per cent of its loan portfolio came from loans that were less than US$250, while 30 per cent of the portfolio was in the US$250–500 category. Using loan size as a proxy for depth of outreach, Mibanco was serving more poor people after transformation than before.
The bank has also significantly increased its scope of outreach. Mibanco started with a single loan product – working-capital loans. One of ACP’s core operating principles was to focus on “doing one thing and doing it well”. While these loans continue to remain significant, as a bank Mibanco has been able to respond to several profitable market opportunities. It has expanded its product menu to include loans for fixed assets, housing, and agriculture. Mibanco has also introduced passbook savings, time deposits, checking accounts and money transfers.

At the end of 2002, Mibanco had 28 branches – 24 in Lima and one in each of four provinces. It is planning to expand this network to 35 branches by the end of 2003 and add automated teller machines at each of its locations. Overall, the transformation from an NGO to a bank has not only improved access to financial services for an ever increasing number of low-income households, but it has also improved the quality of services.

Note 1 In response to the inflationary environment and the rapid turnover of inventory by ACP’s clients, the MFI offered very short-term loans, usually between one and six months. Hence the significant discrepancy between the amount disbursed in a calendar year and the amount outstanding at the end of the year.

Note 2 For an EDPMY, the minimum capital requirement was only US$263,000. However, with this level of capital, an EDPMY was not allowed to mobilize retail deposits. For deposit mobilization, an EDPMY required a higher level of capital, a good rating, and special approval from the Banking Superintendency.

Recommended readings:

Formal Microfinance
- Schmidt, R.H. 2000. Building new institutions instead of remodeling existing ones (Frankfurt, IFC).
Informal microfinance


Combining Institutional Types


General Institutional Issues


By definition, managing involves getting results. But to do that, managers need to know what results they are expected to deliver. One of the first and most important tasks in improving microfinance management is to consider where the MFI is heading. What are the organization’s goals? What does it aim to achieve? In sum, what is its strategic direction?

Managers need to contemplate where they are taking their organizations. If there is a difference between where the institution is going and where they want it to go, the first step in shifting course is to define a new direction. If managers are generally content with where their institution is headed, but want to find ways of getting there faster, they need to see if the organization’s mission is clear, its values influence desired behaviour, and its objectives motivate superior performance.

As depicted in Figure 4.1, this module explores the four key components that define an MFI’s strategic direction:

1. Vision
2. Mission
3. Values
4. Objectives

Figure 4.1 The Relationship between Vision, Mission, Objectives and Values
4.1 Vision

A vision is the big picture image of where an MFI wants to go and what it wants the future to hold. It is a description of what is to become, what the world would look like if the MFI fulfills its mission. A vision is long term; it might take more than one generation to achieve.

There is no established or recommended procedure for creating a vision. Even after one has been created, it may not be easy to put into words. Yet once an organization articulates its vision statement, it can be a powerful source of inspiration, motivation and guidance. It can challenge the MFI to reach lofty and desirable heights, and stay true to its commitment. To accomplish these ends, it is important that the vision statement be written clearly and concisely, so that it can be understood, embraced and articulated by all concerned.

**Box 4.1 Vision Statement Examples**

*A nation where all people have the dignity of being able to provide for their own needs and the needs of others.* ~ Zambuko Trust, Zimbabwe

*A world in which all people have access to high quality affordable market-led financial services.* ~ MicroSave

*To change the face of a poor woman to a brilliant face full of confidence to stand up to the challenges of day-to-day living.* ~ Salvation Army, Lusumpuko, Zambia

*We seek a world of hope, tolerance and social justice, where poverty has been overcome and people live in dignity and security.* ~ CARE

*To be the leader in quality financial services for micro and small entrepreneurs as a contribution to the “bancarización”, intermediation, and development of our country.* ~ Mibanco, Peru

*Our vision is to see our poor and poorest people get out of poverty, reaching a better future from their own creative dynamism and true value, with microfinance services provided by the Fund.* ~ Capital Aid Fund for the Employment of the Poor (CEP), Viet Nam

*BancoSol is, and will remain, the leading institution in microfinance measured in terms of portfolio of loans and clients, in every region of the country where it has operations.* ~ BancoSol, Bolivia

Even if an MFI does not have an eloquent statement for its public relations materials, it still needs a common vision. For example, according to Carlos Danel from Compartamos in Mexico, “we had a clear vision from the start that we wanted to be massive”. So far, Compartamos’ vision seems to be working – it is now one of the largest, most profitable and fastest growing MFIs in Latin America (Miller, 2005), with more than 300,000 borrowers at the end of 2004.

In pursuit of that vision, Compartamos has had to make difficult choices regarding the six degrees of outreach. Its determined quest for breadth and length has come at the expense of worth and cost. Its standardized village banking methodology causes significant dropouts, and its interest rate on loans is considerably higher than other MFIs in the region. However,
now that Compartamos is well on its path toward being massive, it is introducing lower interest rates for repeat groups and is experimenting with more flexible solidarity group and individual lending methodologies.

4.2 Mission

The word “mission” comes from the Latin root *missio*, which means *to send*. An MFI’s mission is a statement of what the institution is sending itself into the world to do. It is the MFI’s reason for being—its core purpose. It should explain what the MFI is going to do to achieve its vision.

A mission statement is more focused than a vision statement and is generally easier to write. Like the vision statement, it should be short and clear; but unlike the vision statement, it should also be specific and precise. A strong mission statement will answer most of the following questions:

1. Who are we? (name, institutional type)
2. Who do we serve? (target market)
3. Where do we work? (geographic area, sector)
4. What do we seek to accomplish? (major objectives)
5. How will we accomplish this? (the strategy or means of service delivery)
6. Why do we exist? (the ends we are trying to achieve, the desired impact, change or outcome)

Ineffective mission statements tend to be:

- **Unclear.** An ambiguous or unclear mission statement is likely to produce confusion and inefficiency, and could result in a failure to achieve key objectives.

- **Static.** A mission statement that has remained the same for a long time may no longer be steering the MFI in a strategic direction. Mission statements should be reviewed regularly to ensure that they continue to be relevant given the changing environment (for example, an increasingly sophisticated customer base, increased competition, or technological advancements).

- **Unrepresentative.** If the official mission differs significantly from the unofficial mission on the ground, the MFI will be conflicted. An MFI can resolve multiple or competing missions (for example, from a new manager or a key financial supporter) through a strategic planning initiative that uses the current mission statement to adjust expectations or revises the statement to reflect new realities.

- **Overambitious.** Stakeholders are unlikely to be motivated by an unrealistic mission. A strong mission statement strikes an appropriate balance between challenge and achievability.

Once defined, a mission statement has value in many respects:

- It helps to keep all members of the institution focused
- It unites staff and other stakeholders under a common goal
- It guides planning and the setting of specific objectives
It assists effective and efficient decision-making
- It brings confidence for action
- It facilitates monitoring and evaluation
- It clarifies outreach objectives
- It differentiates you from the competition

Some MFIs have vision statements, some have mission statements, and some have both. The important thing is that the organization has a clearly articulated strategic direction that is well-known to employees throughout the MFI, and guides and inspires the organization to achieve greater performance. A secretary or data clerk should be able to explain what the institution is all about and where it is going just as well as the CEO.

Box 4.2 Mission Statement Examples

FINCA provides financial services to the world’s poorest families so they can create their own jobs, raise household incomes, and improve their standard of living. We deliver these services through a global network of locally managed, self-supporting institutions. ~ FINCA

We are committed to provide comprehensive financial services for persons, microentrepreneurs, as well as small and medium-sized businesses that belong to the most vulnerable sectors of the economy and represent the majority of the Bolivian population. ~ BancoSol

To promote the development of Colombian micro-entrepreneurs by providing loans, business training and technical assistance; to continuously provide excellence and improve the quality of services; to practice fundamental values that guide our vision, including honesty, responsibility, respect, excellence, service, and integrity. ~ ADEMCOL, Colombia

To extend financial services and social awareness to the poor in underserved and unserved areas of Nepal in a sustainable matter. ~ Nirdhan Utthan Bank Limited, Nepal

To create commercially sustainable financial and information products and networks for small-scale entrepreneurs to increase incomes and employment and to mainstream the poor in Africa. ~ PRIDE Africa

Our mission is to work with and for the poor and poorest by increasing sustainable economic development of the poor through provision of credit and savings to them in an honest, timely and efficient manner so that our vision of reducing poverty is realized and CEP Fund becomes a sound microfinance institution in Viet Nam. ~ CEP, Viet Nam

To provide easy and fast access to microfinance for all people with low incomes and low revenue. ~ PADME, Benin

To market a superior nationwide delivery of high-quality bank products and services at premium prices to meet the needs of the financial and commercial sector and the general public throughout Cambodia. ~ ACLEDA Bank

To disseminate the strategic direction, managers should use the vision and mission as management tools. Having them posted in prominent places around the organization is a start, but they have to be taken off the wall and used. They should be regularly discussed at staff meetings, and should be used as guides in establishing priorities. For example, Pulse in Zambia was...
considering launching a new loan product that promised to be quite profitable, but after analysing the product against its mission, the senior management team realized that the product was not consistent with its strategic direction and they dropped the idea.

4.3 Values

Values are the principles that support and guide an MFI’s mission and performance. They are abstract principles that influence the organization’s thinking and behaviour. They are the things that staff members cherish, ideals they want to achieve.

There are two kinds of values: organizational values, such as customer satisfaction, continuous improvement, competitiveness and efficiency; and personal values, such as excellence, respect, responsibility, fairness and honesty. Together these values provide the basis for determining the ethical and moral obligation of an MFI to its staff, of staff members to each other, and of the institution to its clients. As discussed in Module 14, successful MFIs strive to align staff and institutional values through their recruitment and hiring practices to strengthen the employees’ commitment to the mission and vision.

Values...

- encourage moral and ethical behaviour
- provide guidelines on expected standards
- create a more enjoyable, productive work environment
- increase commitment to the institution
- motivate the optimal utilization of resources
- reduce controversy and conflicts
- inspire greatness
- boost and maintain the corporate image

When an MFI commits to a clear set of values, they govern the behaviour and attitude of everyone within the organization. Values are a unifying influence that motivates performance and commitment (see Box 4.3). They can also be a source of tension and discontent if individuals within the institution, or the institution as a whole, do not uphold the values. If an MFI commits to a set of values, that commitment must be sincere and active. Constant effort needs to be made to ensure that the institution’s values are protected and nurtured. Module 15 discusses methods for using an organization’s values to help shape the institutional culture.
Box 4.3 The Role of Values at Prodem, Bolivia

Unlike many commercial enterprises that shy away from defining a value-based statement of their activities, Prodem emphasizes that its work is possible precisely because of its values and has stressed from the beginning that all employees must uphold those values. Staff are expected to be honest in their relationships and in their treatment of the institution’s resources. Any act of dishonesty or fraud, no matter how small, is cause for dismissal. Employees must commit themselves to the work of the institution and to the long-term pursuit of its mission. They must respect each other and the clients they serve, regardless of any difference in opinion, culture, social or economic status.

This value-based strategy is demanding, but it appeals to staff because it is a two-way street. The institution expects a great deal from its employees, but in return, employees can expect a great deal from Prodem. They can expect to be trusted, to be given responsibility, to be dealt with honestly, to be invested in, and to be respected. Prodem’s employees claim that when they joined the institution they not only signed a legal contract; they also entered into an informal social contract that often carries more weight than the legal contract itself.

Source: Adapted from Frankiewicz, 2001.

4.4 Objectives

While the mission and vision will provide the organization with general guidance as to where it is going, to operationalize the strategic direction an MFI needs objectives. Objectives reduce the mission into smaller, more tangible targets. They help in the coordination of day-to-day activities, the allocation of human and financial resources, and decision-making. They provide the basis for monitoring performance and make it possible to adjust strategies and operations as necessary to ensure that goals are met.

To guide the contribution of different parts of the organization towards a common and coordinated result, objectives are set at a variety of different levels, such as:

- corporate
- branch
- department or unit
- team or committee
- individual

High-level corporate or strategic objectives are usually developed through a strategic planning process, such as a SWOT analysis, in which MFIs assess their strengths, weaknesses, opportunities and threats. This analysis helps the organization identify main areas for improvement and new initiatives to undertake, and then considers these within the context of the vision, mission and values — and available resources — to establish priorities.

The resulting strategic objectives, with a longer-term planning horizon of three to five years, are broken down into operational objectives with shorter time horizons. Senior and middle managers then take corporate operational objectives and translate them into objec-
tives for specific departments or operational units. Middle managers undertake the same process with their employees to identify team or individual objectives. The sum of team or individual objectives should then add up to the corporate objectives.

Objectives are an indispensable management tool, as they combine the planning and controlling functions of managers. Indeed, objectives cannot be set without planning, which ensures that efforts by different parts of the organization are coordinated. At each level, the persons responsible for achieving the results should be involved in setting the objectives. This participatory process creates ownership over the objectives and facilitates the delegation of responsibilities. Instead of telling subordinates what they should do, managers work with their staff to agree on what they should accomplish, by when and with what resources. Then employees have a clearly defined purpose (which they helped to shape) and greater autonomy in deciding how to go about achieving those results.

Regardless of the level at which objectives are set, their usefulness is greatly enhanced if they are written smartly; in other words, if they are:

**Specific**  **Measurable**  **Achievable**  **Realistic**  **Time-bound**

With SMART objectives, an MFI knows exactly where it needs to go by when, and it will believe it is possible to get there. It can easily track its progress towards the achievement of its goals. At the end of the specified period, it will be able to evaluate its performance and make

<table>
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<th>Box 4.4 Checklist for Manager Objectives</th>
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<tbody>
<tr>
<td>1. Do the objectives cover the main features of my job?</td>
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<tr>
<td>2. Is the list of objectives too long? If so, can I combine some objectives?</td>
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<tr>
<td>3. Are the objectives verifiable, i.e., will I know at the end of the period whether they were achieved?</td>
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<tr>
<td>4. Do the objectives indicate: quantity (how much); quality (how well); time (by when); and cost?</td>
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<tr>
<td>5. Are the objectives challenging, yet achievable?</td>
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<td>6. Are priorities assigned to the objectives?</td>
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<td>7. Are objectives coordinated with those of other managers and organizational units?</td>
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<tr>
<td>8. Are the short-term objectives consistent with long-term aims?</td>
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<tr>
<td>9. Do the objectives provide for timely feedback so that I can take any necessary corrective action?</td>
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<tr>
<td>10. Are my resources and authority sufficient for achieving the objectives?</td>
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<tr>
<td>11. Have I communicated the objectives to all who need to be informed, and involved them in setting their own objectives?</td>
</tr>
<tr>
<td>12. Do my subordinates have sufficient skills and authority to achieve their objectives?</td>
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adjustments for improvement in the future. Box 4.4 provides some additional guidance on using objectives effectively.

Writing objectives is actually the easy part. The challenging aspect is assessing the potential tradeoffs between them and selecting a set of objectives, and strategies for reaching those objectives, that will enable the institution to achieve its mission. As introduced in Module 1, MFIs aim to achieve objectives in six areas:

1. **Breadth.** Serve as many people as possible
2. **Depth.** Serve persons who have been underserved by financial institutions, such as women, the poor, and indigenous and rural populations; reduce poverty; empower women or other disadvantaged groups; create employment
3. **Length.** Generate enough revenue to cover costs; provide adequate return to investors to maintain their support
4. **Cost.** Control costs; maximize efficiency and productivity to keep interest rates as low as possible
5. **Worth.** Keep clients satisfied that they continue to choose the MFI over the competition
6. **Scope.** Understand clients' needs for financial services and offer a product menu to address those needs

As illustrated in the Compartarmos example earlier in this chapter, few MFIs try to achieve objectives in all areas simultaneously. One of the greatest challenges in managing an MFI is to balance the different and sometimes competing requirements of these objectives.

Lastly, senior managers should not wait until the next strategic planning effort two or three years down the road before reassessing if the organization is going in the right direction. Market and institutional conditions can change quite quickly in the rapidly developing microfinance industry. The competitive environment may change, new technologies may become available or affordable, and innovations may emerge that justify a reassessment of the organization's operational objectives.

### 4.5 Conclusion

To enhance the effectiveness of the strategic direction, the vision, mission and values should be clear and motivating, ideally developed through a participatory process that involves key stakeholders. The process of shaping and implementing the strategic direction naturally involves the four functions of management:

1. **Planning** occurs at multiple levels. As described in Module 23, managers need to coordinate the objectives of different parts of the organization and ensure that the sum of the component objectives adds up to the corporate objectives. The involvement of implementers in the planning process (again at different levels in the organization) creates ownership of the expected results and an institution-wide understanding of the strategic direction.

2. **Organizing:** The planning process automatically leads into organizing as financial and human resources are allocated to achieve the objectives.
3. **Leading:** Even if staff are involved in shaping the objectives, they still need some encouragement and guidance in developing strategies for achieving results and assistance with implementing those strategies.

4. **Controlling:** Objectives facilitate the process of achieving results by ensuring that everyone knows what is expected of them. Managers fulfil their control function by regularly comparing the team or individual's progress towards achieving the goals, and making adjustments and taking remedial action as necessary.

### Main Messages

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<table>
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<tbody>
<tr>
<td>1.</td>
<td>To achieve results, managers need to know what is expected of them.</td>
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<tr>
<td>2.</td>
<td>To prioritize objectives, consider them through the lens of the vision, mission and values.</td>
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<tr>
<td>3.</td>
<td>Everyone in the organization must know the strategic direction.</td>
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<tr>
<td>4.</td>
<td>Participatory strategic planning processes, at different levels within the organization, will enhance ownership of the MFI's direction and in its efforts to achieve objectives.</td>
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<tr>
<td>5.</td>
<td>Check to make sure that the direction in which you are headed is still strategic and relevant.</td>
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# Markets and Marketing

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Markets and Marketing

Marketing is often confused with selling; however, the two concepts are quite distinct. According to marketing guru, Philip Kotler (1999): “Marketing cannot be equivalent to selling because it starts long before the company has a product. It is the homework that managers undertake to assess needs, measure their extent and intensity, and determine whether a profitable opportunity exists. Selling occurs only after a product is manufactured. Marketing continues throughout the product’s life, trying to find new customers, improve product appeal and performance, learn from product sales results, and manage repeat sales.”

Marketing has also been defined as “the art and science of choosing target markets and getting, keeping, and growing customers through creating, delivering, and communicating superior customer value” (Kotler et al., 2001). This definition provides a useful way of thinking about marketing because of its focus on value.

In microfinance, marketing can be seen as a seven-step process, as shown in the box below.

<table>
<thead>
<tr>
<th>Marketing: A 7-Step Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Select a target market</td>
</tr>
<tr>
<td>2. Identify what the target market values</td>
</tr>
<tr>
<td>3. Develop profitable products that are valued by the target market</td>
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<tr>
<td>4. Communicate their products’ value to the target market</td>
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<tr>
<td>5. Deliver their products in a way that maximizes their value</td>
</tr>
<tr>
<td>6. Monitor the delivery to learn from both client and institutional experiences</td>
</tr>
<tr>
<td>7. Make adjustments that increase the value for both clients and the institution</td>
</tr>
</tbody>
</table>

At the bottom of the pyramid is market research, the foundation on which the rest of the marketing process is built. Through market research, managers can learn about customer needs and preferences, customer satisfaction and competitive trends. Toward that end, Module 5 guides managers through various primary and secondary data-gathering techniques to understand what their market values.

After understanding what the market values, managers can move up to the next layer in the pyramid and use that information to develop valuable products. Module 6 helps managers to understand the product development process and provides guidance on successful product development.
The next layer up the pyramid, Communicating Value, begins with three tools that can help managers to identify what to communicate and to whom: 1) market segmentation, 2) the value triangle, and 3) the 8 Ps of marketing. With that information, Module 7 helps managers to communicate their organization's value to clients through benefit statements, corporate and product brands, promotional literature, and a marketing communications mix that is designed to position the MFI where it wants to be.

Once an organization has communicated its value to the market, it has to deliver services in a way that actually provides value, to meet or perhaps even exceed the expectations created through the communication efforts. Module 8 discusses strategies and tools for improving customer service and creating a customer service culture.

The pinnacle of the pyramid is Module 9, the culmination of the marketing process and the principal aspiration for microfinance managers: customer loyalty. This module demonstrates the importance of loyalty, discusses ways of monitoring loyalty, and describes ways of achieving this ultimate objective.

Marketing, as illustrated by the pyramid and the seven-step process, involves a range of activities, which taken together enable managers and their organizations to meet needs profitably. The more managers can help each member of their team to focus on the value that they can create for their target market over the long term, the more successful the institution will be in meeting its outreach objectives. As Beckwith (1997) has written, “Marketing is not just a department. It is your business.” Everyone in your MFI may not be a salesperson, but everyone should be a marketer.
Microfinance practitioners generally recognize that there is significant scope for improving their products and services to meet the needs and preferences of their customers, or potential customers. Most MFIs have not been as successful as they would like to be in: a) reaching poorer clients; b) reaching more clients, and/or c) increasing the impact of their services. Their limited range of products, and the fact that those products are often not designed to meet the needs of the poor, limits their effectiveness. As the foundation of the pyramid, market research is the first step toward rectifying this situation. This module addresses the following five content areas:

1. What is market research?
2. Secondary research: Mining existing internal data
3. Secondary research: Mining existing external data
4. Qualitative primary research
5. Quantitative primary research

5.1 What is Market Research?

Market research is the process of understanding the needs, behaviours and preferences of clients — both current and prospective — and to understand the environment in which the MFI operates. The microfinance market is heterogeneous: clients do not all behave in the same way, and their needs and preferences change over time. Market research enables MFIs to listen to clients in a systematic and continuous manner, and to become client focused.

In some microfinance circles, where the union between social and commercial objectives leans more towards the former, the term “market research” is met with some derision. It should, however, be embraced by all. Market research is at the core of grassroots development. It allows the poor to contribute to the design, management and evaluation of the services intended to benefit them. Poverty is complex and multidimensional. If an MFI wants to transform the lives of its clients, it needs to discover what services must be in place for this change to occur, and how those services should best be designed and delivered.

This module was adapted from:
- Wright (2000).
MFIs with an effective market research capacity are positioned to accomplish the following:

- Understand the MFI’s products in relationship to other financial services that low-income people use, including informal services
- Understand customer motivations as to why they made certain financial service decisions
- Improve existing products and services
- Develop new products that are responsive to clients’ needs and preferences
- Determine the root causes of customer desertion and loan losses
- Learn what demand factors may be limiting the organization’s growth
- Improve marketing, promotion and outreach activities
- Find ways to improve an MFI’s impact
- Re-engineer delivery systems
- Monitor levels of customer satisfaction
- Diversify into new market niches
- Receive feedback on the quality of customer service that staff provide

Market research essentially involves a basic, four-step process.

1) **Define the research question(s):** Before launching a market research initiative, it is necessary to define what question the research is intended to answer. This first step is critical because it will focus the rest of the research initiative. Without a clear definition of what the research is supposed to accomplish, the initiative can easily get off track.

   Research questions do not have to be defined by specialists; indeed, they can be defined by anyone in the institution as long as the issue being addressed is within their control or ability to influence. For example, a branch manager might want to know why the branch’s retention rate has been falling; credit officers might want to understand what is causing an increase in late loan repayments; and the Business Development Department might like to know what new product or service customers would most like to see the MFI deliver. As shown in Table 5.1, research questions will vary depending on the maturity of the institution.

2) **Determine the most appropriate research methodology.** There are many tools and methodologies for conducting market research; each has advantages and disadvantages. For many questions it may be necessary to choose two or three approaches to see if they generate complementary results.
When designing a research tool, it is important to recognize that many MFIs (and other financial institutions) have probably conducted similar research, and some of them were generous enough to publish their tools and results. In many cases it may be easier to adapt a tool developed by others than to start from scratch. MicroSave and SEEP have produced a number of market research tools that MFIs may find useful.

Table 5.1 Market Research Questions for Different Types of MFIs

<table>
<thead>
<tr>
<th>Level of MFI</th>
<th>Concerns/questions for the MFI</th>
</tr>
</thead>
</table>
| Start-up      | • What is the “financial landscape” of my proposed working area? Where do low-income people access financial services? What do those services look like? What are their strengths and weaknesses?  
• What financial services do low-income people need?  
• What socio-cultural/historical issues will I face?  
• What are the best systems/approaches to deliver these products? |
| Young         | • Will people buy my products?  
• Where should I put my office/branch?  
• How should I promote my services?  
• How much should I charge? |
| Intermediate  | • Are my customers satisfied?  
• Why am I losing clients? Why am I not getting more clients?  
• What is my growth rate and what is it a function of?  
• What is my competition doing?  
• How am I perceived in the market? |
| Mature        | • Is my clientele the right clientele? Whom do I really want to reach?  
• What products are most marketable?  
• How can I improve my products? What new products can I introduce?  
• How can I stay a step ahead of the competition?  
• How am I differentiated in the market and how is this position perceived by the market?  
• How do I become the most profitable institution possible?  
• What do I need to know to be able to respond to outside threats?  
• How do I diversify my products? |

Source: Adapted from Grant, 2001.

3) Collect data. Market research can involve the collection of primary data (i.e., new information) or it can rely on secondary data (i.e., existing information); it can also utilize a combination of both. At this stage of the research process, the challenges encountered are usually logistical and operational in nature – confirming the presence of focus group participants, verifying the completion of a sample, making sure the moderator probes instead of prompts, etc. Whenever primary data collection is called for, it is important that the research tools be pre-tested to ensure that they are producing the type of information that is sought, and then adjusted accordingly.
4) **Analyse the data.** Once information is collected, it must be examined, organized and synthesised to answer the research question. In **quantitative research**, data tables and statistical analysis are typically used for this purpose, with graphs being drawn to show trends and variations. In **qualitative research**, transcripts, grids and matrices are used to compare the outcomes from various groups or individuals, and facilitate conclusions.

Regardless of the analysis tool used, a key strategy for making sense of the data — particularly client data — is to **segment the market**. Microfinance customers are heterogeneous: they have a range of likes and dislikes, they have different priorities. To interpret the data, it is necessary to assess the differences, for example, between men and women, rural and urban areas, different enterprise classifications (e.g., sales, service, manufacturing), and new and long-term customers.

To many people, market research involves gathering lots of data through hundreds of interviews or questionnaires with scores of variables, and then crunching all the numbers to see what different segments of the market think about things. While a large-scale quantitative study may be an important part of an MFI's market research toolkit, it is probably not the best place to start.

To introduce the range of options available to MFIs, the remainder of this module explores four principal research strategies. The first two involve **secondary research**: the analysis of data that either already exist within the MFI or can be mined from external sources. The second two involve **primary research**, the collection of new information through either quantitative or qualitative research methods.

### 5.2 Secondary Research: Mining Internal Data

In determining what types of research would be most appropriate, the first issue to consider is whether the answers might be found in data that already exist within the MFI. Organizations often assume that they should launch a new research initiative without recognizing that the answers to their questions might be found in their client files.

With some foresight, MFIs can regularly collect valuable information that will make their databases more effective sources for secondary research. Two databases in particular — client information and complaints and suggestions — are worth developing and using for this purpose.

**Client Information Database**

Every time a client purchases a service from an MFI — applies for a loan, opens a savings account, buys an insurance policy — the MFI should take that opportunity to collect key information. This information might include:

- **Demographic data.** Information on client characteristics such as age, education, marital status, language, religious affiliation, and employment helps an MFI to know who its customers are.
- **Socio-economic data.** It might be relevant to collect information on income, assets, nutrition and living conditions with each loan applicant for MFIs interested in impact
monitoring (see Box 5.1). Then, with each subsequent loan request, the MFI could assess whether clients’ situations are improving, worsening or staying the same.

- **Marketing data.** To determine which channels are the most effective ways to communicate with the MFI’s target market, it is useful to know what newspapers clients read, radio stations they listen to, and television shows they watch, and their frequency. It is also useful to know how they heard about the MFI in the first place.

- **Product usage.** The client database should be sufficiently integrated so that the MFI can assess whether clients are accessing multiple products, and if so, which ones, and how often. This is relevant for managing credit risks as well as identify cross-selling for opportunities.

- **Family linkages.** An MFI might also want to know about family relationships between their clients. This information may help avoid a concentration risk of too many large loans to one family; or it might assist in delinquency management. This could even be a way of measuring customer loyalty, as described in Module 9.

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**Box 5.1 Impact Monitoring**

A primary objective of market research is to improve the attractiveness and effectiveness of an MFI’s products and services. An important aspect of an MFI’s effectiveness is whether it is achieving the intended goal of assisting low-income clients to break the vicious cycle of poverty. But how does an MFI know whether it is achieving this goal?

It is extremely difficult, if not impossible, to establish causality – to prove that products and services provided by an MFI are at least partly responsible for improving the lives of the poor. Even expensive longitudinal studies with control groups have difficulty authoritatively attributing impact to the provision of financial services. Any number of other interventions may also be contributing to improved living standards.

Impact monitoring is essentially a compromise between a costly and inconclusive scientific study and not assessing impact at all. It is a low-cost method of collecting and analysing selected variables with each ensuing loan cycle to build an understanding of how clients’ conditions are changing while using the MFI’s services. While it does not pretend to prove impact, it does highlight whether clients are generally improving or whether their situation is worsening. If the latter were the case, it would raise a red flag to the institution to investigate more thoroughly the causes of the decline and to determine how the MFI might help rectify the situation.

In selecting five to 10 key indicators to be monitored over time, it is useful to consider both enterprise and household variables, such as:

- **Enterprise.** Monthly sales, value of assets, number of employees (paid, unpaid, by gender), registration status

- **Household.** Assets, expenditures on food, monthly income, value of savings, school attendance
To ensure that MFIs are as efficient as possible, they have to focus on collecting only essential information. Any information that is collected should be entered into a database and analysed.

The client database may also include information on former clients — persons who have stopped borrowing or closed their savings account. Although MFIs are likely to conduct exit interviews (see Module 9), a database of former clients can be used to assess desertion trends (e.g., are lower-income persons more likely to drop out than wealthier clients?).

This database also has a marketing function; for example, so the MFI can send flyers to former clients announcing a new service that is now available.

**Complaint and Suggestion Database**

A complaint and suggestion database works like this: all employees who interact with customers should actively solicit complaints and suggestions. Besides trying to resolve complaints as quickly as possible, the “data collectors” document the exchanges. Documentation of both internal and external customer comments is then centrally analysed and used to guide the organization’s drive for continuous improvement.

Two important aspects of this process are often overlooked: (1) regular and active solicitation is important so that many voices are heard, not just the most vocal; and (2) customers who offer their opinions deserve an institutional response, thanking them for their concern or advice and informing them of what actions are being taken. For example, some MFIs post comment cards on a bulletin board in the branch so clients can see how the organization is responding to their suggestions.

### 5.3 Secondary Research: Mining External Data

MFIs can also conduct secondary research using information that already exists outside of the institution. This type of research is particularly useful in monitoring the changing dynamics in the market — not simply in terms of the supply and demand for financial services, but also with respect to environmental changes that could affect the MFI’s current or future operations. While the sources available in each country will vary, MFIs can take advantage of existing data from a range of external sources:

- **Microfinance networks and trade associations** often collect data from their members and/or from the industry at large, and produce reports, newsletters, journals or websites that disseminate consolidated information on institutional performance and the nature of supply and demand within the industry. They may distribute qualitative and/or quantitative data on specific institutions, and their information systems may permit the mining of data in response to specific queries.

- **Private sector networks and trade associations** collect information on particular market segments, sometimes at a national and local level. The data they have to offer could be useful in identifying financial service needs, designing new products, marketing an existing product to a new group of customers, opening a new branch or office, or understanding the causes of delinquency in a particular sector.
• **Donor agency evaluations or surveys** can provide data on individual financial service providers as well as the microfinance sector as a whole. They are one of the few potential sources of information on informal financial service providers.

• **Government policy statements** can inform an MFI about legislation, regulations and standards that might directly or indirectly affect its operations.

• **Local government surveys, reports and publications** provide information with local-level relevance. This kind of data is particularly useful when a retail outlet or branch seeks to understand its external environment, or when an MFI is thinking of expanding into a new area and is looking for market intelligence.

• **Newspapers** provide tips about studies that may have been published. They run articles that showcase individual microfinance institutions, particularly when they launch a new product or campaign. Newspapers highlight consumer complaints, needs and requests. They also provide regular information on the political, economic, social and technological trends in the MFI’s operating environment.

• **Competitors’ promotional materials** offer valuable information about their products, services, positioning, target markets and marketing strategy.

• **Microfinance literature** that documents and discusses the experiences of microfinance institutions is increasingly available and accessible online (see www.microfinanc_gateway.org). MFIs can examine this literature for tips on product design, institutional development, competitive strategy, market research techniques and more. They can also use the literature to identify individuals and institutions that they might contact for additional information.

• **The MIX** is a global information exchange for the microfinance industry that can be accessed at www.themix.org. It now manages both the MicroBanking Bulletin and the MIX Market, which currently provides data on 611 MFIs and 74 investors worldwide. Through the MIX, MFIs can research the market in 85 countries, compare their performance to that of other similar institutions, and search for funding and investors.

### 5.4 Qualitative Primary Research

If secondary research is insufficient for solving a particular research question, MFIs will need to gather new information to augment their existing knowledge base. This primary research comes in two forms: qualitative and quantitative.

More descriptive than definitive, qualitative research is primarily used to understand the complexity of human behaviour and attitudes. It facilitates the identification of relevant cultural features among target populations, which in turn helps to design appropriate questionnaires. It also provides guidance and insights, and allows one to develop an in-depth understanding of particular issues, but it does not offer firm answers.

In microfinance, qualitative research can be used to:

• Understand clients and explore their perceptions of the MFI and its services/products
  — Why do customers behave or think in a certain way?
  — Why do they prefer certain banks or products to others?
  — How are clients using an MFI’s services?
• Explore drop-out and delinquency problems
  — What is causing people to have repayment difficulties?
  — Why are they choosing to leave the organization?
  — What could the MFI do to attract them back again?
• Monitor trends in the financial landscape
  — Where else do people access financial services?
  — What sources help them to address their financial service needs?
  — What features of those financial services do they like and dislike, and why?

When using qualitative methods, it is important to be aware of their limitations. For example, the results are susceptible to misuse. An analyst with a particular point of view may selectively interpret the comments to support that view. The small sample size also raises questions about the general applicability of the findings — managers may be tempted to accept exploratory results as sufficient for their purposes because they are so compelling. In view of these pitfalls, these methods should be used strictly for insights into the reality of the consumer perspective and to suggest hypotheses for further research.

Two interrelated techniques for conducting qualitative research, focus group discussions (FGD) and participatory rapid appraisal (PRA) are discussed below.

**Focus Group Discussions**

A focus group discussion allows customers to influence an MFI's products and services by sharing their opinions and offering solutions in the context of a collective conversation (rather than, for example, an individual interview). Facilitated by a trained moderator, FGDs are small, usually six to 12 persons, and last about an hour. The moderator guides the discussion and, where necessary, asks probing questions to cross-check, clarify or validate information offered by respondents. Participants are selected to represent different segments of the MFI's customers, or different sessions are run for different market segments. FGDs can also be held with employees, persons in the target group who are not clients, and with members who have chosen to leave the institution.

To interpret the results of an FGD, it is useful to record the discussion (audio or video) and then prepare a written transcript. From the transcripts of several FGDs, researchers can summarize the main messages using citations as evidence.

**Advantages.** FGDs allow the collection of a relatively large amount of data in a relatively short period of time. They also provide an in-depth examination of issues through the dynamics of a peer-group discussion. FGDs are therefore useful when detailed information or descriptive data are required. With trained facilitators, they are fairly inexpensive to administer and may provide an appropriate feedback mechanism for uneducated customers who may not feel comfortable responding to a survey.

**Disadvantages.** Because of their small size, the MFI must run several FGDs to ensure that the results are reasonably representative. They require significant planning, and extra effort is needed to ensure that participants show up. Moderators have to skillfully elicit comments from the group as a whole, and be careful that the session is not hijacked by a few domineering people.
**Participatory Rural Appraisal**

In fact, there are two types of group discussions: 1) guide-led FGDs whereby the facilitator asks a series of questions to stimulate conversations among participants (as described above); and 2) PRA-tool FGDs in which participants are involved in an activity or a game (as described below).

PRA is a qualitative research methodology through which participating communities, with the assistance of outside facilitators, collect and analyse information about their own lives and community. The tools rely heavily on ranking options and assessing trends rather than trying to calculate absolute measurements. Specific examples of PRA tools, such as seasonality analysis, preference ranking and cash mobility mapping are described in Box 5.2.

**Advantages.** PRA techniques are flexible, exploratory, interactive, and responsive to issues raised during the research process. They allow researchers to learn from, with, and through local people, eliciting and using their criteria and categories. Data is collected, validated and analysed all within the group. As a result, the information obtained tends to be richer and more accurate.

Although the accuracy of information gathered within a single group can be quite high, there are often significant differences in the information gathered by different groups using the same tool. It is also rare for one tool to address all aspects of a research question. Thus, when using

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**Box 5.2 MicroSave's PRA Toolkit**

*MicroSave has developed the following 15 qualitative research tools to assist MFIs in better understanding clients' needs, preferences and behaviours:*

1. **Seasonality analysis of household income, expenditure, savings and credit** is used to obtain information on seasonal flows of income and expenditure, and the demand for credit and savings services. This analysis also provides insights into some of the risks and pressures faced by clients and how they use MFIs' financial services to respond to these. In addition, it provides insights into the financial intermediation needs of the community and what products the MFIs can design in response.

2. **Seasonality analysis of migration, casual employment and goods/services provided by the poor** looks at the availability of cash to the people in the community – and examines how far they might have to migrate to find work (when it is available). This has important implications for their ability to make regular savings and loan repayments, and for their potential demand for a remittance or transfer product.

3. **Life-cycle profile** to determine which of the events require lump sums of cash; to examine the implications of these for household income/expenditure; to establish current coping mechanisms; and then finally to discuss how access to MFI financial services can help the household respond to these. The information gathered is useful for designing financial products that match the various needs expressed at different milestones during a person's life cycle.

4. **Venn/Chapati diagram** allows analysis of financial service groups/organizations within the community and their roles, and to understand more about the social capital accumulated by participants.

(cont'd)
5. **Simple ranking** can be used to explore a wide variety of issues when an understanding of the relative importance/desirability etc. is needed (e.g. for understanding the relative importance of different elements of products – interest, rate, opening balance, grace period, etc.).

6. **Relative preference ranking** is used to see how clients and potential clients perceive the financial service providers and components of the financial services they provide.

7. **Pair-wise ranking** examines in detail how clients and potential clients compare and contrast critical components of financial services, and why those elements are important for them.

8. **Simple wealth ranking**, a useful tool to target poorer market segments, provides a rapid way of segregating a community into three basic wealth categories. This exercise can also be used for impact assessment and for examining the socio-economic characteristics of people who chose to join (or don’t join) the MFI.

9. **Detailed wealth ranking** provides an understanding of in what way and why rich people are wealthy and the poor are poor, and a “ranking” of the households in the village, from the most wealthy to the least wealthy, as seen by the members of the community.

10. **Cash mobility mapping** provides an understanding of where the community goes to acquire or spend cash (e.g., markets, waged labour, cooperatives, informal financial organizations, etc.) and to lead into discussions of which financial service institutions they trust or value and why. The exercise also provides initial insights into potential income-generating ventures/projects that the clients might get involved in.

11. **Time series of sickness, death, loss of employment, theft, natural disaster etc.** (this year, last year, five and 10 years before) provides an opportunity to learn from the community about how it views change over time in various areas related to a series of crises. It also allows the research team to integrate key changes into the community profile, which will simplify problem identification; and to begin to organize the range of opportunities for improved delivery of financial services.

12. **Time series of asset ownership** (this year, last year, five and 10 years before) is useful in determining what “productive” and “protective” assets (in a broader sense) are valued the most, and thus the potential for designing or refining corresponding financial products including leasing and contractual savings (e.g., for housing, education, health insurance, etc).

13. **Financial services matrix** is useful in determining which financial services are used by which socio-economic or socio-cultural strata of society and why.

14. **Financial sector trend analysis** determines which financial services have been used over time by which socio-economic or socio-cultural strata of society.

15. **Financial landscape analysis** is useful in determining the types of competition that are operating in the area as well as the rates they charge/offer, etc. The tool also provides insights into the use/availability of a variety of financial services and why participants use them. It can illustrate how poor people’s perceptions of financial services sometimes vary substantially from the actual terms and conditions being offered.
PRA, it is recommended that several tools be applied to each research issue so that the results can be cross-checked. This process of **triangulation** enables researchers to get closer to the truth and to draw conclusions and insights that are both more relevant and more precise.

**Disadvantages.** The most challenging aspect of PRA is the facilitation. Effectively implementing the PRA methodology requires a moderator with skills that enable local people to do the investigation, mapping, modelling, diagramming, ranking, scoring, quantification, analysis and planning themselves, and to own the outcome. The attitude of the facilitator is, in fact, as important as the methodology itself.

**Other Techniques**

Although the two main approaches to qualitative research have been presented above, it is useful to note that other techniques exist and may also be compelling. For example, some MFIs have appointed **customer advisory boards**, which meet periodically to discuss the current state of affairs in their institution. A customer advisory board can provide ideas for new products or services, alert the MFI to the greatest sources of customer dissatisfaction, and otherwise act as a voice for the customers.

**Mystery shopping** is another technique that could be used by MFIs to gather information — particularly customer service information — from within the MFI and/or from its competitors. A “mystery shopper” is an individual contracted to pose as a customer and to evaluate an organization’s (or an outlet’s) services. The shopper, who is essentially a spy, completes a standard report on the service she received (see Box 5.3). To enhance the value of the information, she might pose a complaint to evaluate how it is handled. Or she may make non-standard requests, such as larger loans or longer terms. This technique tends to be more relevant for individual lending methodologies because it is harder to plant a mystery shopper in a borrower group.

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**Box 5.3 Sample Mystery Shopping Form**

*Please complete this form immediately following the branch visit.*

1. How long did you have to wait for service?
2. If you waited in line for more than ten minutes, or if there was any other inconvenience in the branch, did the staff member apologize in a sincere way?
3. Was the staff member otherwise polite?
4. Did the staff member follow procedures?
5. Did the staff member suggest appropriate loan products for your specific needs?
6. Were explanations clear and accurate?
7. Did the staff member offer useful services?
8. Did the staff member ask for appropriate information for the loan application?
9. Were you charged any fees? If so, for what?
10. Please comment on the appearance of the branch and personnel.
Another informal approach to qualitative research is through **customer lunches**. Senior managers could attend an annual lunch in each branch with selected clients. In this forum, it is important not only to listen to customer comments and criticisms, but also to respond to them in tangible ways. While these events are important for all involved — staff, customers and management — managers need to be careful about how they interpret what they hear. Opinionated and outspoken clients tend to make strong impressions on senior managers, yet their comments are not always representative of customer sentiment.

### 5.5 Quantitative Primary Research

There is a natural link between qualitative research and the surveys and questionnaires of quantitative research. Quantitative research tools are typically administered to a large number of people who are representative of the total population in an effort to generate statements such as “75 per cent of the target population use bank-based savings services, 20 per cent use money guards, and the rest do not save”. This is an attractive and effective way of presenting survey data, but the results are generally restricted to a range of predetermined answers. Qualitative research can inform the design of these answers; it can also be used to explore the reasons behind the quantitative results. The two types of research are complementary, although they are fundamentally different, as summarised in Table 5.2.

<table>
<thead>
<tr>
<th>Table 5.2 Differences Between Qualitative and Quantitative Research</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Qualitative</strong></td>
</tr>
<tr>
<td>Used to understand consumer behaviour in an in-depth manner</td>
</tr>
<tr>
<td>Open-ended questions and probing yield detailed information that illuminates nuances and highlights diversity</td>
</tr>
<tr>
<td>Data collection techniques vary</td>
</tr>
<tr>
<td>Sampling depends on what needs to be learned</td>
</tr>
<tr>
<td>Lower number of respondents</td>
</tr>
<tr>
<td>More suitable when time and resources are limited</td>
</tr>
<tr>
<td>Implementers should be well-trained moderators who understand their responsibilities (research objectives, discussion guide, etc.)</td>
</tr>
<tr>
<td>Output takes the form of words and descriptions</td>
</tr>
<tr>
<td>Uses a variety of data analysis techniques</td>
</tr>
<tr>
<td>Provides information on the application of the programme in a specific context to a specific population</td>
</tr>
</tbody>
</table>

*Source: Adapted from SEEP and MicroSave toolkits.*
Quantitative research requires considerable planning, foresight, attention to detail and patience. It is technically demanding and costly. To conduct an effective study, one must start with the objectives of the research. Explicit focus is necessary to avoid asking unnecessary questions and wasting the time of the customers and researchers. It is generally better value for money to focus on a few objectives in detail rather than trying to cover too many topics superficially. Other suggestions for effective quantitative research include:

**Survey or interview?** It is more effective to speak to people than to ask them to fill in a short written survey. Not only are many microfinance clients illiterate, which makes surveys less effective, but interviews allow MFIs to probe issues, and even transition from market research to marketing. The extra expense of interviews is well worth it.

**Duration.** If the interview takes more than 20 to 30 minutes of the customer’s time, it is too long.

**Order of questions.** The interview should open with an easy, interesting question that will draw the customer in. Personal questions, such as those concerning income and expenses, may make the client uncomfortable and are best saved for the end.

**Type of questions.** Consider the following suggestions to avoid biasing the participant’s responses:

- *Do not ask leading questions:* Leading questions have the answer embedded in them, for example, “Do you usually wait in line for a long time at the branch?”
- *Avoid double barrel questions:* These questions ask two things at once, for example, “Do you favour increasing the loan sizes by raising the minimum savings requirement?”
- *Include open-ended questions:* These allow customers to raise issues that the researchers had not considered.
- *Vary the question type:* For example, avoid a series of yes/no questions where “no” generally signifies negative feelings.

**Segment the analysis.** When analysing the results, determine if subsets of the respondents (e.g., women and men, new and repeat customers) have different opinions.

**Sampling.** For the information to be considered representative of the organization’s clients as a whole, it is necessary to randomly select a sufficiently large sample of clients so that the analysis from particular segments of the market includes at least 30-40 individuals in each sub-group (although at least 90 would be even better).

**Non-clients.** MFIs often look internally, to their current or former clients, for market information, but non-clients — particularly those that the MFI would like to reach and is not doing so — represent another valuable resource. For persons who have heard about the services but have not accessed them, why not? For persons who have not heard about the service, what are the information channels that might reach them? Another advantage of interviewing non-clients is that it could easily turn from market research to marketing.
5.6 Conclusion

In many markets, microfinance is becoming increasingly competitive. Pessimists might perceive the entry of new players as a threat, while optimists might see it as an opportunity. The advent of competition brings new ideas and openings to expand the market. Competitors can be a resource to further educate and screen clients, and to develop new product ideas. An MFI can copy a competitor’s product offering and then improve upon it.

For example, BancoSol in Bolivia created an individual loan product to stem the desertion of its clients to Cajas Los Andes. BancoSol combined the best of its current group product — the efficiency and accessibility with which it was delivered — with the flexibility of its competitor’s loans, to go beyond the solidarity group methodology. In another example, ASA in Bangladesh introduced open access savings accounts and contractual savings after seeing the success of these products in BURO, Tangail’s system. BURO, Tangail in turn adopted and adapted the idea of accepting savings deposits from non-target group clients (i.e., not-so-poor) from ASA.

Market research is a prerequisite for success in a competitive environment, regardless of whether an MFI is pessimistic or optimistic about the competition. MFIs must not only track the price, features, packaging and placement of competitors’ products, but also the perceptions of one’s own products in the market. These perceptions will provide valuable information for product refinement, service improvement and the definition of an effective marketing strategy.

Using one or all of the approaches described in this module, MFIs can monitor both the supply and demand for services in different segments of their market. Research into the competition can begin by mining the data that exists in newspapers, industry reviews and competitors’ promotional materials. It can be augmented through mystery shopping in competitors’ premises. Deep insights are likely to come, however, only through conversations with customers, ideally in a semi-structured format such as an FGD or PRA that can yield validated and contextual information. In particular, MFIs can take advantage of tools for analysing financial trends, ranking relative preferences and mapping the financial landscape. It is also important not to rely on just one strategy, but rather employ a variety of different research methodologies and triangulate the results. When applying any of these tools, MFIs should be sure to include both formal and informal financial service providers — the moneylenders, employers, shopkeepers and associations — as members of the competition, competition that the MFI can learn from.

<table>
<thead>
<tr>
<th>Main Messages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Market research is a continuous process - MFIs must find ways to incorporate market research into their operations.</td>
</tr>
<tr>
<td>2. Market research begins by defining the research question.</td>
</tr>
<tr>
<td>3. Before collecting primary data, see if the research question can be answered from existing information, from both internal and external sources.</td>
</tr>
<tr>
<td>4. Triangulate!</td>
</tr>
<tr>
<td>5. Do not collect data just because you can. Collect it for a reason.</td>
</tr>
</tbody>
</table>
Case Study: Quantitative and Qualitative Research for Savings Products

To identify what clients value most in a savings product, certain quantitative research tools build on the priority ranking methods used in qualitative research. Three commonly used quantitative measures allow statistical analysis of what is most important to clients, all of which ACCION has used in surveys in Africa and Latin America:

- **Top of mind** measures the first unaided answer the respondent offers. For example, when asked for the most important consideration in opening a savings account, a respondent may answer “the proximity to their home” as their top of mind response.

- **Total number of mentions** measures the number of times a particular response is given. Using the same example, while proximity may be the first response, usually other factors are mentioned more frequently, and thus would have a greater “total number of mentions”.

- **“Top 2” ranking** uses a valuation system so that the respondent can identify which factors are: (1) most important; (2) very important; (3) somewhat important; (4) not very important; (5) unimportant. The percentage of respondents classifying the factor as “most important” or “very important” is equal to its “top 2” ranking.

For one MFI, this quantitative research affirmed a well-known fact in savings mobilization, i.e., that the most important factor for the poor in choosing where to deposit their savings is the security and soundness of the institution. Although leading attributes — security and soundness — confirmed the findings of the MFI’s qualitative market research, the quantitative analysis uncovered interesting insights with respect to the secondary attributes. Interest rate scored high in top of mind and total mentions, but ranked much lower in overall importance to the clients. The surprise result was that friendly treatment was the second most important consideration for depositors. The quantitative market research also helped define the relative share of the MFI’s primary competitors with respect to savings mobilization. Not surprisingly, commercial and savings banks dominated the savings market in the country. Locally, however, coverage was less concentrated, creating strategic opportunities the MFI could exploit in specific cities.

### Example of a Quantitative Priority Ranking

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Top of mind</th>
<th>Total # of mentions</th>
<th>“Top 2” ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Secure/trustworthy/solvent</td>
<td>1 (53%)</td>
<td>1 (74%)</td>
<td>1 (68%)</td>
</tr>
<tr>
<td>Friendly treatment</td>
<td>6 (5%)</td>
<td>4 (26%)</td>
<td>2 (63%)</td>
</tr>
<tr>
<td>Fast service</td>
<td>4 (6%)</td>
<td>5 (25%)</td>
<td>3 (62%)</td>
</tr>
<tr>
<td>Years of experience</td>
<td>3 (7%)</td>
<td>2 (30%)</td>
<td>4 (60%)</td>
</tr>
<tr>
<td>Access to credit</td>
<td>5 (6%)</td>
<td>6 (18%)</td>
<td>5 (59%)</td>
</tr>
<tr>
<td>Interest rate</td>
<td>2 (10%)</td>
<td>3 (30%)</td>
<td>6 (57%)</td>
</tr>
<tr>
<td>Information</td>
<td>9 (2%)</td>
<td>8 (10%)</td>
<td>7 (56%)</td>
</tr>
<tr>
<td>Hours of operation</td>
<td>13 (1%)</td>
<td>11 (6%)</td>
<td>8 (48%)</td>
</tr>
<tr>
<td>Number of branches</td>
<td>7 (2%)</td>
<td>7 (11%)</td>
<td>9 (47%)</td>
</tr>
</tbody>
</table>

Note: In each column, the figure on the right is the percentage of people who ranked the attribute, according to the method described in each column level. The figure on the left is the rank, from most frequent to lowest percentage.

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This case study was adapted from:

Recommended readings:


6 Product Development

Microfinance began as an innovation. The Grameen Bank’s centre (group of groups), ACCION’s solidarity group and FINCA’s village bank were all revolutionary means of overcoming market imperfections that prevented traditional banks from serving low-income customers. Over time numerous variations on the original models have emerged.

But not all innovations are successful. Although failures are not often discussed openly, the short history of microfinance is probably littered with more bad practices than good. Innovative institutions are risk takers, which means they must be prepared to fail and to learn from the effort. Risk taking, however, does not have to be reckless. MFIs can avoid falling into the bad practices category if they follow a logical and strategic path towards product development. Building on what has been learned about clients through market research, and moving up one layer in the markets and marketing pyramid, this module answers the following five questions:

1. What is product development?
2. Why develop new products?
3. What are the preconditions for product development?
4. What is the product development process?
5. What are the characteristics of successful product development?

6.1 What is Product Development?

To define product development, one must first define product. For MFIs, a product is a financial service that customers purchase because it fulfils a particular need. The most common types of products are credit, savings and insurance. Some products also combine two of these categories, and some integrated products combine financial with non-financial services.

The definition of a microfinance product includes the manner in which it is delivered. A savings product available from a distant office between 9:00 and 14:00 is different from one available five minutes away during weekly meetings – and both differ from a product that is delivered daily to the client’s doorstep. Each product provides different worth to customers, and imposes different costs and demands on the institution (see Box 6.1).
Box 6.1 What is a Product?

Some microfinance institutions offer a general product that can be used for a variety of purposes, whereas other organizations design their products more narrowly. For example, in India, VimoSEWA’s insurance product covers death, hospitalization and loss of property, while other microinsurers require customers to buy each benefit separately.

The same situation occurs with loans. For example, the microfinance units of the Bank Rakyat Indonesia (BRI) offer a versatile loan that can be used for almost any productive purpose. Other MFIs offer different products for large and small amounts, for working capital and fixed asset loans, for trade and agricultural purposes, and for short and long terms. Which way makes the most sense?

From a marketing perspective, there are important reasons to differentiate product features as unique products, especially when they are being targeted to different market segments. It may be advantageous to have different names for different products to tailor the pitch to the appropriate clientele, especially if the eligibility requirements, the application process, the pricing and the assessments are different.

The staff structure is another reason to differentiate products. Perhaps the MFI does not want all of its loan officers to administer all loan products because some products require more sophisticated analysis and specialized training. However, if a broad menu of services makes it difficult for staff to tell the difference between them, or frontline employees get confused when they are explaining them to clients, then the MFI probably has too many products.

Another factor to consider is the clients’ perspective—what do they expect from a product? For example, in VimoSEWA’s situation, the organization provides an insurance product that covers a variety of risks because: a) this is what clients wanted, and b) this was cheaper (better value for money) than what could be offered if the three types of benefits were offered separately.

From an MIS perspective, it does not matter whether the institution calls them separate products or just product features as long as it disaggregates information based on key variables. Portfolio quality is the easiest to disaggregate, providing critical information about the risks associated with certain market segments. Product profitability is equally important—only with income and expense information can the institution price its products or product features accurately. By assessing the profitability and quality by product features, including term, amount and repayment frequency, and by client features, including loan purpose, geographic location and gender, the MFI can analyse the risks and returns for various subsets of its loan portfolio. This serves as an early working system for delinquency, and can encourage strategic thinking regarding outreach, pricing and lending methodology.

Source: Adapted from Churchill, 1999.

The term product development does not mean the same thing to all people. In this module, product development is the process of improving existing products or developing new products, either for the organization’s existing market or for new types of clients. This broad definition leaves the door open to a variety of initiatives, some of which are riskier than others. Table 6.1 outlines recommended priorities for product development based on the associated risks and benefits.
Table 6.1 Product Development Options

<table>
<thead>
<tr>
<th>Product improvements</th>
<th>New products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Existing market</strong></td>
<td><strong>Top priority.</strong> Customer retention is one of the biggest challenges for many MFIs. The first step toward enhancing retention is to see if the core product can be adapted to suit the organization’s existing clientele.</td>
</tr>
<tr>
<td><strong>New market</strong></td>
<td><strong>Medium priority.</strong> If an organization has saturated its existing market, or feels compelled to begin serving a new type of client, if possible the first step would be to modify an existing product to the needs of the new market.</td>
</tr>
</tbody>
</table>

Source: Adapted from Ansoff’s Product Market Matrix.

As shown in Table 6.1, the first priority in product development is to improve existing products for the organization’s existing clients. The second priority depends on the organization’s circumstances: either it will want to deliver an existing product to new markets, or it will want to develop new products for existing markets. The lowest on the priority list, and the riskiest, is the new-new combination of new products and new markets.

A successful financial service meets the objectives of both the customer and the MFI. Satisfying only customer wants may sacrifice the institutional mandate for sustainability; conversely, meeting short-term institutional objectives may compromise customer satisfaction and retention. A successful product offers the greatest degree of overlap possible between customer and institutional objectives, as depicted in Figure 6.1.

![Figure 6.1 In Search of the Product Development Overlap](image-url)
6.2 Why Develop New Products?

There is a trend in microfinance these days to develop new products, and there are numerous good reasons to do so. First and foremost, microfinance needs to move away from the supply-driven, mono-product approach that has characterized its history, which assumed that: a) one basic financial product could meet the needs of many people; and b) approaches that work in one place can easily be replicated elsewhere. The microfinance industry has since learned that people need more than micro (enterprise) loans, and that product designs and delivery methods must be adapted to local circumstances. Other compelling reasons for developing new products include:

- To become more demand-driven
- To reach more people
- To reach poorer people
- To increase market share
- To reduce and diversify institutional risks
- To improve profitability through cross-selling and lower acquisition costs
- To meet the needs of the customers better
- To adapt to the changing needs of existing customers
- To reach out to new market segments
- To improve portfolio quality
- To diversify income sources
- To retain customers

Yet an important note of caution must be raised about the motivations for developing new products. One of the most insidious reasons for new product development is the availability of donor money. Organizations must realize as well that a long menu of financial services is not necessarily going to make them look better to donors, the government or investors. Lastly, it is important to avoid the bandwagon approach – just because other MFIs are developing new products, that does not mean that it is right for every organization.

6.3 Preconditions for New Product Development

To ensure that new product development is appropriate for an organisation, it is important for MFIs to determine if they meet certain preconditions. For example:

**Institutional strategy:** Does the development of new products in general, and the proposed product in particular, fit into the MFI’s strategic plan?

**Financial viability:** Is the organization in sufficient financial health to undertake what might be an expensive product development effort?

**Customer service orientation:** Does the MFI already provide quality customer service and have an appropriate client-orientation?

**Marketing capacity:** Is the organization able to market its products adequately?
Culture of innovation: Is the MFI’s culture geared towards innovation and continuous improvement? Do employees embrace changes?

Effective MIS: Does the organization have a management information system (MIS) that can easily accommodate new products?

Product profitability monitoring: Does the organization already monitor the profitability of individual products by assigning both costs and revenues on a product basis.

Effective internal communication: Does the MFI have effective internal communication channels, for both vertical and horizontal transmission?

Effective training department: Does the MFI have the means to train its staff on the policies and procedures of a new product?

Low staff turnover: Is the organization successful in retaining its key staff members?

Available resources: Although product improvements can be made without major investments, new product development can be an expensive process. Make sure sufficient funds — and human resources — are set aside for this effort.

Context: Has the MFI considered how its external environment influences product design? In particular, has it recognized the impact of the following four elements:

1. Competition. An MFI’s financial products should be compared to other services available to the target market from both formal and informal sources. Almost all microfinance clients borrow and save through other channels, especially informal ones. By understanding what other services clients use, an MFI may gain insight into the product features that are attractive to them.

2. Regulation. The parameters imposed by the legal environment may determine certain product features (e.g., usury laws stipulating interest rate ceilings) or may limit the types of services the MFI can offer (e.g., the common restriction preventing NGOs from providing voluntary savings).

3. Macroeconomic conditions. The macroeconomic conditions, such as inflation and economic growth, may influence the design of a financial product (such as interest rate) or the timing of its launch.

4. Culture. Social and cultural traditions can also influence product design, for example, if a community embraces Islamic finance principles that prohibit the receipt and payment of interest, or if it prefers group-based initiatives to individual entrepreneurialism.

Product Analysis. A final precondition is the assessment of a product’s potential for success from both the customer’s and the institution’s perspective. Each market segment and each institution will naturally have different priorities. Market research will disclose what customers believe is of greatest value. An organizational review will determine the institution’s priorities. The Framework for Product Analysis in Table 6.2 illustrates a tool for analysing a new financial product; in this example, a loan.
Table 6.2 Framework for Product Analysis

<table>
<thead>
<tr>
<th>A new loan product's perceived value from a customer perspective</th>
<th>A new loan product's potential for success from an institutional perspective</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Availability and accessibility</strong></td>
<td><strong>Mission responsiveness</strong></td>
</tr>
<tr>
<td>• Product requires limited or no training</td>
<td>• Product reaches target customer</td>
</tr>
<tr>
<td>• Limited or no collateral required</td>
<td>• Has desired impact</td>
</tr>
<tr>
<td>• Easy and quick access; product is or has —</td>
<td>• Can be priced in keeping with the institutional mission</td>
</tr>
<tr>
<td>— Simple paperwork (e.g., one-page loan application)</td>
<td></td>
</tr>
<tr>
<td>— Available when needed (on demand, not at prescribed</td>
<td></td>
</tr>
<tr>
<td>times)</td>
<td></td>
</tr>
<tr>
<td>— Quick turnaround (time between application and</td>
<td></td>
</tr>
<tr>
<td>receiving the loan is one to three days)</td>
<td></td>
</tr>
<tr>
<td>— Convenient location (loan disbursed close to home or</td>
<td></td>
</tr>
<tr>
<td>work)</td>
<td></td>
</tr>
<tr>
<td>— Easy to understand (to compute interest, payments,</td>
<td></td>
</tr>
<tr>
<td>other requirements, and benefits)</td>
<td></td>
</tr>
<tr>
<td><strong>Restrictions and requirements</strong></td>
<td><strong>Customer satisfaction</strong></td>
</tr>
<tr>
<td>• Eligibility requirements become less restrictive over</td>
<td>• Attracts new customers easily</td>
</tr>
<tr>
<td>time as creditworthiness is proven</td>
<td>• Increases per customer balances (where appropriate)</td>
</tr>
<tr>
<td>• Fewer meetings</td>
<td>• Retains older customers</td>
</tr>
<tr>
<td><strong>Incentives</strong></td>
<td><strong>Competitiveness</strong></td>
</tr>
<tr>
<td>• As creditworthiness is proven, incentives increase</td>
<td>• Is competitive vis-à-vis current competition and potential competition</td>
</tr>
<tr>
<td>— Promise of continued access</td>
<td>• Is competitive with customers' alternatives (such as borrowing from</td>
</tr>
<tr>
<td>— Lower interest rates for best clients</td>
<td>family or using savings)</td>
</tr>
<tr>
<td>— Higher loan amounts</td>
<td><strong>Profitability</strong></td>
</tr>
<tr>
<td><strong>Loan amounts</strong></td>
<td>• Breaks even much sooner than initial core product</td>
</tr>
<tr>
<td>• Appropriate to loan use</td>
<td>— Should be sharing infrastructure and costs</td>
</tr>
<tr>
<td>• Have possibility of increasing</td>
<td>• Satisfies institution's targets for an appropriate financial return</td>
</tr>
<tr>
<td><strong>Repayment model</strong></td>
<td><strong>“Scaleability”</strong></td>
</tr>
<tr>
<td>• Matched to customer's capacity to repay</td>
<td>• Has high initial customer demand, appropriate for</td>
</tr>
<tr>
<td>— Choice of term or flexible terms</td>
<td>significant percentage of current customer base</td>
</tr>
<tr>
<td>— Repayment matches cash flow</td>
<td>• Is easily explained to and understood by customers</td>
</tr>
<tr>
<td><strong>Loan uses</strong></td>
<td>• Requires limited training of customers</td>
</tr>
<tr>
<td>• Multiple, flexible, based on customer needs</td>
<td>• Requires limited new procedures for customers</td>
</tr>
<tr>
<td><strong>Loan price</strong></td>
<td>• Offers repeat utility; same customers can borrow repeatedly</td>
</tr>
<tr>
<td>• Matched to value of product</td>
<td>• Uses same staff (ideally)</td>
</tr>
<tr>
<td>• Price is a more important factor when —</td>
<td><strong>Repayment incentives</strong></td>
</tr>
<tr>
<td>— Alternatives exist (family, savings, competition)</td>
<td>• Are built into product design</td>
</tr>
<tr>
<td>— Cash is not needed immediately</td>
<td>• Opportunities for customers include:</td>
</tr>
<tr>
<td>• Staff and service</td>
<td>— More loans</td>
</tr>
<tr>
<td>• Friendly, non-intimidating</td>
<td>— Lower interest rates</td>
</tr>
<tr>
<td>• Knowledgeable about product and can inform customers</td>
<td>— Less strict requirements</td>
</tr>
<tr>
<td>• Speak local language</td>
<td>• Penalties for customers include:</td>
</tr>
<tr>
<td>• Have authority to make decisions</td>
<td>— More collateral</td>
</tr>
<tr>
<td>• Efficient, do not burden customers</td>
<td>— Late fees</td>
</tr>
<tr>
<td><strong>Other product features</strong></td>
<td>— Peer pressure</td>
</tr>
<tr>
<td>• Product comes with protection</td>
<td>— Higher interest rates</td>
</tr>
<tr>
<td>— Against unexpected events</td>
<td><strong>Impact on staffing and systems</strong></td>
</tr>
<tr>
<td>— Defaults in solidarity groups, etc.</td>
<td>• Manageable impact on:</td>
</tr>
<tr>
<td>— Repeat loans not tied to success of group</td>
<td>— MIS</td>
</tr>
<tr>
<td><strong>Impact on staffing and systems</strong></td>
<td>— Staff and staff training</td>
</tr>
<tr>
<td><strong>Legal and cultural issues</strong></td>
<td>— Organizing and outreach models</td>
</tr>
<tr>
<td>• Product must be in compliance with local laws</td>
<td>— Financial management</td>
</tr>
<tr>
<td>• Product must be suited to cultural context</td>
<td><strong>Staff and service</strong></td>
</tr>
<tr>
<td><strong>Mission responsiveness</strong></td>
<td>• Friendly, non-intimidating</td>
</tr>
<tr>
<td>• Product reaches target customer</td>
<td>• Knowledgeable about product and can inform customers</td>
</tr>
<tr>
<td>• Has desired impact</td>
<td>• Speak local language</td>
</tr>
<tr>
<td>• Can be priced in keeping with the institutional mission</td>
<td>• Have authority to make decisions</td>
</tr>
<tr>
<td>• Attracts new customers easily</td>
<td>• Efficient, do not burden customers</td>
</tr>
<tr>
<td>• Increases per customer balances (where appropriate)</td>
<td><strong>Impact on staffing and systems</strong></td>
</tr>
<tr>
<td>• Retains older customers</td>
<td>• Manageable impact on:</td>
</tr>
<tr>
<td>• Is competitive vis-à-vis current competition and</td>
<td>— MIS</td>
</tr>
<tr>
<td>potential competition</td>
<td>— Staff and staff training</td>
</tr>
<tr>
<td>• Is competitive with customers' alternatives (such as</td>
<td>— Organizing and outreach models</td>
</tr>
<tr>
<td>borrowing from family or using savings)</td>
<td>— Financial management</td>
</tr>
<tr>
<td><strong>“Scaleability”</strong></td>
<td><strong>Legal and cultural issues</strong></td>
</tr>
<tr>
<td>• Has high initial customer demand, appropriate for</td>
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</tr>
<tr>
<td>significant percentage of current customer base</td>
<td>• Product must be suited to cultural context</td>
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<td>• Is easily explained to and understood by customers</td>
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</tr>
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<td>• Requires limited training of customers</td>
<td>• Manageable impact on:</td>
</tr>
<tr>
<td>• Requires limited new procedures for customers</td>
<td>— MIS</td>
</tr>
<tr>
<td>• Offers repeat utility; same customers can borrow</td>
<td>— Staff and staff training</td>
</tr>
<tr>
<td>repeatedly</td>
<td>— Organizing and outreach models</td>
</tr>
<tr>
<td>• Uses same staff (ideally)</td>
<td>— Financial management</td>
</tr>
<tr>
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<td><strong>Impact on staffing and systems</strong></td>
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<tr>
<td>— Organizing and outreach models</td>
<td>• Manageable impact on:</td>
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<tr>
<td>— Financial management</td>
<td>— MIS</td>
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<td><strong>Legal and cultural issues</strong></td>
<td>— Staff and staff training</td>
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<tr>
<td>• Product must be in compliance with local laws</td>
<td>— Organizing and outreach models</td>
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<td>• Product must be suited to cultural context</td>
<td>— Financial management</td>
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6.4 What is the Product Development Process?

The first step in the product development process is identifying innovative ideas for new products or product improvements. Where are these ideas likely to come from? As shown in Figure 6.2, product ideas typically come from four major sources:

**Figure 6.2 Sources for Product Ideas**

- **Customers' Suggestions**
  - From current customers and from those the MFI is unable to reach

- **Outsiders**
  - From other programmes, banks, books, consultants

- **Insiders**
  - Staff, management board members

- **Customers' Behaviour**
  - Observing and analysing dropouts, late payments, meeting attendance

**Customers' suggestions.** Many good ideas originate from customers. A complaint and suggestion database can capture and process these ideas. MFIs should realize, however, that customers will often not know what is possible in terms of product design. A borrower accustomed to a term loan may know intuitively that the product does not meet her needs, but if she has not been exposed to a line of credit, she may find it difficult to articulate such a solution. Therefore staff, management, and even board members must be able to listen to customers and observe their behaviour, and then translate that information into solutions. MFIs should also ensure that potential customers are included in the product development process, for example by conducting focus groups or market surveys.

**Customers' behaviour.** Dropouts provide a wealth of valuable product information. Because former clients have less to lose than existing customers, their responses are often more candid. Another behaviour that should influence product development is repayment performance. Most late payments are not caused by unwillingness to pay; the inability to pay signals that a product may not be designed to meet customers' needs or that a flaw exists in client screening techniques.
**Insiders.** Observation and intuition can be great generators of product ideas. Field staff have ample opportunity to observe customers and prospective customers; the insights of front line personnel should be heeded. To cultivate ideas from insiders, a corporate culture of continuous improvement can be reinforced through the following methods:

- Train staff members how to analyse customers' preferences, to probe to identify customers’ problems, and to analyse the information to produce solutions.
- Create opportunities for staff to share findings. The agenda for staff meetings should regularly include a time slot for discussing product ideas.
- Reward staff through recognition and financial bonuses for ideas that turn into new products or enhancements.
- Bring board members to the field to get their ideas. This activity has the additional benefit of keeping them informed and involved.

**Outsiders.** Consultants, donors, researchers and other visitors may generate good ideas, especially if they have spent time working with other MFIs. The fresh perspective of visitors should be welcome, though many ideas may not be appropriate.

Once an innovative idea has been identified, the product development process should move through a series of steps, depicted in Figure 6.3. (The arrows with “C” in the diagram represent points of customer input.) In practice, the process of moving an idea into a viable financial product or product improvement is not usually linear. Yet regardless of the sequencing, at some point during the development process the institution should have addressed each of the following five activities: a) establish an R&D team, b) conduct market research, c) design the prototype, d) test the product and e) launch the product.

**a) Establish an R&D Team**

Product development requires a tireless commitment from a core research and development (R&D) team, which includes representatives from each of the MFI's departments. It is not critical that departmental representatives are senior personnel; sometimes the inclusion of a few junior staff members brings fresh ideas and fewer assumptions about limitations.

The team leader is known as a product champion because she or he is responsible for managing the development process. The success of the product development depends on the champion’s ability to motivate the team and forge a consensus. It also depends on the authority of the R&D team to make decisions – if the committee is not empowered to act, it will be a frustrating experience for all involved.

The R&D team has an important responsibility to update the organization on its activities, and to solicit suggestions throughout the process. If the R&D team is perceived as a secret club operating in isolation, it will encounter tremendous resistance when it is time to roll out the product. If team members are communicative and participatory, they are much more likely to find a more receptive audience at the end of the process.
Figure 6.3 Product Development Flow Chart

1. Identify a product development opportunity
2. Brainstorm with R&D team
3. Develop product idea
4. Discuss in focus group
5. Design prototype
6. Pilot test
7. Analyse results
   - Yes: Roll out new product
   - No: Refine product
8. Analyse results
   - Yes: Refine product
   - No: Roll out new product
b) **Conduct Market Research**

Successful product development requires customers' contributions at various stages. Before trying to pin down the details of the product, MFIs should use focus group discussions to check the range of possibilities with clients. At the beginning of the process, market research should help answer the following questions:

- **What need does the product fill?** For a product to be viable, customers or potential customers must perceive that it addresses their needs better than alternative solutions.

- **What is the potential value of the product?** A product's viability depends on its perceived value to the customer. How much is the customer willing to pay for the product? It will be difficult to gauge the pricing exactly at this point, but it is still worth getting a rough estimate.

- **What is the possible demand for the product?** This analysis depends on whether the product is designed primarily for new or existing clients. If a product does not appeal to a significant portion of the current customer base, the MFI misses an opportunity to leverage the acquisition investment it has already made in its clients. If the product is for an entirely new market, then a large-scale survey of prospective customers may be necessary to gauge demand.

- **What product features would generate the greatest customer value?** As discussed in Module 5, focus groups provide good forums for discussing the product features that customers find valuable. These discussions can quantify the customers' product priorities through preference ranking techniques.

c) **Design the Prototype**

When designing the prototype, it is critical that the MFI think through all the implications. A review of the product according to a comprehensive framework for product analysis, such as the one presented in Table 6.2, can make an initial contribution. Some information will be missing, but a preliminary review will help identify the gaps. Most importantly, the R&D team needs to answer a few key questions:

- Is the product in line with the mission and focused on the right customer?

- Is it in line with institutional strategies? If not, is it worth changing the business plan?

- Will the new products merely take away clients from existing products for no net gain, or will it generate additional demand? MFIs need to avoid developing new products that merely cannibalize existing products.

- What capacities and resources will the product require? Specifically, what staffing, skills and management systems will be required? Will the management information system accommodate the new product or product changes? Does the MFI have the financial resources to undertake the proposed innovations?

MFIs should resist the temptation to try to do it all on their own. If the proposed product will be too taxing, consider providing the product in partnership with others. This solution is particularly applicable to insurance and non-financial services, and to savings if the regulatory environment prohibits a MFI from mobilizing voluntary deposits.
Finally, the prototype should also be accompanied by three additional preliminary studies:

i. **Break-even analysis.** This study includes projections of costs and revenues, and a break-even time line. While many of the original assumptions will be pure guesswork, if the projections do not stand up to early scrutiny, it is not worth conducting the pilot test.

ii. **Risk analysis.** Offering a new product carries risks to the institution. Managers should assess what and how much the institution might lose if the product fails to attract clients, costs more than anticipated, or has other negative side effects.

iii. **Context analysis.** Poor people access financial services of varying degrees of quality and from a range of sources, both formal and informal. It is important to consider what competitive services this product would be up against, if any, and to review the other two aspects of the context: (i) What do the current and projected macroeconomic conditions mean for this product? (ii) What are the regulatory implications of this product?

The various analyses that accompany the prototype do not need to be formal presentations with glossy covers. At this stage, all of the thinking is preliminary, pending real results from the field that comes from the pilot-testing phase.

d) **Test the Product**

The pilot test is the critical phase in the product development process. The analysis thus far has been theoretical: What is the estimated demand and how much does the organization think customers would be willing to pay? But an expressed interest does not always translate into an actual demand. The pilot test moves the process from the theoretical to the practical and includes the following considerations:

i. **Purpose.** The pilot test uses a controlled environment to determine the actual demand for the new product or product refinements. It enables the MFI to see how the performance of the product compares to its assumptions. The pilot test also enables the organization to collect more information about customer preferences and behaviour to refine the product before making it widely available, or to shut it down entirely if it appears unlikely to succeed.

ii. **Location.** The pilot test needs to take place in an environment that is easy for the R&D team to monitor, such as branches that are close to headquarters. The pilot should take place with branches that are reasonably representative of the intended market so that the conclusions from the pilot can be generalized. Ideally, some of the field staff involved in the pilot test should be members of the R&D team.

iii. **Duration.** The length of the pilot depends on four factors. First, the iterative refinement process needs to continue until the MFI hone in on the product that it is actually testing. Second, the performance of the refined pilot product needs to mature — for example, with contractual savings and term loans, the MFI wants to see if customers renew their participation when the term ends. Third, most products will be affected by seasonal changes, so it is important to see how they perform during holidays and rainy periods. Finally, MFIs in competitive markets may not be able to test for the ideal period if they want to be the first ones to get a product to the market.
iv. **Evaluation.** The pilot is designed to test the assumptions that were made in the preliminary analyses during the prototype stage. The information from the pilot test is therefore used to go back to answer the “Design the Prototype” questions, but this time with actual performance information. Now the organization should have sufficient information to make realistic cost and revenue projections to see if the product is financially viable.

The pilot study provides information on actual customer behaviour, but during the evaluation it is also necessary to conduct another round of focus group discussions with clients who participated in the pilot to understand what they think about the product. MFIs should evaluate the results of the pilot very critically – based on a set of criteria established before the pilot started – and not just use the evaluation to justify the roll-out. There is a natural tendency to want to launch a product after investing so much into getting it through the pilot stage. If the results from the pilot do not point conclusively to a successful roll-out, then refining and testing should continue, or the product should be withdrawn.

e) **Launch the Product**

If the evaluation of the pilot test concludes that the MFI should launch the new product or product refinement, then the hard work begins. Before the product is available on a large scale, it is necessary to:

- Obtain board approval
- Secure funding
- Develop policies and operations manuals
- Train staff members
- Establish a marketing strategy and prepare marketing materials
- Prepare financial management systems, and
- Develop internal controls.

If the preliminary findings from the pilot seem positive, some of these activities can take place before the pilot evaluation is completed so that the roll-out can get under way fairly quickly – a strategy that can help speed up the process in competitive markets.

The MFI should monitor and manage the launch very carefully. It is not sufficient to train field staff and then send them on their way. The organization needs to observe staff interacting with clients to ensure that the delivery is working, the message is clear, and staff members have answers for all the clients’ questions. Follow-up training may be required.

Product launch does not necessarily mean that the new product is immediately available everywhere. In large MFIs, the line between pilot testing and roll-out may be blurred; instead, the number of branches participating in the pilot is gradually expanded. In this cautious scenario, refinements are regularly incorporated into the product as the circle of participating branches gets wider. The implementation should also improve as the circle widens, since the MFI can work out the problems and improve staff training along the way (see Box 6.2).
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Box 6.2 Problems of Rapid Roll-out with Savings Products

After evaluating the pilot results and determining that they are satisfactory, the institution can gradually expand its savings services to all branches, conducting staff training as the expansion moves from region to region. The key word is "gradually".

One bank manager who sought to roll-out savings directly from the pilot to all of the bank’s branches learned the hard way. Systems were not ready, staff members were insufficiently trained, and logistical problems were severe. When the savings programme opened, depositors found long lines, harried staff and disgruntled customers. I talked with a saver who had opened an account at her local branch as soon as it was available. I met her again two weeks later when she was standing in a long line, waiting to make a withdrawal. This was her third attempt; on the other two occasions she was not successful because the computer was down. Again the computer was down, so she asked to close her account.

The bank lost about a year in its savings efforts because it moved too quickly at the roll-out stage; it then had to go back and put in place what should have been there in the first place.

Source: Adapted from Robinson, 2001.

One of the major obstacles to the product development process is inertia. The R&D team needs to find ways to overcome the natural resistance to change that they will encounter as they try to introduce the product throughout the organization. Several strategies to reduce resistance have been highlighted, but are worth reiterating:

- A cross-functional team with representatives from each department drives the R&D process.
- The R&D team regularly communicates with, and solicits suggestions from, employees throughout the organization.
- The MFI launches the product with appropriate training and incentives for “sales” staff.
- Most problems associated with the product design and delivery are fixed during the pilot phase.
- “Pilot” staff are involved in training their peers.
- The organization cultivates a culture of continuous improvement so that employees are ready for change and even embrace it.

Finally, the launch of the product does not mean that the development process is over. Product development is ongoing. MFIs should continue listening to their customers and make adjustments as necessary.

6.5 Conclusions: Characteristics of Successful Product Development

Despite the very structured approach to product development presented in this module, in reality the process is not linear. Managers may engage in many elements of the process at the same time. Therefore, it is perhaps more important to consider the characteristics of a suc-
successful product development process rather than strictly following a prescribed path. When developing or improving products, consider the following ten lessons and recommendations:

1. **Be open-minded.** Product development requires imagination. Innovative ideas come from people who question assumptions and recognize that things do not have to be the way they have always been. Step back and look at the big picture — see the forest and not just the trees.

2. **Solicit client feedback continuously.** Product development has to be based on the foundation of good market research. Seek out customer opinions throughout the product development process.

3. **Assess capacity.** All organizations should strive to improve their existing products; but not everyone is ready to engage in new product development. Of particular concern is whether an organization has the (1) financial resources, (2) human resources, and (3) management information systems (MIS) flexibility to move forward.

4. **Be participatory.** The product development process should involve representatives from each part of the organization to ensure that all perspectives are considered and to create a broad base of ownership over the product.

5. **Take it one step at a time.** MFIs that try to accelerate the product development process, or attempt to develop several new products at once, are lessening their chances of success.

6. **Provide sufficient staff training and appropriate incentives:** New products will not succeed if field staff do not have the skills and knowledge to sell them, and if they are not motivated to do so.

7. **Consider linkages:** MFIs do not have to do everything themselves — in fact, with some products like insurance, they probably should not do it themselves. As described in Module 3, linkages with other financial services providers, both formal and informal, might be the way to go.

8. **Make realistic projections:** Often projections made for donors, investors or board members are overly optimistic. In reality, however, managers will look much better if the results from the pilot, or from the roll-out, exceed expectations, not fall short.

9. **Do not be afraid to pull the plug.** Even though the MFI, and especially the R&D team, has invested a lot in developing the product, they may have to cancel if the conditions are not conducive or if the results are poor.

10. **Expect problems along the way.** Product development is an ongoing process, fraught with complications. To develop and improve their products, MFIs have to be prepared to overcome many obstacles.

Finally, one of the biggest pitfalls that many organizations experience in product development, especially when they are improving their existing products, is that they do not consider the broader implications. Sometimes small changes have unforeseen and undesirable consequences. A new product may (1) interfere with the efficient delivery of other products, (2) dangerously divert senior managers’ attention, or (3) create incentives for clients to behave in an unexpected or undesirable manner.
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Main Messages

Besides the lessons and recommendations above, the additional main messages from this module are:

1. The top priority is to improve existing products for existing clients.
2. Develop products that are valuable to the MFI and the client – look for the overlap.
3. A cross-functional R&D team, led by a product champion, is critical.
4. Pilot test!
5. Product development is a continuous process.
6. Monitor the delivery to learn from both client and institutional experiences

Case Study: Unconventional Product Development in Uganda

The Uganda Microfinance Union (UMU) breaks with conventional wisdom in its approach to product development. The institution offers several loan products, all geared to meet the needs of its customers.

Unlike most programmes whose services are shaped by a model, the UMU shapes its services to its market, choosing and changing the model to meet customers’ needs. “Our approach to product development is simple,” says co-founder Rodney Schuster. “If a potential or current customer wants a new kind of loan, we try to say Yes. First we determine if the loan fits within our existing framework, even if it stretches the boundaries some. If it does, we move forward. For example, one client — a good one with a track record — wanted to borrow an amount larger than we were offering. We said Yes and have monitored this loan closely. If successful, we might offer larger loans to other good clients.”

What if the loan does not fit the current framework? “We still try to say Yes,” says Schuster. “We will go to the trouble of developing a new loan as long as we identify a market — a solid block of similar customers also interested in the product. We then design and test the new loan for a year and closely monitor its performance. For example, we recently gave a loan to a new type of customer, a local school. School fees ebb and flow throughout the year, with income dipping to its lowest point when school is out of session. However, that is the best time for a school to upgrade assets and infrastructure – repair a classroom, improve a playground, build an office. We created the Development Loan as a test to help one school. If the loan allows the school to make a good investment and pay us back based on cash from school fees, we will look to a broader launch, maybe within just one branch. From there we can expand to other branches. Creating a new loan, of course, is only worth the effort if the size of the potential market warrants it. Uganda has thousands of schools so in this instance we know we have a market.”

Even UMU’s bread and butter loans, its Working Capital and Capital Asset loans, are made for the market. While they require a group guarantee, members may borrow at different times for different terms. Savings are also flexible. Customers may withdraw savings whenever they wish. This flexibility keeps customer retention high (less than 10 percent drop-out per year), far higher than other microfinance programmes in Uganda.
The organization’s philosophy is to offer loans the customers want, when they want them. To keep agile, the UMU’s watchword is change. “From the very beginning,” says Schuster, “we have inculcated change as a supreme value. We even say to new staff, ‘Group lending is not our model; change is our model.’ We knew that if we did not make change our guiding principle, staff would get comfortable with one model and soon that model would be cast in stone. As soon as we get too comfortable, we will lose our competitive edge.”

Recommended readings:


Communicating Value

Having introduced market research and product development in the previous modules, it is now necessary to take another step up the pyramid and tie these two subjects together into the marketing theme of communicating value.

In many markets, this has not been a priority for MFIs, perhaps because the demand for their services was so high, or perhaps because they did not have any competition, or both. But the situation is changing in many countries. In some places, MFIs have exhausted the supply of easy-to-reach customers and are now looking to attract persons who are more reticent. Or the competition has increased, and MFIs have to find ways of distinguishing themselves from their competitors. Either way, managers need to develop techniques to communicate to the market the value that the MFI offers through its products and services.

The process of communicating value consists of the four elements covered in this module:

1. Segmenting the market
2. Developing valuable products and services
3. Preparing your message
4. Using the marketing communications mix

7.1 Segmenting the Market

As discussed in Module 5, it is necessary to consider the different needs and preferences of different subsets of the market. This process of market segmentation is also important for communicating value as different messages and communication channels will be more relevant for different market segments. An MFI can segment its market in numerous ways, for example according to:

- **Demographics:** gender, ethnicity, age, household size, education, religion
- **Geographic variables:** location, population density
- **Type of business** or economic sector of employment
- **Level of income**
- **Source of income:** salaried, self-employed
- **Psychographic variables:** personality, lifestyle, likes and dislikes, values, attitudes
- **User status:** ex-user, potential user, first-time user, regular user
- **Usage frequency:** heavy, medium, light or non-users
- **Usage intensity:** large, medium and small depositors

The content of this section was adapted from:

- Wright et al. (2003).
- Handouts 7.3, 9.4 and 9.5 of the MicroSave Product Marketing Toolkit, available at www.microsave.org
- **Size of business**: perhaps with loan size as a proxy
- **Attitude** towards a product or institution: enthusiastic, positive, indifferent, negative
- **Financial service needs**: savings, money transfer, insurance
- **Benefit sought**: low price, high quality, excellent service

Not all of these options will be useful. MFIs must determine which kind of segmentation makes most sense based on the key dimensions that distinguish customers’ needs.

The segmentation process is based on market research. The Small Enterprise Foundation in South Africa, for example, used a participatory wealth ranking system to categorize members of a community by poverty level. Elsewhere, *MicroSave* has used exit interviews to identify which market segments are most appropriately served by a solidarity group loan product. Once an MFI has identified particular market segments, it can and should conduct additional research to shed light on the characteristics and preferences of each segment.

**Why Segment your Market?**

The process of market segmentation enables an MFI to:

- **Deepen its understanding of its current customers**. What different groups of customers does the MFI serve? How do their preferences differ? Do regular users of a product have certain characteristics in common? What about loyal customers, or borrowers with poor repayment records: do they share any characteristics? Which customers would the MFI like more of, and how can you reach this type of customer?

- **Identify opportunities for future business development**. Which market segments is the MFI currently not serving? Why is it not serving them? What might the institution do to make its services more attractive to them?

- **Increase product strategy options**. An MFI that does not segment its market will limit its options in terms of product differentiation. Segmentation provides the option of targeting products to more closely meet the needs of customer groups.

- **Price products more appropriately**. Segmentation allows an MFI to make more delicate trade-offs between price, quality and service, which increases the overall value of the product for customers.

- **Make more efficient use of the institution’s resources**. An MFI cannot be everything to everyone. By understanding the customers that it could serve, and carefully selecting the ones it is in the best position to serve, the MFI can more sharply focus its resources on products that have the greatest impact.

- **Achieve more effective outreach**. Market segmentation can assist an MFI in reaching a specific outreach objective, such as serving clients with a particular poverty level. By identifying and focusing on the segments that it most wants to serve, an MFI can concentrate on meeting the needs of customers in that segment.
In sum, by segmenting the market, an MFI can increase the options for the product development overlap. Instead of assuming that clients have essentially the same needs and preferences, the MFI caters to clients with varied needs and preferences, as depicted in Figure 7.1.

**Figure 7.1 Enhancing the Product Development Overlap through Segmentation**

Many MFIs have found it useful to segment their market by gender and to specifically target women, but more detailed segmentation would enable these institutions to serve particular subsets of women better. According to Brand and Gerschick (2000), some institutions have experimented with segmentation by psychographic characteristics, which have proved to be strong predictors of client behaviour. BancoSol is incorporating a borrower classification system into its regular application process so that it can build a more detailed, dynamic profile of different market segments and tailor its product terms accordingly.

**How to Target Segments**

Before selecting among potential market segments, managers should make sure that the customer groups under consideration have the potential to be effective market segments. An effective market segment should be:

- **Identifiable.** Can you describe the customers in the segment with several characteristics in common?
• **Measurable.** Can the size, purchasing power and characteristics of the segment be measured?
• **Accessible.** Can you effectively reach and serve the segment?
• **Substantial.** Is the segment large and profitable enough to serve?
• **Differentiable.** Is there something unique about the segment’s response to different marketing strategies and communication channels that distinguishes it from other segments?
• **Actionable.** Can effective programmes be formulated to attract and serve the segment?

Once an MFI has identified possible market segments, it should target those segments where it can most successfully achieve its objectives. MFIs will have different reasons for wanting to target a particular segment, but ideally organizations will examine their abilities and resources, and focus on the segments whose needs they can meet most effectively.

An MFI can choose to communicate value to one segment or to several segments, but if it chooses more than one, each segment should receive a different product offering. According to Ferreri (1999), “The more individual segments to which you market, the more campaigns you’ll need, which of course, increases production and media costs. This may tempt you to use the same campaigns for several different markets. Don’t do it — it’s a false economy. If your campaign looks like it speaks to two different markets equally well, it probably doesn’t address either market effectively. You can’t be all things to all people. Heck, you can’t even be all things to two people. Remember, one campaign per market.”

### 7.2 Developing Valuable Products and Services

After identifying the relevant market segment(s), managers need to determine what value they are trying to communicate.

**Identifying Value**

> No matter what business you are in or what you are selling, your customers always want the same thing: value. ~ Jack Ferreri

In its market research, an MFI should not only gather information on client needs, but also look for insights into preferences and value. It should research its competitors and the kind of benefits they provide at what cost. And it should analyse its own strengths, weaknesses, abilities and resources. With this information, it can make a strategic decision about where to position itself relative to its competitors in delivering products that its target market will find valuable. There are two relatively simple ways to go about this.
First, an MFI can plot its comparative advantage on the value triangle (see Figure 7.2). This triangle portrays value as a balance of three elements:

1) **Price**: including the interest rate and other fees
2) **Product quality**: a customized or tailored loan product will have greater product quality than a standardized product that treats all borrowers the same
3) **Customer service**: is the product delivered in a convenient, service-oriented environment by knowledgeable and considerate employees?

Experience has shown that companies can succeed by concentrating on being the best in one particular area, or by being very good in two out of the three areas. They fail, however, when they try to deliver a little bit of everything to everybody, but deliver nothing special to anyone.

![Figure 7.2 The Value Triangle](image)

In the middle, an MFI cannot differentiate itself from its competitors and it will be competing with everyone – those who focus on offering the best price, those who focus on offering the highest quality and those who focus on offering the best service. What can an MFI in the middle offer by comparison? An average product at an average price with average customer service: not an attractive offering. MFIs should not fool themselves into thinking they can be the best in all three areas at once. There is a cost, after all, to quality products and better service.

Customers who want a more convenient or personalized product will be willing to pay more for those benefits, which leads to the second strategy for identifying value. Kotler et al. (2001) define a value ratio by dividing what a customer gets by what he or she gives. In other words:

\[ \text{Value} = \frac{\text{Benefits}}{\text{Costs}} \]
To survive in a competitive marketplace, MFIs do not have to charge the lowest price. They can reduce customers’ transaction and opportunity costs, for example, or add benefits to make their product offering more attractive. They can even charge a higher price as long as they deliver greater benefits. Under these scenarios, an MFI can increase its value. Which scenario is the best? The answer depends on the target market’s preferences, and the MFI’s mission, resources and capabilities, as well as the relative strengths and weaknesses of its competitors.

Whether an MFI thinks about its value position in terms of the value triangle or a cost-benefit ratio, it is important to know what kind of value it wants to provide, and what kind of value customers currently think it provides (see Box 7.1). This information can assist the MFI in developing a message and a promotion strategy that more effectively communicate what the institution has to offer.

**Box 7.1 Questions an MFI Might Ask as it Considers the Value Triangle**

- Are we more expensive than most of our competition?
- Do we provide higher product quality than our competition?
- Do we provide more service with our product?
- Where would we currently plot ourselves in the triangle?
- Where in the triangle do our customers currently place us?
- Do we like where our customers position us? Is that where we want to be? Is that the best position for our long-term success?
- What can we do to change the way customers think of us? How can we position ourselves differently in the market?

**Enhancing Value**

The value that an MFI delivers will be determined by its 8 Ps, a tool that MFIs can use to pursue their marketing objectives (see Table 7.1).
Table 7.1 The 8 Ps of Marketing

<table>
<thead>
<tr>
<th>The “P”</th>
<th>Details of the “P”</th>
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<tr>
<td><strong>Product design</strong></td>
<td>Specific features such as minimum balances, loan terms; also ancillary aspects</td>
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<td></td>
<td>such as collateral or guarantees, repayment schedules and structures (e.g., balloon</td>
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<td>payments or interest-free grace periods, etc).</td>
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<tr>
<td><strong>Price</strong></td>
<td>Interest rate, withdrawals costs, loan fees, prepayment penalties, prompt payment</td>
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<td></td>
<td>incentives, transaction costs, etc. The price needs to be considered fair by the</td>
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<td>customer given the benefits provided by the other 7 Ps, while generating enough</td>
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<td></td>
<td>revenue to cover the institution’s costs of providing those benefits.</td>
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<tr>
<td><strong>Promotion</strong></td>
<td>Advertising, public relations, publicity, and all aspects of sales communication</td>
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<td>(see Section 7.4).</td>
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<tr>
<td><strong>Place</strong></td>
<td>Distribution, making sure that the product/service is available where and when it</td>
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<td></td>
<td>is wanted. This includes such options such as outreach agents, mobile bankers and</td>
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<td></td>
<td>ATMs. From the customer’s perspective, place refers to convenience and accessibility</td>
</tr>
<tr>
<td></td>
<td>of the product or service being offered.</td>
</tr>
<tr>
<td><strong>Positioning</strong></td>
<td>Is the MFI occupying a distinct competitive position in the mind of the target</td>
</tr>
<tr>
<td></td>
<td>customer? This could be in terms of low transaction cost, low price, high quality,</td>
</tr>
<tr>
<td></td>
<td>security of savings, quick turnaround time, professional service, etc. It is a</td>
</tr>
<tr>
<td></td>
<td>perception. The positioning of products needs to be consistent with the overall</td>
</tr>
<tr>
<td></td>
<td>positioning of the institution.</td>
</tr>
<tr>
<td><strong>Physical evidence</strong></td>
<td>Makes the MFI and its intangible services visible. It includes the presentation</td>
</tr>
<tr>
<td></td>
<td>of the product, how the branch looks, whether the chairs are comfortable, the</td>
</tr>
<tr>
<td></td>
<td>appearance of the brochures, posters and passbooks, etc.</td>
</tr>
<tr>
<td><strong>People</strong></td>
<td>How are clients treated by the MFI’s staff? Are they treated with the courtesy</td>
</tr>
<tr>
<td></td>
<td>and attention befitting a customer? Are they made to feel welcome?</td>
</tr>
<tr>
<td><strong>Process</strong></td>
<td>The way in which product and services are delivered; how the transaction is</td>
</tr>
<tr>
<td></td>
<td>processed and documented, the queues, the forms to be filled, etc.</td>
</tr>
</tbody>
</table>

Source: Adapted from Wright, 2000.

MFIs can use the 8 Ps to help them build customer-responsive products. An MFI can also use the 8 Ps to distinguish itself in the marketplace (see Box 7.2). In fact, the more common the product (for example, a generic solidarity group loan or a basic savings account), the more important it is to use the 8 Ps to communicate differences in the product offering.

MFIs can, and should, use a different marketing mix for each product and for each market segment. Each “P” does not need to change from one segment to another, but the mix as a whole should cater to the market’s particular needs and preferences. Each set of 8 Ps must be consistent with the institution’s resources, business strategy, image and culture. Individual elements should also be consistent, so that as a whole they can convey a coherent message.
Box 7.2 MFI Differentiation Strategies

- Focusing on personalized customer service
- Offering different loan sizes from the competition
- Offering a broader range of financial products
- Offering more flexible access to credit
- Adding non-financial products for clients who want broader services than credit
- Offering faster loan processing than the competition
- Being the oldest MFI in the country, the market leader
- Offering lower interest rates

Source: Adapted from Grant, 2001.

7.3 Preparing Your Message

Before selling a product, an MFI must prepare the message that will announce the product’s existence. This important step in the marketing process is often underrated. Somehow, the act of communication — the radio or newspaper advertisement, the product brochure or the smile on the customer service officer’s face — is given more attention than the message that will be delivered in that advertisement, brochure or conversation. Even if an organization has done excellent market research and has a quality product, clients will not buy it unless the MFI communicates how the product meets their needs and, in a competitive environment, how it meets their needs better than anyone else.

When preparing their marketing message, MFIs should pay particular attention to their benefit statements, their brand and the design of their promotional materials.

Benefit Statements

Customers do not buy products; they buy solutions to problems. If a competitor offers a better solution, even with a completely different product, customers will defect to the better solution. ~ Kim Wilson, “Marketing Myopia”

Customers do not buy products and services; they buy benefits or the value that they expect to derive from those products and services. For example, the customer looking for a drill is not really looking for a piece of equipment; what he or she needs is a hole in something.
What is an MFI really selling? A loan? No. A solution to a problem. What solution? That is what the MFI must clearly explain in its marketing message. One way for an MFI to identify the benefits that its product offers is to:

1. Make a list of the product's features in each of the "8 P" areas.
2. Translate each feature into a short benefit statement from the perspective of the customer (Box 7.3 provides some ideas about how to view the 8 Ps from the customer's perspective).
3. Use these individual statements to craft an overall benefit statement or message for marketing materials.

**Box 7.3 The 8 Ps from the Customer's Perspective**

<table>
<thead>
<tr>
<th>Feature</th>
<th>Customer Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Price</strong></td>
<td>Clear, Competitive Cost</td>
</tr>
<tr>
<td><strong>Physical evidence</strong></td>
<td>Cleanliness, Creativity</td>
</tr>
<tr>
<td><strong>Promotion</strong></td>
<td>Communication</td>
</tr>
<tr>
<td><strong>Place</strong></td>
<td>Convenience, Comfort</td>
</tr>
<tr>
<td><strong>Positioning</strong></td>
<td>Commitment, Consistency</td>
</tr>
<tr>
<td><strong>People</strong></td>
<td>Courteous, Competent Care</td>
</tr>
<tr>
<td><strong>Process</strong></td>
<td>Concise, Confidential</td>
</tr>
<tr>
<td><strong>Product</strong></td>
<td>Customer solution</td>
</tr>
</tbody>
</table>

Some product features may not translate into customer benefits, but most will. Of course, not all benefits will be attractive to all markets. Rather, the sum of product benefits provides an MFI with its most powerful sales tool. Sales staff will need to be sensitive to the needs and responses of the target market to ensure that the product's benefits are appropriately pitched.

*MicroSave* suggests that the benefit statement can position the MFI in three ways:

- **Superior**: Delivers valued benefit; better, faster, longer lasting than the competition.
- **Distinctive**: Offers a unique feature important to the customer
- **Image**: Affiliates the product with something the customer values

An effective benefit statement should answer these questions:

- Our service offers the following benefit ...
- To the following customers ...
- Our service is unique in the following manner ...
- We can prove we are unique because....
Building a Brand

A brand is a complex symbol. It is the intangible sum of a product’s attributes, its history, reputation and the way it is advertised. A brand is also defined by consumers’ impressions of the people who use it, as well as their own experiences. ~ David Ogilvy

A brand is the relationship between an MFI, its products and its customers. It includes the institution’s name and logo, but it also includes the promises, personality, values and expectations that customers attach to that brand name and logo. A solid, attractive brand is an extremely important part of marketing because it can provide:

- **Instant recognition.** Consumers feel they know the institution and what they can expect from it.
- **Differentiation.** A well-branded MFI stands out from the crowd in a competitive market.
- **Credibility.** Consumers can trust the organization, which is particularly important for savings and insurance.
- **Warranty.** A brand provides a certain level of assurance with respect to the quality and reliability of services offered by the MFI.
- **Facilitated promotion.** The sales team can spend less time explaining what the MFI is, and more time communicating its competitive advantages and products.
- **Word-of-mouth marketing.** Customers can easily recommend the MFI and its services, and those hearing the recommendation can remember the MFI’s name.
- **Goodwill.** The MFI is better equipped to overcome problems, and better positioned to talk to stakeholders above and beyond its existing customers.

Effective branding can greatly facilitate an MFI’s efforts to communicate the value it brings to the market. It can make purchasing decisions easier for its customers, create emotional attachments to the MFI and ultimately help build customer loyalty (see Box 7.4).
Markets and Marketing

Box 7.4 Branding Success at Caja Los Andes

The more closely customers identify with an institution’s brand, the stronger the customer satisfaction and overall client retention, which in turn enhances efficiency. For example, Caja Los Andes’ brand is defined by its individual (vs. group) lending products and streamlined delivery. Its agile lending system, which involves fewer guarantees and a simpler application process than most of its competitors, reinforces this brand image so much that Caja Los Andes actually spends relatively little on explicit promotions. As a result, its retention rate has been higher than that of its competitors. Not surprisingly, its efficiency ratio is also stronger than that of most of its competition.

Source: Adapted from Brand and Gerschick, 2000.

There is no step-by-step procedure for building a brand. Brand development is an ongoing process that typically begins with the selection of a brand name. An effective brand name will possess some or all of the following qualities:

<table>
<thead>
<tr>
<th>Brand effect</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suggest something about the product’s benefits</td>
<td>Compartamos’ “CreditoIndividual” – an individual loan product</td>
</tr>
<tr>
<td>Suggest product qualities such as speed or reliability</td>
<td>Tanzania Postal Bank’s “Domicile Quick Account” – a computerized branch-based savings account</td>
</tr>
<tr>
<td>Be easy to pronounce, recognize, and remember; short names help</td>
<td>Mibanco’s “MiCasa” – a home improvement loan</td>
</tr>
<tr>
<td>Be distinctive</td>
<td>Equity Building Society’s “Jijenge” – a “build it yourself” savings product</td>
</tr>
</tbody>
</table>

After choosing a brand name, the MFI must give it meaning. It must communicate the attributes, benefits, values and personality that it wants the public to associate with the brand. It must communicate who it wants to buy the product and what kind of relationship it wants to have with those customers.

The organization can use a unique selling proposition (USP) to articulate what sets it apart from the competition. This statement of competitive advantage should be relevant to the target market and simple, so that customers can easily understand what the MFI is promising; for example, “the largest branch network in the country.”

Brand meaning is cultivated through slogans or taglines, such as BancoSol’s “Juntos Crecemos” – “Together we grow”. Symbols, colours and logos make the brand easily recognizable and memorable. Finally, pictures and stories make a brand come alive and convey who the institution serves and what kind of service it provides.
Some helpful hints for MFIs as they build their brands include:

- Make sure the brand name is consistent with the position the MFI is taking in the value triangle
- Keep brand associations simple and clear
- Check product branding against that of the competition to ensure there is no potential for confusion
- Use product brands that reflect the institutional brand (see Box 7.5)
- Test customer perceptions of brand names and images before launching them
- Remember that everyone, from the Chairperson to the cleaner, is responsible for maintaining the brand

**Designing Promotional Literature**

Once an MFI has defined the core components of its marketing message, it is ready to put them into a tangible package that can be distributed to customers and used by MFI staff as sales tools. In designing this literature, MFIs should consider the following:

- Start with a **statement of benefits**. Remember, clients do not buy features or even products, they buy benefits and solutions.
- **Consider the audience**. Make sure that the language, detail and tone are appropriate for the target market.
- **Be clear and concise**. The literature must be easy to understand and not create confusion about product features or requirements.
- **Be creative**. The literature needs to be interesting if anyone is going to read it. Use graphics, photos, pictures and colour.
- **Be consistent**. If an MFI has a series of brochures describing different products, use common themes, colours, layout and size to tie them together and strengthen the overall brand.
- **Be distinctive**. Potential clients are likely to compare an MFI's literature with that of the competition. Thus, an MFI should create something distinct and more attractive for itself.
- **Consider regulatory requirements**. If the service is regulated, there may be strict guidance as to what information must be in the product literature. The marketing challenge is to present this information in a user-friendly way.
- **Keep prices out of it**. Prices must change and each time they do, the MFI will have to throw away its promotional literature. To avoid waste, print separate price sheets to be inserted into the brochure or made available alongside it.
- **Test the literature** among groups of potential customers to ensure that it is attractive and effective.
7.4 Using the Marketing Communications Mix

The next step in the marketing process is for an MFI to communicate its value to potential customers through the five components of the marketing communications mix: a) personal selling, b) advertising, c) sales promotions, d) public relations and e) direct marketing. An MFI can draw from any or all of these strategies to create a sales strategy that:

- Is appropriate for its products, target market and available resources
- Clearly conveys what the institution has to offer
- Differentiates its offering from that of the competition
- Encourages potential customers to buy

*Just having a better product is not enough. You have to let customers know about it and why it's better. Then you have to convince them it is better.* ~ F. John Reh
a) **Personal Selling**

Personal selling is face-to-face salesmanship. It is the most direct, the most personal and the most commonly used microfinance sales technique. To make the most effective use of a personal selling strategy, MFIs should:

- **Establish common sales approaches** so that agents explain product benefits in a similar, consistent and appropriate manner, recognizing that different products will require different approaches (see Box 7.6).
- **Define transparent and fair incentive schemes** for the sales force. MFIs using personal selling can set targets by team, region and/or person, and should ensure that the sales team buys in to those targets.
- **Adequately prepare staff to sell the institution, its products and its services.** Sales training includes specific product information, institutional knowledge and marketing techniques. Sales persons need to cultivate communication skills, such as the ability to read body language, listen and empathize with the customer and be courteous yet confident.
- **Provide sales staff with support materials**—brochures, Frequently Asked Questions (FAQ) sheets, etc.—in **Clear, Concise, Client language.**
- **Educate clients** and respond to their questions, as well as obtain information from them that can be fed into future marketing activities. This is particularly important in a competitive market where clients have several options and want to ask questions about the service before choosing which MFI to use.

**Box 7.6 Different Financial Products, Different Marketing Strategies**

The sale of savings, credit and insurance products are quite different. When developing a marketing strategy, it is important to consider (among other things) the risk relationship between the institution and the client.

With credit, the MFI puts its money at risk. Despite intentions to reach large volumes of people, microfinance institutions need to carefully select creditworthy applicants. Not all poor people are good credit risks. Credit should not be oversold because if the supplier aggressively drives outreach, it will invariably reach an increasingly risky market. For savings, the risk roles are reversed. Depositors need to trust that the institution will be financially solvent and safeguard their assets. Savers can fairly easily test whether their money is accessible and secure by withdrawing their funds.

The risk relationship with insurance is more complex. As with credit, there is a screening element to ensure that the client pool does not include an over-representation of high-risk individuals. But like savings, there is a critical need for prospective policyholders to trust the institution. Unlike depositors, however, policyholders cannot easily test whether the insurer will fulfil its obligations—with life insurance, the policyholder has to die before the insurer has to respond.

The risk relationship between client and insurer has direct implications for selling insurance. To convince customers to trust the institution, sales techniques need to present the insurer as solid and viable, with an impeccable reputation, an organization that keeps its word, and one that will be there for its clients in their time of need. If these
characteristics do not describe the MFI — perhaps because it had a history of disbursement delays, fraud or processing errors — then it must significantly improve its reputation before it considers offering insurance.

It is relatively easy to sell insurance to high-risk people. To build a representative risk pool, however, the MFI needs a marketing strategy that identifies and appeals to low-risk clients. To encourage low-risk persons to purchase life insurance, for example, one strategy is to use the power of imaging to help the customer consider what happened to the dependants of the deceased and how their situation could have been less dire if the deceased had life insurance.

If this approach seems distasteful, it is important to recognize that the demand for insurance is softer than the demand for other financial services. People want safe places to save their money, and many are eager for the injection of capital that credit provides, but they are less enthusiastic about purchasing insurance. The softness is partly due to the fact that most people do not like to think about death and other risk events. To sell insurance, a salesperson has to harden the soft demand, which involves bringing the risk to life and making it real.

Source: Adapted from Churchill et al., 2003.

b) Advertising

Advertising is designed to generate demand without face-to-face communication. An MFI pays for media space or time to sell its products at a distance, in hopes of reaching more potential customers more quickly at a lower cost than through personal selling. Designing an advertising campaign is a four-step process:

1. Knowing your objectives. Ensure that everyone in the campaign understands the purpose of the advertising: what are the objectives and on what criteria will the campaign be judged? The objectives will dictate the type of message, the way it is conveyed and the media used. The most common objective will be an increase in the number of sales, although the campaign may also strive to increase name awareness or to enhance the brand.

2. Agreeing on a budget. Advertising costs money — in some cases, a great deal of money. The budget and the objectives will go hand-in-hand: the size of the objectives and the purpose of the advertising dictate how much money will be needed. It is no use having ambitious targets unless there is an adequate budget to support them.

3. Crafting a clear, creative and concise message. The creativity of the message will often determine the success or failure of the campaign. However, creativity must not interfere with clarity. The message should be simple and straightforward, in a language that the target market will understand and relate to. It should also be tested with a few customers before the campaign proceeds.

4. Selecting an appropriate channel. The final step is to determine the type of media to use. The available budget will have a big influence on this decision, as will the target audience and the purpose of the campaign. MFIs should conduct adequate research (or use a media planning agency) to identify which media channels are likely to reach the intended
market segments most cost-effectively. The general advantages and limitations of major media types are summarised in Table 7.2.

Traditionally, MFIs have organized advertising campaigns to coincide with the opening of a new branch. They use the event to publicize the institution and its products using newspapers (both special articles and advertisements), radio, television, and broadcasting cars. These mass-media channels are accompanied by street theatre, brochures, posters, leaflets, flyers, calendars, billboards, banners, bumper stickers or other items. MFIs may also involve local leaders or celebrities in major product or office launches to attract attention, generate enthusiasm and build credibility.

**Table 7.2 Profiles of Major Media Types**

<table>
<thead>
<tr>
<th>Media type</th>
<th>Advantages</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newspaper</td>
<td>Flexibility; timeliness; good local market coverage; broad acceptability; high believability; allows some targeting (can choose a newspaper read by the target audience).</td>
<td>Short life-span; poor reproduction quality; competitors are likely to advertise there as well; small pass-along audience; not appropriate for illiterate market.</td>
</tr>
<tr>
<td>Television</td>
<td>Good mass-marketing coverage; low cost per exposure; combines sight, sound, and motion; appealing to the senses.</td>
<td>High absolute costs; high clutter; fleeting exposure; nature of viewers is difficult to predict; difficult to target market segments.</td>
</tr>
<tr>
<td>Radio</td>
<td>Good local acceptance; high geographic and demographic selectivity; low cost.</td>
<td>Audio only, fleeting exposure; low attention (&quot;the half-heard&quot; medium); fragmented audiences.</td>
</tr>
<tr>
<td>Magazines</td>
<td>High geographic and demographic selectivity; credibility and prestige; high-quality reproduction; long life and good pass-along readership.</td>
<td>Long advertisement purchase lead time; high cost; no guarantee of position; limited applicability for typical microfinance client, but perhaps relevant for some market niches.</td>
</tr>
<tr>
<td>Billboards</td>
<td>Flexibility; high repeat exposure; low cost; low message competition; good positional selectivity.</td>
<td>Little audience selectivity; creative limitations.</td>
</tr>
</tbody>
</table>

c) **Sales Promotions**

Sales promotions are used by MFIs to stimulate demand. These promotions typically have the following characteristics:

- **Time-bound:** “Open an account before 31st December and we’ll waive the fees.”
- **Activity-based:** “Bring in 5 new customers and we’ll raise the interest rate on your savings account by 2 per cent.”
- **Segment focused:** “Special offer for students – no minimum balance on this account.”
Sales promotions are short-term activities designed to boost sales for a limited time, or to entice new customers to experiment with the institution’s products and services. Sales promotion techniques used by MFIs include: coupons, special pricing, point of sale offers, contests, rebates, prizes and lotteries (see Box 7.7).

**Box 7.7 Promotional Strategies for Savings Products**

Many financial institutions have specific marketing strategies for their savings products. Experience from BCS (Colombia), BAAC (Thailand), BRI (Indonesia) and RBP (Philippines) has shown that savings lotteries are very popular among depositors. The larger the average balance that depositors have in their accounts, the more lottery numbers they can earn – creating a significant boost to savings balances. The prizes, which may be put on display in the branch office, are especially suited to the preferences of low-income customers, including pickup trucks, motorcycles and household appliances.

Apart from the economic value of the prizes, depositors are attracted by the drawing parties that are treated as important social events. In rural areas, the entire community participates in drawing parties at the local branch, which also attracts new depositors. For the urban clientele, a nationwide lottery transmitted on television seems to be a more promising marketing tool.

Financial institutions also use public relations activities, such as sponsoring social events and establishing links with local authorities and community leaders. Traditional marketing tools such as leaflets and posters are combined with videos, jingles and taped messages. The design of special logos and product labels also attracts depositors. BCS, BAAC and BRI have promoted savings products with self-explanatory names (Save to Win, Grow Every Day Savings, Savings of the Rural Community) and showy product brands. Product labels make it easier for depositors to select the product that best suits their financial needs. In addition, they help to distinguish the products from those offered by competing financial institutions.

*Source: Adapted from Wisniwski, 1997.*

d) **Public Relations**

Public relations are deliberate, planned and sustained efforts to establish and maintain mutual understanding between an organization and the public. Most MFIs get some form of publicity even without trying. A public relations strategy aims to ensure that an MFI gets good publicity.

Public relations based selling efforts are time-consuming and often slow, but they can have a significant and somewhat unique impact. They can have a strong effect on the public’s knowledge and perception of the MFI – its products, its people and its position – at a lower cost than advertising. They can also contribute to building trust and credibility.

The primary task of a public relations strategy is to ensure that there is a steady flow of positive, brand-strengthening stories circulated in the media to build strong links between the MFI and the public. The roles of public relations are summarized in Table 7.3.
Table 7.3 The Roles of Public Relations

<table>
<thead>
<tr>
<th>Press relations</th>
<th>Placing newsworthy information in media appropriate for the target audience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product publicity</td>
<td>Generating positive institution or product-focused publicity</td>
</tr>
<tr>
<td>Public affairs</td>
<td>Developing and maintaining national or local community relations</td>
</tr>
<tr>
<td>Lobbying</td>
<td>Influencing legislation or regulation</td>
</tr>
<tr>
<td>Investor relations</td>
<td>Strengthening relationships with shareholders or the financial community</td>
</tr>
<tr>
<td>Development</td>
<td>Liaising with donors or non-profit organizations to get financial or volunteer support</td>
</tr>
</tbody>
</table>

With such diverse roles, it is important for public relations to be coordinated, planned and targeted to ensure optimal impact and effectiveness. An MFI should examine its key stakeholders, their information needs and the best channel to communicate with them. The variety of public relations tools includes:

- **News**, placed or naturally occurring; for best results the news relating to the MFI should tie into larger-scale current events
- **Speeches**, usually by senior staff at conferences or workshops
- **Special events** such as news conferences, press tours, grand openings or educational programmes – usually these coincide with important events (branch openings, product launches, etc.) or milestones (ten years of operation, the 100,000th loan made)
- **Written materials** such as annual reports, brochures, articles or company newsletters
- **Audio-visual materials** such as videos and slideshows, which are particularly powerful for audiences that cannot get out to see the MFI in the field
- **Corporate identity materials** including logos and signs
- **Public service activities** such as financial advice for low-income families
- **Sponsorship** of events or people; since MFI clients often value education so highly, sponsoring the education of even a few children (selected in a transparent and fair manner) can create excellent community relations and press coverage; other MFIs have sponsored small business fairs, which also provide their customers with marketing opportunities

**e) Direct Marketing**

Like personal selling, **direct marketing** is a sales strategy that directly links an MFI with potential customers. It is a flexible, low-cost and creative strategy that is less visible to competitors. As such, it is both an appropriate and useful strategy for institutions with limited resources. Direct marketing will have the most impact when applied by institutions with databases that are sufficiently sophisticated to allow market segmentation and analysis.
Direct marketing approaches used by MFIs include:

- leaflet distribution
- a marketing kiosk in high-traffic locations
- direct mail
- telemarketing

With direct marketing, it is essential to ensure that the potential customer is given an easy opportunity to respond to the MFI and buy its product. Direct marketing is usually more effective when it is backed up (or proceeded) by an advertising campaign so that potential customers recognize the MFI and its brand before the direct marketing contact is made.

7.5 Conclusions

No matter what marketing strategies an MFI uses, the following general recommendations are worth keeping in mind:

Market Research

- Test your assumptions. Avoid stumbling into the trap of believing there is nothing to be learned about the marketplace.
- Conduct informal “How am I doing?” conversations with your customers on a regular basis.
- Avoid thinking that the market will remain the same indefinitely.
- A strong benefit directed to the wrong market is no benefit at all.
- Your position is all in people’s minds. Find out what that position is.
- Know your competition.
- Evaluate your marketing efforts.

Marketing Strategies

- Announce your marketing activities internally before they take place.
- Pay attention to price, but pay even more attention to value.
- When you market your product, you must not only appeal to the customer (and to each type of customer separately), but you must distinguish yourself from the competition.
- You are never finished marketing.
- Go where others are not.
- Marketing can be dangerous if you cannot deliver what you are selling, if your supply does not keep up with demand, or if what you say you are is not what you really are.
- Where possible, under promise and over deliver!

An effective marketing strategy can help save you money. ~ Lisa Parrott, MicroSave
Sales Tips

- Be professional – but, more importantly, be personal.
- Identify and polish your first impression anchors.
- Sell the benefits, not the features. What is in it for your customer?
- Tell people — in a single compelling sentence — why they should buy from you instead of someone else.
- After you say one thing, repeat it again and again.
- Make your last impression strong.
- Focus on buying rather than selling. Make your service easy to buy.

In conclusion, managers must remember that marketing is not a department; it is their business. Everyone in the organization is responsible for communicating the value of the MFI and its products, and for maintaining the brand. Consequently, managers must market internally as well as externally so that the marketing concept is believed by employees and confirmed by its customers.

Main Messages

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Communicate value in different ways to different market segments</td>
</tr>
<tr>
<td>2.</td>
<td>The middle of the value triangle is like the Bermuda triangle – position your organization in a corner or on the side.</td>
</tr>
<tr>
<td>3.</td>
<td>Use the 8 Ps to build customer-responsive products.</td>
</tr>
<tr>
<td>4.</td>
<td>An MFI's brand should communicate value.</td>
</tr>
<tr>
<td>5.</td>
<td>When designing a marketing strategy, consider the five components of the marketing communications mix.</td>
</tr>
</tbody>
</table>
Recommended readings:

Customer Service

The delivery of quality customer service is one of the most important strategies for an MFI to lift the value of its products above that of its competitors. But what exactly is customer service and how can managers improve it? This module answers these questions by exploring the following five themes:

1. What is customer service?
2. Why should customer service be a priority?
3. Delivering quality customer service
4. Improving customer service
5. Creating and maintaining a customer service culture

8.1 What is Customer Service?

According to one marketing guru, "Customer service is a commitment of all employees in a company to make being a customer a completely positive experience, one that every customer will want to experience time and time again" (Ferreri, 1999). MicroSave's Graham Wright offers an alternative definition: "Customer service is delivering products and services to intended customers in an appropriate, professional and quick manner."

Both of these definitions beg the question: What is it that determines whether a customer will find his or her experience to be positive, appropriate and professional? What do customers care about? Box 8.1 summarizes the ten dimensions of customer care, or ten criteria according to which customers judge the quality of the service that is provided to them.

---

Box 8.1 Ten Dimensions of Customer Care

1. **Tangibles**: a clean, comfortable meeting space, professional-looking brochures
2. **Reliability**: getting it right the first time, honouring promises
3. **Responsiveness**: willingness, enthusiasm, readiness to provide service
4. **Communication**: keeping customers informed in a language they can understand
5. **Credibility**: honesty, trustworthiness
6. **Security**: safe offices, sound institution, where clients' personal information is kept confidential
7. **Competence**: possession of required skills and knowledge of all employees
8. **Courtesy**: politeness, respect, consideration, friendliness
9. **Understanding**: knowing the customer, his or her needs and requirements
10. **Access**: ease of approach and contact, e.g. opening hours, queues, phones

*Source: Adapted from Lewis, 2000.*

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8.2 Why Should Customer Service be a Priority?

Of all the responsibilities managers must fulfill, of all the tasks they must perform, why should customer service be at the top of the list? There are many compelling reasons:

- **Enhance sustainability.** MFIs are in the service business; they will not be able to stay in business very long if they cannot produce and deliver quality financial services.

- **Build word-of-mouth business.** Referrals are the most valuable marketing available to MFIs. The best way to stimulate referrals is to provide memorable customer service. There is also a corollary: bad service destroys business via word-of-mouth. Dissatisfied customers are likely to tell many more people about their bad experiences than satisfied customers about their good experiences.

- **Increase cross-selling opportunities.** Employees who have developed rapport with their customers, and who understand the products they are selling, are capable of identifying customer needs and suggesting other relevant services to them.

- **Overcome competitive disadvantages.** An institution may not have the same financial resources or research capabilities as its competitors, but if it can deliver more value — for example, being responsive, reliable and convenient — it can still compete successfully.

- **Create happy employees.** An MFI that delivers good service to its external customers is more likely to have satisfied internal customers. When employees give good service, their morale and commitment to the institution tends to increase. This encourages future performance and minimizes the costs of staff turnover.

- **Retain customers.** An MFI’s outreach goals are much easier to achieve if it can build a loyal customer base. Long-term relationships are strategic relationships for MFIs.

- **Improve efficiency.** Successful service leads to lower costs through fewer mistakes, and a smaller operating, advertising and promotional budget. The result is increased productivity, market share, profitability and business performance.

8.3 Delivering Quality Customer Service

To provide quality customer service, MFIs must pay attention to all of the mechanisms through which they serve customers, not just the most common points of contact. The major variables to be considered when trying to deliver quality customer service are:

- **Product range.** As explored in Modules 5 and 6, MFIs must understand customers’ needs, desires, preferences and expectations, and then design products that respond appropriately. The value customers derive from the MFI’s products — and correspondingly their impression of the service — will depend on the organization’s ability to offer a full range of products.

- **Delivery systems.** MFIs must take care that their product delivery systems operate efficiently and effectively. At a minimum, they should be reliable and responsive to both external and internal customers (employees). Ideally, these delivery systems will also assist MFIs to communicate effectively, to develop long-term relationships with clients and to provide a safe, courteous and easily accessible service.
• **Delivery environment.** Customer service is also enhanced by the office layout, its accessibility (e.g., operating hours, convenience of location and privacy), as well as its atmosphere such as the noise, lighting, temperature, colour and comfort. In shaping its environment, an MFI will need to balance the tradeoffs between cost, form and function. What environment would customers find most pleasurable? Can MFIs improve their delivery environment without increasing costs? If not, would improvements in the environment be important enough to customers that they would be willing to pay for them?

• **Technology.** Recent technological advances have made major contributions to facilitating customer-MFI contact, improving the collection and organization of data, managing tasks and monitoring performance. Computerization and automation make it possible for MFIs to increase their speed, efficiency and accuracy. Queues can be shortened, processing time can be reduced, and productivity can be raised. Indeed, technology can be integral to a financial service, its environment, its delivery or, in the case of ATMs or card-based savings accounts, a combination of all three (see Module 20). As such, it is a strategic customer service tool.

• **Employees.** As the principal point of contact between the MFI and its customers, the role of employees in delivering quality customer service cannot be overstated. They physically, intellectually and emotionally deliver the MFI's products and services. They build relationships with clients and learn to understand their needs and expectations. As a result, they control a great deal of the quality of service delivered.

Consequently, employees must receive sufficient support to deliver quality service. MFIs should do their best to hire the right people, understand employee skills and needs, and structure training and mentoring to convey relevant technical knowledge and communication skills (see Module 14). Incentives can also effectively motivate employees to respond to customer needs (see Module 19).

Critical to this effort is the need for MFIs to value internal customer service just as much as external customer service. Employees are unlikely to serve clients well if they are not being treated well by their institutions. In fact, quality service is important at all levels:

- between customers and front office staff
- between front and back office staff
- between operations and non-operations staff
- between staff and management at all levels and locations.

If these internal encounters are poor, the external customer will not receive quality service. Loan officers cannot disburse loans on time if funds are not available. Tellers cannot determine a client's account balance if their computers have crashed. Field staff cannot accept repayments if they do not have receipts. And so on.

Usually when one thinks about customer service, the direct interaction between client and field staff comes to mind. In reality, however, customer service is the responsibility of everyone in the organization. If every employee realizes that their job is to provide outstanding customer service, it will be much easier for the MFI to achieve that objective.
8.4 Improving Customer Service

As discussed in Module 21, there are several ways that MFIs can improve customer service. One approach is to use gap analysis to determine where an MFI’s service is suffering, to identify possible causes of the gap between the service that the MFI wants to deliver and the service it is actually delivering, and then to take actions to close the gap, or to make it as small as possible. This technique is easy to apply, but it is also ad hoc and can only be used when an MFI’s service is already failing to meet customer expectations.

A second approach would be through a continuous improvement process. Using feedback loop mechanisms, ongoing market research and an institutional culture that values continuous improvement, MFIs can constantly seek out ways to do what they do better. This approach can be particularly useful for MFIs that aim to exceed customer expectations, but it can lead MFIs into the trap of trying to improve everything everywhere when resources are limited.

A third approach seeks to improve customer service through the application of a quality management process. This four-step process is outlined in Figure 8.1 and described below.

Figure 8.1 Overview of the Quality Management Process

1. **Define the required quality**
2. **Establish service standards**
3. **Monitor service provision against standards**
4. **Ensure remedial action is taken when required**

*Source: Adapted from MicroSave “Strategic Marketing Toolkit”.

**Step 1: Define the required quality of the product or services being offered**

Not all products need to have the highest level of quality. As discussed in the previous module, a premiere product with a premium price should have higher quality than a low-cost, basic product. Recognizing this reality and defining the degree of quality required for each product
will help employees prioritize the use of their resources to deliver the best customer service possible.

At a more specific level, this step involves the diagnosis of opportunities for improvement, and subsequently, the definition of a specific change in quality that the MFI would like to achieve.

**Step 2: Establish procedures and service standards that reflect the level of quality required**

Service standards are measures against which MFIs can judge their actual performance. It would not be cost-effective to establish standards for everything; thus, MFIs should limit their standards to the areas in which a quality standard could actually be of some benefit. MFIs should get a feel for what their customers want, what they feel is important and what influences their purchase decisions — and then define quality standards for those areas. If there are costs involved in achieving the standard, these should be identified and measured against the expected benefits.

Whenever possible, MFIs should set measurable standards for customer service, like the examples in Box 8.2. Measurable standards can easily be set for quantifiable factors such as speed or efficiency and even product knowledge. Qualitative factors, such as professional appearance, friendliness or attitude, are more difficult to measure, but once standards are set, systems can be established to identify strong or weak performance.

<table>
<thead>
<tr>
<th>Box 8.2 Quality Standard Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>• All customer correspondence will be replied to within one week.</td>
</tr>
<tr>
<td>• Field staff will not be late for group meetings.</td>
</tr>
<tr>
<td>• The telephone will always be answered within three rings.</td>
</tr>
<tr>
<td>• Customers will spend no more than 15 minutes in the queue.</td>
</tr>
<tr>
<td>• Every customer will be greeted with a smile.</td>
</tr>
<tr>
<td>• The lending decision will always be available to the customer within 48 hours of the application being received.</td>
</tr>
<tr>
<td>• The administration fee will never be higher than the average fee charged by our five main competitors.</td>
</tr>
</tbody>
</table>

In conjunction with such standards, MFIs may want to establish a service policy, which details actions that they want employees to take in response to customers. For example, should employees greet customers with a particular phrase? What steps should they take to narrow in on the root cause of a customer's dissatisfaction? Should they follow a specific procedure in responding to or resolving customer complaints (see Box 8.3)? These procedural guidelines can help ensure that everyone understands what to do, why, and how often.
Box 8.3 Dealing with Hostile Customers

Complaints are an opportunity to improve an MFI’s operations, products and services, and should be seen as a valuable source of information. To make the most of the opportunity, here are some tips for dealing with disappointed and vocal customers:

1. **Acknowledge your mistake.** Don’t blame it on the computer, lazy headquarters staff or the customer’s lack of understanding. If the MFI has made a genuine error, just confess it and move on to the next step.

2. **Admit the serious implications** of the MFI’s mistake and empathize with the client. For the MFI, this is just another business transaction: but for the customer, the MFI’s error can range from a minor inconvenience to a major trauma. Inquire sensitively about the implications of the problem. Try to get a feel for the actual impact.

3. **Ask how you can make things right** for this particular transaction. Do you redo the service? Do you discount your price? Your response depends on a range of factors, but make the decision as part of your effort to retain the customer relationship, not just to put out the fire.

4. **Learn how you can repair the relationship.** Once you’ve worked out the details of remedying the particular transaction, ask how you can restore the relationship to where it was before the problem surfaced. Think about the big picture. You should be willing to invest something in retaining the relationship, especially if it’s a long-term customer and the MFI is the one which made a mistake.

Source: Adapted from Ferrari, 1999.

Customer service standards do not just pertain to the MFI’s external customers; standards should also be established for internal customer service. Some of the more obvious examples include:

- Processing loan applications within “x” days
- Producing monthly reports a certain number of days after the end of the month, and
- Disbursing loans and paying salaries on time.

However, internal customer service standards could also go deeper. For example, MFIs could also consider monitoring the number of transactions that get entered per day (more is better) or the number of errors per month (less is better). It is also possible to set benchmark results for internal customer satisfaction surveys to assess the performance of service departments, such as human resources, information systems, or finance and accounting.

**Step 3: Monitor the production and provision of services against the standards**

Once standards are in place and everyone in the institution knows about them, the MFI should measure and judge performance against these service standards. A complaint and suggestion system plays an important role in monitoring service standards for external customers as it provides a communication channel for unhappy customers. It enables them to
share their dissatisfaction with the institution and (hopefully) to suggest ways to improve conditions. Such a system could take any number of forms:

- A regularly monitored suggestion box (perhaps with incentives to provide suggestions)
- A customer service hotline (a telephone call centre)
- A customer service representative, prominently positioned in each branch
- A customer advisory board that meets periodically to discuss the current state of affairs in the institution from the customers' point of view
- Customer satisfaction surveys
- Focus groups
- Mystery shopping

Perhaps most importantly, since credit officers and other front-line staff have the most contact with customers, they are in an ideal position to observe customer preferences, needs and sources of dissatisfaction. Consequently, field staff are an integral part of any complaint and suggestion system.

Customers will casually comment on operations while making loan repayments or filling out loan applications, and front-line employees have to keep an open ear to customers' thoughts. Not only are employees in an ideal position to identify dissatisfied customers, but they are also in an ideal position to suggest solutions that will make customers happier, and to document the experience (see Figure 8.2).

**Figure 8.2 Sample Complaint Solicitation Form**

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**Complaint Solicitation Report Card**

**Employee's Name:** John Barrett  
**Date:** June 15

**Comment or Observation/Complaint:** Observed one of my customers getting into a loud argument with one of the cashiers.

**Where was the complaint made?** When the transaction was complete, I went to the customer and asked her if everything was all right. She told me that the cashier could not provide her with any small change, which she needed for her market stall. I told her to talk to the customer service representative and/or fill out a customer comment card, and that someone would definitely get back to her about the situation.

**What happened to you after that?** She took my advice. In fact, she went to the representative and filled out a comment card. She really felt like she was receiving poor service.

**Conclusion:** I've heard this complaint before. Since it isn't difficult to provide small bills, and since the request is legitimate, I think we should make the effort to accommodate our customers in this case.
To encourage this behaviour and boost customer satisfaction, MFIs could reward loan officers who stimulate suggestions. At the same time, MFIs must take care to avoid disincentives for sharing that information. For example, do not use the volume of complaints generated by an employee as grounds for disciplinary action.

To stimulate enthusiasm by staff for collecting suggestions, the MFI has to create a "complaint is a gift" culture. It is true that 90 per cent of dissatisfied customers never complain. But when complaints are received and responded to, and the problem is fixed, the vast majority of previously unhappy customers will come back — and they are likely to be even more loyal in the future because you made the extra effort to solve their problem. If staff believe that, and see how it could benefit them, then they are more likely to actively solicit complaints and suggestions to reach those persons who would otherwise be reticent to share their feelings.

In designing a complaint and suggestion system, MFIs need to make it easy for customers to complain. For example, if most customers are illiterate, then a suggestion box will not be very effective. Besides field staff, MFIs should have multiple channels through which customers can voice their options. At Tanzania Postal Bank, for example, a customer service hotline, suggestion boxes, an open door policy among branch managers and daily staff meetings provide a range of opportunities for collecting information. The Bank finds the diversity of channels useful because each one gathers a different kind of information from a different subset of customers.

**Step 4: If quality falls below the standards, quickly take appropriate action**

The results from the service standard monitoring, including the complaints and suggestions that are collected, need to be used by the MFI to improve the situation. Someone associated with the R&D committee should be in charge of tracking results and analysing trends. This "complaint tsar" must ensure that the information flows all the way through the feedback loop. After complaints and suggestions are documented, they must be collected and analysed at the branch and institution level.

The MFI then has to do something about the findings. Maybe the product needs to be redesigned or a new product introduced; maybe staff need more training or some employees need to be disciplined; perhaps the offices need to be open longer or the bathrooms need to be cleaned more frequently — any number of possibilities might emerge. Major adjustments may be required, but often small changes go a long way toward improving service quality (see Box 8.4).

To close the feedback loop, information needs to channel back to customers, informing them how the MFI is responding to their concerns. This feedback to customers can be on an individual basis, perhaps through a letter or a phone call from the branch manager. Feedback can also be done collectively — especially if the complaint was anonymous — by posting a response on a bulletin board or in a newsletter. When other customers see that the MFI is indeed taking their complaints and suggestions seriously, they will be much more likely to offer suggestions of their own. Consequently, a combination of individual and collective feedback is generally recommended.
Box 8.4 A Minor Change Has a Major Impact at Equity Building Society

Equity Building Society learned that a major reason for its long queues was the large number of salaried employees who were waiting in line to ask whether their salaries had been deposited. These employees could queue for several days in a row before their salaries finally arrived and they were able to withdraw funds. To eliminate the need to queue, Equity created a large salary board near the entrance to the banking hall on which it posted the names of all employers who directly deposit salaries along with a “yes” or “no” indicator to show whether funds had been deposited or not. Customers could enter the branch, glance at the board and know immediately whether it was worthwhile to enter the queue. Congestion in the banking hall decreased tremendously as a result of this board and clients were thrilled with the increased efficiency.

8.5 Creating and Maintaining a Customer Service Culture

The most important component of any customer service strategy is creating a service culture. This culture goes beyond making sure employees smile when they greet customers at the door. It requires a commitment to making customer contact with the institution a completely positive experience, one that every customer will want to repeat over and over again. It means internalizing a set of values, attitudes and habits that promote quality customer service. It involves systems and processes that facilitate the flow of information to and from customers, and the implementation of decisions that respond appropriately to customer needs.

Module 15 addresses the topic of proactively shaping an institution’s culture. However, a few specific tips for building a customer service culture are worth mentioning here.

- **Encourage internal and external feedback.** Offer customers and employees a variety of channels for sharing their suggestions, complaints and comments, and actively solicit their contributions. To encourage feedback, the MFI could even offer quarterly prizes for the best customer suggestion.

- **Be accountable to customers.** As discussed above, a communication feedback loop must consolidate the customer suggestions, analyse them and channel the input into the decision-making process. Communicate the MFI’s response to customers — be it through an announcement on the branch bulletin board, a customer newsletter, the posting of suggestion box responses by the teller window — so that customers can see the impact of their input and recognize the MFI’s responsiveness.

- **Develop reference cards with answers to frequently asked questions (FAQs) to facilitate consistency in the service delivered to customers.**

- **Include a reference to customer service and the search for quality in the MFI’s objectives or mission statement.**

- **Review policies and procedures to make sure they promote the institution’s customer service values.**

- **Set and monitor standards.** Make sure every employee understands that the MFI is developing a quality culture and is aware of the customer service standards. Standards are
important not only for staff who serve the customer, but also for support staff and employees in the back office.

- **Inspire “opinion leaders”** — individuals within the institution who are respected or admired by staff — to model and promote the culture that the MFI wants to create.

- **Commit the institution and its employees to long-term relationships** with customers. This will help to create a rationale and an incentive for quality customer service because long-term relationships will be impossible without it.

- **Encourage employees to be customer problem solvers.** An MFI should not see itself as a business that provides financial services to low-income communities, but rather as a solver of customers’ problems through financial services. If employees see themselves as problem solvers, they are more likely to go out of their way to ensure that the MFI’s products are indeed achieving that objective.

- **Empower employees** to do whatever is necessary to help an upset customer feel good about his or her relationship with the MFI. Allow staff to exercise judgement and creativity in responding to customer needs and problems.

- **Treat your employees as you would like them to treat your customers.** Most successful organizations appreciate the direct relationship between customer relations and staff relations. If management cuts corners with its employees, employees will cut corners with customers. There is no way to instil a positive customer service ethic before the MFI embodies a positive employee ethic.

- **Recruit employees** who demonstrate a commitment to customer service.

- **Reiterate the importance of customer service** and practical ways of achieving it throughout an employee’s tenure with the MFI, from the initial interview through orientation and training, and in ongoing training and professional development.

- **Motivate employees** to care about customer service through incentives, transparency and fairness. Build customer service into the performance review process and reward employees for providing excellent customer care.

- **Involve staff** in the setting of standards and the evaluation of performance.

- **Make it every employee’s responsibility** to step out of the office on a regular basis and talk to customers — not just to their customers, but also to their competitors’ customers, their former customers, and their potential customers.

- **Make it easy to complain.** There are many reasons why dissatisfied customers keep quiet: they think it will be too much hassle to complain, they do not know whom to complain to, they do not believe that sharing the information will change anything, or there is simply no one available to complain to. By eliminating these barriers to information flow, MFIs can significantly expand their opportunities for customer service improvement. Many barriers will automatically fall if staff believe that a complaint is a gift.

- **Celebrate** the spirit of service. Sponsor occasional community service activities or small appreciation events for staff.
### Main Messages

1. Customer service is the responsibility of everyone in the organization.
2. Outstanding customer service generates new business; bad customer service destroys the business.
3. When handling complaints, strive to strengthen the relationship with the client, not just solve the problem.
4. Establish and monitor internal and external customer service standards.
5. Help your staff live and breathe customer service – create a customer service culture.

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**Recommended readings:**

Successful market research, product development, marketing and quality customer service are intended to produce one critical result: long-term relationships with customers. This module focuses on the pinnacle of the markets and marketing pyramid — customer loyalty — and the strategies through which MFI managers can achieve such lasting relationships. Specifically, it sets out to answer four questions:

1. What is loyalty?
2. Why is customer loyalty important?
3. How can an MFI monitor customer loyalty?
4. How can management create loyalty?

### 9.1 What is Loyalty?

Loyalty is the attachment a customer feels to an organization’s staff, products and services. A loyal customer is someone who:

- Makes regular purchases
- Purchases across product and service lines
- Refers others
- Is immune to the pull of the competition

The fact that a customer returns to an institution does not necessarily demonstrate customer loyalty. Loyalty can actually be broken down into four categories based on a customer’s attachment to the MFI and his or her purchase pattern, i.e., how likely the customer is to repeatedly take a loan, deposit money or buy an insurance policy (see Figure 9.1).

**Figure 9.1 Four Types of Loyalty**

<table>
<thead>
<tr>
<th>Purchase pattern</th>
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</thead>
<tbody>
<tr>
<td>Premium loyalty</td>
</tr>
<tr>
<td>Latent loyalty</td>
</tr>
<tr>
<td>Inertia loyalty</td>
</tr>
<tr>
<td>No loyalty</td>
</tr>
</tbody>
</table>

Source: Adapted from Griffin, 1995.

This module was adapted from:
a) **No loyalty:** Some customers never become loyal. They switch their affiliations depending on who offers the best deal. For example, if MFIs try to achieve market share by providing service at the lowest price, by issuing coupons, or by making special introductory offers, then customers may move from one institution to another as they follow the “deal of the day”; they may even feel cheated if they do not receive a discount.

b) **Inertia loyalty:** In less competitive microfinance markets, MFIs can be lulled into assuming that their clients are loyal when in reality they simply have nowhere else to go. Clients may keep their savings in a particular institution, but not necessarily because they have a high attachment to that organization. If a new player arrives on the scene, these customers would be the first ones to close their accounts.

c) **Latent loyalty:** While customers may feel loyal to an organization, they may not want to access financial services all the time. Perhaps they only borrow to stock up on inventory during the holiday season, or perhaps their business is generating enough revenue that they no longer need to borrow. While not highly profitable, these “latent loyals” represent a valuable market for new products as well as an indispensable source of referrals.

d) **Premium loyalty:** Characterized by a high affinity and repeat patronage, premium loyalty is the most desirable form of loyalty. Customers who exhibit premium loyalty are proud of their affiliation with an organization and take pleasure in sharing their positive experience with others. The challenge for MFIs is how to cultivate premium loyalty.

Although they are obviously related, there are some important differences between customer satisfaction and customer loyalty. A customer may be satisfied with an MFI’s products or services, but that does not mean that she will return for a repeat service or recommend the MFI to her friends. Loyalty involves a strong sense of identification, for example, that the customer sees herself as a MicroBank customer, and would never dream of going anywhere else. Even if MicroBank were experiencing some difficulties, she would be willing to stick with it through the hard times because she is loyal to MicroBank.

### 9.2 Why is Customer Loyalty Important?

Customer loyalty is an important determinant of long-term financial performance. Microfinance institutions that do not keep customers satisfied will lose them to other financial service providers. Competitors are not the only barriers to customer retention; unsatisfied demand for quality products and for friendly, efficient service can also contribute to massive desertion — many people will choose not to access any service rather than access a poor-quality one.

There are at least a dozen reasons why MFIs should care passionately about customer loyalty. Since lending activities are the primary source of income, the following items focus on achieving loyal borrowers:

1. **New clients are expensive:** It takes a lot of effort to find, recruit, process, train and serve new clients. Because of high acquisition costs — the time spent on loan applications, business appraisal, due diligence, training and group formation — in some organizations the cost of delivering a first loan is higher than the loan amount!
2. **Smallest loans generate the least income:** New clients typically receive the smallest loans, which generate the least amount of revenue.

3. **Life-cycle profitability:** The combination of low income and high costs means that most MFIs lose money on new clients. As illustrated in Figure 9.2, it may take two or three loan cycles before the income from a loan covers the cost of making it, and it may take several more loan cycles before a customer generates enough income to cover the deficit from the initial loans (i.e., when the cumulative net income on that customer exceeds the net expenses). Furthermore, when a customer leaves, the MFI essentially forfeits any future profits that it would have earned from that customer.

![Figure 9.2 Life-cycle Profitability of Microloans](image)

4. **Achieve greater efficiency and productivity:** Besides avoiding the acquisition costs associated with new customers, an MFI can significantly reduce the costs of delivering loans to repeat borrowers in good standing through streamlined applications, reduced screening requirements and less frequent repayments. Since repeat borrowers with good repayment records take significantly less time to manage than new customers, loan officers should be able to manage many more loans (see Box 9.1).

5. **Repeat borrowers should be lower risks:** The longer a client has borrowed from an MFI, the more information an organization should have on the client to ascertain her creditworthiness — although unfortunately this is not always the case in microfinance, especially when loan sizes are automatically increased without assessing the borrower’s repayment capacity. In addition, loyal customers value the service that they are receiving, so they are more likely to maintain an unblemished credit record than a client with low affinity toward the MFI.
Box 9.1 The Efficiency of Repeat Borrowers

The retention of repeat borrowers is a critical aspect for enhancing efficiency because much less work is involved in serving repeat customers – or at least, that should be the case. MFIs often streamline their procedures for loan renewals to achieve two objectives: 1) reduce the average cost per loan and hence the efficiency of the service; and 2) provide the organization’s best borrowers with a preferred service, which encourages them to remain clients.

For example, at Calpiá in El Salvador, repeat loan assessments for its standard product take approximately 45 minutes, which is less than half the time for an initial loan. Unless the client is problematic, for repeat loans the loan officer only makes one client visit, usually to the business site, instead of to the home and business for new applicants. The client's existing information is updated rather than rewritten, further enhancing efficiencies. After three loans with excellent repayments, clients can become eligible for automatic credits that can be available in 20 minutes. When faster loan processing is coupled with less frequent repayments and longer loan terms, significant efficiencies are gained.

Source: Adapted from Churchill, 1999.

6. **Dropouts destabilize groups**: When a customer leaves a group lending programme, her group must recruit a new member who will generally qualify for a smaller loan and will have to take a disproportionate risk by guaranteeing the larger sums borrowed by other group members. The new member will probably be less experienced and may not receive the training that original members received when their group first began borrowing. In the face of frequent or multiple dropouts, some groups may disintegrate entirely.

7. **Generate increased referrals**: Most clients come to an MFI through word-of-mouth; this enables MFIs to use the information from references to make good character lending decisions. The retention of loyal advocates can generate a stream of new customers with a reference’s seal of approval. Customers also tend to have a stronger attachment to a service provider if they were referred by a friend than if they heard about the organization through another marketing means.

8. **Stimulate healthy growth**: High customer retention allows the MFI to grow steadily while limiting the percentage of new clients in the portfolio. Without loyalty, the organization spends too much time replacing lost customers instead of growing; and untested and time-consuming new customers can destabilize a portfolio.

   In addition, long-term customers are more likely to take a personal interest in helping the MFI grow. They want to see the institution find ways of serving them better over time and will often go out of their way to provide honest, constructive recommendations for change.

9. **Compounding profits**: The combination of higher loan balances, lower costs, greater efficiency and productivity, and word-of-mouth referrals produces an increasing volume of profits during the customer’s relationship with the MFI. Research in other industries (e.g., credit card companies) has determined that firms can improve profits anywhere from 25 to 85 per cent by reducing customer defections by 5 per cent (Reichheld and Sasser, 1990).

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10. **Desertion can subsidize the competition**: If a client leaves one MFI to borrow from another, the original organization is effectively subsidizing the competition because it taught the client how to borrow and supported the client while she was developing a credit history.

11. **Customer loyalty breeds staff loyalty**: An MFI that serves satisfied and loyal clients will have a good chance of keeping and motivating its employees – most field staff prefer interacting with happy clients.

12. **Achieve impact**: One small loan is not going to make a major difference for a borrower or her business. MFIs need to provide ongoing financial services to clients to achieve their social mission.

While the arguments for promoting loyalty among clients that access an MFI’s other services such as savings, insurance and remittances are less dramatic, the rationale for retaining these clients is nonetheless similar, especially with respect to acquisition costs. Research in other industries has shown that it is five to eight times more expensive to attract a new customer than to retain an existing one (Reichheld and Sasser, 1990), and it is reasonable to assume that the same would be true with attracting depositors.

For voluntary microinsurance, the costs of attracting new policyholders relative to retaining existing ones might be even higher than in other industries because it is an unfamiliar product in many markets. There is a saying in the insurance industry that “insurance is sold, not bought”. That would certainly apply to microinsurance where it can sometimes be very difficult to persuade clients to part with their limited resources to buy peace of mind. Desertion tends to be a significant problem for many insurance products because if customers do not make a claim before their policy term ends, they feel that they have wasted their money and are unlikely to renew. As microfinance institutions gain more experience with voluntary insurance, client retention will certainly be an area that will deserve closer examination.

### 9.3 How Can an MFI Monitor Customer Loyalty?

Keeping in mind that a loyal customer is one who refers others, makes regular purchases across product lines, and demonstrates immunity to the pull of competition, there are a number of ways for an MFI to gauge if it has loyal customers.

**Retention Rates**

Tracking customer retention ratios is an inexpensive and common means of tracking loyalty. It serves two primary purposes:

1. It provides a blunt or general indicator of customer satisfaction
2. It is important in forecasting the overall financial performance of the MFI

Although customer retention rates are not a direct indicator of financial performance, a drop in retention is a critical early warning signal that trouble may be brewing. Low retention can lead to a reduction or stagnation of average loan size, which can reduce future returns and cause other financial hazards. However, a drop in retention from one month to the next does not always mean that there is a serious problem. All MFIs experience natural seasonal varia-
While seasonal variation is most obvious for MFIs serving agricultural communities, urban traders and manufacturers also experience seasonal differences, particularly around festivals and the start of the school year. Information about natural seasonal variations helps the institution to plan ahead for anticipated fluctuations in product demand. This information can also contribute to a marketing plan that reflects customer needs at various times. To smooth the effect of seasonal variations, the most useful way of tracking customer retention is on a monthly basis for the previous 12 months.

Regularly monitoring retention requires a simple and straightforward retention formula. For credit, the recommended formula is:

\[
\frac{\text{Number of follow-up loans issued during the past 12 months}}{\text{Number of loans paid off during the past 12 months}}
\]

It is unreasonable to assume that all customers will want to borrow all the time. Credit-only programmes have natural desertion rates that vary by region. Some customers will no longer need to borrow; others will only borrow when they absolutely have to. It is difficult to be a staunch advocate of customer retention for organizations that only provide loans, because most people do not like being in debt perpetually. Measuring the retention of total clients is preferable, but is more complicated, especially for savings clients (see Box 9.2).

**Box 9.2 “Desertion” of Depositors**

Calculating a desertion rate for savings customers can be difficult for several reasons:

- When a savings service is first offered, or the institution is serving customers who are unfamiliar with savings accounts, customers may test the service by depositing funds one day and withdrawing their money the next.
- Because many customers drain their accounts to a bare minimum, but do not bother to actually close them, their accounts may lie dormant for months or even years. Therefore, when estimating the desertion rate for savers, the institution should look at account inactivity (i.e., for passbook savings, no deposits or withdrawals in the past 12 months) as well as account closings.
- The liquidity features of different savings products would determine the period inactivity. For example, the definition of inactivity for a passbook account would be very different than for certificates of deposit (CDs).
- Some customers close and open accounts at the same time. For example, a CD may come due, and rather than renewing it, the customer opens up a liquid account instead.
- An institution also needs to monitor average account balance and dissect the analysis by product and by various segments of the customer base. An MFI may not see the number of accounts declining, but it may experience declining account balances. Rather than full-fledged desertion, this leakage of balances could reflect a risk management strategy by customers.
Exit Interviews

Exit interviews enable the institution to learn what lies behind the retention ratio by determining who is leaving and why. Of all the strategies included in this list, the exit interview (or lost customer analysis) is the most important means of collecting information to improve the quality of an MFI's products and services. There are two objectives of exit interviews: 1) to learn at the point of departure, when the customer is potentially most dissatisfied, why he or she chose to leave; and 2) to gain (some) customers back by using the information to develop a customer recovery process. To achieve these twin objectives, exit interviews include questions such as those highlighted in Box 9.3.

Exit interviews can be performed either as needed or on a regular basis. Smaller MFIs and organizations with limited MIS capabilities might conduct exit interviews when they begin to experience a retention problem. In this case, they should conduct a rigorous sampling exercise of lost customers so that the findings from the study are representative. A possible downside of this "as needed" approach is that there is a built-in delay between identifying a retention problem and learning what lies behind it. In addition, it may be difficult to find some former customers and their memories of why they left may not be particularly fresh.

Larger organizations, particularly those that operate in competitive markets, should consider integrating exit interviews into their normal course of action. Whenever borrowers make their final loan repayment, the loan officer or teller could conduct a simple interview. This makes it possible for the MFI to communicate with and learn from its entire customer base on a regular basis, including customers who are interested in renewing their loans. This immediate action is helpful because it could pick up signs of dissatisfaction before they mutate into defection. Often it is not one incident or issue that causes customers to leave, but rather it is a series of little things that build up over time. The downside of the integrated approach is that it is very costly to interview, code and input data for every single customer after every single loan. MFIs that are struggling to improve efficiency may see this as an unnecessary expense.

Box 9.3 Sample Exit Interview Questions

- What is the nature of your business?
- How long have you been a member of the organization?
- For what purpose did you join the organization?
- For what purpose(s) did you save with (or borrow from) the organization?
- Did the savings (or credit) services allow you to meet those needs/purpose(s)?
- What should the organization do to further improve its savings (or credit) services?
- Why are you choosing to leave the organization?
- In what other ways could the organization have better met your needs?
- What procedures/systems would you change in the organization?
- What would convince you to come back?
Track Referrals

Customers who regularly refer other customers could be categorized as loyal advocates. Loyal advocates who stop making referrals may have had a bad experience, or for some reason have become less enthusiastic than they once were. By tracking referral sources, an MFI can identify waning enthusiasm and try to rectify the situation.

There are two primary ways to track referrals. The first is to use customer surveys to inquire whether current clients would recommend your organization to their friends and neighbours. The second is to ask new clients who referred them to the MFI and to monitor the number, nature and timing of the referrals made.

3-D Loyalty

Another way to conceptualize loyalty is through the dimensions of length, breadth and depth (see Figure 9.3). Length refers to the average number of years that a customer has used an MFI’s services. Institutions can monitor customer longevity to determine whether or not loyalty is increasing. In this case, the distribution of longevity is more important than the average number of years that all customers have accessed services. For example, what percentage of customers has been with the MFI for more than five years? Less than one year?

Figure 9.3 The Dimensions of Loyalty

Breadth refers to the number of products that a client (or that client’s family) has with the MFI. A customer who has two different savings accounts, a housing loan and a life insurance policy — and her husband, mother and daughter all have savings accounts — is a much more loyal customer than someone who just has an outstanding loan. To measure the breadth of relationship, MFIs need to have an information system that is organized around the customer, as well as the product, and if possible provides the opportunity to establish family or household linkages.

These dimensions apply to the customers and should not be confused with the six degrees of outreach that apply to the financial service providers.
Exclusivity is an important indicator of loyalty and measures the depth of a customer's relationship with an MFI. In fact, the ultimate measure of loyalty is the institution's share of a customer's total purchases (i.e., the degree to which a customer uses an institution for all her financial services needs). To measure depth of loyalty, there are various points to consider. Regarding deposits, for example, what percentage of a customer's savings or assets is held by your organization? For loans, does the customer have outstanding debts with other lenders? The PRA tool “Financial Landscape Analysis” could be useful in this regard (see Box 5.2 on page 71).

Besides indicating the degree of loyalty, these details are also important for two other reasons:

1. If customers have outstanding loans from other sources, an MFI needs that information to gauge whether they have the capacity to repay another loan. Unfortunately, customers have a disincentive to provide accurate information, since it might adversely affect an institution's loan decision either by reducing the size or rejecting the application outright. MFIs that operate in environments served by effective credit bureaus are more likely to extract truthful responses in this regard.

2. Information about the customer's use of savings and loans from other sources provides priceless information for new product development. If the MFI can learn about the design and delivery of the other products that its customers are accessing, and why they prefer those products, it can imitate or improve on the services provided by its competitors.

9.4 How Can Management Create Customer Loyalty?

As discussed in Module 7, customers consider a complex set of factors when they choose between competing service providers. On the one hand, they consider the benefits or the value that an MFI delivers. This value can come from the product itself, the service attached to it, the individuals delivering it, or the image of the institution delivering it. On the other hand, they consider the cost of accessing the MFI's services, which includes monetary costs as well as time, energy and psychological costs. While impossible to quantify, these benefits and costs are all weighed and balanced against each other to produce a decision about net customer value, as shown in Figure 9.4. To retain loyal customers, an MFI must keep its net customer value above that of its competition.

This section explores these four aspects of value. When creating value in the context of customer loyalty, where possible it is necessary to differentiate the service or approach for loyal customers from the ordinary service for regular customers.
**Product value**

The primary ways MFIs create product value for loyal customers is by streamlining the application process, increasing the loan sizes and lowering the interest rates. Not only are these strategies intended to enhance loyalty, but they have the added advantage of improving efficiency.

The approach to improving product value, however, should be taken further. It is a commitment to creating lifelong relationships by providing services that will develop as customers' needs evolve. Today's microentrepreneur may need a retirement savings account for the future; her children may need education savings plans. If an MFI can anticipate these upcoming needs, it will be well positioned to offer new products to customers before the competition can.

Developing new products for existing customers also enables the MFI to increase the breadth of its relationship with them, which further strengthens the loyalty bond. For example, operating in the competitive Peruvian microfinance market, Solución offers a variety of incentives to retain its best customers. One of the more successful incentives from this for-profit finance company is the provision of free management training using the ILO’s Improve Your Business materials to repeat customers. While the intention was to enhance loyalty, this incentive has had the added advantage of improving clients’ businesses and therefore making it possible for them to borrow larger loans – so the free service is paying for itself (Sievers and Vandenberg, 2004). Other MFSs allow repeat borrowers with excellent repayment histories to access short-term parallel loans to take advantage of business opportunities.
Markets and Marketing

Deliver product value by:
- Developing new products to create lifelong relationships
- Improving existing products
- Using attractive product features as loyalty rewards

Service value

Microfinance institutions often recognize service value, but they do not always have an enthusiastic commitment to improving customer service. As discussed in the previous module, an MFI that is committed to providing quality customer service does the following:

- Regularly checks to ensure the customer is satisfied with products and services
- Seeks out customer complaints and relishes the opportunity to resolve them
- Actively solicits customer suggestions for improvements
- Works to discover new ways of meeting customers' evolving needs
- Strives to exceed customers' expectations

Customer service begins at the top. Management sets the tone for how staff should treat the customer by how the company treats its staff. It needs to ensure that the head office provides its internal customers with quality service so they can in turn provide their external customers with the best possible service. In addition, the organization's culture, structure and human resource policies must reinforce the importance of customer service.

If customers overwhelmingly expect your MFI to provide quick turnaround for services (service value), and your institution begins to fall short, customers will react more strongly than if they had lower expectations. Employees have an important role in managing the expectations for customers. If staff do not know the product features and processes inside and out, they may create false expectations. Ideally, a service that is promised within one week can be delivered in three days, therefore exceeding expectations and enhancing service value.

While service value is harder to differentiate for loyal customers than product value, it is still possible. For example, some MFIs expedite loan processing for repeat clients.

Enhance service value by:
- Monitoring customer satisfaction
- Seeking out complaints and solving them
- Soliciting customer suggestions
- Making it easy for customers to communicate with the institution
- Striving to exceed customer expectations
- Making clients want to refer their family and friends
**Personnel value**

In microfinance, the personal relationship between customers and front-line staff is more important than in most service industries, making personnel value of utmost importance. Loan officers who create close relationships with their customers develop a sixth sense in evaluating an applicant's character and repayment capacity. A constructive relationship encourages customers to be forthright about pending delinquency problems, which enables the problems to be solved more easily, with less stress on everyone. Most importantly, developing a positive relationship between field staff and their customers breeds customer loyalty.

Desertion can become a problem if MFIs fail to communicate with their customers after the loan is booked or the savings account opened. To generate personnel value, field staff must regularly maintain relations with the customer outside the financial transaction. Instead of only visiting when a repayment is late, for example, the loan officer should periodically stop by to see how the business and family are doing, if she is faring well with the services provided, and if there is anything else the MFI can do for her or her household members. Ideally loan officers should know all of their customers by name, and know them well enough to ask after their spouses and children.

To make such visits cost-effective, the field agent stops by customers' homes or businesses on the way to or from regularly scheduled loan disbursement or collection activities. While these visits are informal, staff must maintain a sense of professionalism so as not to imply relaxed attitudes towards timely repayment.

To differentiate personnel value for loyal repeat borrowers, some MFIs offer financial incentives that reward loan officers for client retention. Such incentives help reinforce the importance of retention among staff and reward those who are effective in forging lasting bonds with their customers.

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**Enhance personnel value by:**

- Hiring knowledgeable, personable, committed employees
- Providing regular professional development opportunities for staff
- Thinking about after-care for encouraging repeat business
- Leveraging the staff-client relationship
- Providing staff incentives for client retention

---

**Image value**

Of the four, perhaps the most overlooked customer value is image. This prioritization is understandable given that image probably carries the least weight with microfinance customers. Yet precisely because it is generally underutilized, MFIs may generate the greatest additional customer value through an effective branding strategy. As discussed in Module 7, a brand is more than just a name or an easily recognizable logo. It conveys a complex level of meaning about the company, its products and its customers. Strong brands generate loyalty
because customers like being associated with the image that the company or its products represents (see Box 9.4).

**Box 9.4 Branding at BancoSol**

Through talking to customers, BancoSol discovered that clients do not want a "bank for the poor," since they pay their debts, pay their bills, and have businesses. They do not want to be reminded of their economic status, they simply want a bank. BancoSol's marketing department has tweaked the bank's image — through marketing materials and advertisements — so that it reflects this sentiment. New marketing materials boast, "We can grow together", and fully explain all of its products. A piece of marketing material for individual loans contains a picture of a middle-class man with a caption proclaiming that services are "simple and rapid". Another marketing piece asserts that BancoSol will keep deposits secure with state-of-the-art technology.

To bolster their image value, some MFIs use rewards and incentives to enhance loyalty, recognizing that customers value these social and psychological benefits. MFIs should be creative in designing their loyalty incentives and ensure that those incentives are appropriate for their customers. The following are some examples of how this works, or could work, in microfinance:

- **VIPs.** Some microfinance institutions, such as Calpiá in El Salvador, classify their best customers as Very Important Persons (VIPs), which entitles them to preferred services. Besides providing preferred product features and better service, MFIs might also allow VIPs to post advertisements in the branch offices or to participate in MFI-organized trade shows to market their wares.

- **Milestone awards.** Awards can be given to customers who meet certain milestones. For example, they may be classified as "golden customers" once they have been with you for five years, and this could entitle them to receive one loan at half price. Or perhaps once they have successfully repaid ten loans without delinquency, they can receive their 11th loan at a discounted rate. These types of programmes not only reward repeat patronage, but they also create disincentives for desertion since a customer on her ninth loan will want to make sure she sticks around for at least one more cycle so she can get her reward.

- **Branded give-aways:** Some organizations give branded presents (e.g., a T-shirt or cloth shopping bag) to customers when they reach certain milestones.

- **Bulk buying discounts.** Some MFIs have negotiated discounts for their customers from wholesalers. To make this a loyalty incentive, the institution needs to issue special identification cards that expire when the loan term ends; if the customer renews the loan, then the card can be updated. Some MFIs also arrange discounts on training courses for their VIP clients.

- **Newsletter or magazine.** Where MFIs serve mostly literate entrepreneurs, they may enjoy receiving a free subscription to a magazine or newsletter with tips on running their own business. ABA in Egypt sends a free newsletter out to its best customers.
The experience with loyalty incentives in other industries suggests that the first company to introduce such a programme will benefit the most, especially if the competition is slow to respond. Once the whole industry has similar reward programmes, then the companies that offer the most distinct programmes, that offer relevant benefits to their customers and that are operated most efficiently can succeed in using loyalty incentives to forge mutually rewarding relationships with their customers.

Repeat customers are more demanding and discerning than first-time customers; their expectations increase over time. These incentive programmes have to keep evolving as well. In general, incentive schemes can create administrative headaches and become more trouble than they are worth. They need to be approached as a long-term strategy because it can become a public relations nightmare if the organization decides to close down its rewards programme.

Deliver image value by:

- Building a brand
- Redesigning retail outlets and marketing materials to reflect the brand
- Adopting an image that clients like to be associated with
- Designing loyalty benefits for repeat clients

Main Messages

1. Customer loyalty is a key driver of long-term financial performance.
2. Just because a customer comes back for a repeat loan does not mean that she is loyal.
3. Monitor loyalty!
4. Enhance loyalty by creating greater customer value than your competitors.
5. Find ways to treat loyal customers differently than new customers.
6. Be creative in developing loyalty incentives and customize them to your clients’ preferences.
Recommended readings:


Managing Risks
III Managing Risks

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Microfinance is a risky business. As illustrated in Box 10.1, MFIs are vulnerable to a range of risks. Some risks are just annoying, while others threaten to destroy the institution. In their pursuit of improved performance, managers need to find a way of dealing with risks to limit the damages or losses that their organization might experience.
Managing Risks

A risk is the possibility of suffering harm or loss. Microfinance institutions take risks all the time—that is their purpose, or at least one of their purposes. They lend money to low-income persons, often without collateral, and take the risk that borrowers will not repay their loan. Indeed, all financial institutions have to take risks to generate a return. Consequently, managers cannot avoid all risks, but they do not have to love them too much either. Managers need to take calculated risks.

This module introduces the section on risk management by answering three questions:

1. To what risks are MFIs vulnerable?
2. What is risk management?
3. How does one manage risks?

10.1 Major Categories of Risk

Many managers think about risks on an ad hoc basis, often after they suffer some kind of loss. A holistic or comprehensive risk framework allows managers to consider the entire spectrum of risks to which they might be vulnerable before a loss actually occurs. Figure 10.1 presents the four categories of risk that make up this framework: institutional, operational, financial management and external. By considering each category of risk, this framework provides managers with a means to comprehensively assess their organization’s current and potential vulnerabilities.

**Institutional Risks**

a) **Social mission.** While all MFIs do not have the same mission statements, in general they have a dual mission: a social mission and a commercial mission. Their social mission is to improve the welfare of the poor by providing valued financial services. Microfinance institutions are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to their intended clientele.

b) **Commercial mission.** The commercial mission of MFIs is to operate as an ongoing concern; that is, to exist for the longterm. Also known as bankruptcy risk, MFIs are exposed to this risk if they do not set interest rates and fees high enough to cover costs and if capital is not sufficient to cover losses stemming from risk exposures. Since the social and commercial missions sometimes conflict with each other, the challenge for MFI managers is to strike a balance between the two.

c) **Dependency.** Dependency risk is similar to commercial mission risk, but it is most pronounced for MFIs started and supported by international organizations. These MFIs are vulnerable to dependency on donor support. While this support may seem like an advantage, it can significantly undermine efforts to build an independent institution that will exist for the long term.

Methods for controlling these first three institutional risks are discussed in Section I of this manual. In particular, the six degrees of outreach (Module 2) are a useful tool to balance an organization’s social and commercial missions. Vision, mission, values and objec-
Strategic. Bad business decisions or improper implementation of those decisions, typically the result of poor leadership or ineffective governance, causes strategic risks. For example, MFIs may lose value if they introduce inappropriate new products, open offices in the wrong places, or launch a costly yet ineffective marketing campaign. The strategies and tools presented in Section II can help managers develop the right product for the right market, and avoid strategic risks.

e) Reputation. The fifth type of institutional risk refers to the prospect of losing value due to negative public opinion. Bad news travels faster than good news, so it is easier to lose one’s reputation than to build it. Strategies for creating and retaining one’s reputation are covered in Module 7.

**Operational Risks**

a) Credit. As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern because most microlending is unsecured. Module 11 discusses strategies for controlling credit risk in detail.

b) Staff Fraud. Any organization that handles large volumes of money is extremely vulnerable to staff fraud, a vulnerability that tends to increase in poor economic environments.
Exposure to fraud is particularly acute whenever money changes hands. Module 12 describes methods for preventing, detecting and controlling staff fraud.

c) **Security.** As with vulnerability to fraud, the fact that most MFIs handle money also exposes them to theft. This exposure is compounded by the fact that MFIs tend to operate in environments where crime is prevalent or where, because of poverty, temptation is high. This subject is also addressed in Module 12.

d) **Personnel.** As service companies, an organization’s human resources are the interface between the MFI and its customers. Consequently, the MFI’s performance can suffer if staff are sick or injured, or if they are just demotivated. MFIs are vulnerable if personnel leave the company after the organization has invested considerable sums in building their expertise, especially if they take that expertise to a competitor. Another personnel risk common in microfinance is the dependency that organizations have on a couple of key individuals, especially the founding managing director. Methods for controlling personnel risks are addressed in Section IV (especially Module 14 on human resource management), as well as Module 20 on staff incentives.

**Financial Management Risks**

a) **Asset and Liability.** The financial vulnerability of an MFI is summarized in asset and liability risks, which include interest rate, liquidity and foreign exchange risks. **Interest rate risk** arises when the terms and interest rates of assets and liabilities (which fund assets) are mismatched. For example, if the rates on short-term liabilities rise before an MFI can adjust its lending rates, the spread between interest earnings and interest payments will narrow, seriously affecting the MFI’s profit margin. MFIs operating in inflationary environments are particularly vulnerable to this type of risk. **Liquidity risk** involves the possibility of having to borrow expensive short-term funds to finance immediate needs such as loan disbursement, bill payments or debt repayment. MFIs are most vulnerable to **foreign exchange risk** if they have to repay loans in a foreign currency for which they are earning revenue in the local currency.

b) **System Integrity.** Another aspect of financial management risk is the integrity of the information system, including the accounting and portfolio management systems. An assessment of this risk involves checking the quality of the information entering the system, verifying that the system is processing the information correctly and ensuring that it produces useful reports in a timely manner.

Neither asset and liability nor system integrity risks are addressed in this manual. Both require specialized technical expertise that does not fit into the roles and responsibilities of most general managers. They are mentioned here because they are important components of a comprehensive risk management framework. Although most managers do not have to deal with these issues directly, they must be aware of asset and liability and system integrity risks, and ensure that they hire people with the right expertise to manage these risks.

c) **Inefficiency.** Efficiency remains one of the greatest challenges for microfinance institutions. It reflects an organization’s ability to manage costs per unit of output, and thus is directly affected by both cost control and level of outreach. Inefficient microfinance institutions waste resources and provide clients with poor services and products, as the
costs of these inefficiencies are ultimately passed on to clients. Section V provides a range of strategies and tools to manage the risk of inefficiency.

External Risks

Although MFI managers and directors have less control over external risks, they should assess the external risks to which they are exposed so that they can plan responses that lessen the impact of the risk should it occur. A microfinance institution could have relatively strong management and staff, and adequate systems and controls, but still be prone to major problems stemming from its environment. Even though these risks are usually outside the control of the MFI, it is important that managers perceive them as challenges that the MFI must address, rather than excuses for poor performance. As described in Module 13, these risks include the regulatory environment, competition, changes in demographics, adverse political influences, the physical environment such as natural disasters, and macroeconomic conditions.

10.2 What is Risk Management?

Risk management, or the process of taking calculated risks, reduces the likelihood that a loss will occur and minimizes the scale of the loss should it occur. Risk management includes the prevention of potential problems, the early detection of actual problems when they occur, and the correction of policies and procedures that permitted the occurrence. Combining the planning and controlling functions of managers, risk management is an ongoing six-step process, as shown in Figure 10.2.
1. **Identify Risks**: Before managing risks, it is necessary to identify the organization’s vulnerability points, both current and future. The risk assessment framework in Section 10.1 is a useful structure to guide MFIs through the process of identifying their vulnerabilities.

2. **Measure and Prioritize**: The second step is to assess the potential impact of the identified risks. This involves four main questions:
   - **Likelihood**: How likely is it that the risk will occur?
   - **Frequency**: How often might the risk occur?
   - **Severity**: How great a loss will it be?
   - **Trends**: Is the likelihood, frequency and severity getting worse, better or staying the same.

   When measuring risks, it is useful to disaggregate bigger risk categories into smaller subsets. For example, instead of considering the organization’s credit risk as a whole, it is necessary to consider subsets of the portfolio, such as analysing it by geographic region, loan product (e.g., group vs. individual loans), loan purpose (e.g., enterprise, housing, consumption) and borrower characteristics (e.g., women vs. men, new vs. repeat borrower).

   Besides analysing the current state of the organization, this step involves using a crystal ball to anticipate possible changes in the internal and external conditions during the short, medium and long term. Since no one can accurately predict the future, it is recommended that managers consider best, worst and average case scenarios for each of the three time periods. While it is probably excessive to prepare for the absolutely worst-case scenario, risk management involves taking a conservative approach in preparing for potential outcomes. Managers who only plan for best-case scenarios are setting their organization up for disappointments, and perhaps disasters.

3. **Design Policies to Manage Risks**: Once an MFI has identified its vulnerabilities, it can design controls to mitigate those risks (see Box 10.2). This step is closely linked with Step 2 because an organization can also prioritize its interventions based on an assessment of its current controls. As described in Section 10.3, managers (in consultation with their boards) need to decide whether they want to retain, mitigate, transfer or avoid specific risks.

4. **Implement Policies and Assign Responsibility**: Everyone in the organization has some responsibility for risk management (see Figure 10.3). It is critical to assign responsibilities, otherwise some things might fall through the cracks. Often organizations have a risk management committee chaired by a risk manager, which assumes responsibility for developing an organization’s risk management strategy.
Control is one of the four functions of managers, and nowhere is a discussion about controls more important than when addressing risks. When designing a risk management strategy, the controls to prevent or mitigate risks should be extremely clear and specific, and they need to be carefully monitored to ensure that they work. Controls can be conceived and structured in a variety of different ways, for example:

- **Product design:** For businesses that generate ongoing income, frequent repayments help to reduce delinquency and quickly identify delinquency problems that do occur. Loan size limits for new borrowers (who do not have collateral) can be kept small to mitigate the MFI’s exposure until it gets to know them better.

- **Policies and procedures:** Portfolio diversification — whereby a limited percentage of the portfolio is allowed to go into risky ventures, such as agricultural lending — is an example of a policy control. The separation of duties is also critical, for example so that the cashier does not have access to accounting records and the accountant does not have access to cash.

- **Human resources:** Many organizations conduct background checks on personnel before hiring them. Immediate termination for even minor incidents of fraud is another valuable control.

- **Performance measures:** An analysis of PAR by loan officer is a way of monitoring both credit risk and fraud. MFIs can also use it as a control by not allowing staff to disburse new loans if their portfolio quality deteriorates beyond a certain threshold.

These types of controls are critical, but they should not become straightjackets. While controls may make sense in general, there are likely to be exceptional circumstances in which one can justify overriding them. In such circumstances, MFIs should also have processes for making exceptions and methods for monitoring them.

In addition, **external audits and rating assessments** can be valuable contributions to both the design and monitoring of risk management policies as outsiders bring a fresh perspective and exposure to effective risk management strategies in other organizations.

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**Figure 10.3 Risk Management Roles and Responsibilities**

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<thead>
<tr>
<th>Board Members</th>
<th>Approve policies</th>
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<tbody>
<tr>
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<td>Approve risk indicators</td>
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<td></td>
<td>Monitor adherence</td>
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<tr>
<td>Senior Management</td>
<td>Identify risks</td>
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<td></td>
<td>Develop policies</td>
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<td>Assign responsibility</td>
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<td>Branch Management</td>
<td>Implement policies</td>
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<td>Monitor adherence</td>
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<td>Operational Staff</td>
<td>Adhere to policies</td>
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<td></td>
<td>Offer suggestions</td>
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<td>Provide feedback</td>
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<tr>
<td>Internal Audit Staff</td>
<td>Verify compliance with policies</td>
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<td></td>
<td>Identify uncontrolled risks</td>
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</tbody>
</table>

Source: Adapted from MEDA, 2004.
In reviewing the strategy, the board should ensure that there is sufficient capital for the MFI to absorb any financial loss that does occur and set levels of risk tolerance. For example, what portfolio at risk is acceptable for each product? The board may have a higher tolerance for delinquency in its housing loan portfolio, which is a secured mortgage, than it does with its consumption loans. The board might even set tolerances for customer desertion and staff turnover, as they profoundly affect the MFI's vulnerability to risk.

Once the board has approved the policies, management then develops guidelines and procedures for day-to-day operations, which are implemented by middle managers and (hopefully) adhered to by operational staff.

5. Monitor Effectiveness: Once the risk management policies are in place, MFIs needs to monitor their effectiveness. In fulfilling their controlling function, managers ensure that their subordinates are properly implementing the policies and procedures. If they find that staff members are not complying with certain policies, it may suggest a need for staff training or mentoring, the staff may require disciplinary action, or perhaps the policy was not practical or appropriate.

Another key player in the monitoring of risk management policies and procedures is the internal audit department. Internal auditors have responsibility for regular operational audits of the MFI’s branches and departments, as well as special audits if serious breaches of the policies are identified.

For senior managers and directors, monitoring tools consist primarily of performance ratios that they can track to ensure that risks are being managed, comparing the results to the tolerance levels set by the board.

6. Revise Policies and Procedures: The risk management process is ongoing because vulnerabilities change over time. Risks also vary significantly depending on the institution’s stage of development. An MFI with 2,500 borrowers will experience different challenges from an organization with 25,000 outstanding loans. As participants in a new industry, MFIs cannot afford to become complacent if they want to avoid being toppled by innovations, competition and new regulations, among other things.

The risk management committee generally meets on a regular basis, perhaps quarterly, although emergency sessions may also be necessary. Similarly, the board typically dedicates one meeting per year to a review of the risk management strategy.

10.3 Risk Management Strategies

MFIs can manage risks in four main ways, either on their own or in combination with each other. First, they may choose to retain the risk as part of doing business. For example, loan losses will occur, and they cannot be eliminated, so MFIs set aside loan loss provisions for the very purpose of retaining part of the credit risk. Second, an MFI can transfer the risk to someone else. The most common example of transferring risk is through insurance, such as buying group credit life coverage so that an insurer will repay loans if borrowers die.

The third and fourth strategies, mitigate and avoid, are similar. An MFI can mitigate or reduce the impact of a risk, through carefully designed policies and procedures. For example,
to reduce the amount of money that it might lose through staff collusion, MFIs typically set loan approval limits whereby loan sizes above a certain amount need to be authorized by a more senior manager. Or an MFI might try to avoid certain types of fraud altogether by not allowing field staff to ever touch cash and instead having all disbursements and repayments processed by the MFI's bank partner.

The subtle distinction between mitigation and avoidance can also be illustrated through controls for security risks. MFIs that have their own teller services may hire security guards and install safes and alarm systems to prevent theft. They also might mitigate the impact of theft by limiting the amount of cash that can be left in the branch overnight. Indeed, for many risks, different strategies will be appropriate for different aspects or subsets of the risk, so strategy combinations become essential.

Microfinance institutions cannot completely eliminate their exposure to risks. Efforts to do so would be prohibitively expensive. Thus, MFI risk management involves a search for the perfect, though elusive, balance between the costs and effectiveness of controls, and the effects that they have on clients and staff. In deciding which strategy to use, managers must consider the cost-benefit tradeoffs. For example, larger credit committees may improve the scrutiny of the applications, but they also increase the costs of approving loans.

To select an appropriate risk management strategy, managers should begin by taking into consideration the likelihood, frequency, severity and trends associated with a particular risk, as well as the level of risk tolerance established by the MFI's leadership. They can then make informed decisions about which controls need to be put in place to ensure that risk does not exceed an acceptable level, and how much to spend on these controls. If an MFI is rarely vulnerable to a particular risk and the loss would be small if it occurred, little should be spent to remove the risk. If the potential loss is great and the institution has an opportunity to transfer it at a cost that is less than controlling it internally, it should choose the transfer strategy.

For major risks that cannot be transferred or avoided and are difficult, if not impossible, to control (such as the risk of natural disaster or civil conflict), contingency planning is required. MFIs must prepare themselves in advance to cope with such events if and when they should occur. For example, in the case of a natural disaster, an MFI may be able to insure its buildings (transfer) and back up its information system through an off-site data warehousing firm (avoid), but what will it do about its clients? The MFI needs an emergency plan that it can quickly implement in the event that a disaster strikes (see Box 10.3).
Managing Risks

Box 10.3 Disaster Preparation

Microfinance institutions often operate in disaster-prone environments, both of the human and natural varieties. Consequently, MFIs should prepare for such events and have disaster management schemes ready to pull off the shelf as soon as a crisis occurs. Some key considerations include:

• **Access to savings**: In a disaster, the mutual support system of neighbours and friends often breaks down because all are affected. Consequently, savings become the first line of defence. MFIs that require forced or compulsory savings should allow clients to access them.

• **Loan rescheduling**: Under adverse circumstances, the zero-tolerance approach to delinquency management no longer makes sense. MFIs must be prepared to reschedule loans, but to do so in a customized fashion that meets the circumstances of each borrower. MFIs that have “disaster rescheduling policies” will be better prepared to react quickly.

• **Disaster loans**: Immediately after a crisis, people have emergency cash requirements. They may need to buy food, get clean water or pay for medical services. On a case-by-case basis, small short-term loans — perhaps even on a subsidized or interest-free basis — may be needed to help people cope with urgent needs.

• **Reconstruction loans**: An MFI’s clients may also need to rebuild their houses, businesses or community infrastructure. Long-term, low-interest loans for reconstruction may be appropriate.

• **Relief grants**: When large disasters occur, relief organizations may appear to deliver supplies as well as cash. An MFI’s infrastructure may be an efficient means of delivering such services, although it needs to ensure that clients do not confuse the grants and the loans.

From the perspective of the institution, these services are important, not just because they help people in need, but also because they increase clients’ commitment to the organization. Furthermore, additional injections of capital may be the only means of recovering outstanding loans. For example, if someone gets access to an emergency loan for consumption, they are probably less likely to sell productive assets to make ends meet. Consumption loans that help borrowers keep their businesses going may be the best way of ensuring that the original loan is repaid.

In these circumstances, MFIs are likely to experience two key challenges. The first is **liquidity management**. MFIs must ensure that they have access to sufficient funds to meet withdrawal requests, as well as the demands for new loans. To address this issue, MFIs should make arrangements ahead of time for lines of credit with governmental relief agencies, as well as with banks, so that they can draw down if a crisis occurs. Second, the institution will have to convey to clients that the crisis situation necessitated a **different approach than usual** — i.e., rescheduling loans, cheap credit or even grants — but those conditions will not carry over once things are back to normal.
Main Messages

1. You cannot eliminate risk.
2. A risk framework helps assess the entire range of risks to which an MFI might be vulnerable.
3. Risk management is about prevention, detection and controls.
4. Use cost-benefit analysis to set risk tolerances.
5. Risk management is an ongoing process. Assess the effectiveness of risk management strategies and adjust them accordingly.

Recommended readings:


Financial Management Risks

Credit Risk — the chance that an MFI may not receive its money back from borrowers (plus interest) — is the most common and often the most serious vulnerability in a microfinance institution.

One microloan does not pose a significant credit risk because it is such a small percentage of the total portfolio. Since most microloans are unsecured, however, delinquency can quickly spread from a handful of loans to a significant portion of the portfolio. This contagious effect is exacerbated by the fact that microfinance portfolios often have a high concentration in certain business sectors. Consequently, many clients may be exposed to the same external threat, like a crackdown on street vending or a livestock disease. These factors create volatility in microloan portfolio quality, heightening the importance of controlling credit risk.

Credit risk management can be divided into the preventive steps lenders take before issuing a loan and the use of incentives and disincentives after loan disbursement to extract timely repayment. Prior to issuing a loan, a lender reduces credit risk through controls that reduce the potential for delinquency or loss, such as loan product design and client screening. Once a loan is issued, a lender's risk management expands from controls that reduce the potential for loss to controls that reduce actual losses. Therefore, this module is therefore organized into two sections:

1. Credit risk prevention
2. Credit risk control

11.1 Credit Risk Prevention

This section considers three means of preventing credit risk:

- Loan product design
- Client screening, including the 5 Cs
- The role of credit committees

Loan Product Design

Loan product features include the loan size, interest rate, repayment schedule, collateral requirements and any other special terms.

To mitigate default risk, MFIs can start by designing loan products that meet clients' needs. Loan products should be designed to address the specific purpose for which the loan is intended. For example, a loan to purchase inventory for a neighbourhood grocery store might have a different repayment schedule and use different collateral than a loan for a sewing machine. A loan for purchasing seeds and fertilizer to grow maize may have another structure,

This module was adapted from:
perhaps with repayment coming in a lump sum at harvest time. Loan products for non-business purposes, such as housing, emergency, education and consumption smoothing, also require different design features.

In designing loan products to minimize credit risk, consider the following features:

1. **Eligibility**: Is there a way of using the eligibility requirements to reduce credit risk? Some MFIs only lend to women, in part because they think they are lower risk. Other organizations are careful to only lend to poor people because in part they consider the not-so-poor to be too knowledgeable and more likely to take advantage of the loan scheme.

2. **Interest rate and fees**: Should the MFI charge a higher interest rate for those persons that it considers riskier borrowers?

3. **Term**: Shorter terms are generally less risky because it is easier to predict what will happen in the next three months than in the next three years.

4. **Repayment frequency**: More frequent repayments (i.e., weekly) are less risky because it provides the MFI with a way to continuously monitor whether borrowers are upholding the loan contract. If the borrower is only expected to repay the entire principal and interest at the end of a nine-month term, the MFI has to wait for nine months before it will know whether the loan will be repaid.

5. **Instalment amounts**: Low-income households generally do not have equal monthly incomes, so it can be difficult for them to pay equal monthly loan instalments. Ideally, repayment amounts should be designed to accommodate the borrower's expected cash flow.

6. **Collateral and collateral substitutes**: If the borrower cannot pay, who will? MFIs use a variety of different means for securing loans, including group guarantees, co-signers or guarantors, and non-traditional collateral such as business equipment, household appliances and livestock. Some loans are also backed by a household member's salary (i.e., the employer repays the loan to the lender by deducting a small amount from each pay cheque).

For new clients, MFIs commonly adopt conservative product design features, such as small loan amounts, short loan terms and frequent repayment periods. This approach is particularly relevant for clients who lack business records (i.e., they cannot provide evidence of their capacity to repay) and cannot offer collateral.

Once the client establishes a track record with the lender, the MFI often increases the flexibility in loan terms to make the product more appropriate to the borrower's needs. This change reflects a balance between risk and control. New clients are categorized as high risk. Once they establish a credit history with the MFI, they can usually be considered a lower risk and the lender can reduce some of its controls (see Box 11.1).

The process of loosening these controls also rewards timely repayment. The MFI should inform clients from the beginning that their ability to access more accommodating services depends on their repayment history. If they repay on time, they can access preferred product features such as larger loan sizes, lower interest rates, less frequent repayment periods and even additional products. As discussed in Module 9, another positive benefit of reducing controls for low-risk, repeat borrowers is that it helps to reduce client desertion.
Managing Risks

Box 11.1 Are All Repeat Borrowers Low Risk?

One challenge of lending is having sufficient information to make a good credit decision. The application process is designed to overcome some of the information problems, but the process of collecting information should not end there. Clients who pay on time every month are providing the institution with valuable information about their reliability. Unfortunately, in the interest of efficiency, some group methodologies intervene between the client and the MFI, so the institution does not know which group members are the low-risk borrowers.

The “stepped lending” methodology may actually increase the risk of lending to repeat borrowers. Many organizations automatically increase loan sizes for clients who have repaid on time. If this is done without re-establishing the client’s capacity to repay, MFIs may encounter the unfortunate situation of having poorer portfolio quality for repeat borrowers.

Client Screening

A second step in limiting credit risk involves screening clients to ensure that they have the willingness and ability to repay a loan. When analysing client creditworthiness, microfinance institutions typically use the five Cs summarized in Table 11.1. If any of these components is poorly analysed, credit risk increases. To limit this risk, institutions develop policies and procedures to analyse each component.

Table 11.1 The Five Cs of Client Screening

<table>
<thead>
<tr>
<th>(1) Character</th>
<th>An indication of the applicant’s willingness to repay and ability to run the enterprise</th>
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</thead>
<tbody>
<tr>
<td>(2) Capacity</td>
<td>Whether the cash flow of the business (or household) can service loan repayments</td>
</tr>
<tr>
<td>(3) Capital</td>
<td>More assets than liabilities in the business and/or household</td>
</tr>
<tr>
<td>(4) Collateral</td>
<td>Access to an asset that the applicant is willing to cede in case of non-payment, or a guarantee by a respected person to repay a loan in default</td>
</tr>
<tr>
<td>(5) Conditions</td>
<td>A business plan that considers the level of competition and the market for the product or service, and the legal and economic environment</td>
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These five components are relevant to all types of lending institutions. The weight assigned to each component will vary depending on the lending methodology (i.e., solidarity group, village banking or individual), the loan size and whether it is a new or repeat customer.

Not everyone who applies for a loan is a good credit risk. Regardless of the lending methodology, loan officers should be expected to make wise credit decisions. Unfortunately, in some MFIs, field staff act more like loan administrators than loan officers – if the paperwork is in order and the applicants have fulfilled whatever savings and meetings requirements there might be, then they automatically receive a loan. This process can result in poor portfolio...
quality. Loan officers and their immediate supervisors should consider the 5 Cs when making credit decisions, and they should be held accountable for those decisions.

**Character.** In microfinance, character is the single most important means of screening new applicants. By assessing a client’s character, the lender gains important insight into the client’s willingness to repay. Although the MFI does not want to put clients in a difficult situation, clients with good character will find a way of repaying their loans even if their businesses fail. The importance of character as the key trait to select new borrowers is heightened by the fact that many microenterprises do not have sufficient records to demonstrate their capacity to repay.

Screening for character varies by the lending methodology. In group-lending programmes, the group assumes responsibility for selecting members of strong motivation and character because members guarantee each other’s loans.

With individual lending, besides interviewing neighbours and opinion leaders in the community, loan officers also need to ensure that information provided by the applicant is **internally consistent.** This is often tested through a three-stage method whereby applicants provide information about themselves and their business in a loan application. Then the loan officer visits the household and/or business to, among other things, verify that the application information is correct. Finally, the loan officer checks other sources to assess the reliability of the information, such as a landlord regarding the size of rent and the length of residence, or a supplier regarding the frequency and size of inventory purchases. Figure 11.1 summarizes methods for character screening.

**Figure 11.1 Methods for Screening an Applicant’s Character**

- Check personal and community references for reputation (i.e., do they have a history of womanizing, gambling or excessive drinking?)
- Speak with customers about their view of the business
- Use peer groups to select reliable and honest members
- Maintain a blacklist of past poor performers
- Interview the applicant to assess the motivation for borrowing
- Check credit history with suppliers, other lenders, credit bureaus and previous experience with the organization
- Test for internal consistency of supplied information
- Rely on the loan officer’s gut feel

Over time, loan officers develop instincts for assessing the character of applicants. Besides assessing their honesty through internal consistency, they also look for warning signs that suggest that the applicant might be risky. For example, some loan officers are wary of applicants who are in a hurry to get a loan, because that might suggest that they need the money to pay
off other loans. If applicants have unrealistic ideas, or their business plans are too polished, that might actually put off (instead of impress) some microlenders. Or if the applicants are wearing too much jewellery or expensive clothes, perhaps it suggests that they do not spend their money wisely.

Obviously the red flags will differ depending on the environment and target market, but MFIs should help their loan officers develop a gut feel for who is and is not creditworthy by assisting them in analysing common **characteristics of bad borrowers**. A systematic review through the files of defaulters will likely identify some patterns that could help loan officers and credit committees avoid repeating their mistakes. Some patterns may be so sharp that the MFI feels compelled to modify its lending policy accordingly. For example, after such an analysis, one MFI stopped giving loans to bachelors. If men were married, they were more stable; but single men were nothing but trouble.

**Capacity.** To assess an applicant’s capacity to repay, loan officers conduct both business and household assessments. One challenge in determining the business’ capacity to repay is the fungibility of money – what the client says she will use the loan for and what she actually uses the loan for may be different. Because the lines between a microentrepreneur’s business and household activities are often blurred, it is important for the loan officer to understand the flow of funds within and between the two (see Box 11.2).

It is difficult to assess the repayment capacity of a low-income applicant. Estimates of income and expenses may not be reliable, and applicants often do not have supporting financial records. Experienced loan officers develop methods of improving the quality of these estimates by determining the basis on which they are made and then testing whether the assumptions are valid. However, wide variations may still exist between estimated and actual cash flow of a business, even if the applicant is not intentionally misleading the loan officer.

To compensate for these challenges, some MFIs take a conservative approach and assess a client’s capacity to repay without taking into account the effect of the loan on the business. That means that the current net income of the business is a certain multiple of the proposed installment amount; in other words, the applicant estimates that the business (or the household) is already generating enough revenue to repay the loan. In this way, microfinance is closer to consumer finance than to enterprise lending.

MFIs also use small initial loan sizes and an ongoing process of collecting information to overcome the challenge of assessing the applicant’s repayment capacity. Initial loan sizes tend to be smaller than the applicant requests because the loan officer does not have good information to assess repayment capacity. Clients are then asked to maintain basic business information on income and expenses so that loan officers can make future credit decisions based on more reliable information and tailor subsequent loans to the cash flow of the business.

With small loan sizes, it is appropriate that the applicant’s character is the key screening element. As loan sizes increase, however, there needs to be a shift from “soft” information like character to harder information such as capacity. To make good credit decisions, it is important that loan officers collect information over time that will allow them to understand the capacity of their clients’ businesses.
Box 11.2 Business and Household Assessments

Loan officers visit applicants to observe the business in action, and assess how the applicant interacts with customers and the condition of business equipment. Since microentrepreneurs are unlikely to have the documentation required by traditional banks, microlenders collect information through observation. During the assessment process, credit officers can probe if the applicant’s responses do not seem realistic or do not have internal consistency, rather than take information at face value.

The process of assessing applicants’ businesses, and in most cases their households as well, achieves five main purposes. First, the assessment determines if the applicant is creditworthy by collecting objective data regarding the business, the applicant’s outstanding debts, and the household’s cash flow. Second, it provides information to ensure the product is designed to the applicant’s credit needs and capacity. Third, the assessment allows the credit officer to collect subjective information about the applicant’s character to develop a “gut feel” if the applicant is trustworthy. Fourth, this process plays a role in educating the client about the lender’s motives and mechanisms. Fifth, the assessment helps to forge a positive working relationship between client and loan officer.

Source: Adapted from Churchill, 1999.

Capital. Besides assessing the cash flow of the business to determine if it has the capacity to repay a loan, many MFIs collect information on the assets and liabilities of the business to construct a simple balance sheet. This allows the loan officer to determine if the business is solvent and how much capital the client has already invested in the business. With the smallest loans, this C is less important, but its significance grows as the loan sizes increase. In some cases, loan sizes are linked to the equity in the business.

Some MFIs also conduct an asset inventory to reduce credit risk. Although they may not say so explicitly, loan officers convey the message that, if the client does not repay, the institution might seize these assets. This is known as implicit collateral.

Collateral. One reason for the development of the microfinance industry is that banks do not serve persons who cannot offer traditional collateral. Many microlending methodologies use peer groups, restrictive product terms and compulsory savings as collateral substitutes. Subsequent lending innovations have resulted in the provision of microloans with non-traditional collateral, such as household assets and co-signers. Pawn lending and asset leasing are other methods of overcoming collateral constraints.

Perhaps more important than the type of collateral is how it is used. In microfinance, collateral is primarily employed as an indication of the applicant’s commitment. It is rarely used as a secondary repayment source because the outstanding balance is so small that it is not cost-effective to liquidate the collateral, much less legally register it. Only when clients are not acting in good faith do microlenders take a hard-line stance and seize collateral. Consequently, MFIs tend to be less concerned about the ratio of the loan size to the value of collateral than how the clients would feel if the collateral was taken from them. As the loan size increases, however, this soft approach to collateral needs to change so that larger loans are indeed backed by appropriate security.
Managing Risks

Conditions. The fifth component, conditions, is often the hardest for loan officers to assess. Some MFIs adopt a microenterprise development approach to microfinance, which means that they are as concerned with improving the business as recovering the loan. As such, the process of assessing the level of competition, the size of the client’s market, and potential external threats can play an important role in helping the client to make smart business decisions and help the loan officer to make good credit decisions.

Since loan officers do not usually have the expertise to analyse the conditions of all types of businesses, the primary means of controlling the credit risk posed by business conditions is to require that applicants be in business for a certain number of months (usually six to 12 months) before they are eligible for a loan. This requirement means that applicants should have sufficient experience to answer questions about market conditions. The existing business requirement also makes it easier to assess repayment capacity and business capital needs.

Credit Committees

A committee of persons to make decisions regarding loans is an essential control in reducing credit (and fraud) risk. If an individual has the power to decide who will receive loans, the conditions of the loans and which loans will be written off or rescheduled, this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved.

For larger loans, a committee of three or more individuals is appropriate. A credit committee typically includes senior and middle managers, but it might also include community leaders, local bankers and even clients. The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and, should borrowers have repayment problems, getting involved in delinquency management. This way the credit committee lives with the implications of its decisions.

MFIs should have written policies about the role and responsibilities of credit committees that clearly identify their loan approval authority. These policies specify the loan amounts that can be approved with two signatures, loan amounts requiring additional signatures and who has the authority to approve loans. This reduces the risk of loans being inappropriately approved.

With group lending methodologies, the group usually fulfils part of the credit committee’s function. Since group members guarantee each other’s loans, it is important that they be involved in the approval process. But MFIs should not abdicate all responsibility for loan approval to the group. Borrowers are unlikely to have the skills to make good credit decisions, and therefore the loan officer needs to be familiar with the businesses and should facilitate the discussion.

Ultimately the MFI’s money is at risk, so loan officers and their immediate supervisors need to sign off on all credit decisions and feel comfortable that the money will be repaid. Loan officers should feel comfortable:

a) Rejecting entire groups if the members do not know and trust each other very well or if they do not appreciate the importance of joint responsibility
b) Encouraging good group members to exclude inappropriate members; and
c) Promoting smaller loan sizes that members are confident that they can repay

To act in this way, loan officers need the tools and the training to conduct business and character assessments, to facilitate group discussions and to test the group's commitment to each other.

11.2 Credit Risk Control

Strategies to prevent credit risk — product design, client screening and credit committees — are extremely important, but insufficient. It is unrealistic to plan on designing a perfect product and selecting only perfect clients to avoid loan losses. Some loans invariably become delinquent. To minimize losses, it is necessary to: a) develop appropriate delinquency management systems; and b) monitor portfolio quality.

Delinquency Management

In developing a delinquency management system, consider the following seven strategies designed to balance carrots (incentives) and sticks (penalties):

1) Institutional culture. A critical delinquency management method involves cultivating an institutional culture that embraces zero tolerance of arrears and immediate follow up on all late payments. MFIs can also remind clients who have had recent delinquency problems that their repayment day is approaching.

2) Client orientation. A logical first step toward developing a zero-tolerance institutional culture is to communicate this concept to each new client before she receives a loan. An orientation curriculum should be prepared along with graphics and teaching aids to simply and clearly describe the terms of services being offered, the expectations of each client and procedures that will be followed in the case of arrears.

3) Staff incentives. Creating staff involvement in discouraging delinquency, through a staff incentives system, can be effective. As discussed in Module 19, to be eligible for financial incentives MFIs establish a minimum portfolio quality criterion; in addition, the scheme should have a greater weight for portfolio quality than for portfolio quantity. Staff should carry bad debts in their portfolio for a significant period of time (at least six months) to ensure that they are held accountable for making credit decisions. Some organizations even use negative incentives, docking the loan officers' pay if they incur loan losses. Non-financial incentives include branch and loan officer competitions and special recognition for top performers.

4) Client incentives. The primary reason clients repay their loan is to access another loan. Consequently, microlenders' primary incentive to reward clients in good standing is through access to subsequent loans, which often means larger loans. Preferred services for repeat clients may also include lower interest rates, faster loan approval and access to parallel credit products such as seasonal loans. Another tangible incentive is an interest reimbursement. For example, the Bank Rakyat Indonesia (BRI) offers a prompt payment incentive for clients who pay on time for six consecutive months, which amounts to one
quarter of the interest payment during that period. In effect, BRI charges the delinquency fee up front and then reimburses clients who repay on time.

5) **Delinquency penalties.** Clients should be penalized for late payment. This could include delinquency fees pegged to the number of days late and limiting access to repeat loans based on repayment performance. Figure 11.2 shows an example of these types of penalties from the Alexandria Business Association in Egypt.

**Figure 11.2 Alexandria Business Association: Delinquency Penalties**

<table>
<thead>
<tr>
<th>Number of days (cumulative)</th>
<th>Sanction</th>
</tr>
</thead>
<tbody>
<tr>
<td>3+ days late (first loan)</td>
<td>A repeat loan is refused</td>
</tr>
<tr>
<td>&lt; 5 days late (repeat loan)</td>
<td>No consequences</td>
</tr>
<tr>
<td>6 to 9 days late (repeat loan)</td>
<td>A penalty of one month’s interest and the next loan amount may be kept constant</td>
</tr>
<tr>
<td>10+ days late (repeat loan)</td>
<td>A second penalty of one month’s interest and further loans will <strong>likely</strong> be refused</td>
</tr>
</tbody>
</table>

6) **Enforcing contracts.** An MFI will quickly lose control of portfolio quality if it fails to enforce its contracts. MFIs should not have any policies in their contracts that they are not prepared to enforce. Clients should be oriented to penalties and delinquency procedures before receiving their first loans, so they know exactly what to expect if their loans become delinquent. While certain accommodations can be made for borrowers who are willing but unable to repay, MFIs must respond to any uncooperative behaviour from delinquent clients by escalating the pressure.

Microfinance institutions should have policies that stipulate their escalating responses to delinquent borrowers and the acceptable time period between each intervention. For example, in the case of individual microloans, typically the first response would be a visit from the loan officer the day after the repayment was due. If the loan officer is unable to collect during this friendly, courtesy visit, the client and the loan officer would agree on a new date and time (usually in the next day or two).

If that deadline is breached, then the tone from the loan officer starts getting more severe. If a subsequent loan officer visit does not produce a payment, the branch manager will get involved. The two of them might establish a “good cop-bad cop” routine where one shows sympathy for the borrower, while the other adopts a more hard-line stance—at this point the MFI still does not want to completely alienate the client as there may be a chance that this is an ability-to-pay problem. If payment is still not forthcoming, the MFI further tightens the screw. For larger loans, a more senior manager may also need to get involved. Additional measures might include official letters, pressure on co-signers and persons who gave character references for the applicant, seizing collateral and perhaps even the involvement of local law enforcement.

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6 Delinquency management with group loans will follow a slightly different path since other group members are actively involved at various stages in the debt-collection process.
7) **Loan rescheduling.** Given the vulnerability of the target market, it is common for borrowers to be willing but unable to repay. After carefully determining that this is indeed the case (i.e., sceptically concluding that clients are not cleverly pulling on one’s heartstrings), it may be appropriate to reschedule a limited number of loans. Only done under extreme circumstances, this may involve extending the loan term and/or reducing the instalment size. The case study of Grameen II at the end of this chapter illustrates an approach that tolerates rescheduling and emphasizes repayment incentives instead of penalties to suit better the characteristics of a vulnerable target market. MFIs must be transparent about their rescheduling policies and they must report their portfolios accordingly. Portfolio quality indicators and provisioning requirements should clearly distinguish between regular and rescheduled loans.

In developing their delinquency management policies, senior managers and the board have to determine their credit risk tolerance. In many new organizations operating in areas where clients are not familiar with credit from formal sources — or where clients are used to grants that are disguised as loans — the zero-tolerance approach discussed above may make sense. This approach follows the logic that if you give them an inch, they will take a mile; it is designed to create repayment discipline.

As institutions and markets mature, and as staff develop expertise, MFIs may want to consider adjusting their tolerance for credit risk. For example, if a loan officer knows that a client will repay her loan, but she will just be a few months late, does the MFI have to go through the costly contact enforcement steps described above? MFIs need to compare the costs of credit risk controls and their contract enforcement procedures with the returns that they get in the form of lower loan losses. If a 5 to 10 per cent portfolio at risk ultimately results in a 1 to 2 per cent loan loss, is it all right to let clients take their time to repay loans if interest is charged on the declining balance? If an MFI chooses to do so, it must keep in mind the contagious effect that might occur with unsecured loans. If clients sense that the MFI is turning soft, some may try to take advantage of the situation.

**Credit Risk Monitoring**

An MFI manager should at least monitor portfolio quality ratios (see Box 11.3) on a monthly basis — but for the most sensitive ratios, weekly or even daily would be better. In addition, managers must be aware of the number and value of loans that have been rescheduled, and this segment of the portfolio should be tracked separately.

While repayment rate is typically the most cited portfolio quality indicator, in practice it is not as effective as portfolio at risk because it does not reveal the full degree of vulnerability that an organization faces when a loan repayment is late. Portfolio at risk accounts for both: the loss that an MFI faces today due to late repayment and the potential loss that it faces if no future payments are made on that now delinquent loan.
Managing Risks

Box 11.3 Portfolio Quality Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio at risk</td>
<td>Value of outstanding balances of all loans in arrears / Value of loans outstanding</td>
</tr>
<tr>
<td>Loan loss ratio</td>
<td>Amount written off / Average loans outstanding</td>
</tr>
<tr>
<td>Reserve ratio</td>
<td>Loan loss reserve / Value of loans outstanding</td>
</tr>
<tr>
<td>Loan rescheduling ratio</td>
<td>Amount of loans rescheduled / Average loans outstanding</td>
</tr>
</tbody>
</table>

Because of the small loan sizes, microfinance portfolios are not typically exposed to the same concentration risk as traditional banks, which have policies to ensure that individual loans do not represent a significant portion of the portfolio. However, MFIs need to monitor their loan portfolio composition and quality by region, business sector, loan number and loan size to reduce the institutions’ vulnerability to external threats that may affect a larger portion of their clients. For example, if 25 per cent of the portfolio goes to coffee farmers and the price of coffee beans drops, a quarter of the portfolio will likely be at risk.

For institutions interested in undertaking a comprehensive assessment of the risks inherent in their loan portfolio, MicroSave and the India-based Micro-Finance Consulting Group have recently developed a Loan Portfolio Audit Toolkit that managers may find useful. The tool kit guides a review of an MFI’s lending systems and procedures as well as the internal controls in place to mitigate credit risk. It explains the basic methodology of how to structure a loan portfolio audit and provides a series of checklists that can be used to conduct the audit.

Main Messages

1. For microloans, character is the most important factor in assessing creditworthiness.
2. MFIs should help field staff develop their instincts for character assessment by analysing common characteristics of defaulters.
3. As loan sizes get larger, credit risk controls need to transition from soft approaches, like character-based lending and collateral substitutes, to harder controls such as business capacity and tangible collateral.
4. The primary reason clients repay their loan is to access another loan.
5. MFIs should monitor the credit risk associated with different segments of their loan portfolios.
Case Study: Rethinking Repayment Culture under Grameen II

In 2002, the Grameen Bank completed an overhaul of its products and services, including its lending methodology. After 25 years of adding and subtracting bits and pieces to its product menu, Dr Yunus and his colleagues decided it was time for a holistic revision that would make Grameen's services more appropriate for poorer members and more considerate of members who were experiencing difficulty. Instead of a huge menu of specialized loan products, each with its own specific rules and regulations, Grameen II consolidated more than a dozen loan products into three: a basic loan, a flexi-loan, and a business loan.¹

Grameen II was designed to overcome the rigidities of the previous core product, which became particularly pronounced after the severe flood in 1998 that affected many members. The main weakness was that members had to follow a strictly prescribed schedule of borrowing and repaying and, according to Dr Yunus, "once a member fell off the track, she found it very difficult to move back on."

So Grameen, after exhaustive dialogue with staff and members, and considerable testing, produced a three-track approach, the main road (basic loan), the highway (business loan) and the country road (flexi-loan) as a strategy for accommodating the heterogeneous needs of its target market. For all of these loans, the environment or delivery system is unchanged — members still borrow and repay loans through five-person groups meeting in the company of several other groups (a centre) at a weekly meeting served by a Grameen staff person. The loan products and the approach to credit risk management, however, are fundamentally different.

On the surface, the new basic loan — the main road — looks very much like the old general loan. No collateral is required, but one's group and centre have to approve the loan which is repayable in weekly instalments. However, all general loans were for 50 weeks, whereas the basic loan can be for three months or three years (or various intervals in between). First loan amounts are still Taka 5,000, but loan ceilings for subsequent loans depend on the repayment performance of the individual and the centre — loan ceilings can drop if repayment and attendance are poor. It is also now possible for repayment amounts to be designed up front to vary from week to week due to seasonal fluctuations (previously all instalments were of equal amounts), although thus far, few clients have taken advantage of this option (primarily because it is not promoted by the loan officers). Perhaps one of the most popular changes has been the top-up option — when a member is half way through a loan of 12 months or more, she can re-borrow the amount that she has already repaid and extend the term for the same period of time so the instalments do not change.

Borrowers can get off the main road and on to the highway, and therefore access even larger loans in addition to the basic loan, based on their repayment record, savings balances (savings is now mostly voluntary) and the business's viability — borrowers have to demonstrate that they have a larger enterprise capable of absorbing the extra loan capital. There are no fixed limits for business loans, but it is helpful to have high savings balances (including the pension fund) and a gold membership status (i.e., members with perfect repayments over a five-year period). These loans appear to be growing in popularity among clients and staff.

Note ¹ There is actually a fourth loan product, a housing loan, but it was not affected by the transition to Grameen II; under Grameen II, there have also been significant changes to the savings products, but those are not discussed here.
The country road is less travelled. The flexi-loan is a basic loan that has been rescheduled because the borrower has difficulty repaying. Grameen knows that repayment difficulties are inevitable for the poor, and the flexi-loan is designed to be a routine, non-shaming, sensible way to solve the difficulty. When borrowers experience repayment difficulty, they can move off the main road onto the country road, which means that they can agree to a new loan term and repayment amounts. If the borrower is able to repay the loan based on the new repayment schedule, she can get back on the main road, with a smaller loan size ceiling. The intention is to rely more on repayment incentives (i.e., future loans) instead of the penalties of peer pressure that were problematic in the old Grameen system. This product was commonly used during the transition to Grameen II to help those in arrears get back on track. It is less common now, largely because conservative staff have been reluctant to promote it. In addition, the top-up option, and the fact that members can now access their savings, means that borrowers have other means for coping with difficult periods besides rescheduling their loans.

Even though the experience with Grameen II is quite new, it looks promising. Several important new features (e.g., top-up option, business loans and accessible savings) have been embraced, and perhaps the other flexible features will follow. Like the old approach, the Grameen II methodology is founded on the belief in the character of its clients: that the poor always repay their loans. Now, with this new approach, it is possible to test that theory.

This case study was adapted from:
- Rutherford, various MicroSave Briefing Notes.

Recommended readings:
12 Staff Fraud and Security Risk

All microfinance institutions will at some point experience fraud perpetrated by staff members, perhaps in cahoots with clients. They are also likely to experience theft. Wherever there is money, fraud and theft cannot be far behind. Managers should not assume that they can eliminate these evils; however, through proper controls they can reduce their vulnerability.

This module includes the following sections:
1. Who commits fraud
2. Types of fraud
3. Methods for preventing fraud
4. Methods for detecting fraud
5. Responses to fraud
6. Reducing security risks

12.1 Who Commits Fraud?

Before thinking about how to prevent, detect and respond to fraud, it is useful for managers to consider who they are trying to protect their institution against. Contrary to popular belief, fraud is not typically carried out by devious characters who scheme from the moment they are hired to steal from an institution. Rather, it is ordinary people who commit fraud: loan officers, tellers, messengers, accountants, finance managers, internal auditors, branch managers and even CEOs. Loan officers are probably involved in most cases of fraud, although the money lost is usually not large. There are fewer instances of management-level fraud, but they tend to be for larger amounts of money (Valenzuela, 1997a).

Research in the banking industry has shown that employees who commit fraud have typically been employed with the bank they defraud for many years. They are usually non-technical, authorized staff with no record of being problem employees. Often they use legitimate computer commands to commit fraud and do so primarily during normal banking hours (Trinkler, 2005).

One additional point worth noting is that people who choose to commit fraud usually believe they are justified in doing so (American Institute of Certified Public Accountants, 2003). This has tremendous implications for microfinance institutions as they attempt to protect themselves from fraud. To the extent that MFIs can hire staff who believe in the institution's mission, maintain momentum in the pursuit of that mission, and treat staff in such a way that they feel respected, cared for and appropriately compensated, fraud should be less of a problem.

This module was adapted from:
• Churchill and Coster (2001).
12.2 Types of Fraud

The first step toward preventing and detecting fraud is to identify the types of fraud that may occur and determine the organization’s points of vulnerability. For example, an analysis of the lending process might reveal the types of fraud highlighted in Table 12.1. By organizing fraud into categories such as this, it enables managers to consider carefully where their organizations might be most vulnerable.

### Table 12.1 Examples of Microlending Fraud

<table>
<thead>
<tr>
<th>Disbursement</th>
<th>Repayment</th>
<th>Collateral</th>
<th>Closure</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Loan officer issues loans to “ghost” clients.</td>
<td>• Loan officer collects payment, issues receipt, but does not deposit.</td>
<td>• Loan officer collects collateral but does not deposit it in storage area.</td>
<td>• Forced savings refunds do not find their way back to the clients, and borrowers forget to ask for them.</td>
</tr>
<tr>
<td>• Cashier makes loan to himself.</td>
<td>• Agents collecting loan payments do not deposit them in a timely manner.</td>
<td>• The storekeeper appropriates the collateral and conceals it by making false entries in the warehouse records.</td>
<td>• Loan officer collects payments on loans that have been officially written off.</td>
</tr>
<tr>
<td>• Loan officer charges clients an unofficial “fee” to apply for a loan.</td>
<td>• Loan officer charges unofficial delinquency fees.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Microfinance fraud certainly is not limited to the organization’s lending activities. In fact, an MFI is even more vulnerable to fraud associated with savings because it is harder to detect. Fraud can also occur in managing the business operations of the branch, such as misuse of petty cash, false claims for travel reimbursement and kickbacks from procurement contracts.

12.3 Fraud Prevention

**Internal control** involves a combination of “hard” policies and procedures, as well as a “soft” approach designed to create a fraud-free culture. A central challenge in designing an internal control apparatus is its cost-effectiveness. The hard approach is typically used to reduce the risk of fraud committed by an employee on his own, but it is generally not cost-effective in reducing risk stemming from **collusion** among employees or from **management override**. The latter occurs when a high-level employee uses his/her authority to incite a lower-level employee to violate control policies or procedures, enabling the high level employee to commit fraud. An example is a finance manager ordering the cashier to give him the key to the safe for some fictitious reason.

Risk of fraud stemming from collusion among employees or from management override is usually reduced through soft controls, such as a strong emphasis on ethical conduct, high levels of control consciousness, an environment of open communication, and swift action against anyone committing fraud.
In preventing microfinance fraud, consider the following nine categories of operational controls that are particularly relevant for savings and lending activities:

a) Excellent portfolio quality

b) Simple and transparent products

c) Human resource policies

d) Institutional culture

e) Client education

f) Credit committees

g) Handling cash

h) Collateral controls

i) Write-off and rescheduling policies

j) Office management

a) **Excellent Portfolio Quality**

If very few loans are in arrears, the chances that the MFI is experiencing fraud in its lending activities are significantly reduced. The handful of delinquent loans can be easily checked to determine if they are fraudulent. But when large volumes of loans are in arrears, and delinquency management systems get overloaded, then fraudulent loans may go undetected for long periods of time, which will breed more fraudulent loans.

b) **Simple and Transparent Products**

If an MFI's products and delivery systems are simple and straightforward, this will go a long way toward preventing fraud. As an organization becomes more complicated and diversifies its services, there is a much greater likelihood that fraud will proliferate. Fraud is a particular concern in MFIs where loan officers have significant discretionary authority, such as determining loan sizes, accepting collateral and setting interest rates. In this way, an MFI has to balance being responsive and customizing its services to each client's needs with the concern that this will expose the organization to fraud.

A particular area of vulnerability is the discretion that field staff may have regarding the imposition of delinquency fees. Some MFIs charge a delinquency fee for late payment, yet waive the fee if clients have a good reason for being late. Consequently, it is difficult to monitor whether fees are being paid and pocketed, or whether they are regularly being waived, in which case they are not serving their purpose. To reduce exposure to fraud, MFIs should either make the fees mandatory regardless of the reason, or find another way of penalizing late payers like creating a repayment incentive for those who pay on time.

c) **Human Resource Policies**

An MFI's human resource policies serve as potential controls for preventing misappropriation of assets, for example:

- **Hiring.** MFIs should use staff screening mechanisms, like personality tests and employee references, to ensure that they are hiring upstanding citizens. They should also consider conducting background checks.
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- **Training.** A critical aspect of bringing on new recruits is to indoctrinate them into the institution’s culture, to promote the organization’s core values of honesty and integrity, and to demonstrate a zero-tolerance policy with respect to fraud by making examples of fallen employees who succumbed to temptation and suffered the consequences.

- **Compensation.** Employees who do not feel sufficiently compensated will be much less likely to carry out their responsibilities with the necessary thoroughness and attention to detail. They are also much more likely to committing fraud, especially in economies where the cash that they handle represents months or even years of salary. A competitive salary is a strong preventive control in deterring fraudulent behaviour.

- **Termination.** Employees’ awareness of the consequences for inadequate job performance can also be a preventive control for staff fraud. MFIs should send a clear message that employees will be immediately terminated, lose their valuable source of income and benefits, and be taken to court (if possible) if they perpetrate fraud. Swift and permanent action in response to even the least consequential fraudulent activity sends a clear message to employees that the MFI does not tolerate fraud of any type.

d) **Institutional Culture**

Internal auditors do not identify most fraud. Co-workers do. To take full advantage of this fact, well-run MFIs create a culture in which staff find fraud to be unacceptable and are willing — even eager — to report it. Prodem used the slogan, “Not even a drink of water” to reinforce the message that its staff must not accept bribes or kickbacks from clients, and that the organization would not accept dishonesty or fraud in any form, no matter how insignificant. Staff embraced the slogan and took pride in their institution’s attempt to differentiate itself in a country that is widely corrupt.  

Of course, slogans alone are not enough to create a culture that opposes fraud. Efforts can and should be taken by MFIs to incorporate transparency and integrity into their institutional values, to raise consciousness of the controls that exist in routine processes and the importance of implementing them as designed, to make audits positive learning processes rather than an occasion for pointing fingers and assigning blame, to keep lines of communication open and accessible, and so on. Managers must also establish policies and procedures, some of which have been mentioned above, to clearly describe what constitutes fraud, to convey the institution’s unwillingness to accept it, and to make fraud easy to report.

e) **Client Education**

Informing clients of their rights and responsibilities in the loan process is a critical preventive control. Because clients tend to be illiterate and/or under-educated, they are more vulnerable to being defrauded by loan officers, and to not catching errors in the loan process. This risk is especially problematic because of the importance of the loan officer-client relationship to the ultimate success of a MFI. Thus, an essential control for preventing errors and potential frauds is to actively educate clients of their rights and responsibilities, including:

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• Demanding an official, pre-numbered receipt whenever money or collateral changes hands
• Only giving or receiving money from a designated MFI employee – if possible, this should be the cashier
• Knowing the appropriate channels to voice complaints and concerns

Well-publicized campaigns to this effect will not only educate clients, but also make employees think twice about taking advantage of their customers. In group-lending programmes, it can be reinforcing to have clients provide peer orientations around these issues to new clients entering the programme.

**f) Credit Committees**

Credit committees not only play an important role in reducing credit risk, but also are an essential element of an operational integrity and fraud prevention strategy. **Every loan must be approved by at least two persons.** With small loans, the signatures typically come from the loan officer and the branch manager. The branch manager must take this responsibility very seriously. When reviewing applications, the branch manager ensures that they comply with MFI policy and do not contain unreasonable information, such as unrealistic monthly income levels. To reduce the chances that loan officers are creating “ghost” borrowers, the branch manager should meet all applicants, preferably before they receive the loan.

**Loan approval authority** levels also reduce MFI exposure to fraud. The authority levels might look like this:

<table>
<thead>
<tr>
<th>Loan Amount</th>
<th>Signatures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below US$500</td>
<td>Two signatures: Loan officer and branch manager</td>
</tr>
<tr>
<td>Between US$500 and US$2,000</td>
<td>Three signatures: The previous two plus an external chair of the credit committee</td>
</tr>
<tr>
<td>Above US$2,000</td>
<td>Five signatures: The previous three plus the operations manager and a member of the board</td>
</tr>
</tbody>
</table>

Therefore, if the branch manager and loan officer collude to defraud the company, they would only be able to steal US$500 at a time.

Any person who places his/her signature on an application must realize the significance of that action. Too often, signing applications, vouchers or other documentation is not taken seriously. Sometimes senior people do not even look at what they are signing because they have to approve so many items. This behaviour obviously defeats the purpose. If an organization suffers from “blind signing”, it needs to revisit its authority levels.

If five signatures provide greater protection from fraud than two, then why does the MFI not require five signatures for all loans? As with all risk management, a fraud prevention strategy needs to balance the costs of minimizing fraud with the need to reduce vulnerability to risk. The more people involved in the application review process, the more expensive it is to issue loans. Since the smallest loans generate only a tiny amount of revenue, the organization would lose money if five people had to review the applications. To reduce approval costs, some
organizations set variable authority levels for branch managers depending on their level of seniority and their portfolio quality.

The other factor determining approval authority is quality of customer service. The more people involved in the review process, the longer it takes to turn around loan applications. For MFIs to provide prompt service, they need to cut out unnecessary approval layers.

**g) Handling Cash**

MFIs face the greatest risk of misappropriation when money changes hands, such as when the loan is disbursed, repayments are made and deposits are placed in a savings account. Here is a 12-step process for reducing the **risk of misappropriation in loan disbursement**. If the disbursement is made by a bank or into the client's account, certain modifications are required.

1. Use standardized, pre-printed, pre-numbered loan agreement forms, reviewed and approved by local legal counsel.
2. Prepare loan agreements in triplicate, maintaining one copy at the branch, giving one to the borrower, and sending one to the accounting department.
3. Loan agreements should include borrower name and identification number, unique loan reference number, loan amount, interest rate, payment schedule, description of collateral (if applicable), definition of late payment and penalty for late payment.
4. Access to blank loan agreements should be restricted and carefully safeguarded.
5. Accounting department determines whether the agreement is properly completed. If so, Accounting prepares and approves a disbursement voucher, and gives it to the cashier along with a copy of the loan agreement.
6. Before disbursing funds, the cashier matches the loan amount on the agreement with the disbursement amount on the voucher and determines whether the loan agreement contains the necessary signatures.
7. The cashier prepares, in duplicate, an official pre-numbered disbursement receipt, containing date, amount, and payee name and signature.
8. The cashier retains one copy of the disbursement receipt and gives the other to the payee.
9. If disbursing funds to the borrower, the cashier inspects evidence that the person accepting funds is the borrower named in the loan agreement by inspecting a picture ID and/or comparing the person's signature to the borrower's signature on the loan agreement.
10. If compensating controls are not in place to reduce risk of the cashier keeping loan disbursements and making loan payments himself, then monthly, an accountant compares payee signatures on all loan disbursement receipts to signatures of borrowers on loan agreements.
11. If the cashier disburses loan funds to an agent who then gives funds to borrowers, such disbursements are recorded as advances to agents. The advances are liquidated when agents present disbursement receipts containing correct loan amounts and borrower signatures to the accounting department.
12. Accountants must not have access to funds, and cashiers must not have access to changing accounting records.
To reduce the risk of irregularities or fraud in the repayment process, consider the following seven-point plan:

1. Agents collecting loan payments prepare repayment receipts, in triplicate, containing date, amount, and agent’s and payer’s signatures.
2. Agents retain two copies and give the other to the payer.
3. Agents deposit funds to designated accounts in a timely manner. MFIs should have a policy on where to deposit funds and on the definition of “timely”.
4. Agents request a deposit slip containing date, amount and signature of person accepting funds for every deposit made.
5. Agents submit to the accounting department a copy of receipts documenting borrower payments and deposit slips documenting deposits.
6. Accounting staff match amount of deposit slip with amount on borrower’s receipt, and record interest and principal based on loan agreement and payment amount on borrower’s receipt.
7. Accounting staff reconcile amount of cash deposited per bank records with cash received per the accounting records on a monthly basis.

Organizations that offer voluntary savings services are particularly vulnerable to fraud. This is partly because of the high volume of transactions, but also because the deposit amounts and frequencies are unpredictable. With loan repayments, the organization knows how much and when they are expected, so if the amounts or dates are different than expected, they can be investigated. Savings accounts do not have a similar early warning signal, yet it is absolutely critical to reduce the potential for savings fraud because it could undermine consumer confidence in the banking institution.

To control for savings fraud, clients must have savings records (i.e., passbooks) that they keep in safe places. The MFI should have a signature card and a copy of the client’s identification. The signature on the deposit/withdrawal slip needs to match that on the client’s savings book and the organization’s account record. A tighter review of larger withdrawals is also recommended.

**Box 12.1 Procedural and Policy Changes to Reduce Fraud in Mali**

An internal assessment of a microfinance NGO in Mali that uses a group lending methodology identified several discrepancies between the amount of funds that groups said they had deposited in the bank and the amount reported in their accounts. Further investigation indicated that the individuals who transported funds from the village to the bank were pocketing some of the money. To reduce the risk of financial loss to the groups, the NGO implemented new procedures requiring the transporter of the funds to record the amount of funds taken twice; first, in a register in the village prior to departure and, second, by collecting a receipt from the bank where the funds were deposited. For illiterate individuals, the NGO now requires the group member who transports funds to provide an oral report to the village authorities. In addition, the NGO added an additional policy in which it now requires the money carrier to be a group member, which averted the problem of women’s groups turning their funds over to the care of the men in the village.

*Source: Adapted from Campion, 2000.*
h) **Collateral Controls**

If an MFI secures its loans with collateral, it is vulnerable to potential irregularities or fraud in the collection, storage and return of collateral. The assigned staff person may collect collateral but not deposit it in the designated storage area, or collect the wrong type of collateral, or neglect to collect it at all. Risk associated with collateral can be mitigated by:

- Policies and procedures on when to require collateral, whether to assume custody of collateral versus allowing the borrower to maintain custody, where to deposit and store collateral, and how to value collateral.
- Periodic inspections of collateral by the loan officer to check for impairment, if the borrower maintains the collateral. The loan agreement should include a detailed description of the collateral and serial or other identifying number of the property, and require that collateral must not be sold without prior notice to the loan officer.
- Procedures for returning collateral to the custody of the borrower upon full repayment of the loan.
- Procedures to improve the chances that liquidation of collateral is at the best available price, and that proceeds from liquidation are deposited into the bank.

i) **Write-off and Rescheduling Policies**

Another area of risk is loan write-off or rescheduling. While MFIs usually have carefully followed policies for receiving loan repayments, they tend to be more lax in following up delinquent loans and ensuring that procedures are carefully followed in the event of repayment difficulties. Loan write-off and rescheduled loans should follow similar procedures as regular loans: the credit committee should make all decisions and multiple signatures should be required for a write-off or rescheduling to be authorized.

In the write-off process there are two primary fraud vulnerabilities. First, the MFI needs to make sure that it is not writing off a fraudulent loan. To control for this risk, each person involved in the process of recovering the loan needs to document the steps that they took. This documentation, in a delinquency management log, provides evidence that proper steps were taken by several people, and this was indeed a bad loan not a fraudulent one. Second, once a loan has been written off, the MFI is still vulnerable to the unauthorized collection of the outstanding balance by its employees. This risk is often controlled by handing over bad debts to a workout department or an external debt collector whose collection activities may reveal unauthorized efforts.

j) **Office Management**

Besides the savings and lending activities, MFIs are also vulnerable to fraud in their other financial transactions. Consequently, managers need to develop clear policies that reduce the risk of fraud in handling petty cash, reimbursing staff for expenses, managing employee loans, and in purchasing supplies and other inputs. Indeed, many MFIs are particularly vulnerable to fraud perpetrated by senior managers who negotiate arrangements with banks, landlords and other suppliers. The audit or internal control committee of the board should carefully review such contracts.
12.4 Fraud Detection

The best prevention strategies in the world are not going to eliminate fraud. This is partly because the policies may be ignored or flaunted; and partly because, in an effort to balance the costs of the controls with the potential exposure, the organization is still going to have areas of vulnerability.

Whenever fraud occurs, it reflects poorly on the whole MFI and everyone who works there. Fraud detection is therefore the implicit responsibility of all staff members. Once an organization reaches a certain scale (around 100 employees), it can justify having an internal auditor or internal audit department.

Fraud detection involves the following four elements:

- Operational audit
- Loan collection policies
- Client sampling
- Customer complaints

**Operational Audit**

After creating appropriate controls, the first step in fraud detection is to ensure that those controls are implemented. Microfinance managers must make sure that staff working under them follow institutional policies. MFIs should consider conducting regular operational audits to confirm that policies are being followed. When policies are not followed, it is usually for one of three reasons: 1) the employee was involved in some sort of fraudulent activity; 2) the employee did not know about the policy or did not understand it; or 3) the employee believed that the policy was unreasonable. So while an operational audit might detect fraud, it will also identify staff training needs as well as certain policies that may need to be re-evaluated.

An operational audit is a review of all operational activities, procedures and processes, including human resources, procurement, finance, information systems and any other operational areas. **Internal auditors** usually perform operational audits as they will have experience with an organization’s operations and will be prepared to analyse the structure of operations critically. If an **external audit** firm is used, management should be very careful to gauge the level of experience and understanding of microfinance, of the organization and of operational auditing.

For organizations that are large enough to hire an internal auditor, it is important that this person or department report to the board of directors (or its audit committee), not to management. Without sufficient independence from management, internal auditors cannot conduct an objective review of the MFI’s operations. This reporting line also ensures the board’s involvement in the internal audit process, and it gives creditability to internal auditors as they conduct their reviews.
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**Box 12.2 Loan Collection Policies**

- Senior management establishes a written policy on past due loans that includes when to take collection efforts and what efforts to take.
- Those assigned to collect loans should not have access to changing the accounting records.
- The loan officer who issued the loan should conduct the first delinquency visit.
- If that proves unsuccessful, a different agent (or the branch manager) should perform the next collection visit.
- If that visit is unsuccessful, ideally another, more senior person should make the third visit. This sends the message to the client that the institution's concern is escalating. It also plays an important control function since subsequent personnel can make sure that a collection agent was not pocketing some or all of a past due payment.
- All visits to the client are recorded in a delinquency management log.

**Loan Collection Policies**

While loan collection policies are primarily seen as a response to credit risk, they also have a very important role in fraud detection. By involving several different people in the collection process, MFIs not only escalate the pressure on the client, but also help to identify instances of fraud. If the loan officer is the only person who ever interacts with a delinquent borrower, he could easily be pocketing repayments. Box 12.2 provides an example of loan collection policies designed to detect such a situation.

**Client Sampling**

A main aspect of fraud detection is to visit clients to ensure that their records and the MFI's records are in agreement. Given the large volumes of customers, internal auditors use **selective sampling of borrowers** to identify clients for balance confirmation so that the visits are biased toward loans that are more likely to be fraudulent. For example, an internal auditor may select all clients with more than three payments in arrears, 50 per cent of clients with more than two payments in arrears, and 25 per cent with one payment in arrears, as well as a number of clients who are up-to-date. If the MFI reschedules loans, then the internal auditor should also visit all or most of those clients as well.

While this sampling technique primarily selects customers who are in arrears, it is important to also include clients whose loans are current. The internal auditor may find major discrepancies between information in the client's file and the reality in the field, which could expose the organization to credit or fraud risk. Loan officers also might be receiving **kickbacks** on loans that do not show up in a delinquency report.

Selective sampling is not possible with voluntary savings accounts because there is no warning sign that some accounts are more vulnerable to fraud than others. Consequently, the sample of **depositors** will probably be larger than the sample of borrowers.
Prior to visiting specific clients, the internal auditor reviews their files to ensure that the documentation conforms to the organization's policies and procedures. When visiting borrowers, the internal auditor compares the disbursement and repayment information in the MFI's records with the client's records, including current balances, the amount and date of each transaction, and the collateral that was pledged. It is also important to compare the information in the file with the actual business, including address, type of business, purpose of the loan, assets, and so on. If there was false documentation, then either the client took advantage of the loan officer, or they collaborated to give a loan to someone who was ineligible.

While these visits are primarily for internal audit purposes, they can fulfill other important functions such as delinquency management, gathering information on customer satisfaction and market trends, and identifying staff training needs. An internal auditor may not be the most popular person in an MFI, but she can fulfill one of the institution's most critical functions if the job is well designed, if she has the skills to play multiple roles and if she spends the vast majority of her time in the field.

**Customer Complaints**

Even though MFI customers tend to be poor and uneducated, they are not stupid, and they often realize that someone is trying to take advantage of them. The problem is that they are not always empowered to do anything about it, and even if they want to do something, they may not know how since their primary contact with an MFI may be the person who is causing the problem.

Another important method for detecting fraud, and for improving customer service (see Module 8), is to establish a complaint and suggestion system that creates a communication channel through which clients can voice their opinions. If it is easy for clients to complain, and if their complaints can bypass the local branch office, then they will be more likely to report questionable conduct on behalf of loan officers and other field staff. When branch managers, the operations manager or the internal auditor investigate this conduct, it often reveals fraudulent activities.

**12.5 Responses to Fraud**

If fraud is suspected, in most cases the MFI should immediately suspend the persons involved, conduct a fraud audit and then implement damage control proceedings.

**Fraud Audit**

A fraud audit, sometimes called a forensic audit, determines whether irregularities have occurred and, if so, their magnitude. A fraud audit generally consists of an extension of ordinary audit procedures, as proposed by the auditors and agreed to by the client. The decision to conduct a fraud audit involves considerable judgement. Two important factors in this decision are the potential magnitude of the fraud and the extent of evidence of a fraud. Frauds involving potentially very large amounts with scant evidence are more likely to require a fraud audit than frauds involving small amounts with considerable evidence. Fraud audits should be
conducted by auditors with specialized training in forensic auditing. Contrary to common belief, most auditors do not have the training to conduct this kind of audit.

**Damage Control**

If fraud is identified, the MFI needs to move into damage control mode. For this to happen quickly, organizations should consider developing contingency plans that can be dusted off and put into action when the need arises. This **contingency plan** might include the following elements:

- What action will the MFI take against the perpetrator (i.e., termination, legal proceedings, efforts to recoup losses)?
- How will other staff be informed about the fraud?
- What approach will the organization take with clients who were victimized?
- How can the MFI turn this public relations nightmare into a marketing opportunity?
- What changes to the internal control policies need to be made to prevent this from occurring again?

Some MFIs require new employees to pay a security deposit, which they will lose if they are involved with fraud. This serves both as a deterrent to fraud as well as a means of reducing the MFI's vulnerability to losses, although such a policy may not set the cultural tone that the organization would like to promote.

It is natural for MFIs to want to sweep fraud events under the carpet and keep them secret. This approach can be quite damaging, however, if rumours begin to circulate, which will undoubtedly be worse than reality. These rumours can create significant insecurity among staff, clients and the general public, possibly causing serious damage to the institution's reputation. It is (almost always) better to be honest and to show clients and staff that you are responding to the issue in their best interests, that the organization has learned from the experience and will now be stronger because of it.

**12.6 Security Risk**

Another major challenge for MFIs besides fraud is their exposure to theft, fire and other damage. This security risk has three main elements:

1. **Safety of cash.** Any MFI that disburses and receives money directly is vulnerable to theft. They need to ensure that cash is protected from theft during office hours, after office hours and in transit.

2. **Safety of office assets.** Although thieves usually prefer cash, it is not the only asset that is vulnerable. MFIs need to ensure that they are protecting their computers, fax machines, photocopiers, and even office equipment like desks and chairs, from theft. Furthermore, assets and management information are vulnerable to fire and other damage.

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8 Employees may also lose their security deposit if they leave the organization within a specified period of time, often 12 to 24 months. If employees leave earlier, their security deposit is used to pay for their training.
3. **Safety of personnel.** Staff who handle the MFI's assets are also vulnerable to security risk, particularly when they are transporting cash or equipment from one location to another. MFIs need to put policies and systems in place to protect employees' safety, both in the office and in the field, and to support them in the event that injury or harm does occur.

The most effective control to safeguard cash is not to handle it. Many microfinance programmes conduct all their financial transactions (disbursements, repayments, savings) through local banks. This control dramatically reduces the threat of theft, but it also limits the MFI's ability to provide valuable services to its customers. MFIs are constrained by the location of banks, their hours of operation and their willingness to process large volumes of small transactions.

For MFIs that do handle cash, they should consult with local security experts and banking officials regarding controls for reducing vulnerability to theft. Appropriate responses may vary significantly from branch to branch. Some **security measures** to consider include safes or vaults with two key systems, window bars, door locks, teller shields, interior and exterior lighting, security guards (armed or unarmed), and security alarms and surveillance cameras.

MFIs also reduce their exposure through **liquidity policies** that stipulate the maximum amount of cash that can be kept in the branch over night. Liquidity policies require an effective system for transporting money to a central depository and then delivering sufficient cash to each branch in the morning.

In addition to the systems designed to protect cash, MFIs should also have a **fixed asset register** that lists all the organization’s assets, description, date and price of purchase, and serial number (if applicable). Internal auditors should compare the equipment in the branch with the asset register to ensure that equipment has not been taken (temporarily or permanently).

Microfinance institutions should also have a system whereby **information is protected** from destruction, theft or loss. MFIs can protect non-computerized information systems by storing duplicate copies at another location. Those with a computerized database should create daily back-up files and store them off-site. Computer users should be issued with individual passwords and be given levels of access to the system that are appropriate for their position. In general, the more an MFI embraces electronic technologies, the more vulnerable its information will be to security risk, and the more care will have to be taken in designing controls, policies and procedures to mitigate this risk. Fortunately, the more an MFI embraces technology the more options it will have for protecting its data (see Box 12.3).

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**Box 12.3: Using Technology to Mitigate Security Risk**

In addition to protecting customers, Prodem’s digital fingerprint technology also protects the institution against employee fraud by controlling access to files. Before accessing central files, employees sign in using fingerprint identification, and the central information system keeps a record of which employee conducted each transaction.

*Source: Adapted from Campion and Halpern, 2001.*

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Managing Risks

To protect from some security risks, such as fire or theft, microfinance institutions can take out insurance policies or can self-insure by making regular deposits into a reserve account that the MFI can use in case of emergency. In this way, the MFI protects itself from large unforeseen expenses by redistributing the cost of this protection over a longer period of time.

Perhaps most importantly, MFIs must put policies and systems into place to protect staff from security risk. Microfinance can be dangerous work in some operating environments, and staff run the risk of being harmed during a robbery, a fire, a bus or motorcycle accident. Some of the measures mentioned above for protecting the security of the institution’s physical assets can also protect staff, for example, teller shields, door locks, proper lighting, security guards, and insurance.

There is a need for additional policies and procedures that provide staff with specific guidance for handling threats of violence that may come from disgruntled clients, thugs or even fellow staff, such as in the case of sexual harassment. Policies and procedures can also define geographic areas in which the institution will not operate (for example, where violence between armed factions is common). They can set working hours that enable staff to be home before nightfall. They can organize collections and disbursements in the field so that staff members do not have to travel with large amounts of cash. They can also vary travel schedules and patterns so that staff movements are not entirely predictable. If injury or harm does occur, it is also important that policies, procedures and systems are in place to care for injured employees and to support their recovery, both physically and psychologically.

Main Messages

1. MFIs cannot eliminate fraud, but through proper controls they can significantly reduce their vulnerability.
2. A fraud-prevention strategy needs to balance the need to reduce vulnerability with the costs of putting controls in place.
3. Co-workers and clients identify most cases of fraud, so make it easy for them to tell you about it.
4. The key to effective damage control is having a contingency plan in place before a fraud happens.
5. When responding to fraud, honesty is the best policy. Look for ways to turn the crisis into an opportunity.
6. Identify your vulnerability to security risk and introduce proportionate controls.

Recommended readings:

External Risks

External risks are different from other risks to which a microfinance institution is exposed because the organization has less control over them. This lack of control does not imply, however, that the risks cannot or should not be managed. MFI managers and directors should assess the external risks to which the MFI is vulnerable in order to:

- **Obtain the best outcome possible.** An MFI could have relatively strong management and staff, and adequate systems and controls, but still be prone to major risks from the environment in which it operates. If the MFI is monitoring its external risks, it will have an opportunity to learn more about them, and to better understand the nature of the risks and the likelihood of their occurrence. It can prepare itself and its clients for what might come, and design contingency plans that lessen the impact of challenges when they arrive.

- **Avoid using external risks as excuses.** It is fairly common for MFIs that are not doing particularly well to point to external causes for their plight, such as the following excuses for poor portfolio quality:
  - These clients have never borrowed money before.
  - The clients are used to handouts.
  - Our clients are so poor that it is hard for them to repay their loans.
  - The economy is so bad that it is hurting their businesses.

Statements like these indicate a need to better understand microfinance. The purpose of microfinance is to serve poor people who do not have experience with credit and who live in difficult conditions. The rationale behind the design of a microloan product is to overcome these challenges. If a microloan product is not working, unless there has been a significant and recent change in the local conditions, the problem probably lies with the product or its delivery, not the market. If a MFI commits itself to treating external risks as challenges, it will be better able to identify actions that can be taken to improve performance rather than dwell on factors over which it seems to have no control.

This module discusses six types of external risk:

1) Regulatory
2) Competition
3) Demographic
4) Macroeconomic
5) Environmental
6) Political

In managing external risk, MFIs should focus on monitoring the sources of risk in their environment and responding in a way that mitigates the impact of potential challenges. Table 13.2 at the end of this module summarizes the six types of risk and provides some monitoring and response suggestions.
13.1 Regulatory Risks

Policy makers, banking superintendents and other regulatory bodies are becoming increasingly interested in, and concerned about, microfinance institutions. This concern is heightened when MFIs are involved in financial intermediation – taking savings from clients and then lending out those funds. In many jurisdictions, policy makers are regulating the activities of microfinance institutions, occasionally with policies that can threaten the institution, such as usury laws. Other regulatory issues that can create vulnerability in an MFI include the quality of supervision by regulatory authorities, restrictive labour laws, and contract enforcement policies.

Banking Regulations

In the last 20 years, MFIs have developed new technologies — such as group lending methodologies and streamlined delivery systems — to provide financial services to excluded populations. These developments were possible because MFIs had considerable freedom to innovate and experiment beyond the purview of most regulatory bodies. Now that microfinance institutions are growing in scale and number, regulators and policy makers are becoming increasingly interested in them.

This attention has the potential to be constructive. Appropriately designed regulations can create an enabling environment within which microfinance can blossom. However, the opposite reaction is also a possibility. Microfinance is different from traditional banking in many ways. Policy makers who do not appreciate the unique characteristics of microfinance are likely to impose inappropriate regulations that could stifle the industry.

Within this context, there are two areas of banking regulation to which microfinance institutions are particularly vulnerable:

- **Usury laws.** Many jurisdictions have usury laws that limit the interest rate that financial institutions can charge on loans. These interest rate ceilings tend to be lower than MFIs’ need to charge to cover their costs (see Box 13.1). Microfinance institutions need to charge interest rates that allow them to serve low-income communities for the long term. To do this, most MFIs charge annual effective interest rates that range from 20 to 50 per cent. This wide range depends on many factors including the local labour market, loan sizes, loan terms and the institution’s size.

- **Regulations regarding financial intermediation.** Regulators are primarily responsible for two things: 1) preserving the integrity of the financial system; and 2) protecting the savings of depositors. In general, the microfinance industry believes that as long as MFIs do not mobilize voluntary savings from the public, they should not be regulated as a banking institution. If an MFI goes bankrupt, it will only lose the money of donors and investors, neither of whom regulators are obligated to protect.

A grey area emerges when an MFI requires compulsory savings as a part of its lending methodology. In this case, as long as it is not intermediating or on-lending those funds, then the MFI generally should not fall under the authority of bank regulators. But as a microfinance institution matures, clients may demand access to voluntary savings products. In addition, the institution may encounter funding constraints, in which case it might use the deposits that it
has mobilized as loan capital. If these conditions occur and the MFI goes bankrupt, then it could lose the savings of depositors. If it is a large institution, its poor health could even undermine the integrity of the financial system. Regulators should be concerned when MFIs start entering the territory of financial intermediation.

Many common banking regulations for financial intermediaries are not applicable to microfinance institutions. For example, security and documentation requirements, portfolio examination methods, and performance standards for commercial banks are inappropriate for microfinance institutions. MFIs that become regulated so that they can offer savings services may find that regulations force them to adopt policies that are prohibitive to serving their intended market.

Box 13.1 Interest Rate Restrictions and Supervision in West Africa

The West African Monetary Union has long had interest rate controls on the books, but as a practical matter these controls were generally not enforced in the case of credit-only MFIs. In the late 1980s the central bank, with donor assistance, embarked on a major effort to regulate the non-bank financial sector. The new PARMEC law, promulgated in 1993 and ratified by the member countries through 1998, underscored the universal applicability of the usury limits, and made their enforcement much more likely. Many MFI operators are caught in a bind: they can't cover the costs of their programmes without a higher interest rate, but they feel themselves at serious legal risk if they charge sustainable rates.

The finance ministry in each country is responsible for the supervision of all institutions covered under the PARMEC law. In the past few years, the West African Central Bank and international donors have focused on the ministries' capacity to handle this responsibility. Seven of the eight countries covered by the PARMEC law have created special units of one to five people to supervise these institutions. The central bank is organizing training, and several donors are providing short-term technical assistance, equipment and funding for these specialized units. Nonetheless, the volume of work will be enormous: full compliance with the supervision responsibilities outlined in the PARMEC law would quickly overwhelm the current capacity of the finance ministries in the region.

Source: Adapted from Christen and Rosenberg, 2000.

Quality of Supervision

MFIs can also become vulnerable if banking regulations are interpreted differently by different regulatory authorities, or are applied differently for different institutions. Such variations in the quality of supervision may result from an understaffed supervisory body, a lack of microfinance training for the staff of that body, or the nature of the relationship between the MFI and the supervisory authorities. It may also be due to a willingness on the part of certain supervisors to bend the rules that they know are particularly cumbersome for MFIs. While these allowances may be much appreciated in the short term, they also make the nature of supervision unpredictable, and risky, if the MFI becomes dependent on a compassionate interpretation of the regulations.
In addition, poor monitoring and supervision by authorities can also result in microfinance institutions becoming insolvent. When this happens, it poses a risk to the entire industry because it calls into question the trust clients place in the institution, especially if people lose their savings in the process.

**Contract Enforcement**

For microfinance institutions to be successful lenders, they must enforce their credit contracts. As described in Module 11, when borrowers default on their loans, the MFI goes through several stages of delinquency management to recover its money whereby retribution typically escalates. The MFI hopes that it can rely on the legal system to support its efforts. If the MFI cannot legally enforce contracts by seizing collateral or taking defaulters to court, then it is deprived of important options in its delinquency management strategy.

**Labour Laws**

Labour law risk is the concern that labour regulations will prevent MFIs from containing salary costs or dismissing employees, even if it is warranted for cost reasons or for internal control purposes. Salaries represent the single largest budget item for most MFIs. The sustainability of the organization often depends on its ability to hire inexpensive staff; credit methodologies are often designed to be implemented by moderately skilled employees. In environments where labour regulations inappropriately inflate salary costs, MFIs will have significant difficulty achieving self-sufficiency.

MFIs also need to be able to take appropriate action with staff members who do not perform appropriately, particularly when fraud is involved. If the institution cannot dismiss staff members who have committed fraud and is unable to seek appropriate retribution, the MFI will not be able to operate optimally.

**Monitoring and Responding to Regulatory Risks**

Regulatory risks are considered external risks because microfinance institutions, particularly small to moderately sized ones, tend to have little influence over the regulatory environment. Individual MFIs tend to only exert authority in the policy arena if they have very influential board members who are big players in the local political scene.

However, an industry association or network of MFIs can have an active and even influential voice in shaping public policy (see Box 13.2). A downside of this active industry role is the potential to be distracted from the MFI's operations. Therefore a careful assessment of the potential regulatory risks will determine the appropriate involvement at the industry level.

To remain in good standing with regulators, it is a good idea to conduct a regular compliance audit to review conformity with external requirements and relevant legislation. Compliance audits can be done by internal or external auditors, and require a lower audit skill level than operational audit, as compliance auditing requires less need for exercising professional judgment.
Box 13.2 Influencing the Legal Framework in Colombia

The Association of Women's World Banking (WWB) affiliates in Colombia has been very active in influencing government policy on microfinance. The five Colombian affiliates, with support from WWB, carried out a series of policy change actions that involved the analysis and assessment of the best structures for microfinance, a meeting with the Economic Advisor to the President of Colombia, and the formation of a Policy Working Group in Colombia. Some of the progress in changing the policy and regulatory environment to create a more favorable milieu for microfinance includes:

**Interest Rates.** In response to advocacy efforts by the five Colombian affiliates, the government took a moderately pro-microfinance stance in 2000 and enacted legislation that promotes micro, small and medium enterprises, thus allowing financial entities specializing in microfinance to charge fees and commissions that are not part of the controlled interest rate. In effect, this gives some benefit to MFIs with respect to interest rates, but does not constitute a fully liberalized interest regime. The law affirms that financial institutions will be supported in promoting microfinance.

**Understanding of Microfinance – Fairer Evaluation of Risk.** An October 2001 regulation explicitly recognizes and defines microcredit loans. In addition, this circular provides for changes in the way the Superintendency evaluates risk in microfinance, away from loan collateral to portfolio quality and provisioning levels.

Spurred by their interest in potentially converting into a regulated entity that can mobilize savings, the Colombian affiliates have been pushing the Government to revise the Commercial Finance Company structure. They have been in active dialogue with the Government over proposed changes to the CFC structure that would make it more appealing. They have already succeeded in overturning a provision that prevented CFCs from borrowing from financial institutions, and they are working on extending the rights of CFCs to offer current accounts.

*Source: Adapted from Women's World Banking, 2002.*

13.2 Competition

In some environments, microfinance is becoming increasingly competitive, with new players, such as banks and consumer credit companies, entering the market. The three main sources of competition risk are:

- Lack of knowledge of whether a competitor is providing a similar service to a similar market
- Lack of familiarity with a competitor’s services to adequately position, price and sell one’s own services
- Lack of sufficient information about clients’ current and past credit performance with other institutions

Without this information, an MFI can experience client desertion and lose market share, which can hamper an MFI’s ability to expand.
Managing Risks

Monitoring Competition Risks

If an organization has high retention rates, then it is probably protecting itself from competition risks today. But the market can change very quickly if a new competitor arrives on the scene with a more attractive product. To monitor your organization’s vulnerability to competition risks, managers must keep a close watch on other service providers and prospective providers, including banks, consumer credit companies and suppliers, and even informal providers.

To monitor for competition risk, managers should ensure that they have current and accurate information about the products and services of other institutions in the market. A mystery shopper approach can be used to collect product and service details from other MFIs. Some of the other methods of measuring customer satisfaction can also be used to learn about the service provided by the competition, such as exit interviews and focus groups (see Module 5).

One of the easiest ways of monitoring the competition is through questions on loan applications. Some MFIs routinely ask with each loan if the applicant has ever borrowed from formal or informal sources, including friends, neighbours, moneylenders, suppliers, banks and other MFIs. If applicants answer affirmatively, they may be asked follow-up questions to understand the nature of the competitors’ products and the clients’ analysis of the strengths and weaknesses of each.

Competition Risk Responses

Managers should use information about competitors to reduce their vulnerability to competition risks. The information they receive will determine the appropriate response, which might include:

- **Credit product refinements.** Longer and/or shorter terms, different loan sizes, lower interest rates or fee arrangements, various forms of security
- **Incentives for retention.** Provide repeat clients with preferred services, such as fast loan approval, lower interest rates
- **Offering new products.** Introduce new credit and savings products that are designed to meet a wider range of household needs besides just self-employment
- **Improving access.** Change office locations, add satellite offices, extend hours of operation
- **Improving service.** Train staff on customer service

Another response to market risks is a credit bureau, a mechanism for sharing information between MFIs regarding credit histories and current level of indebtedness (see Box 13.2). If this database exists, then it would also be possible to produce another indicator to monitor market risks: market share.

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<th>Market Share</th>
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<td>Number of outstanding loans (or clients) of the MFI/total number of outstanding loans (or clients) in the industry</td>
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Credit bureaus are businesses that collect information on the payment habits and current debt of individuals. They gather this information from financial institutions and other sources (such as utility companies, retailers, consumer creditors, tax authorities, governments, etc.) and organize it in a database. Access to the database is then offered to creditors for a fee.

Financial institutions working with the poor are exploring credit bureaus as a way to increase their efficiency in reviewing new loan applications and clients. Armed with reliable information on a client’s repayment record, these institutions may be able to offer loans safely to more people, more rapidly and limit over-indebtedness among clients. In 1999, the Inter-American Development Bank sponsored a comprehensive study on the global experience of credit bureaus which concluded that in competitive markets, “information sharing improves the pool of borrowers, decreases defaults, and reduces interest rates”.

Credit bureaus can be public or private. Among those working globally are Equifax, TransUnion, Experian and CRIF. Many international credit bureaus affiliated with these companies include microfinance clients. Credit bureaus specifically created for microfinance institutions and clients can be found in Benin, Bolivia, Bosnia and several other countries.

To be useful, credit bureaus must maintain accurate, up-to-date information on a regular basis. To be attractive to microfinance providers, the cost of accessing information from credit bureaus needs to be affordable.

One potential bottleneck for credit bureaus in microfinance is the absence of unique client identification schemes, such as those based on national identity cards. Another challenge is the resistance of microfinance providers to sharing information, especially if they fear that competitors may “steal” their clients on the basis of such information. The incapacity of the management information systems of many MFIs to provide information on a regular and reliable basis is yet another challenge to the growth of credit bureaus. If these challenges can be overcome, however, credit bureaus may be able to both decrease risk for MFIs and increase low-income households’ access to microfinance services.

Source: Adapted from Isern, 2002.

13.3 Demographic Risks

Since most MFIs target disadvantaged individuals in low-income communities, microfinance managers need to be aware how the characteristics of this target market increase the institution’s vulnerability. In assessing demographic risks, consider the trends and consequences of illness and death (including HIV/AIDS), education levels, entrepreneurial experience, the mobility of the population, the social cohesiveness of communities, the past experience of loans and repayment, and the local tolerance of corruption.

Best practices in microfinance methodologies tend to be adopted in one region based on what was successful in another. When conducting a risk assessment, consider whether the organization is sufficiently addressing local characteristics that might generate special challenges. Several factors should be considered:
• **Education level of clients.** If clients lack literacy and numeric skills, they may be greater credit risks and are probably more vulnerable to fraud. Special systems and controls should be used in serving illiterate borrowers.

• **Entrepreneurial attitude and aptitude.** Some societies have a strong tradition of informal markets, as in West Africa; others, like post-communist countries, do not have this expertise. Client training may form a larger component of the service delivery in regions that have less entrepreneurial expertise.

• **Social cohesion.** Character assessments and peer pressure are important aspects of most microlending methodologies, yet the ability to exert pressure or collect character information varies from one region to the next. In cohesive communities, where everyone knows each other's business, it is easier to analyse an applicant's character and to use the borrower's standing in the community to exert repayment pressure, even with an individual lending methodology. It is challenging to serve transient populations in communities where people do not know or trust each other very well, and where there is a high likelihood that a borrower will disappear.

• **Societal attitudes towards fraud.** The level of tolerance in the political and business culture for corruption and lack of transparency must be considered when determining appropriate controls for reducing risk.

• **Prevalence of crime.** In low-income communities, particularly in urban areas, the prevalence of crime can create a significant challenge for MFIs. The controls required to reduce this vulnerability can be quite expensive.

• **Past experiences with NGOs and credit providers.** Different countries have different attitudes and expectations regarding NGOs. If the MFI is perceived as an extension of an international agency, this might create the perception that loans are "gift money". This notion would be reinforced if the market had previous experiences with credit facilities that were not operated on a commercial basis.

• **Occurrences of illness and death.** In some regions, a major cause of credit risk is associated with the poor health of clients or their family members. To address this issue, some organizations use a lending methodology that enables them to deliver health education along with credit (see Box 13.4). Others allow repayment "slides", in effect rescheduling loans due to illness if the client has a note from a health care professional. An increasing number of MFIs are entering partnerships with insurance companies to provide health care coverage, or to pay for outstanding balances in cases of illness and death, or both.

Demographic risks can also extend to an organization's employees. An implication of working in an area with minimal levels of education is that staff recruitment and training can be challenging, which impacts both the operating costs (staff may be expensive in relation to their productivity) and also the design of management, information and control systems. This situation creates another balancing act: the MFI wants to be more responsive to its clients by offering customized products and services but, if it does so, field staff will find it increasingly difficult to implement the diverse product offering.
Box 13.4 Providing HIV/AIDS Education at FOCCAS Uganda

FOCCAS (Foundation for Credit and Community Assistance) is a Ugandan MFI utilizing Freedom From Hunger's Credit with Education microfinance model. It utilizes a village banking methodology to provide credit and savings products to rural women. Each week, when the women meet for loan repayment, they receive a 30-45 minute education session on a health or nutrition topic, including HIV/AIDS.

The HIV/AIDS component of the education is designed to provide members with information and to emphasise that HIV/AIDS is a community problem. Loan officers encourage women to consider how to use this information to change their behaviour to remain healthy and uninfected, and to help others in their community affected by HIV/AIDS.

According to FOCCAS Uganda, many positive results have been generated by the HIV/AIDS education:

- Communities have become aware of HIV/AIDS and its effects
- Some have learnt to live positively with HIV/AIDS
- People can now nurse their relatives suffering from HIV/AIDS
- People know how HIV/AIDS is spread and how to protect against it
- Because the loan is provided with the HIV/AIDS education, the well-being of some HIV/AIDS affected members is improving.

Source: Adapted from McDonagh, 2001.

13.4 Physical Environment Risks

Some areas are prone to natural calamities (e.g., floods, cyclones or drought) that affect households, enterprises, income streams and microfinance service delivery. In addition, the absence of physical infrastructure in the MFI's area of operations can substantially increase its vulnerability. The local conditions raise two sets of issues that need to be considered in a risk assessment:

- **Infrastructure challenges.** The infrastructure in which the MFI operates significantly impacts the organization's ability to maintain efficient operations with tight controls. Key factors include the availability of electricity, telephone, transport systems and banking facilities. Perhaps the best control to overcome these challenges is to operate in a limited number of areas that are near each other. It is extremely difficult to manage risk if you operate in numerous distant regions with poor communication, although technology is beginning to make this possible (see Module 20).

- **Natural disaster risks.** Some areas are prone to natural calamities that affect households, enterprises, income streams and microfinance service delivery. Countries that experience repeated natural disasters will require specific risk management strategies, such as requiring business diversification, accessing disaster insurance, creating disaster relief funds, encouraging savings, and developing appropriate rescheduling policies (see Box 10.3 in Module 10 and Box 13.5).
Managing Risks

Box 13.5 Piloting Weather Insurance in India
Weather insurance is not only a tool for big farmers in rich countries – several hundred smallholders in India are now buying insurance policies that protect them against extreme changes in weather patterns.

Having worked on crop insurance pilots for the previous four years, BASIX (one of India’s largest microfinance institutions) launched a rainfall insurance programme in July 2003 through its KBS Bank in Mahabubnagar at the eastern end of Andhra Pradesh. The district had experienced three consecutive droughts in the past years.

KBS Bank bought a bulk insurance policy from Indian insurer ICICI Lombard, which conceptualized and modeled the “rainfall insurance” policies with support from the World Bank and IFC. KBS Bank then sold around 250 individual farmer policies to small, medium and large groundnut and castor farmers. Premium rates for groundnut crop were Rs 400 (US$1 = Rs 50) for the small farmers, with a maximum claim of Rs 14,000. Medium farmers paid Rs 600, with a maximum of Rs 20,000, and large farmers paid Rs 900 for a maximum of Rs 30,000. In the pilot stage, KBS Bank decided to limit liability per farmer rather than imposing per acre limits to manage overall liability and make the scheme easy to understand for farmers.

Informal interviews with farmers who bought the policies revealed that they are very aware of the rainfall-based index nature of the contracts and the stepped payout structure, that the liability limit is a theoretical number, and that historical maximum payouts are around Rs 3025 and would have occurred in 2002 and 1997. The farmers seem to value the quick payout of the rainfall policy, which distinguishes it from the existing crop insurance in India, where claims take at least one year to settle.

Source: Adapted from World Bank, 2003.

It is interesting to note that the mitigation strategy for infrastructure challenges could be exactly the opposite of the strategy for natural disaster risks. While poor infrastructure may encourage an MFI to cluster operations in a small geographic area, this increases the vulnerability to localized natural disasters.

Besides the effect that disasters might have on an MFI’s clients, it is also important to protect against the effects that they might have on the institution itself. An MFI should consider its own insurance needs, for flood or fire, as well as appropriate protection of its information system and records.

13.5 Macroeconomic Risks

Microfinance institutions are especially vulnerable to changes in the macroeconomic environment such as devaluation and inflation (refer to the MiBanco case study at the end of Module 3 for an example). This risk has two facets:

- How these conditions affect the MFI directly
- How they affect the MFI’s clients, their business operations, and their ability to repay their loans

The poor tend to be more vulnerable to economic fluctuations than other segments of the population. Microfinance institutions protect themselves from these challenges by keeping
loan terms short, diversifying their lending portfolio (by sector and by geographic area), pegging interest rates to a relevant index, and/or lending in foreign currency. Opportunity International successfully used the third strategy, pegging interest rates to the US dollar, in both Bulgaria and the Russian Federation. It was easy to implement and very transparent, but as highlighted in Table 13.1, clients had to bear all the risk and cost of currency fluctuations.

Other MFIs operating in high-inflation environments have pegged loan repayment to an inflation index or to commodities. This reduced the level of risk borne by clients, but required sometimes complex and constant adjustments to loan terms and payments, which both MFI and clients can find confusing (Vanderweele and Markovich, 2001, p. 33).

### Table 13.1 Three Strategies for Protection against Currency Fluctuations

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peg loan repayment to US dollar or other stable currency</td>
<td>• Insulates MFI from inflation (if no default)</td>
<td>• Client bears all the risk/cost of inflation</td>
</tr>
<tr>
<td></td>
<td>• Offers transparent value</td>
<td>• In high- and hyperinflation environments, many clients will be unable to pay, and default rates will increase</td>
</tr>
<tr>
<td></td>
<td>• Is easy to calculate</td>
<td></td>
</tr>
<tr>
<td>Peg loan to inflation index</td>
<td>• Insulates institution from inflation (if no default)</td>
<td>• Requires constant recalculating; can be confusing</td>
</tr>
<tr>
<td></td>
<td>• Depending on funding, might better reflect real price levels (to institution and client)</td>
<td></td>
</tr>
<tr>
<td>Peg loan to commodities</td>
<td>• Is better suited to clients’ repayment capacity and, consequently, clients are less likely to go into default</td>
<td>• Can be difficult or confusing to calculate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• If institution is receiving external funding, institution bears all of the currency risk</td>
</tr>
</tbody>
</table>


### 13.6 Political Risks

Despite its good intentions, microfinance is quite vulnerable to various political risks, including directed credit, agitation by debtors’ groups and civil unrest.

**Directed credit** is when local policy makers will legislate or otherwise pressure an MFI to lend to certain individuals for political reasons. Successful microfinance institutions, which tend to have strong community support and significant outreach, may be attractive vehicles for policy makers to use for political purposes. Few things could undermine a microfinance institution faster than political pressure to provide credit or other services to particular communities or individuals. It is imperative that MFIs retain their independence regarding where they operate and to whom they lend. MFIs are especially vulnerable during an election period when incumbent politicians may try to use them inappropriately.

In some countries, microfinance institutions have experienced problems with **debtors’ groups**, associations of borrowers which agitate for political solutions to a personal crisis, namely over indebtedness. In Bolivia, for example, debtors’ groups tried to garner political support to cancel outstanding debts – a result that would have completely undermined the microfinance industry (see case study at the end of this module). Similarly, general **civil unrest** represents a threat to MFIs, both for the security of their assets and the effect that it might have on their clients.
## Table 13.2 Summary of Risks and Responses

<table>
<thead>
<tr>
<th>Risk</th>
<th>Sources of risk</th>
<th>What and how to monitor</th>
<th>How to respond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory</td>
<td>Banking regulations, Contract enforcement, Labour laws, Quality of supervision</td>
<td>Are there usury laws? What services is the MFI legally permitted to offer? What are the rules for loan classification, provisioning, capital adequacy and income recognition? What are the MFI's responsibilities under current labour law? Watch for proposed changes to legislation or regulations</td>
<td>Influence public policy through an industry association or network Conduct regular compliance audit</td>
</tr>
<tr>
<td>Competition</td>
<td>Lack of knowledge about the services offered by the competition, Lack of information about clients' current and past credit performance with other institutions</td>
<td>Current and potential competitors' positioning, pricing, products, target market, market share Client retention Loan application questions about the competition Mystery shopping in your own and your competitors' institution Measure customer satisfaction through exit interviews and focus groups Regular data collection through a variety of channels to ensure current and accurate information</td>
<td>Refine products Provide incentives for retention Offer new products Improve access Improve service Focus on an underserved market niche Access a credit bureau or industry-wide bad debtors list</td>
</tr>
<tr>
<td>Demographic</td>
<td>Adopting a product that was successful elsewhere without sufficiently adapting it to local factors, An inherently vulnerable market</td>
<td>Education level of clients Entrepreneurial attitude and aptitude Social cohesion Societal attitudes towards fraud Prevalence of crime Past experiences with NGOs and credit providers Occurrences of illness and death</td>
<td>Create special systems for illiterate borrowers Train clients Adapt internal controls Enter partnerships with insurance companies Enter partnerships with non-financial service providers</td>
</tr>
<tr>
<td>Physical environment</td>
<td>Weak or inadequate infrastructure, Natural disasters</td>
<td>Availability of electricity, transportation systems, banking facilities, communication infrastructure Early warning systems</td>
<td>Operate in a limited number of areas that are near each other Diversify business Access insurance Create disaster relief funds Offer emergency loans Encourage savings Develop appropriate rescheduling policies Protect information and records</td>
</tr>
<tr>
<td>Macro-economic</td>
<td>Direct effects, Indirect effects due to impact on clients, their business operations and their ability to repay their loans</td>
<td>Exchange rates Interest rates Level and volatility of inflation Regional and national growth Commodity prices</td>
<td>Short loan terms Peg interest rates Lend in a foreign currency Diversify portfolio by sector and geographic region</td>
</tr>
<tr>
<td>Political</td>
<td>Directed credit, Debtors' groups, Civil unrest or violent conflict, Declarations of debt forgiveness</td>
<td>Is there political pressure to provide credit or other services to particular communities or individuals? Negative PR for the institution or industry? Inaccurate or misrepresented? Domestic and regional tension</td>
<td>Put in writing clear operational policies that include checks and balances Conduct PR activities through an industry association or MFI consortium Advertise neutrality during election campaigns Develop contingency plans and train staff in preparation for coordinated response</td>
</tr>
</tbody>
</table>
MFIs can try to mitigate political risks by putting in writing clear operational policies that include checks and balances that protect the institution from political pressure and provide clear guidance for operational staff and leaders on how to respond to pressure when it comes. They can advertise neutrality during election campaigns; educate policy makers about their operations, perhaps inviting them to visit their premises; and/or work through their local microfinance association to facilitate sensitization workshops for key individuals or committees in the government.

Uganda’s microfinance association, AMFIU, launched a consumer protection and education campaign in December 2004, together with the Uganda Consumers’ Protection Association. This was primarily intended to increase microfinance clients’ awareness about their rights and responsibilities, but was also a proactive strategy for managing potential political criticism and interference. In Bolivia, senior managers from several MFIs participated in radio talk shows in order to respond directly to criticism targeted at the industry during the crisis of 1999/2000.

### Main Messages

1. External risks can be managed.
2. Focus on monitoring the sources of external risk in your environment and designing response strategies that will lessen the impact of challenges when they occur.
3. Prepare your systems, your staff and your clients for what might come so that everyone will know how to respond.
4. Avoid using external risks as excuses.
Managing Risks

Case Study: Facing Multiple External Risks in Bolivia

In the late 1990s, the microfinance sector in Bolivia had become increasingly competitive as a number of private commercial players had entered the market, and microcredit and consumer lending had grown immensely while increasingly overlapping in terms of clients. Many clients were taking on multiple loans from different institutions for productive investments and consumption.

In the midst of this fierce competition, an economic crisis hit the country. It sprang from troubles throughout South America, starting with financial crisis and currency devaluation in Brazil. The ensuing recession hit the informal economy particularly hard, reducing demand for their goods both inside Bolivia and in export markets. Another contributing factor was the crackdown on "informal" importing and exporting that took place as part of a reform of Bolivia's customs administration.

The fact that overindebtedness due to fierce competition coincided with Bolivia's economic slide propelled a significant problem to crisis proportions. After years of relative quiet, Bolivia began to experience heightened social unrest, with mass protests about issues like water and electricity prices. Interactions with clients started to sour, as loan officers spent more and more time trying to collect from over-indebted customers. These conditions set off a backlash against microcredit.

A handful of "professional" union organizers began gathering borrowers into debtors' associations to protest against the consumer and microfinance lenders. These associations grew quickly because organizers promised new recruits debt forgiveness. The associations staged protests, a few members engaged in hunger strikes, and in the most extreme example, demonstrators carrying dynamite took over the offices of the Superintendency of Banks, holding employees hostage and threatening to blow up the building.

The affected MFIs, working through their newly created association, Asofin, sought aid from the courts to stop the demonstrations. Even though Asofin hired high-priced lawyers, the tearful testimony of a few market vendors carried the day. In fact, Asofin had scant legal basis for stopping the associations from mounting street protests. Eventually, the debtor associations forced their way into a dialogue with the Superintendency of Banks and Asofin, in which the microfinance lenders agreed to consider debt relief to association members on a case by case basis. Ultimately, the concessions granted to the associations were minor. The major importance of the protests was to politicize microfinance, changing attitudes about credit and damaging Bolivia's once-excellent repayment culture.

The consumer credit market eventually crashed since its large portfolio was overly exposed and its relationship with clients was tenuous at best. The microfinance sector survived the crisis, but remained vulnerable since MFIs experienced the highest delinquency ever registered in the sector and a dramatic fall in profits. As a survival strategy, MFIs — with the blessing of the Superintendency of Banks — increasingly began to use rescheduling, a practice they rarely used before 1999 as it was considered highly risky, and likely to have a long-term adverse effect on repayment discipline if used too often. There is some indication that many MFIs moved upmarket as another coping strategy (their client numbers stagnated while portfolio increased). In general, all the main MFIs in Bolivia strove to maintain their commercial orientation in the face of the crisis and continue charging full-cost interest rates.

This case study was adapted from:

Recommended readings:

Regulation and Supervision


Competition


Challenging Environments


IV

Organizational Architecture
### IV Organizational Architecture

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Organizational Architecture

This manual uses the metaphor of "organizational architecture" as a framework for designing and analysing three interrelated components that are essential to managing growth: (1) human resource development, (2) institutional culture and (3) organizational structure. This metaphor is borrowed from two sources. Both Nadler et al. (1992) and Tomasko (1993) use the concept of organizational architecture as a way of thinking about the process of building solid and lasting institutions — literally, institution building.

The Three Components of Organizational Architecture

A microfinance institution needs to be built in the same way an architect designs and constructs a building. A building cannot be erected without a plan. A building plan outlines not just where the walls and windows will be, but also how the plumbing and electricity will flow and connect all the rooms. The shape and the location of the rooms are determined by the proposed function of that space. In the process of building — or reconstructing — architects must balance competing forces, such as the concern for beauty with the need for energy con-

This introduction was adapted from:

servation and the multiplicity of owner-specified requirements with budgetary constraints (Tomasko, 1993).

These architectural elements are also applicable to building a microfinance institution. Organizational architecture includes the formal structure, such as the design of work practices; the nature of the informal organization or operating style; and the process for selecting, socializing and developing its staff members.

Constructing a building without a plan is a recipe for disaster. The same is true of the process of building or remodelling an MFI. It needs a plan that takes a holistic view of the organization and considers how the pieces fit together. The design of the organization is just an empty shell – boxes on an organization chart. Inside the shell, the organization is filled with people, people with skills and experience who perform important functions. The spirit and vision that motivate and guide the human resources are derived from the institutional culture. These three components must be considered collectively.

MFIs can use the logic of architecture to build an organization that embodies the competencies and strengths of microfinance. The elements that are critical to success in microfinance should also be reflected in its architecture. The organizational architecture of microfinance prizes speed, flexibility and focus. It emphasizes micro by eliminating costly barriers that isolate the provider from its customers, that separate managers and employees, that divide the head office from the branch or field activities.

Towards that end, this section starts with a chapter on human resource management (Module 14), which guides managers through six dimensions of an HRM strategy:

1) hiring the right people
2) orientation and training
3) career development
4) performance management
5) compensation
6) care and appreciation

Module 15 introduces the concept of institutional culture and provides managers with ideas on how they can proactively shape their culture to create a better working environment and improve performance. The third architectural component, organizational structure, is covered in Module 16, which describes common structural elements in effective MFIs. The last chapter in this section, Module 17, brings the three elements of organizational architecture together to illustrate how they can be used collectively to manage growth.
Human Resource Management

The first component of organizational architecture, human resource management (HRM), is the process through which an institution recruits, develops and motivates people to accomplish its mission. Interrelated with every aspect of the organization — from the culture and customer orientation to the products and delivery channels, to the organizational structure, processes and technology — effective HRM is critical to microfinance success.

An MFI's human resources (HR) contribute significantly to its productivity; they provide the locus of interaction between the MFI and its customers; they also represent the single largest cost item for the institution. As such, they constitute one of the most important areas of focus for both efficiency and performance improvement.

As defined in Module 1, a manager is someone who gets things done with and through other people. The better managers are at managing their human resources, the better results they will have. This module explores the components of human resource management that are most important to microfinance institutions. Specifically, it addresses the following seven themes:

1. Creating an HR strategy and policies
2. Hiring the right people
3. Orientation and training
4. Career development
5. Performance management
6. Compensation
7. Care and appreciation

14.1 Creating an HR Strategy and Policies

Human resource management is not just a series of activities that are somehow related to an organization’s personnel. It requires a strategy, a plan for those activities. An HR strategy provides coordination and integrates activities so that they all work together. It also reinforces and strengthens the institutional culture, and helps ensure that the human resource management activities are internally consistent. Often included in the MFI’s overall business or strategic plan, the HR strategy includes: 1) a statement about the role that human resources play in enabling the organization to fulfill its mission; and 2) high-level human resource goals for the period covered by the strategy (e.g., initiate an employee loyalty programme, introduce relevant in-service training, assess the effectiveness of an incentive scheme).

Parts of this module were adapted from:
- Brand and Gerschick (2000).
- Rhyne and Rothblatt (1994).
The main objective of an HR strategy is to enable employees to contribute as much as possible, as quickly as possible, to the achievement of the institution’s mission. From the perspective of a microfinance manager, a key equation to remember is:

$$\text{Performance} = \text{Ability} \times \text{Motivation}$$

An analysis of this equation offers managers four important insights:

1. Some performance will be achieved as long as an MFI’s employees possess some ability and some motivation.
2. If either ability or motivation is non-existent, performance will be nil. An MFI can have a wealth of technical, human and financial resources, but if no one is motivated to serve poor clients, they will not be served.
3. Even if an MFI possesses relatively less ability than it desires, it can achieve superior performance goals if its employees are relatively more motivated. In other words, the more employees are motivated the more results an MFI can achieve with a given level of ability.
4. The fourth insight is simply the converse of the third, i.e., the less employees are motivated or capable the less the MFI can achieve.

An effective HR strategy, therefore, focuses on creating and maintaining a capable and motivated workforce. Essentially, it strives to ensure that the organization has the right people in the right place at the right time with the right skills and motivation to achieve the organization’s goals and objectives. Whether the HR strategy is one component of the MFI’s overall strategic plan or a stand-alone document, it needs to describe how the institution’s human resources will enable it to fulfil its mission.

The HR strategy is used to guide and shape an organization’s human resource policies. These policies, often packaged into a human resource manual, are given to all employees to provide clear guidance on what is expected and acceptable, to specify the penalties for unacceptable behaviour and to state what the organization will do (or will not do) in relation to its employees. Box 14.1 provides an example of what the contents of an HR policy manual or handbook might look like for a MFI. Note that the introduction provides an opportunity to summarize both the values and the HR strategy according to which the policies and procedures have been designed.

Typically these policies are drafted by HR experts to ensure that the MFI’s policies comply with the country’s labour laws. Line managers who are involved in implementing the policies must be thoroughly trained so that they know what they can and cannot do. For example, many organizations have policies against discrimination on the basis of gender, race, disability, etc., but a careful look at actual hiring practices shows that those policies are not always, or even regularly, followed.
14.2 Hiring the Right People

The first component of a successful HR strategy is the hiring of sufficient people at an appropriate time with the required skills and attitudes, as well as a high level of motivation. To ensure that the “right” people are hired, MFIs must pay careful attention to the early stages of the hiring process, namely recruitment and selection.

Hiring for Staff Positions

For entry-level or field positions, the hiring process in a microfinance institution usually consists of the following eight steps:

1) Defining an HR plan. Human resource management begins with human resource planning. The MFI’s business plan should provide guidance on what positions it has to fill, with how many people, in what locations and when. The HR plan should outline how the organization will address the human resource requirements of the business plan while complying with its HR policies.

2) Being informed by the past. If the MFI is seeking a replacement for an existing job, it is important to hold an exit interview with the departing staff member. The purpose of this conversation is threefold: a) to inform the MFI about the reality of the post being vacated; b) to reassess the content of the job description; and c) to explore the fit between the work that needs to be done and the stated skills required to do the job.
Organizational Architecture

Box 14.2 Sample Job Description

Job title: Loan Officer
Reports to: Branch Manager
Supervises: N/A
Definition: The Loan Officer is the primary point of contact with all borrowers in a designated area. The Loan Officer is a problem-solver, providing appropriate credit services to assist low-income people to solve their own problems. As such, the Loan Officer markets loan products, assists clients to determine credit needs, manages the application and approval process, insures prompt delivery and repayment of loans, and provides periodic portfolio information.

Duties, roles and responsibilities:
1. Conduct survey to determine credit needs within area of assignment.
2. Initiate client contact.
3. Meet with clients to determine credit needs and business viability.
4. Assist clients with applications, including visits to workplace, completion of financial analysis forms, collection of client baseline data and verification of loan security.
5. Analyse loan applications and make recommendations to Credit Committee.
6. Disburse funds, obtain signature on contract, verify business conditions and formalize relationship.
7. Ensure prompt repayments.
8. Collect relevant data and submit timely and accurate reports.
9. Visit all customers periodically to build a relationship of mutual trust and assess future credit needs. Provide financial counselling as needed.
10. Solicit, respond to and resolve customer complaints. Document all complaints and suggestions.

Technical skills:
- Secondary school or university degree
- Demonstrated ability in mathematics, economics or finance
- Fluent in the local language

Cultural and social requirements:
- Social entrepreneur
- Utmost honesty and integrity
- Previous experience working in grassroots activities
- Excellent interpersonal and communications skills
- High levels of motivation and ability to work independently
- Strong decision-making and problem-solving skills
- Excellent organizational and time-management skills

Source: Adapted from Edgcomb and Cawley, 1996.
3) **Defining the position.** The MFI must describe the position and the characteristics of the most appropriate person for the job. A **job description** should outline key duties, roles and responsibilities; it should include the technical skills, as well as the cultural and social requirements for effective performance (see Box 14.2). When hiring a new person for an old post, do not assume that the previous job description is still relevant.

MFIs vary widely in how they define the optimal skill sets for staff positions. While there is no one right profile, the clarification of specific skill requirements enhances the chance that skill sets and job requirements will match. In defining microfinance skill sets, it should be noted that more is not necessarily best. MFIs may want to:

- **Consider employing less-educated staff.** Less-educated persons are often less costly and more likely to stay with an MFI than employees with greater opportunities. For example, MDF-Kamurj in Armenia no longer hires loan officers who speak English because they kept leaving to work for international organizations. In Bangladesh, ASA deliberately keeps job responsibilities simple so that it can hire loan officers with little education or experience at low salaries. This approach, however, may limit the product diversity or flexibility that the MFI can offer.

- **Consider employing staff with little or no work experience.** Many MFIs argue that good field workers are made rather than found, especially in places where prevailing values conflict with the institutional culture. The Grameen Bank deliberately avoids hiring anyone with previous banking or financial experience for precisely this reason.

4) **Clarifying the selection procedure.** The MFI should specify the selection process and criteria that determine whether candidates have the required skills and characteristics specified in the job description. Consider for example, the description in Box 14.2. How will the MFI assess whether candidates have the expected cultural and social requirements? The MFI needs to define a specific means of assessing each requirement. The details of the process should be clearly mapped out before advertising the vacant position.

5) **Marketing the position.** Once an MFI has defined the job opening and the process for selecting someone to fill that position, it is ready to advertise the vacancy. The approach that an MFI takes to advertising matters because it defines the pool of potential applicants who will hear about the job. MFIs should consider the methods and languages they will use to communicate the job opening, as well as the cost. The goal should be to choose the communication channel that will help recruit the most appropriate and qualified candidates.

The recruiting process depends on the institution and labour market, but two strategies are particularly effective. First, a good source of new recruits is a satisfied and effective employee. This employee presumably understands the corporate culture and will know people who are a good match for the MFI. He or she can make a stronger sell to a prospective staff person than a human resource specialist who may not fully understand the intangible benefits of working in the field. Some organizations actively encourage peer recruiting by giving a bonus to employees who recruit others — half upfront and the second half if they pass the probationary period.

A second approach is to determine what mentors, books or organizations helped shape the character of the MFI's most outstanding employees. If there are some common sources — such as youth clubs, schools or community associations — then they would be fruitful places to actively recruit new staff. Such places might serve as incubators that
either attract or cultivate people who exemplify the MFI's institutional culture, attitudes and beliefs.

These two techniques are effective because they are more targeted than mass media advertising, and can lessen the burden on the HR department to review hundreds of applicants responding to a broadly advertised vacancy announcement. But more importantly, these approaches propagate the institutional culture because they ensure that like-minded people are being considered for employment.

6) Evaluating candidates. After recruiting a pool of potential candidates, the MFI will need to evaluate them according to the agreed-upon process and selection criteria. In this effort, MFIs would be wise to use a combination of assessment tools to screen applicants.

If there are many candidates for few posts, an MFI needs to find quick ways to cull applicants who are weak or not serious before investing time in the more labour-intensive process of interviewing them. One way to improve the efficiency of the screening process is to provide a video orientation about the MFI and the work that it does. If the video is done well, some candidates will realize that this is not the kind of work they are seeking and immediately exclude themselves. Another approach to pre-screening candidates is through written aptitude tests, whereby only those persons who achieve a certain minimum score advance to the next round of the selection process. Although it may seem simplistic, the administration of tests to determine the applicant's skills can help avoid hiring individuals who falsify or exaggerate their capabilities.

Individual interviews are probably the most common way of screening applicants, but they should not be relied on exclusively. Just because someone comes across well in an interview does not mean that they can do the job. Group interviews and role-play exercises can expose applicants' leadership and communication skills, their willingness to be team players, and their character. For example, since honesty is an important characteristic for all microfinance employees, MFIs could design a group exercise that tempts candidates to cheat to win.

In their efforts to hire the right person, some MFIs require their shortlisted candidates, for both head office and field posts, to visit clients. By observing them interacting with clients, the organization can get a better idea of how they relate to the target market. A variation on this approach is to ask candidates to interview low-income persons and then to prepare a presentation for the selection committee. This screening method has the added advantage of assessing if candidates are good public speakers who can organize their thoughts. These types of tools give a balanced picture of the applicants and their ability to operate in the MFI’s environment, both in terms of the internal culture and the external environment in which the MFI does business.

In some organizations, pre-screened candidates are given opportunities to demonstrate their talents in a working environment before they are actually hired. At Equity Building Society in Kenya, selected candidates are not given an immediate contract. Instead, they are invited to work with the MFI for a week so that managers can see how they perform. Similarly, Moznosti in Macedonia rarely hires for entry-level posts directly. Instead it has one-month internship positions for persons who are interested in learning about microfinance, and it uses the internship process to assess the personality, attitude and motivation of prospective employees.
Besides helping an MFI identify the right candidates to hire, these exhaustive screening methods promote teamwork. Co-workers who were all selected through a thorough and competitive process tend to respect each other and feel a strong sense of belonging (see Box 14.3).

**Box 14.3 Candidate Selection at Prodem**

Once a job profile was defined, Prodem began identifying candidates who met the profile. Advertisements were placed in the most important national newspapers announcing the open position. Thirty-five to 50 CVs were received for each position, of which seven or eight people were invited to participate in the next step of the recruitment process. They were brought together and two exams were administered. The first was a psychotechnical exam that tested candidates’ abilities in the areas of spatial, mechanic and numeric reasoning, verbal logic, and comprehension. The second exam consisted of group simulations that tested candidates’ ability to work in teams, interact with others, and exercise leadership. If relevant, a third exam was given to assess whether the candidate possessed the technical knowledge necessary to carry out the responsibilities of a particular position.

Results of the exams were tallied and finalists were chosen competitively on the basis of their average scores. Each exam was weighted equally, but a minimum score was required on each exam in order to pass; there was also a limit on the acceptable difference between the scores of the different exams. This helped to ensure that future employees were relatively balanced in all of the areas Prodem identified as important.

In the last step of the recruitment process, approximately three candidates per position were interviewed to assess their ability to do the job in question and their affinity with Prodem’s culture. Since Prodem was more concerned with the potential of the person being interviewed than with his or her past accomplishments, many of the questions asked involved hypothetical situations. The interviews were generally conducted by a panel that included the supervisor for whom the new employee would be working and a representative of the Human Resource Department.

Besides facilitating the recruitment of qualified staff, Prodem’s rigorous hiring process helped establish a culture of merit and integrity within the institution. Because the process was so intense, and involved so many stages and people, there was no single individual to whom an employee needed to feel loyal once he or she was hired. Loyalty could be given to the institution that had sponsored the process and to the other individuals who had survived it. Knowing that everyone had passed the same quality check made employees feel like they were part of a high-calibre team, and that motivated them to perform as a high-calibre team.

*Source: Adapted from Frankiewicz, 2001.*

Three other recommendations can be made with respect to the evaluation process:

- **Screen for staff who are motivated by the organization’s mission.** A MFI may be better able to retain staff if it hires persons who want to get more out of their jobs than just a pay cheque, people who want to make a difference in the world, work with amiable colleagues, and be respected and trusted. This characteristic can be assessed through certain interview questions, psychometric exams or role-play exercises.
• **To serve women, hire women.** According to Mayoux (2003), there is a clear linkage between the empowerment of female clients and the levels of female staff in MFIs. If it cannot hire a sufficient number of women field agents, perhaps because the local culture prevents them from working outside the home or riding motorcycles, the MFI needs to carefully screen male applicants for their attitudes towards women.

- **Check references.** This step in the screening process is often skipped by managers who think that it will take too long and that they are not likely to get useful insights by persons who are handpicked by the applicant. Those sceptics will be surprised at how valuable reference checks can be, especially if they specifically request the contact information of previous supervisors and co-workers from the applicant’s last two or three positions. Often the most impressive applicants have some unsavoury skeletons in their closets that only get detected through reference checks.

7) **Select the best candidates.** At the conclusion of the evaluation process, MFIs should select the best candidate to fill the open position. The best way to avoid firing people is to hire the right people in the first place. This may seem obvious, but in the rush to hire employees an MFI may not screen prospective staff members properly. Hiring in haste invariably results in hiring the wrong person. MFIs may also want to involve current employees in the selection of their future team members. Ideally, the people who will work with the new employee should have a loud voice in the hiring decision. This input is especially important if the MFI relies on teamwork and group-based incentives since the chemistry between members helps determine the success of the team.

8) **Negotiate contracts.** Once a candidate has been selected, the MFI needs to make an employment offer and negotiate a contract to bring the candidate into the institution. Most MFIs include a **probationary period** in their initial employment contracts. They are also careful to specify the performance-based component of any compensation agreement. Typically incentives are not paid while new hires are in their probationary period to avoid stimulating unhealthy growth.

**Hiring for Management Positions**

Recruitment and selection for more senior posts follows the same general process, although there are some important differences:

- Since expected vacancies for senior positions only arise occasionally, i.e., through retirement or new positions, it is more difficult to have a hiring plan.
- There is a smaller pool of potential candidates, so the recruitment process has to be even more targeted, perhaps involving a “head hunter” (an executive search firm).
- Unlike entry-level positions, for senior posts MFIs need to consider internal candidates, as described in more detail in Section 14.4.
- More attention must be given to assessing the existing capacities and skills of candidates because it is difficult for MFIs to provide technical training for senior posts.
- More careful background checks are required for persons with greater responsibilities.
- It may be difficult to use group interviews or role-plays as screening techniques, but MFIs definitely need to see how top candidates interact with their target market.
Training is the second aspect of human resource management. New employees must be introduced to the institution, its culture and its way of doing things. This important HR element enables new employees to contribute quickly and effectively to the MFI. Existing employees need to develop themselves as well, adding new skills, knowledge and responsibilities that enable them to grow and to help the institution grow. Indeed, staff training is an ongoing process throughout the entire relationship between the employee and the MFI.

Staff training for both new recruits and existing employees generally focuses on two objectives: 1) promoting and sustaining the institutional culture; and 2) teaching staff the operating procedures they need to follow in performing their jobs, which includes exposure to the procedures performed by other parts of the organization.

New Employee Orientation

New employee orientation is the first opportunity to align corporate and employee values – and perhaps the most important opportunity as first impressions are enduring. Orientation transmits and propagates the institution’s culture in three ways:

- **Buy-in**: It is challenging to get new staff to embrace an MFI’s values as their own. During training, new recruits can be asked to discuss ideal working conditions, how they would like to see co-workers interact with each other and with clients, and how they would like to be treated by management. This discussion can be facilitated in such a way as to identify the core elements of the institution’s culture, and to give new staff a sense of identification with it.

- **Explicit messages**: Building on this discussion, the training can explicitly communicate the organization’s mission, values and culture. It can transmit clearly what the MFI aims to achieve, how it expects the staff to treat each other and its clients, and why this is so important to the institution. In some MFIs, the chief executive officer participates in the orientation session to welcome new employees, to share with them his or her vision for the organization, and to indicate how they will benefit if they are committed to making that vision a reality.

- **Modelling the culture**: Trainers should also “walk the talk”, modelling their explicit messages and the behaviour expected of staff. For example, if the MFI expects employees to be critical and analytical, then the training should encourage debates and welcome differing opinions.

Initial staff training usually includes two components: a) classroom training and b) on-the-job training. During the classroom phase, new recruits receive an overview perspective of the organization to see how their roles fit into the bigger picture. This setting is used to indoctrinate employees into the MFI’s core values, such as a commitment to quality and customer service, and to teach them the theoretical aspect of their jobs. The training curriculum will depend partly on the organizational structure. For example, if the business is organized around teams, it will be necessary to teach interpersonal and problem-solving skills. If the organization relies on the self-management of field staff, employees will be taught how to read and interpret performance indicator reports.
The on-the-job training phase, which may last several months, allows new staff to learn the technical aspects of the job and the tricks of the trade from experienced personnel. In microfinance, many skills of field staff, such as client selection and delinquency management, can be learned best through experience (see Boxes 14.4 and 14.5). The on-the-job phase can be enhanced through an apprenticeship system with trained mentors where new recruits can learn many of the nuances of microfinance without having to make major mistakes.

**Box 14.4 Unique Training Techniques at Grameen Bank**

Grameen has no formal training manual. Instead, its written training materials contain a list of questions about Grameen objectives and operations that trainees are supposed to answer for themselves while they are in the field. Classroom time is devoted to discussing the answers trainees have found to these questions and comparing field experiences, rather than to the presentation of additional material. This technique places responsibility for learning on the trainees, while keeping them focused on the topics of greatest importance to Grameen.

*Source: Adapted from Rhyne and Rotblatt, 1994.*

**Box 14.5 On-the-job Training at Actuar Bogotá and ADEMI**

After a week of initial orientation, new recruits at Actuar Bogotá in Colombia are assigned to work with an experienced field worker who already has a full quota of clients (60 groups). They work together for two months, during which time they are expected to add 20 more groups to their portfolio. When this target is reached, the portfolio is split, giving each worker a set of 40 groups.

Similarly, in the Dominican Republic new ADEMI employees spend two weeks at headquarters for an induction programme, followed by four weeks accompanying an experienced agent in the field. After observing the loan officer with his clients, the recruit is expected to start building his own portfolio in an adjacent geographical area within three months, at which point he will go off on his own.

*Source: Adapted from Rhyne and Rotblatt, 1994.*

It is critical that mentors know how to train new staff effectively since they, above all, bring the institution’s culture to life. Their actions should demonstrate what the mission, values and culture mean in practice. MFIs should develop a mentorship course to teach experienced field staff how to provide on-the-job training. The human resource department should also follow up with new staff once they have been on the job for three or four months. By observing their performance in the field, it can assess the skills of both the trainee and the mentor, and recommend any additional training for either that might be required.
**In-Service Training**

In successful MFIs, staff training does not end after new staff orientation. **Ongoing training** is required to assist employees to develop their skills, adapt to change, and contribute more productively and efficiently to the MFI’s objectives. The HR strategy should include regular monitoring of the skills employees need to fulfill personal and institutional objectives, and it should facilitate **professional development opportunities** that respond to those needs.

Some MFIs provide all employees with two weeks of training every year. Others offer in-service training only when required. Although the latter strategy is cheaper, it is not necessarily effective. Recent literature on adult education supports the hypothesis that employees need ongoing training to reinforce and extend what they previously learned.

There are several different types of in-service training:

- **Job-specific training** is often a one-time event and is commonly associated with the installation of new software or the introduction of new products. However, job-specific training can also address an employee’s evolving needs as identified during regular performance reviews.

- **Promotion-related training** prepares an employee for a higher level of responsibility or managerial authority. This usually includes job-specific training for the new position as well as leadership and management training to improve employees’ ability to guide, supervise and motivate the performance of others. Promotion-related training may also endeavour to strengthen planning, analysis and reporting skills.

- **Cross-training** enables employees to perform a variety of different jobs. By developing employees who can perform multiple functions, MFIs can reduce their vulnerability to absenteeism and attrition, and increase their flexibility. Staff can be moved around based on changing demands; they can deliver multiple products; and they can participate meaningfully in redesigning procedures because they understand the work environment from various perspectives. Cross-training is particularly relevant in MFIs that are diversifying or are aggressively seeking efficiency improvements.

- **Basic skills training** provides opportunities to learn skills that can be applied in almost any position, such as word processing or financial spreadsheets.

- **Cultural seminars** can reinforce the institutional culture, promote teamwork and motivate staff. Some MFIs provide such refresher courses on an annual basis, while others hold a 30-minute session at the branch level every two weeks. These activities usually focus on improving cooperation, enhancing communication and building morale, but they can be used to strengthen any cultural area. They can be particularly useful in helping an MFI maintain and/or adjust its culture during times of growth, reengineering, or major change in the external environment.

- **Staff rotation** moves employees to another physical location, i.e., to another branch or department. Unlike cross training, new skills will not necessarily be learned, but the change of perspective can enable employees to learn new ways of doing their old jobs. Serving different types of clients in a different environment under the supervision of a manager with a different style provides opportunities for employees to develop their skills and to find ways of dealing with new challenges. The rotating employees also have an
opportunity to bring their experiences, perspectives and innovations to the new location, thus providing a transfer of lessons learned in both directions. Some MFIs also use this strategy to reduce their vulnerability to fraud.

14.4 Career Development

Career development is another key component of HR management. This section covers the following important issues: job enrichment as an alternative to promotion; the advantages and disadvantages of promoting from within versus hiring from the outside; career development obstacles for women; and succession planning.

Job Enrichment

A key staff retention strategy is to provide employees with opportunities to advance within the institution — to be promoted to a higher level of responsibility, to be delegated additional responsibilities within one’s current position, or to be given greater autonomy in implementing one’s current responsibilities, for example, by increasing a credit officer’s loan approval authority.

MFIs tend to have relatively flat organizational structures, so opportunities for promotion are often limited. Since everyone cannot be promoted, the jobs for deserving employees can be made more interesting or challenging through job enrichment. Similar to cross-training, job enrichment strategies expand the scope of an employee’s involvement in and contribution to the institution, such as self-management opportunities, participation in task forces that are working on product innovations, engaging in market research or learning new skills.

Promoting from Within?

Yet all MFIs have some promotion opportunities to offer their employees, and growing institutions will frequently need to fill non-entry-level positions. In staffing these positions, MFIs face a choice between promoting from within and hiring the most qualified people from outside the institution. The definition of a recruitment and advancement policy involves significant tradeoffs between corporate identity, staff satisfaction and the proper mix of internal knowledge versus technical skills. MFIs resolve these trade-offs in different ways, and thus their career patterns vary considerably.

At one extreme, MFIs like the Grameen Bank recruit almost entirely from within. All but a handful of its head office staff members originally served as field workers or branch managers and have been promoted into their current positions. The benefits of this history include the sense of solidarity among staff, and the clear understanding that head office personnel have of field operations.

There is much to gain by promoting from within. Successful companies develop, promote and carefully select managerial talent grown from inside their organization as a key step in preserving their core values and institutional culture. Promoting from within is also an important motivational strategy — encouraging employees to deliver the kind of quality performance that would enable them to be promoted.
This promotion strategy, however, has some limitations. MFIs that develop their human resources entirely in-house miss out on the cross-fertilization and stimulation that can come from bringing people into the institution from the outside. Employees that are promoted from within may also make assumptions about the way things work in the field based on their own experiences, and fail to recognize changes in the environment.

In general, MFIs combine promotions with external hiring. Most MFIs first try to fill positions through internal recruitment, but if they cannot find the right person for the job, they go outside. As MFIs choose between internal and external recruitment, they may want to consider the following recommendations:

- If an MFI has a long-term relationship with an employee who has developed, learned new skills and demonstrated leadership attributes and abilities, that person should be considered a strong candidate when a management position opens up.
- People should be promoted only because they can perform the responsibilities of the new position. Promoting people into positions that are above their heads or for which they are not adequately prepared is a recipe for disaster, both for the MFI and for the employee. Good loan officers do not necessarily make good branch managers.
- If an MFI wants to pursue internal recruitment seriously, it needs to commit itself to ongoing training to ensure that, when staff are promoted, they can handle their new responsibilities.
- Internal promotions may make transitions easier. During periods of rapid growth, a new external manager may not have time to learn on the job. In this situation, someone from the inside who already knows the organization may be a better candidate. However, in structural transitions, such as when NGOs are transformed into regulated financial institutions, MFIs may be better served by an external manager who is familiar with the new institutional type and has the skills to manage it.
- All MFIs can benefit from the new ideas and perspectives that come from externally recruited staff.

**Gender and Career Development**

In designing their approach to career development, MFIs should also pay attention to gender issues, especially obstacles that may prevent women from being promoted or even seeking promotions. When organizations analyse this issue, the results often surprise senior managers. Executives often assume that women are not interested in leadership positions, but such research may identify the institutional culture and attitude of top executives as a major source of the problem (see Box 14.6). If such findings emerge, hopefully senior managers will instigate a discussion about how to change the culture to provide legitimate career development opportunities for women.
Organizational Architecture

Box 14.6 The Glass Ceiling for Women Managers in Microfinance

Although equal employment rights are an essential element of women’s human rights and non-discriminatory development, they do not necessarily lead to women’s empowerment. The experience of many MFIs with equal opportunity policies indicates that recruiting women, particularly to senior positions, is often difficult. This is due to the gender constraints that affect clients as well as staff. To overcome these constraints, fundamental changes in recruiting procedures, institutional culture and conditions of work may be necessary. For example, staff frequently lack expertise in gender analysis, so additional training may be required. If MFIs are serious about their mission to empower women, then they need to set an example for their clients by hiring and promoting women.

Source: Adapted from Mayoux, 2003.

Besides the perceptions of senior management, there are also more concrete issues that need to be addressed to reduce gender barriers for career development. In particular, a common challenge is the conflict between the demands of the home and office, which in most cultures is felt more strongly by women. To allow female and male managers to combine their work and family responsibilities, MFIs could consider the following:

- **Flexible working hours**: The MFI’s office hours may not make the most sense for all employees, particularly parents who have to adjust their schedules because of their children. MFIs can be parent- and gender-friendly if they allow more flexible working hours, perhaps even including telecommuting. Some organizations find that such flexibility actually increases productivity.

- **Part-time opportunities**: Because of parenting responsibilities, some employees would prefer part-time work, either shorter hours spread throughout the week, or just a couple of days a week.

- **Job-sharing arrangements**: To accommodate part-time employees, some organizations arrange for job sharing whereby two (or more) persons complete the work of one position. For example, two half-time loan officers could manage the portfolio of one full-time loan officer. Job sharing is a little bit more difficult to arrange for management positions, but not impossible. For several years, CARE’s small enterprise unit was managed by a husband and wife team who each worked three days a week.

- **Day-care allowances**: Since most MFIs are not large enough to provide day-care services, an alternative is to support their parent-employees financially. In some circumstances, such allowances might also make sense for tax purposes.

- **Career breaks**: An important factor in supporting the professional advancement of women is to allow them to take time off during their careers, and allow them to return to the organization when their personal situation permits, without losing seniority or benefits. Such leave-without-pay or sabbatical arrangements can be particularly important for female managers.
Succession Planning

It is difficult to find strong leaders – when possible, it is better to create them. A final career development issue that is essential for MFIs is succession planning. Microfinance institutions tend to be dependent on the leadership and expertise of a small cadre of executives – sometimes very small. If the CEO was involved in an accident, it could potentially destroy the organization. Consequently, as an HR risk management strategy, the board should have a plan to replace key members of the senior management team, and be developing the expertise of those replacements accordingly.

Even if the organization is not concerned about accidents, it is still wise to be grooming internal candidates for future executive posts. The process of leadership creation also includes leadership renewal. Rising stars in the organization should be encouraged to take sabbaticals to further their education and broaden their experiences.

14.5 Performance Management

Once an MFI has hired and trained staff, its HR strategy must guide and motivate employee performance so that it contributes to the institution’s objectives. Ideally, it will motivate employee performance over the short and long term so that the institution can reap as much benefit as possible from its early and ongoing investments in its staff. Towards this end, an effective human resource strategy requires managers to: 1) set performance objectives and evaluation criteria with each employee for a specified time period; 2) supervise employee performance in pursuit of these goals; 3) discipline employees whose performance or behaviour is unacceptable; and 4) evaluate the degree to which employees achieve their goals so that performance can be rewarded, adjustments can be made and goals for the following period can be set. For employees that still cannot meet the targets, even after repeated remediation attempts, managers need to consider a fifth element: termination.

Setting Performance Objectives

To generate strong performance, managers must communicate what they expect from employees and how their work contributes to the overall plan of the institution. The process of setting performance objectives is most successful when both managers and staff are involved. Staff members contribute to the discussion from their perspective of past work and experience, their aspirations and the areas of work they particularly enjoy. Managers make the link between individual or unit goals and institutional goals and strategy. This combination enables a focus on both:

DOING THINGS RIGHT (the individual contribution)

and

DOING THE RIGHT THING (the managerial contribution)
This process, summarized in Figure 14.1, helps to set objectives that are challenging, yet realistic. Challenging goals lead to higher employee performance — provided the goals are accepted by those who have to achieve them. Not surprisingly, the degree to which employees accept performance objectives is a function of their level of participation in setting them. If a goal is too difficult, employees will not even try to attain it, or they will become frustrated and stop trying.

Figure 14.1 The Process for Setting Performance Objectives

Taking the objectives of the MFI as a starting point, targets or individual objectives should be set for each employee (or for each team, if the institution organizes its work in this manner). The targets should describe the contributions that employees are expected to make to the institution’s objectives, and then define specific, measurable outputs. This process includes:

- Reviewing the previous year’s objectives and performance
- Agreeing on a work plan or personal action plan that outlines the areas of work for which an individual is responsible
- Developing a professional development plan to ensure the employee has the skills to meet the challenge ahead
- Agreeing on an incentive and compensation plan that links achievement of the objectives to individual and/or group rewards
In setting individual or team performance objectives, MFIs should consider the following:

- **Aim for SMART objectives:** Targets that are specific, measurable, achievable, realistic and time-bound are much easier to understand, pursue and evaluate.

- **Include quality objectives:** Most MFIs limit quality objectives to levels of delinquency or portfolio at risk. Although portfolio quality is undeniably important, quality objectives should also take into consideration customer service, paperwork errors (e.g., with loan applications or receipts) and timeliness (e.g., for staff meetings, customer appointments).

- **Establish performance objectives at all levels of the institution:** In many MFIs, the establishment of performance objectives begins and ends with the loan officers and branch managers. Yet the creation of a dynamic, enthusiastic team that intentionally and routinely seeks out opportunities to improve quality, customer service and efficiency requires motivation at all levels.

- **Make sure employees have control over outcomes:** For objective setting to positively impact performance, employees must have control over the results they are asked to produce. If external barriers make it impossible for them to achieve the objectives, and if they have no way to remove the barriers, the unachievable goals are likely to discourage performance.

### Supervising Performance

Once objectives are set, employees need constructive feedback and encouragement to perform to the best of their abilities. They need supervision that offers more than reprimands and instructions for correcting performance. They need coaching, energizing and assistance removing performance obstacles. In other words, they need supervision that supports successful staff performance.

In a **staff-centred approach** to supervision, managers see their primary role as problem solvers and mentors, not as overseers. They demand accountability and track progress towards goals, but they also recognize achievements and support necessary training and development. They provide honest and timely feedback to employees to reinforce effective behaviour, to reduce ineffective behaviour and to help employees identify opportunities to improve their work performance (See Box 14.7).

Experience shows that most of the energy for ensuring good performance comes from the **daily interaction** between staff and supervisors. Staff-centred supervision must be hands-on, consistent and systematic. Be aware of the squeaky wheel syndrome — it is not only poorly performing employees who should receive attention. Nor should employees receive feedback just once a year during a formal evaluation process. Performance monitoring and appraisal needs to be an ongoing process if it is to have a real and direct impact. Indeed, this is such a critical issue that managers who recognize that they are not particularly good at interpersonal communication should urgently investigate training opportunities for themselves.
Box 14.7 Techniques for Providing Feedback

1. **Focus on specific behaviours.** Tell the recipient why you are being complimentary or critical. Use examples that demonstrate your feedback, especially when giving negative feedback.

2. **Keep it impersonal.** Examples in negative feedback should be descriptive not judgmental or evaluative. Examples should be *job related*, not personal.

3. **Make it well timed.** Feedback is most meaningful to a recipient when there is a short interval between her/his behaviour and the receipt of feedback on the behaviour.

4. **Ensure understanding.** Feedback needs to be concise and complete. The recipient needs to clearly and fully understand your communication.

5. **If the feedback is negative make sure the recipient can control it.** Negative feedback should be directed to something the recipient can do something about.

6. **Be solution oriented:** If there are problems, rather than dwelling too much on the criticism, re-direct the discussion into the positive: what ideas does the employee have to fix the problem?

7. **Tailor the feedback to fit the person.** High performers with potential should get frequent feedback to encourage them to take corrective action, but the feedback should not be controlling. Adequate performers require minimal feedback as they display reliable and steady behaviour, but they can be encouraged to reach for more. Poor performers require frequent and very specific feedback to bring about change in behaviour. Feedback should also be geared to personality style.

*Source: Adapted from Pityn and Helmuth, 2005.*

One technique that MFIs may want to consider as part of their monitoring system, especially for managers, is **360 degree feedback.** A 360 degree feedback process assesses an employee’s performance through a number of people (i.e., manager, subordinates, peers, and customers), and provides feedback to that employee. It has proven most useful when applied as a confidential tool for ongoing staff development so that responses cannot be traced back to an individual rater. The process helps employees identify where and how they can improve their own performance, and it helps MFIs identify areas for organizational improvement (see Box 14.8).

**Discipline**

One of the more difficult tasks of managers is to discipline those whose performance or behaviour is unacceptable. It is much easier to tell employees what a great job they are doing and to keep up the good work than to take action against those who are not complying with the HR policies or are not reaching their performance targets. To help managers be effective disciplinarians, MFIs need to have transparent human resource policies that not only outline the “dos” and “don’ts”, but also the ramifications of flouting policies or not achieving results. If these are clear to everyone in the organization, much of the subjectivity will be taken out of managers’ hands and make it easier for them to discipline employees.
Box 14.8 How a 360 Degree Feedback Process Works

Individuals are asked to rate an employee's performance on a number of statements representing the competencies related to the employee's position. This is typically facilitated through a written or electronic survey that is completed by the employee, as well as by staff and customers who interact with her. The assessments from all raters are then summarized to provide a detailed document on the individual's strengths and development areas. Most often an outside consultant or HR Manager will collate the results and present the findings to the employee. As an outcome of their meeting, the employee can establish a development plan which is then discussed with the employee's manager. By reviewing the results for all employees together, the HR Manager or consultant can identify overall trends and development needs for the MFI and establish an organizational development plan. Although the process can be repeated as often as necessary, it is usually recommended every two to three years.

Source: Adapted from Pityn and Helmuth, 2005.

Managers should think distinctly about two types of behaviour that would require disciplinary action, as they require quite different responses (although some employees may require disciplining for both):

- **Unacceptable behaviour** can take many forms, from relatively minor transgressions like repeated tardiness or dress code violations to more intermediate problems like insubordination and instigating conflict at the workplace, to gross misconduct like dishonesty and fraud. HR policies should categorize the types of unacceptable behaviours into degrees of severity and establish proportional responses (e.g., informal warning, formal warning, suspension, dismissal). Clear cause-and-effect policies will allow managers to take appropriate disciplinary action rather than over-responding in the heat of the moment.

- The only way to assess **underperformance** is if the manager and subordinate have established objective targets against which the performance can be compared, as discussed above. Performance objectives are easier to establish for loan officers (e.g., number of loans, portfolio at risk below a certain threshold), but they are also possible with other positions. For example, managers can assess the performance of data clerks and tellers based on processing speed and errors.

In both cases, managers will need to take disciplinary procedures, but with different styles. For underperformance, a manager has to be a mentor, providing support and encouragement, helping the employee to identify the root causes of performance problems, and suggesting training if necessary. For unacceptable behaviour, the manager adopts a more disciplinarian approach, stern and strict, but fair.
A model disciplinary process should aim to correct unsatisfactory behaviour, not punish it. In addition, managers should thoroughly investigate situations before taking disciplinary action. Disciplinary procedures are likely to include the following items:

- Allow the individuals concerned to state their case, ideally accompanied by a fellow employee (or union representative)
- Document all disciplinary actions. Managers should even keep a record of informal warnings since cumulatively they could justify a formal warning
- If in doubt, managers should discuss formal disciplinary situations with their supervisors or with the HR manager before taking action
- Formal warnings should stipulate the nature of the misconduct or underperformance and the expectations for the coming period, for both the manager and the subordinate. The document should be signed by both parties
- Senior management, such as an HR manager, should always be called in to assist with serious disciplinary actions that might result in suspension or dismissal
- Employees should have a right to a formal appeal against any disciplinary action

**Evaluating Performance**

In traditional performance evaluations, supervisors sit with their employees on an annual or semi-annual basis to review each individual’s performance during that period against the objectives set during the previous performance appraisal. The manager recognizes achievements and identifies areas for improvement. Then the supervisor and employee prepare objectives for the following period.

Some managers are reluctant to appraise their employees, preferring to rely on informal supervisory practices. They must recognize that these informal means are insufficient. The vast majority of employees crave an opportunity to have a structured discussion at least once a year to receive formal feedback about their performance and to raise any issues or concerns that they might have. In fact, the performance appraisal process can be seen as a unique opportunity to fulfil four functions of management simultaneously, an opportunity not to be missed:

- **Planning:** The performance appraisal process is used to set targets for the next period of time. It is also an opportunity to discuss future roles for the employee in the organization and to identify the training and development needs to fulfil those roles.
- **Organizing:** Managers may use the performance appraisal to reassign the employee’s roles or responsibilities.
- **Leading:** Managers can take advantage of this one-to-one time to motivate and perhaps even inspire employees. In an effective appraisal, managers and subordinates should spend roughly the same amount of time talking and listening so the result is a sharing of ideas and observations.
- **Controlling:** A performance appraisal is certainly not the only forum in which managers should compare the employee’s performance to expectations, but it does provide a formal opportunity to do so. In addition, managers may use performance appraisals to reward employees for their contributions to achieving team or institutional objectives.
Typically, the performance appraisal process is directly linked with annual salary increases. In MFIs, which are generally flat organizations with relatively few opportunities for promotion or significant changes in compensation systems, appraisals may have a less overt connection with pay rises and promotions. Instead, the performance appraisal process can focus on increasing an employee's value to the team and personal satisfaction with his or her current job.

There should be no major surprises in the annual review discussion; indeed, there will be none if:

- Performance expectations have been clearly communicated
- Performance monitoring has taken place regularly throughout the year
- Manager feedback and coaching has been open, honest and consistent

The annual appraisal discussion should be a wrap-up session, a summary to a year-long review process. It should also be a forward-looking process that is action oriented. The past will be useful only in terms of what the manager and employee can learn from it (Pityn and Helmuth, 2005).

**Termination**

Unfortunately, not everyone will meet expectations. Not everyone will respond to remedial efforts. Invariably at some point, managers will have to perform their most difficult task and dismiss an employee, either because of repeated underperformance or gross misconduct. When dealing with performance problems, managers who maintain records of their interventions, agreed targets and remedial efforts will find the termination process somewhat less difficult than those who lack documentation.

Regardless of the reason for termination, it is important to plan a process that will clearly communicate the situation to the employee in a compassionate manner. Some of the elements to consider in planning a termination process include (Pityn and Helmuth, 2005):

- **Legal counsel:** If the employee has not been given appropriate written warnings or management is concerned about the reasons for termination, the MFI should seek legal counsel for advice on severance payments and other potential legal issues.

- **Termination package:** This usually consists of a letter outlining the amount and terms of the termination pay, how long benefits will continue, and information regarding any career services the MFI may be providing.

- **The meeting:** The primary purpose of a meeting is to communicate the decision to terminate. The meeting should be conducted by both the terminating manager and the HR Manager (or other senior manager). The HR Manager is present in the meeting to support both parties, diffuse a potentially volatile situation and to act as a witness. By conducting a well-prepared meeting, both the manager and the employee will feel more at ease with the transition.

- **Communicating to staff:** The MFI must decide how and when it will inform staff that an employee has been terminated. The way this process is handled will speak volumes to the remaining staff about how the MFI treats employees, and will impact morale and the office environment. Be sure to plan the message and deliver it carefully. Clear communication can be the difference between a successful and an unsuccessful termination.
Communicating to clients: When the terminated person works in the field, it is also critical to communicate the situation to his or her clients. The MFI does not want to lose the clients and the staff member. In addition, to control fraud risk, clients need to be informed not to give that person any repayments or savings deposits.

Transition of work: As part of the decision to terminate, the HR Manager and the manager should decide how the employee's work will be passed on to others in the MFI. This will allow for a smooth transition and no duties will be left undone.

Of course, not everyone who leaves the organization is asked to do so. Some employees retire while others move on to other organizations. If employees leave willingly, the human resource department should conduct exit interviews to understand why they are leaving. As with client exit interviews, sometimes the most honest feedback is given by persons leaving the organization. Such discussions might reveal specific problems with individual managers, or they may uncover general problems in the organization unbeknown to senior managers.

14.6 Compensation

Once an MFI's goals are set and employees help to achieve them, the HR strategy must compensate staff for their time, ideas and effort. Inadequate compensation will tempt employees to take their time, energy and skills elsewhere. Even if they remain with the MFI, employees who do not feel adequately compensated will not be willing to give the organization the best they have to offer. Thus, compensation is key to motivating both performance and commitment.

The traditional approach to compensation encourages people to do what is in their job descriptions, but not necessarily what is best for the company. Employees are typically paid based on their position in the corporate hierarchy, their level of responsibility and the number of people who report to them. This approach actually rewards additional overhead and higher costs. MFIs cannot afford to adopt this approach because they have to remain lean organizations with few layers of bureaucracy. As a result, they must seek alternative approaches to complement their basic salary and benefits package, such as the performance incentives described in Module 19.

MFIs need to ensure that their salary packages are competitive, in both the development and the finance markets, to minimize staff turnover. In countries with a national association of MFIs, such research would fit into its mandate. If for financial reasons an MFI is unable to offer a competitive package, it should heighten the use of non-financial rewards. As MFIs grow, however, they will need to find resources to become competitive employers. In the past, there was an impression that, because MFIs pursue altruistic objectives, their staff should work for less than the value of their effort. This was a mistake. The organizations that reward their staff in market terms attract better employees and are more successful. In some markets, the competition for staff is almost as fierce as the competition for clients, stimulating a discussion for an industry-wide solution, as described in Box 14.9.

MFI managers looking for guidance on how to create competitive salary systems should see MEDA's tool kit, Pityn and Helmuth (2005), "Human Resource Management for MFIs", developed for MicroSave.
Box 14.9 A Collective Labour Agreement in Senegal

Microfinance in Senegal has experienced remarkable growth during the past five years. In February 2005, there were 781 MFIs, including 7 networks, 422 mutual institutions, 348 savings and credit associations and 11 NGOs. In 2004, MFIs created 1,630 new jobs compared to 793 in 2000. The industry, however, lacks a legal framework to regulate working and employment conditions. The analysis of working conditions in Senegalese MFIs reveals that:

- MFIs are using more volunteers without a proper labour contract, such as interns.
- The cooperative structure of many MFIs does not facilitate a discussion for improvement of working conditions since board members, who often earn less in their day jobs than the MFI managers, have difficulty considering better compensation packages.
- Long distances between branch offices make it difficult for workers to meet, discuss their problems and collectively find solutions.
- Lack of regulation of working and employment conditions allows arbitrary actions by managers. Workers are not organized, do not know their rights and therefore are not able to negotiate with management for better working conditions.
- The heterogeneity of MFIs, and the small size of the large number of MFIs, poses a problem for regulating working conditions: to what extent can employment in small MFIs be regulated?
- The absence of social protection is a problem. Most MFIs do not provide pensions, health insurance and protection for workplace accidents.

These problems concern small MFIs more than the networks. In fact, the networks have managed to achieve a good level of salaries, benefits and social protection. They recognize the contribution that improved working conditions can make to the financial viability of the institution. As a service industry, microfinance is labour-intensive, with personnel costs representing 50 to 70 per cent of an MFI’s total expenses. Consequently, MFIs have to take great care with their human resources and retain them whenever possible.

In 2005, with support from the ILO, the Senegalese microfinance industry initiated a discussion about creating a collective agreement to improve the working conditions for microfinance employees. Collective agreements are deals negotiated by unions and employers. They provide employment terms and conditions including wage rates, health benefits, vacation entitlement, and occupational safety provisions for a group of employees, who are represented by a trade union. Procedures for enforcing employee rights are also set out in collective agreements.

During initial discussions about a collective agreement, all the parties — government, workers and employers — were willing to be involved in a social dialogue process to ensure more harmonization and equity. They recognize that better-quality human resources are needed to professionalize the industry, and a collective agreement could help avoid some of the tension between board members and managers in cooperatives since it would establish minimum conditions for the industry at large. Furthermore, staff turnover of competent employees is a significant concern. Larger MFIs with better benefits are in a position to attract staff away from the smaller MFIs.

Although the results of these discussions are unlikely to be felt for several years, the microfinance industry should be carefully watching the situation in Senegal to see if collective agreements make sense in other jurisdictions.

Source: Adapted from Diop, 2005.
14.7 Care and Appreciation

The ways in which an MFI can motivate performance and commitment are limited only by
the institution’s creativity. Each MFI should holistically strategize about what might work
best in its environment and define an HR strategy that is attractive to staff. A salary and bene-
fits package, training and career development opportunities will no doubt be part of the strat-
egy, but beyond this, what will motivate staff is the sense that their employer cares about
them, values them as people, and regularly demonstrates its appreciation. To create an envi-
ronment that brings out the best in employees, an MFI could consider the following sugges-
tions:

• **Recognize accomplishments.** Recognition can be as powerful an incentive as a bonus
  cheque. Many MFIs designate an employee of the month who receives special privileges,
such as lunch with the executive director, an article in the newsletter or a picture on the
  wall. Other recognitions include most-improved loan officer, best innovative idea and
  most promising new staff member. But recognition need not be a special occasion. As
described in Module 19, managers can and should recognize superior performance when-
ever they see it. They should also recognize improvements in performance of any kind,
since this appreciation can go a long way towards encouraging additional improvements.

• **Create the social infrastructure to support staff.** Often the human resource depart-
  ment is tasked with the responsibility of attending to the staff’s social needs, such as assist-
ing employees during personal crises or addressing grievances. Larger organizations may
even have an in-house social worker to support employees’ mental health.

• **Ensure that employees work in a safe environment:** In some environments,
  microfinance can be very dangerous work. Every year, hundreds of field agents are
  involved in traffic accidents as they travel around visiting clients by bicycle, motorcycle or
  public transport. Even more are threatened by disgruntled clients (and their spouses)
  whose loans were late or whose applications were rejected, or by borrowers trying to avoid
  repaying their loans. MFIs that handle cash are also extremely vulnerable to security
  threats, as thieves try to steal the money either at the branch or in transit. Microfinance
  institutions have a legal and moral responsibility to carefully analyse this issue and find
  solutions to create a safe work environment. There is also a compelling business reason
  for investing in occupational safety since an injured loan officer cannot very well generate
  sales or income.

• **Give employees a voice** in shaping their work environment. Through staff surveys,
  employee advisory committees and open communication channels, MFIs give their staff
  opportunities to participate in decision-making at a variety of levels.

• **Forge a strong sense of belonging.** Use the institution’s culture to integrate an
  employee’s personal identity with the institution’s identity (see Module 15).

• **Use the mission to give the workplace greater meaning.** A powerful mission — such
  as improving the lives of the poor — makes work more than an economic exchange. By
  creating an environment in which all employees feel that they can make a difference, an
  MFI can increase the value of the job.
• **Build social ties.** Loyalty to companies may be disappearing, but loyalty to colleagues is not. By encouraging the development of social ties among employees, MFIs can often reduce staff turnover.

• **Encourage teamwork.** Commitment is easier to establish among individuals than between an individual and an institution. Team members work hard because they do not want to let the rest of the team down. The more accountable a team is for its performance, the greater the peer pressure on members to make sacrifices for the team (see Module 16).

• **Hire and develop servant leaders:** Seek out managers who serve as facilitators and resource providers rather than bosses and controllers. Employees feel valued and cared for by managers who listen to them, encourage them, provide guidance and feedback, help to remove obstacles, and give their ideas a forum at more senior levels of the institution.

• **Give personal treatment:** If managers want to bring out the best in people, they need to avoid treating everyone alike. A reward to one person may be of little value to the second person, and a punishment to a third. They must also recognize that employee interests change over time. Through the performance evaluation process and other mechanisms, managers need to ensure that they regularly learn what their staff members want from their jobs. Listening to employees and endeavouring to deliver what they value demonstrates that the manager and the organization care for them and want to recognize their contributions in a meaningful way.

Ultimately, it is a mix of strategies rather than any one technique that will convey to employees that the MFI values a productive, long-term relationship with them and will motivate employees to want the same.

### Main Messages

1. Managers cannot do their jobs effectively if the organization does not have an HR strategy and clear policies.

2. An ounce of prevention is worth a pound of cure – make sure you hire the right people!

3. Carefully plan the orientation and training for new employees to convey the required skills and indoctrinate them into the institution's culture.

4. Training is an ongoing requirement.

5. Evaluate for the future, not for the past.

6. Involve employees in setting objectives and evaluate performance against those objectives.

7. Regularly and creatively demonstrate appreciation for employees.
Case Study: BASIX’s Recruitment and Selection Policy

Recruitment Policy

1. BASIX is an equal opportunity employer, making no discrimination in recruitment on the basis of sex, caste, religion or political beliefs. However, recognizing the value women could add and difficulties faced by them in the present-day socio-cultural context, additional care will be taken to facilitate their joining the company.

2. BASIX believes that high-quality human resources, including people with professional training in a technical field such as agriculture, animal husbandry, engineering, management, accounting, banking, computers and social work, need to be deployed in the rural areas.

3. Being in the service industry, BASIX attaches high value to its human resources, who generate its services.

Recruitment Sources

1. Internal sources
2. Campus recruitments at educational institutions
3. Word-of-mouth
4. Advertisements in the media

Selection Process

1. Applications are processed as and when received, even one at a time.

2. Applicants whose profiles match the job requirements are asked to spend some time in one of the units.

3. On completion of his/her stay, the applicant prepares a report of his/her observations and submits it to the HR Division.

4. Feedback about the candidate is also sought from various levels of the organization, including potential reporting officers, peers and subordinates.

5. Motivation mapping of the candidates is done using psychometric instruments developed for assessing achievement, power affiliation and motivations of the candidates.

6. Shortlisted candidates are called for an interview on the basis of the:
   - Curriculum vitae
   - Report prepared by the candidate
   - Report received from potential mentor, peers and subordinates
   - Motivation map of the candidate

7. Interview of the candidate is conducted by a Panel comprising of three managers.

8. At the final interview, the following parameters are evaluated:
   a) Motivation
   b) Clarity of thought
   c) Communication
   d) Grasp of subject matter
e) Attitude towards rural people and working in rural areas  
f) Mental alertness  

9. The Managing Director will make the final selection of Executives and Managers. Other selections will be done by the Vice President, Human Resources.  

10. Candidates shortlisted by the interview panels will be finally interviewed by the recruiting authority as indicated above.  

11. If found suitable, the candidate will be appointed, under probation for six months.  

12. Confirmation of services, on the completion of the probation period, will be done on the basis of:  
   • Achievement of some mutually agreed performance parameters  
   • Written report of the mentor, and  
   • A test of minimum level of understanding administered by the HR Division  

This case study was adapted from:  
> The Operations Manual of Basix Finance, India.
Organizational Architecture

Recommended readings:


Institutional Culture

The second component of the organizational architecture is institutional culture. Culture is hard to define precisely, but it is certainly something perceived or felt. Anyone who visits different microfinance institutions will likely be struck by the different atmospheres, levels of energy and the personality of each organization. Culture can be one of an MFI's greatest assets, but it can also be a subversive factor that undermines performance. The challenge for managers is how to achieve the former and avoid the latter.

This module answers four questions:

1. What is an institutional culture?
2. Why does culture matter?
3. What does an effective culture look like?
4. How does management create an effective culture?

15.1 What is an Institutional Culture?

An institutional culture is a set of values, attitudes and behaviours that is shared consistently throughout an organization. It is embedded in an MFI's policies and practices, in its systems and structures, how behaviours are rewarded or penalized, and in the unwritten rules that guide employee behaviour. Institutional culture is evident in the way staff, management and governing bodies interact with each other, and how they represent themselves to the outside world, particularly to their clients (see Box 15.1).

Box 15.1 Definition of Organizational Culture

According to Galpin (1996), organizational culture is a mosaic of interrelated elements. As these individual elements interact each work-day, they collectively create the organization's culture. For example, a manager who continually gives orders to subordinates can be called authoritarian. But a single manager's leadership style does not create an authoritarian culture. In fact, many other managers in the same organization may frequently solicit input from employees, collectively creating a participatory culture. There are 10 components that together establish an operational description of organizational culture:

1. Rules and policies
2. Rewards and recognition
3. Communications
4. Physical environment
5. Organizational structure
6. Management behaviours
7. Goals and measurement
8. Customs and norms
9. Training
10. Ceremonies and events

Parts of this module were adapted from:

15.2 Why Does Culture Matter?

Microfinance seeks to accomplish something extremely difficult: to provide sustainable financial services to the poor. If this were easy, banks would have been doing it for years. In striving to profitably provide financial services to the poor, MFIs have to grapple with tight margins, reluctance to charge high interest rates, high volumes of small transactions and challenging working conditions.

These characteristics result in a need for high staff productivity and low staff turnover, yet they also constrain salary expenses. An effective institutional culture is one of a manager’s best tools for addressing these challenges because it can make employees feel valued and respected, and inspire them to reach and even exceed performance targets without requiring a major increase in expenditure.

All organizations have a culture, but they do not necessarily have a constructive culture. If MFIs adopt a laissez-faire approach to their institutional culture, they are likely to find it evolve into an obstructive or even demoralizing force that can create a downward spiral. For example, one MFI manager commented that the employees in his organization were always complaining, always finding problems but never suggesting solutions. Whenever anyone new was hired, they were quickly corrupted by the old staff members — certainly not conditions to inspire excellent performance!

Culture matters, therefore, because it can be an effective tool for meeting the inherent challenges of providing financial services to the poor, and also because it can be a destructive force if left to evolve on its own. Managers who pay attention to their institution’s culture, and take the initiative to shape it into an asset that is valued by employees as well as clients, will be investing in a tool that can help them generate many positive results. Ultimately, culture could end up being the thing that differentiates their institution from others in a competitive marketplace.

15.3 What Does an Effective Culture Look Like?

Successful MFIs use their institutional culture to create a pleasant working environment in which employees feel respected and valuable. In such an environment, employees believe they are making an important contribution to their communities. As such, their monetary compensation may not be as important as the intangible benefits that they receive from their work. When culture firmly aligns personal and professional identities, employees cannot imagine working anywhere else.

While cultures are often very different between MFIs, an effective culture should be consistent within an MFI. When someone visits different branch offices, they should get a common impression of the institution from the office space and the interactions with staff members. If organizations have a consistent culture from branch to branch, it is a good indication that the MFI has made an effort to nurture and shape the culture; whereas widely different impressions from different offices suggest that the culture is emerging more spontaneously, which can be extremely dangerous.
What important values or behaviours should an MFI espouse and promote? There is no right answer — an institutional culture is, naturally, culturally specific. That said, some of the elements that microfinance organizations may consider vital include:

- Commitment
- Excellence
- Valuing staff
- Honesty
- Transparency
- Cost-effectiveness
- Arrears intolerance
- Customer service
- Continuous improvement
- Learning organization
- Communication
- Teamwork
- Reliability
- High productivity

This list is not intended to be comprehensive, but merely illustrative. These are the types of values, attitudes and behaviours that MFIs might promote when shaping their culture.

One value that deserves particular attention, however, is trust. Microfinance is built on trust. Loan officers have to trust that clients will repay their loans; clients have to trust that the MFI will safeguard their savings and return it to them when they want it. The trust relations between management and staff, and between the head office and field offices, are just as important. Managers have to trust that their “self-managed” employees are really doing what they are supposed to do; employees have to trust that the board and senior management are making decisions in the best interests of the MFI and its staff members. If these internal bonds of trust are broken, the MFI will find it difficult to operate.

15.4 Proactively Shaping the Culture

After an MFI decides what its culture should look like and what values to espouse, the challenge is to bring that culture to life. It is not enough to know that these cultural elements are important — it must turn them into institutional habits. An effective culture must be conceptualized, guided and nurtured. To do so, an MFI needs to determine what the prevailing culture is, and then find ways of modifying it to where the institution wants to be.

Cultural Assessments

If an MFI has not proactively shaped its culture in the past, a useful first step is to analyse what type of culture the organization has at present. Even if it has tried to shape its culture previously, this type of cultural assessment may still be useful since culture is dynamic and likely to change over time if not carefully maintained.
A cultural assessment can help an organization identify prevalent attitudes and behaviours through staff surveys, individual interviews, focus group discussions and a considerable amount of general observation. It is usually best performed by an external evaluator who is removed from institutional politics, can objectively analyse the organization, and with whom staff might be more forthcoming. This assessment might explore some of the following issues:

- How are power and control handled? Are they centralized or more diffused?
- What type of power is respected in the organization? Charisma or personal power; resource power held by those who approve spending; bureaucratic power depending on one's position in the hierarchy; or technical power of experts?
- How is information shared? Where are information blockages and what causes them?
- Do subsets of the organization's staff (e.g., men and women, minorities, head office and field offices) have similar perceptions of the institution's culture?
- What is the preferred working method: individualistic, collaborative, competitive?
- Are there any obvious contradictions between the professed values of the organization and the actual behaviours of people?
- Do people have to fit into the structure, or does the structure serve the people?
- Whose interests are served by the dominant culture?

While it is generally preferable to rely on a consultant to conduct the assessment, some organizations might want to regularly monitor their culture to see if it is improving or worsening. If an assessment is done internally, then it probably needs to rely on an anonymous questionnaire to take the pulse of the staff. Figure 15.1 provides an example of such a tool, although in practice the actual questionnaire would be much longer with a number of questions addressing similar topics from different perspectives to check for internal consistency.

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_The idea was to start with concepts and then move to attitudes. It wasn't enough to understand what teamwork and communication were; you had to make it an attitude. Then, the attitudes had to become habits, not only personal habits but institutional habits. Once institutional habits are built up, it's easier for new employees to go along with them than to fight them._

~ Steve Gross

---
## Figure 15.1 Sample Institutional Culture Questionnaire

Please indicate to which extent you (dis)agree with the following statements: Mark the circle.

<table>
<thead>
<tr>
<th>Statement (pertaining to your regional office/work environment)</th>
<th>Strongly Disagree</th>
<th>Disagree</th>
<th>Unsure</th>
<th>Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. In my work environment, we have open trusting relations between staff and management.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>2. In my work environment, we have open and trusting relations amongst colleagues/staff.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>3. I get honest feedback on my work performance.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>4. I know exactly what is expected of me.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>5. I get the information I need to know what is going on at MicroBank.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>6. Everyone is treated fairly in my region/work environment.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>7. My management encourages suggestions from staff.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>8. In my opinion the pay here is lower than in other companies.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>9. My supervisor is always breathing down our necks, he/she watches us too closely.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>10. If I have a complaint, I feel free to talk to somebody at a more senior level.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>11. Management is really trying to build the organization and make it successful.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>12. They encourage us to make suggestions for improvement around here.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>13. Qualified women are usually overlooked when filling job openings.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>14. The longer you work for the company, the more you feel you belong here.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>15. I have little opportunity to use my abilities in this company.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>16. My supervisor gets staff to work together as a team.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>17. Around here, the staff are usually friendly towards each other.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>18. I am becoming more and more dissatisfied (unhappy) working for MicroBank.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>19. This company succeeds in keeping us informed on the things we want to know about MicroBank.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>20. I have enough freedom on the job to use my own judgement.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>21. The people who get promotions here usually deserve it.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>22. We are well informed about the company's business prospects and standing with competitors.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>23. When dismissals are necessary, they are handled fairly.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>24. I am proud to tell other people that I work for MicroBank.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>25. Many staff members I know would like to see a stronger trade union representation in MicroBank.</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
</tr>
</tbody>
</table>

*Source: Adapted from Pityn and Helmuth, 2005.*
Suggestions

The cultural assessment is intended to determine the prevalent culture in the organization today – that could be considered the cultural baseline. Then the MFI can determine which aspects it wants to keep and build on; which ones it wants to eliminate; and which additional values, attitudes, and behaviours it wants to introduce. To proactively shape an institution’s culture, consider the following 20 suggestions, as well as the guidance in Box 15.2.

1. **Take your mission statement off the shelf:** To shape the culture, revisit the organization’s mission and values because these should influence how staff members act and interact. Indeed, mission statements are meaningless unless they shape the institutional culture, guide behaviour and incite action. To proactively shape their culture, MFIs must take their mission statements off the shelf and put them to work, as illustrated in Figure 15.2.

2. **Recruit employees who value what the MFI values.** Staff members who share the organization’s values will reinforce its culture. Consequently, some MFIs use targeted recruitment strategies and diagnostic tools to screen for personal values to attract and select the right people (see Section 14.2).

3. **Indoctrinate new staff.** Orientation sessions can incorporate creative role-playing exercises to indoctrinate new staff members into the institution’s culture, to explain why the MFI does what it does, and to solicit new staff’s commitment to the organization’s values and attitudes. By learning the organization’s history and traditions, new staff members begin to feel that they are part of something big and powerful. If the culture is particularly strong and pervasive, new staff members will find it easier to conform to the culture rather than to reject it.

4. **Use innovative training techniques.** MFIs can use innovative training techniques to help new staff members understand the culture and values of the institution. For example, to instil client commitment in new staff, the Grameen Bank asks trainees to interview a poor woman and write her life history, including how she coped with economic crises.
5. **Create apprenticeship opportunities.** On-the-job training for new staff provides them with an opportunity to see the culture in action; mentors should be trained in how to model the culture for their apprentices (see Section 14.3).

6. **Revisit values, etc., at staff meetings.** The institution’s culture should be discussed regularly. Staff meetings provide the ideal opportunity to revisit institutional values, attitudes and behaviours.

7. **Set internal standards** that reflect the culture the institution wants to create. These standards must be realistic, measurable and clearly communicated (see Module 8). They must also then be monitored and performance should be rewarded or disciplined as relevant. In one Vietnamese MFI, staff chose to impose a fine to enforce a particular standard; everyone agreed on the amount and monitored each other. The first day the fine was enforced, some colleagues paid a hefty sum, but gradually the system proved effective and the bad habit was changed.

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**Box 15.2 Indirect Ways to Communicate Institutional Culture**

The principles of transmitting organizational culture are pretty simple: senior management must communicate and lead by example. It sounds easy, but is difficult in practice. How this is applied within your unique MFI needs to be determined by you. In addition to direct tools such as policy and mission statements, performance standards and training, here are some of the ways that MEDA communicates our organizational culture:

1. Before staff meetings, we have someone from the group share a personal reflection.
2. We have an internal newsletter sent to all staff that tells stories from work, interesting things in the news that relate to MEDA, and personal staff news.
3. In between newsletters, we send out staff announcements to all MEDA staff.
4. The President and other senior staff travel frequently to other MEDA offices, and often all the staff in that office have lunch together and share what is happening in offices.
5. At team meetings, the department leader often takes time to give an update on corporate MEDA.
6. Financial statements are shared with staff on a monthly basis with comments on trends and issues.
7. Regular staff gatherings include: weekly staff meetings to review workload, specific planning sessions and special social events.
8. We have an all-staff retreat every two to three years for a few days to carry out team-building and training, and share experiences.
9. Commitment by managers to have regular and ongoing reviews with staff.

*Source: Adapted from Pityn and Helmuth, 2005.*
8. **Recognize staff and performance** that embodies the desired culture. This can be done at any time of the year by identifying and rewarding the “best team player” or the employee with the least number of transaction errors. Alternatively, an MFI could include key cultural criteria in its performance reviews and/or incentive system, and reward (or penalize) staff on the basis of their ability and willingness to promote the institution’s culture. As discussed in Module 14, the institution could then use feedback from these reviews to develop plans for strengthening staff performance in areas of weakness.

9. **Review policies and procedures** to make sure they promote, or at least support, the desired culture. Where there are inconsistencies between existing policies and the values an institution wishes to embrace — e.g., an organization says that it has zero tolerance for fraud, but does not have a policy to immediately suspend staff accused of fraud, or wants to promote trust, but requires all field staff to start the day at the office so they can sign their time sheet (and demonstrate that they are actually working) — the inconsistencies must be resolved so that the new culture can take root.

10. **Use staff attire**, such as employee uniforms or dress codes, to align employees’ personal and professional identities.

11. **Post visible reminders.** A poster in the office could publicly proclaim the MFI’s values and what it is trying to accomplish. Other signs or stickers could provide inspirational messages and propagate **staff slogans**, such as “He who does not work in a team, does not work at Prodem.”

12. **Familiarize clients with the culture.** By using the client orientation session to inform customers why the institution exists and what it is trying to accomplish, the MFI recruits clients as partners in achieving its mission. The process of repeating the mission and values to all new clients will also reinforce the mission for all field staff and help them remember and internalize it.

13. **Create a unique language.** Unique language and terminology can reinforce a frame of reference and a sense of belonging to a special, elite group. For example, instead of calling field staff **loan officers** or **field agents**, they could be called **poverty fighters**, **customer service representatives**, or some other descriptive term that is unique to the organization.

14. **Celebrate institutional rituals.** An employee’s identification and belonging can be buttressed through institutional rituals, such as a **certification ceremony** for new hires after they have completed their training period where they are welcomed into the family by other employees. Some MFIs have annual social or recreational events for employees and their families, an annual “State of the MFI” address by the CEO, as well as **milestone celebrations** that help reinforce success (for example, the 50,000th client party). Some organizations begin all meetings with an **institutional song**, chant or pledge that reinforces employees’ psychological commitment to the organization.

15. **Launch campaigns or competitions** to encourage a shift from one way of doing things to another. The hype, ceremony, fun and (perhaps) rewards can help push staff to make a change and get new behaviours in motion. MFIs may not want to institutionalize an incentive for a particular kind of behaviour, but they might introduce an initial incentive to motivate people to try something new. After staff have made the shift (and hopefully seen some kind of benefit as a result), the MFI can use other tools to institutionalize the new behaviour or attitude.
16. **Publish an employee newsletter.** With articles from staff and management, an employee newsletter can enhance both vertical and horizontal communication. It can be used to document progress towards achieving organizational and departmental objectives and serve as a vital forum for reinforcing the institution’s culture. A newsletter can make announcements regarding personal events (e.g., births, birthdays) and professional accomplishments. It can share best practice tips, technical articles such as “how to handle hostile customers”, and more.

17. **Design the office layout.** For MFIs that deliver services through branch offices, the office layout can reinforce the institutional culture. For example, if the organization focuses on customer service, then the office could be organized around a customer service representative who handles initial inquiries and directs traffic. If the MFI wants to avoid creating unnecessary hierarchy, then its office space and equipment would not denote special privileges or rank.

18. **Organize periodic trainings.** Facilitated by internal or external trainers, periodic training and team-building exercises can reinforce the institutional culture. Courses might cover customer service, sales and marketing, or time management.

19. **Cultivate in-house leadership.** To ensure that there is continuity in the culture, it is particularly important to cultivate in-house leadership.

20. **Lead by example.** Whatever mechanisms an MFI adopts to operationalize its institutional culture, the key to successfully establishing and maintaining that culture is through leadership. Managers need to demonstrate in their daily decisions and actions a commitment to the institutional culture. An MFI’s managers must lead by example. If the MFI values communication, for example, then the CEO and other senior managers need to regularly update staff on institutional performance, and regularly solicit feedback from staff and clients. Managers also need to stay attuned to whether the staff and board members themselves have internalized this culture in their decisions and actions, and to undertake measures to re-centre the institution if there is cultural drift.

Many of these examples — like posters, uniforms or an institutional song — are essentially **artefacts of culture**, overt signs of something that one cannot actually see or touch, but has to be felt or sensed. Consequently, it is important to recognize that these cultural symbols themselves are not as important as the underlying meaning or the effect that they have on the values, attitudes and behaviours of the employees. For example, an MFI should not produce a newsletter just for the sake of having one, but rather as a channel for propagating or promoting the culture. The same is true for many of these other examples — if they are to proactively shape the culture, these artefacts need to mean something or have an intended purpose.

If a major cultural shift is required, such as that which often accompanies transformation, or if managers are trying to get rid of an undesirable and stubborn cultural element within their institutional architecture, Module 21 on managing change can be of great assistance. Cultural change is one of the most difficult types of change to accomplish successfully and will not happen overnight. As Kotter (1996) concludes near the end of his best-selling book *Leading Change*: “Culture changes only after you have successfully altered people’s actions, after the new behaviour produces some group benefit for a period of time, and after people see the connection between the new actions and the performance improvement.”
Making one speech, writing one article and posting signs all over the office will never be sufficient to effect a lasting, much less significant change in the culture of an institution. To proactively shape an institution's culture, managers must know what kind of culture they want to create and work towards creating it just as they would any other organizational objective – with planned, coordinated efforts that are monitored and strengthened over time. Even if a particular cultural objective is eventually achieved, efforts will still be required to maintain that new culture and to ensure that it remains relevant as the institution, its environment and clients continue to change.

### Main Messages

1. An MFI’s culture should be one of its most valuable assets.
2. Proactively shape your institution’s culture.
3. Leadership is the key to ensuring that culture is a constructive force.

### Recommended readings:

Case Study: The Institutional Culture of Prodem, Bolivia

Prodem actively designs and propagates its institutional culture. Although the organization had been designing and redesigning its culture for years, in 1993 the human resource department assembled a diagram of the culture for new staff training. The visual rendition became known as the “torta” or cake.

The cake identifies all the major elements of the institution’s culture. The first layer represents dedication to client service. Everything that the organization does depends on its ability to serve three types of clients: (1) the external client (the borrowers), (2) the internal client (one’s colleagues), and (3) the personal client (oneself).

Three pillars stand on the foundation of client service. The pillar of communication represents the importance of sharing information, giving and receiving feedback, questioning and listening, and doing that in a way that treats others with respect. The pillar of transparency symbolizes the attitude of openness and honesty needed to build trust and be accountable to clients. The pillar of self-management characterizes Prodem’s belief in the ability of staff members to complete their own tasks to the best of their ability, using their own initiative, skills, and creativity.

The three pillars support the second layer of the cake, teamwork. This layer makes it possible for members of the institution to work together towards a common objective, not by completing all tasks together, but rather by having each person do his or her part to move the institution in the desired direction. Prodem believes that teamwork was the key to the institution’s ability to operate efficiently and generate creative solutions.

The third layer of the cake, total quality, rests upon the foundation created by the elements described above. It represents the institution’s commitment to excellence and to a continuous process of improvement in the quality of its operations. Finally, the candle on top of the cake represents self-sufficiency. It celebrates the institution’s ability to achieve results over the long term by generating sufficient income to cover its costs.

This case study was adapted from:

Organizational Structure

Structure may not seem important to small MFIs with a single product to offer. Once institutions begin to grow, however, they must develop systems for dividing the work, for communicating that division of responsibilities and for guiding implementation. The organizational structure arranges people and functions into groups, which clarify channels of information flow and accountability. Naturally, the more functions or employees an MFI has to organize, the more complex its structure will be, yet the basic purpose of the structure will remain the same – to channel information (about customers, markets, competitors, lessons learned) and accountability (to clients, to investors, to each other) so that informed decisions can be made quickly and enable the MFI to achieve its objectives efficiently.

This module explores microfinance structural issues from the following four perspectives:

1. The ideal organizational structure
2. Common characteristics of effective MFI structures
3. Ongoing structural debates
4. Building an effective organizational structure

16.1 The Ideal Organizational Structure

No single structure will be ideal for every MFI. In fact, there is no one structure that will be ideal for any MFI at all points in time. The ideal organizational structure will depend on a variety of factors, namely:

- **Size.** The larger an MFI is, the more entities there are to organize, and the more complex the structure is likely to be.
- **Institutional type.** Different types of institutions lend themselves to different types of structures; some find it easier to outsource or forge alliances to deliver certain functions.
- **Stage of institutional development.** As an MFI gains experience and maturity, it will adapt and refine its structure in pursuit of more ambitious outreach objectives.
- **Service delivery methodology.** A standardized product can be more easily supported by a standardized structure.
- **Number of products or services provided.** Diversified institutions will tend to focus their structure on customers or business units rather than a particular product line.

This module draws from:

- Brand and Gerschick (2000).
- Rhyne and Rotblatt (1994).
• **Institutional culture.** Formal structures must fit with informal work practices, styles and values.

• **Market concentration.** A dispersed client market will necessitate a thinner retail structure than that used to serve a dense concentration of clients.

• **Competition.** Depending on the degree and character of market competition, MFIs will face pressure to make their structures more efficient.

• **Local wages.** The cost of different skill base categories will influence the quantity and nature of positions created within the organizational structure.

• **Infrastructure.** An MFI must structure itself to ensure contact between its various parts given available communication and transport infrastructure.

• **Technology.** Affordable and reliable technology can make it possible to automate certain functions that would otherwise need to be carried out manually.

Taking this list into account, every MFI faces the challenge of building an organizational structure that provides the strongest possible framework of support for its activities. This means creating a structure that:

1. Organizes the MFI's human resources and functions
2. Clarifies channels of accountability and supervision
3. Facilitates information flow
4. Enables quick and responsive action in an efficient and cost-effective manner

The ideal structure is the one that can best accomplish these objectives at a given point in time.

### 16.2 Common Characteristics of Effective MFI Structures

Although the shape of an MFI's structure depends on the variables noted above, the structures of successful MFIs tend to have common characteristics: they are accessible, flat, decentralized, modular and supported.

**Accessible**

The closer employees are to their clients, and the more contact they have with them, the easier it is for the MFI to provide high-quality service. Structuring operations so they are near customers reduces transaction costs for both parties. Proximity makes it easier for MFIs and clients to interact, to get to know each other and to develop mutual trust.

MFIs have three main ways of making their organizational structures accessible to clients. Some organizations have branch offices or retail outlets that are located close to where clients live and work. In other MFIs, field workers meet with groups of clients in their villages, perhaps in a community centre or under a tree. The third approach is through mobile outlets, such as a van that visits communities on a regularly scheduled basis to serve individual savers and borrowers. In the future, service points may become virtual, i.e., accessible via the Internet.
Organizational Architecture

Flat

A flat or horizontal organization — as opposed to a hierarchical organization — encourages frontline employees to assume greater responsibility. Without multiple layers of middle management, capable and well-trained frontline staff can respond quickly to customers. They are also more likely to be involved in the development of new products and the setting of policies. This involvement tends to increase the appropriateness of product design and the buy-in of the employees who sell the MFI’s services. There are also financial reasons for being flat. With their already high cost structure, MFIs cannot afford to become top heavy.

Decentralised

A flat structure that is accessible to clients seems to be a necessary but insufficient condition for success. Significant authority and decision-making ability must also be located close to clients; bodies and buildings by themselves are not enough to make an organizational structure effective. MFIs with decentralized structures tend to respond more quickly and more appropriately to local conditions because the decision-makers are in the field, not in the head office, and they are more highly motivated to provide quality customer service than their colleagues who lack the authority to act.

The appropriate level of decentralization will vary depending on the context in which an institution is working. It appears critical, however, to somehow empower individuals close to the customer to make decisions and be responsible for the institution’s success. In general, front-line employees are empowered when they have authority to make decisions within the framework of agreed-upon objectives, policies and performance standards. For decentralization to be effective, staff must be knowledgeable about the MFI’s business and have access to considerable information.

Modular

The mainstream business literature suggests that employees prefer working in smaller businesses where they find more challenging and interesting work, have a better chance to see their ideas adopted and feel a higher sense of accomplishment. The microfinance industry echoes the mainstream in this respect, as small business units have proven to be the most effective way of organizing people and functions to meet outreach objectives.

Microfinance service outlets are usually simple structures that employ between ten and 20 people — although outlets may be much smaller in dispersed markets — who work as a team and are evaluated on their ability to achieve desired results. Because of their simplicity and small size, these outlets (or modules) can be easily replicated. New outlets can be opened by copying a core module pattern. If one outlet expands greatly, it can be split into two smaller entities, each one more manageable and in closer proximity to clients than the original. Regardless of an MFI’s specific growth strategy, the modular structure facilitates expansion while enabling the institution, through each modular unit, to respond quickly and appropriately to local needs.
Successful MFIs organize their service outlets as **profit centres**, which increases the autonomy of each unit as well as the institution’s ability to keep it accountable for a certain level of performance. Each month, units prepare a profit and loss statement and a balance sheet.

**Supported**

Besides local service outlets, effective MFI structures contain a centralized “superstructure” that supports the local level outlets. The services offered by the superstructure are usually provided at the head office or regional level and are delivered more cheaply, more quickly or at a higher level of quality than would be possible if each local outlet had to source them on its own. The services commonly provided by the superstructure include governance and leadership, treasury functions, human resource management, information consolidation and marketing.

### 16.3 Ongoing Structural Debates

Beyond these common characteristics, MFIs debate the details of the organizational structure that can provide the most effective and efficient support for their operations. Given the range of legal forms that MFIs adopt, and the variety of environments in which they operate, it is hardly surprising that different institutions find different structural solutions to be more successful than others. There are no right or wrong answers to these questions; however, some lessons are emerging as to the solutions that make sense in particular contexts.

**Standardization versus Flexibility**

In general, MFIs have standardized structures. Standardization simplifies operations, for both the institution and the clients, and makes it easier for an institution to grow. Standard methodologies, processes and structures can be more easily replicated. They are usually more efficient and help minimize costs. Standardization is also limiting, however. One product with one delivery system cannot meet all client needs. Institutions that want to improve their ability to satisfy clients’ financial needs must become more flexible.

Flexibility enables MFIs to respond to changing customer demands, dynamic market environments, emerging opportunities and competitive threats. Of course, flexibility has its disadvantages as well: it makes clarity and consistency harder to achieve; it can cause confusion in the flow of information and accountability; it is generally more expensive to implement; it is more vulnerable to fraud and it requires well-trained staff and careful guidance.

Logically, MFIs attempt to create an organizational structure that allows some standardization and some flexibility. They may have a standard set of products, but may not offer all products in all locations. They may pilot test new products only in locations that have demanded them. In the case of larger institutions such as Mibanco (see Box 16.1), they may develop standardized structures for a particular type of market or size of branch. The range of creative options for balancing standardization and flexibility is vast. As discussed in Module 20, technology is expected to play a major role in facilitating this experimentation process by making flexible options more affordable.
Box 16.1 Structural Change at Mibanco

One of the structural changes that Mibanco made in managing its growth was to introduce an operations manager (a funcionario) into its largest branches. This individual assumed most of the administrative responsibilities formerly performed by branch managers. As a result, branch managers now have much more time to focus on more important issues, such as planning for future growth, monitoring and controlling late repayments, chairing the credit committee, developing the skills of credit officers and maintaining the quality of the loan portfolio.

Mibanco also created a more standardized process to staff growing branches by establishing benchmarks for appropriate staff levels at different stages of growth. Using estimates of the number of clients required to break even, Mibanco established three general stages of branch growth (small, typical, and large), with corresponding standards of required staff (see table). By establishing these standards, Mibanco significantly reduced unplanned and unsupported staff expansion.

<table>
<thead>
<tr>
<th>Mibanco’s Standardized Branch Staffing Requirements</th>
</tr>
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<tbody>
<tr>
<td><strong>SMALL</strong></td>
</tr>
<tr>
<td>Branch size (# of Clients)</td>
</tr>
<tr>
<td>Branch manager</td>
</tr>
<tr>
<td>Loan officers</td>
</tr>
<tr>
<td>Office manager</td>
</tr>
<tr>
<td>Receptionist</td>
</tr>
<tr>
<td>Operations support</td>
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<tr>
<td>Cashier</td>
</tr>
</tbody>
</table>

* Service provided by receptionist or operations support person.

Source: Adapted from Brand and Gerschick, 2000.

Centralization versus Decentralization

The debate about where functions and staff should be located within an MFI begins with the question of how tasks, responsibilities and capacity should be distributed between the superstructure and retail levels of the MFI.

When MFIs are small and geographically concentrated, it makes operational and financial sense to centralize key decision-making in the hands of a few functional professionals. These professionals can provide services in such areas as marketing, information technology, finance and administration. They can also serve multiple retail outlets simultaneously, which eliminates the need for each outlet to employ its own resources. As long as retail units are small and do not generate enough business to effectively utilize the services of full-time technical resource persons, this strategy makes sense. As retail outlets grow or as the number of outlets increases, however, the administration of support services from the head office can
become expensive (in terms of labour, communication and transport costs), while the relative benefits of centralizing the services decrease.

With the growth of individual branches or clusters of branches, MFIs usually find that they are able to decentralize more functions to the branch or regional level because of the increasing economies of scale. They also often find that their network of service outlets becomes more heterogeneous, thus enabling them to provide a higher quality of service at the regional or local level by matching the services delivered to the particular needs of the outlets. In addition, the more authority is decentralized, the more local outlets become empowered to provide excellent customer service. Decentralization is particularly important in institutions that grow so much that they must insert an additional layer into their organizational structure (for example, a regional layer). Although the institution may add a layer, the number of layers between the customer and the person with the authority to make most decisions should ideally remain the same.

The decentralization of authority, functions and staff has benefited many MFIs, but some industry players question whether it might also result in excessive administrative costs. Given the high administrative cost ratios of many MFIs, this criticism appears warranted. The decentralization versus centralization debate is not an argument about extremes, but rather a discussion about the degree of centralization that will enable them to be most efficient. The following examples provide some insight into what institutions have learned about the appropriate degree of centralization in five core functional areas.

1) **Marketing.** If an MFI operates only in one market, a centralized approach to marketing is most cost-effective. As an institution enters new markets, each marketing strategy should be customized from the bottom up. Perhaps a new branch is located in a community where customers speak a different language, honour different traditions or prioritize different needs. Perhaps radio or newspaper advertising is appropriate in some markets, whereas street theatre and village meetings work better in others. After each branch develops its own marketing strategy, it may be possible to achieve some economies of scale by coordinating efforts — for example, by mass printing of brochures. But a centralized initiative should begin only following the bottom-up process; otherwise, the initiative risks failure and the MFI may be stuck with thousands of useless brochures.

2) **Sourcing supplies.** If a retail unit can find less expensive supplies from a local source, it should be allowed to purchase locally. Alternatively, if buying in bulk by a central office can lower costs, including shipping and corporate overheads, a centralized approach might work. But cost is not the only determining factor. The quality of service is also important. For example, if a centralized photocopy machine service contract does not result in timely responses, a more expensive and more responsive arrangement with a local service agent may be more appropriate.

3) **Staff training.** There are economies of scale associated with centralized staff training, particularly when common products are offered in most or all branches. In addition, it is important for field staff to participate in centralized orientation sessions to create a common corporate culture. However, as local outlets introduce different products, training needs to be customized to the unique menu of each branch. Training can therefore be separated into general issues addressed through a centralized approach, and technical training implemented in a more decentralized manner.
4) **Human resources.** At the retail level, prospective teammates should have the primary responsibility for hiring their co-workers. It is critical that peers can work together cooperatively, and therefore colleagues have to be involved in the screening and hiring process to ensure they are comfortable with the candidates.

5) **Credit approval.** Successful MFIs have demonstrated that, with the proper use of management information systems and internal controls, authority for credit approval within specified parameters (that is, up to a maximum loan size) can and should be decentralized to the local service outlet. Among other things, this allows each unit to determine the quality of its own customer service and eliminates the blaming of others for late disbursements or other complications.

**In-House versus Outsourced**

The debate over where an MFI’s functions and staff should be located goes beyond the issue of decentralization. Some MFIs have also explored the conditions under which functions can be delivered by a partner institution instead of being provided by the MFI. If an institution can outsource functions that are relatively expensive or difficult to implement, it might improve its efficiency by locating those functions outside the institution.

MFIs have collaborated effectively with other institutions to fulfil a variety of functions outside their own organizational structures:

- Most commonly, MFIs have used **commercial banks to process repayments** and sometimes disbursements. This arrangement eliminates the need for MFIs to hire tellers; it lowers their infrastructure and security requirements; and it reduces losses due to error and fraud. In some cases, outsourcing the repayment and disbursement function even lowers transaction costs for clients. At ABA in Egypt, for example, clients pay monthly instalments at local bank branches, which tend to be closer to their place of business than the ABA offices.

- Institutions have employed **debt collectors as external agents** to collect the overdue payments of selected clients. This linkage has the advantage of escalating an MFI’s delinquency management strategy. Once an organization has exhausted its own collection efforts and suspects that it will need to write off a loan, it can turn the delinquent client over to another agency that is willing to follow up and perhaps adopt more persuasive tactics. Since debt collectors usually earn a percentage of what they collect, the capital recovered reduces write-offs rather than creating an additional expense. This outsourcing strategy lowers costs and creates efficiencies because loan officers can concentrate on borrowers who are willing to repay.

- MFIs have also entered into agreements with NGOs, cooperatives or other community associations to **mobilize new clients.** For example, some MFIs have agreements with training centres to provide loans to course graduates who meet the loan criteria.

- They have contracted **external research or marketing firms** to assist them in refining existing products, developing new products, or launching marketing campaigns.

- MFIs outsource **technical areas of expertise** such as legal services, training, software development, hardware maintenance, backup facilities, insurance or evaluation. They have found this to be a useful strategy when an expensive service is not required on a con-
tinuous basis or it is difficult to retain staff who are qualified to provide quality service in a particular area.

- Some institutions also outsource administrative functions such as photocopying and printing, catering, janitorial services, transport or security. Companies that specialize in these functions can often provide them more efficiently than can an MFI in-house, either by eliminating waste (e.g., in the case of photocopies) or by making more productive use of staff time.

- A final strategy is franchising. Under this model, an MFI effectively outsources its entire retail operation by granting external entities the right to establish independently owned branch offices. In exchange for fees and the obligation to adhere to strict quality standards, the franchisee uses the franchiser’s trademark and receives marketing support, operation manuals and staff training, and can borrow funds from the franchiser for on-lending. If the franchiser offers a profitable franchise model, and develops the services to support this model, this approach can rapidly expand. It should be easier for the MFI to monitor a franchise than a branch network, and the capital risks are shifted to the franchisee. If the franchisee is willing to adhere to the franchiser’s standards and depend on the franchiser for support services, it can also benefit significantly from the relationship (see Box 16.2).

Of course, there are disadvantages to outsourcing. An MFI typically has less control over the implementation of a function if it is outsourced rather than delivered in-house. It may be difficult for the MFI to convince a contractor to deliver the service in a particular way, with an appropriate degree of urgency. For instance, when commercial banks process an MFI’s repayments, they may not always treat its clients the way the MFI would like. Although outsource relationships can help MFIs mitigate certain risks, they can also increase vulnerability in other areas. The MFI may not receive advance warning of problems, and it may have limited opportunity to give feedback on how well its needs are being met. The time and effort it takes to coordinate an effective relationship may outweigh the efficiency benefits gained through outsourcing.

**Who and What to Group Together**

A fourth and increasingly interesting debate surrounds the grouping of staff. How can work responsibilities be divided to make the best use of the skills of different employees? What combinations of people will be most productive? MFIs are still struggling with these questions, but some insights are emerging.

MFIs could organize their work in three main ways: by function, by division or by team. Most MFIs are organized by function, such as finance and administration, human resources and marketing. At the head office, functional organization facilitates accountability and information flow within clear technical channels. Individuals in each channel speak a similar language, share similar perspectives and focus on similar objectives. At the branch level, the functional distribution of responsibilities among tellers, credit officers, bookkeepers and managers is easily understood and is important for internal control purposes.
Box 16.2 XacBank Credit Franchise Model

In 2001, XacBank launched a new product called the “Development Guide” franchise product for credit and savings cooperatives. As part of the service offered to franchisees, XacBank transfers all existing products, services, policies and technologies. It also provides training, operational manuals and wholesale loans. In exchange, XacBank receives quarterly fees in addition to a base fee from the cooperatives. By the end of 2005, it planned to have 100 savings and credit cooperatives operating as franchises.

<table>
<thead>
<tr>
<th>Overview</th>
<th>Key Characteristics</th>
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<tbody>
<tr>
<td>XacBank provides credit franchise package at low cost to rural co-ops in Mongolia</td>
<td>Rural co-ops (franchises) do not keep Xac name</td>
</tr>
<tr>
<td>Began franchising in 2001; currently 24 credit unions, approximately 1,000 members</td>
<td>XacBank provides franchise package, initial training, and initial funding for executive director of co-op</td>
</tr>
<tr>
<td>Franchise package (&quot;Development Guide&quot;): handbook manual with 5 modules: lending (3 loan products); training; accounting; governance (currently establishing MIS system)</td>
<td>In return, co-op must meet certain requirements (e.g. amount of assets, members)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Strategic Rationale</th>
<th>Lessons Learned and Key Success Factors</th>
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<tbody>
<tr>
<td>Increases outreach to remote rural areas; XacBank began with mobile model, but franchise model seen as more sustainable</td>
<td>While XacBank offers franchise package, success dependent on co-ops taking control and initiative – cannot force co-op to grow (2002: liquidated bank and brought assets to co-op; unsuccessful and forced to write it off)</td>
</tr>
<tr>
<td>XacBank collects revenue from franchise fee (not currently profitable, but plans for future profitability; may charge for training and raise fees)</td>
<td>Challenge in identifying local people to take initiative and start cooperative</td>
</tr>
<tr>
<td>XacBank provides wholesale loans to co-ops; hopes to build loyalty through initiatives such as co-ops buying bank shares</td>
<td>Operational challenges in implementation and risk management</td>
</tr>
</tbody>
</table>

Yet under a functional approach, communication and coordination between functions tend to be poor. Work that requires the involvement of multiple departments takes longer to conclude and, if targets are not met as planned, there is a strong temptation to put the blame on other departments and avoid taking responsibility for failure. The rigidity and communication barriers of the functional approach are compounded as MFIs grow. Management succession can be problematic if candidates get promoted having worked in only one function and lack experience in general management. Furthermore, since a functional orientation is based on the type of work that someone does rather than on the reason that work is done, i.e., to serve clients, it is difficult to create a strong customer orientation within a functional structure.

For larger organizations, a divisional approach that is product, territory or market based may be more attractive. An MFI could organize its staff by product lines, such as savings, credit or
insurance; by territory or geographic location, such as Eastern Region or Northern Region; or by market segments, such as urban market vendors and agricultural producers.

Organizing in these ways can improve communication and coordination across functions and facilitate a stronger customer orientation. However, it is only economically feasible if the demand for an MFI's products is large enough to justify multiple, self-contained operations. The idea behind this kind of organization is to make each division (product, territory or market) completely responsible for all its inputs and outputs – that is the strength of this approach, as well as its limitation. Managers in charge of these divisions have greater autonomy, but they must also make decisions taking all aspects of the business into account. This requires persons of a higher calibre than those in charge of functional units and higher salaries are generally required to attract and retain them.

A purely divisional structure has not been embraced by MFIs, but combinations of the functional and divisional approaches have been popular. Many institutions are generally organized by function, but have a regional layer of superstructure that is divided along geographic lines. The major risk inherent in combining a functional and divisional approach is that information flow and accountability channels can become unclear. When a customer service representative is responsible to a branch manager at the local level and a marketing manager at the regional level, whose leadership has priority? Coordinating the operational needs of the branch and the programmatic needs of the marketing function through individual employees can be complex.

**Teams** of individual staff members offer an alternative approach to grouping staff that can improve the coordination, competitiveness and customer service of an MFI. How can teams do this?

- **By facilitating communication across organizational boundaries.** Cross-functional or vertically integrated teams can more effectively move issues across and up the organizational hierarchy. They reduce the opportunity for misunderstanding and increase the likelihood of buy-in since commitments are made collectively.

- **By improving responsiveness to customers.** If employees are trained to perform several functions and focus on serving customers as a team, they can provide faster and higher-quality service than individuals who must transfer customers from one functional department to another to meet their needs.

- **By increasing speed.** A cross-functional product development team can bring a product to market in half the time it takes an organization that is structured along functional lines.

- **By increasing employee satisfaction and development.** The team approach provides workers with knowledge and skills, information, rewards, and power they do not have in traditional structures. By empowering employees to plan their work and make decisions, organizations find that talents emerge and develop that were neither recognized nor utilized previously.

- **By increasing productivity and decreasing costs.** By putting multiple heads together instead of one, improving coordination and communication, and increasing flexibility, teams can both increase organizational productivity and decrease costs.
An MFI can use a variety of different types of teams, depending on its circumstances and objectives. As a radical option, it could structure itself to have neither individual jobs nor functional departments – only teams, team members, and some limited management superstructure. This approach is common in countries like Japan, where well-entrenched cultural values favour group effort over individuality. In countries with a hierarchical social structure, or in institutions that do not have experience working in teams, managers will likely prefer to introduce teams on a pilot basis, initially with limited levels of autonomy that can be increased gradually over time.

For MFIs that would like to use teams to organize their staff and functions, here are some possibilities:

- **Suggestion teams**, such as advisory committees, have low levels of autonomy with no decision-making or implementation authority, and require no change in an organization's structure or work processes. They can be used effectively by an MFI to gather and consolidate information about its own performance, to brainstorm ideas for responding to change, or to identify ways for the institution to increase its productivity, reduce waste and costs, and improve quality.

- **Problem-solving teams** research activities and develop effective solutions to work-related problems. Often these teams are set up as task forces to handle a crisis or a particular challenge. For example, Grameen Bank “firefighting” teams move from branch to branch to respond to problems in the field. Problem-solving teams may be organized diagonally, to cut across hierarchical layers in the organization, or horizontally across functions. Usually these teams make recommendations, which must be approved by senior management, and the team is not responsible for implementing its recommendations.

- **Standing committees** include members from a cross section of departments and fulfil a specific ongoing function such as monitoring customer service, designing cost cutting strategies, or developing new products. A cost management committee, for example, might include members from finance, MIS, operations (including field staff), human resources and marketing. Through monthly meetings to review expenditures and consider staff suggestions, this team would be responsible for reducing costs and developing cost management controls. As with suggestion teams and problem-solving teams, standing committees derive some of the benefits of teams without completely reorganizing the institution.

- **Semi-autonomous teams** are managed by a supervisor and have considerable input into the planning, organizing, and controlling of their work. Team members help establish the goals of the work unit and make daily operating decisions. This type of team is used for tasks that are best accomplished by employees with considerable freedom to act.

- **Self-managing teams** have the same responsibilities as semi-autonomous teams and they hire team members and allocate resources. These autonomous teams are used when employees need the freedom to act and there are minimal requirements for coordination with other teams. Self-managing teams require significant changes in the organizational structure and institutional culture.
• **Growth management teams.** A growing MFI may want to create a team that parallels and mirrors the existing management structure. This cross-functional team would be responsible for creating an environment for cohesive and planned growth. Because it would be dedicated to designing growth strategies, rather than managing ongoing operations, the growth management team can spend more time worrying about what the organization is not doing instead of what it is doing.

• **Executive teams.** In some companies, titles such as president and executive director have disappeared from the organizational chart and have been replaced with a management committee, a policy committee, or a corporate office. As with all teams, the fundamental rationale for establishing an executive team is the creation of synergy—the effective coordination of functions and activities so the performance of the whole is greater than the sum of its parts. Executive teams have emerged because of the need to manage diverse yet interdependent organizational units. This approach is useful for growing institutions, particularly when they reach a significant scale that is too consequential for one or two people to make all the strategic decisions on their own. An executive team also helps facilitate succession planning and can expedite change processes.

The team approach will not be appropriate in all work environments nor in the pursuit of all objectives. Poorly functioning teams can deteriorate into groups of unhappy and uncooperative individuals who become less productive than the sum of their individual participants. Some people, and some cultures, are more individualistic and have difficulty exposing themselves to the will of the group. If not properly implemented, teams can become obstacles to progress that reinforce conformity and kill individual initiative.

If properly implemented, however, teams can facilitate performance improvements and increased outreach. The team approach is particularly useful if a variety of expertise is required, if an organization's culture and reward systems support group efforts, and if employees want to be empowered. MFIs that wish to adopt a team approach should be aware of its implications for human resource management. Heavy reliance on teams would require revisiting hiring procedures to screen for self-starters and team players. Training curricula would have to include new sets of skills such as problem-solving and team-building exercises. In general, teams will not naturally appear; they have to be made.

**Optimization of the Field Structure**

The fifth and final structural debate focuses on the retail structure. Identifying an optimal structure for field operations represents a significant challenge for many MFIs, particularly with respect to management ratios, the dependence on the staff-client relationship for lending activities, and the extension into rural areas.

• **Management ratios.** Historically, managers were able to supervise five to seven employees effectively, but advances in technology and management techniques have made it possible to increase that ratio. In ADEMI's urban branches, for example, the manager supervises up to 14 loan officers, a lawyer and several administrative assistants. The old ratio of employees per manager reflected the number of people a manager could effectively control. Today, the key factor determining the management to employee ratio is the number of individuals with whom a manager can effectively communicate.
Organizational Architecture

One way to enhance management ratios is to separate technical and administrative functions. Managers who spend all their time completing paperwork and submitting reports may find it difficult to supervise and support their staff members. Once a branch or work unit reaches a sufficient scale, administrative responsibilities can be delegated to allow managers more face-to-face time with employees and customers. A similar separation of responsibilities can also take place within a loan officer's job. At Calpiá in El Salvador, for example, the files of low-risk, repeat borrowers are transferred to loan administrators since these customers no longer need the technical analysis of the loan officer.

- **Employee dependence.** The relationship between a field agent and her borrowers represents a double-edged sword for most MFIs. A bond of mutual trust motivates loan repayments and enhances customer loyalty, yet a close relationship makes the MFI vulnerable to fraud and staff absences, due to illness, vacation or training for example. MFIs typically reduce their dependency on individual field agents through either a) designated back-ups, such as the branch manager or a co-worker who also meets the applicant before she gets a loan and knows where she lives or works; or b) roving loan officers who fill in for staff members in different branches.

The roving loan officer approach is particularly effective because it creates job enrichment opportunities for loan officers, while facilitating strategic staff training (i.e., making it easier for employees to be away from their posts), creating quality control (e.g., paperwork would have to be accurate, up-to-date and organized for the rover to fill in) and providing an effective internal control (e.g., the rover would easily identify ghost loans).

- **Extension to rural areas.** In extending financial services to remote or rural areas, MFIs may not have the luxury of using a team structure since there may not be a sufficient volume of customers to be served by a group of people. Consequently, staff serving rural areas need to be versatile and skilled at providing a range of services on their own. They also need to rely on locally available expertise and infrastructure, including farmers' cooperatives and agricultural extension agents.

### 16.4 Building an Effective Organizational Structure

To build an effective organizational structure, MFIs must carefully analyse their environment, their outreach objectives, their operations and their culture. They should consider the cost-benefit implications of various structural options. In trying to make sense of these inputs, MFIs may also find it useful to consider four general recommendations that are offered below as a conclusion to this module.

1. **Build a structure that evolves as the institution evolves**

   At each level of organizational development, different structures are required. Young MFIs must be learning organizations – flexible, adaptable and constantly in pursuit of feedback that can help them increase the relevance and quality of their service. At this stage of development, proximity and flatness are critical structural attributes. The organizational design of a young MFI should be as simple as possible. These MFIs cannot afford the overhead expenses involved with opening up new branches or hiring functional specialists. Nor can they afford the delays and complications of communicating up a vertical structure.
In the next phase of institutional development, the MFI needs to reach a critical mass of clients to become financially self-sufficient. This pressure to grow makes these MFIs especially vulnerable to premature expansion. Instead of adding significant size, these institutions should build the capacity for healthy, sustainable growth, which includes customer service infrastructure, procedures for hiring and training staff, an effective MIS, and channels for the vertical and horizontal flow of information that can replace the informal communication prevalent in less mature institutions. MFIs at this stage should expand their branch network with caution—a patient growth strategy will allow the MFI to learn about the challenges associated with expansion without being overwhelmed by them.

Once an MFI is comfortable with its basic methodology, has excellent portfolio quality, customer service and retention, and is trending toward profitability, it is ready to replicate its model in numerous sites. As MFIs expand their operations and diversify their product line, their organizational structure tends to become more complex, less flexible and—this is the major danger—less capable of adapting to a changing environment. Mature MFIs face the challenge of organizing staff and functions so that innovation remains an ongoing process and well-tested products and product modifications can be brought to the market quickly.

2. **Build a structure that revolves around the customer not the product**

Most financial institutions are organized around products. When customers at a traditional bank make an inquiry, they speak with someone in the personal checking department, the mortgage department, or the commercial department. If they want to transact business across the internal boundaries of the bank, they may spend all day trying to talk to the right people. To improve customer service, an organization’s structure and decision-making processes need to revolve around the customer, not around a particular product. Instead of organizing work by function, MFIs should organize themselves to meet client needs.

Within such a structure, decisions can be made quickly by responsible employees at the point of customer contact. At some MFIs, customers are greeted by a flow manager who escorts them to the staff person who is in the best position to meet their needs. In others, customer service representatives sit at a reception desk where clients can ask questions, make suggestions or request information about any of the institution’s products. Employees who staff the new accounts window are able to help customers open any account they wish.

3. **Build a simple structure**

An MFI’s structure is supposed to provide clarity and facilitate the flow of information and accountability. In an attempt to grow, to provide perfect support in all functional areas, to make the best use of employees’ varied skills and to respond quickly to changes in the external environment, an organization’s structure can easily become complex and efficiency will be lost instead of gained.

MFIs should use their need for clarity and flow as a structural compass and avoid creating complicated arrangements such as parallel reporting structures in which an employee reports to two or more supervisors for different responsibilities. They should minimize structural layers and keep the scale of operations manageable, perhaps by grouping staff
into teams of a relevant size given available management capacity, perhaps by splitting branches into two when they reach a critical mass. Finally, MFIs should make sure their structure is well communicated so that everyone understands who does what and how information and accountability are supposed to flow from the customer, through the institution, and back to the customer.

4. **Build with business units as building blocks**

At this point in time, the **business unit** appears to be the most appropriate structural tool for balancing centralization and decentralization; flatness and manageability; flexibility and standardization; customer service and cost. A business unit is essentially a company within a company. It serves as its own profit centre, and it sources external support services either from the corporate superstructure or from external agents at market prices. If it is not happy with a particular service or the cost of the service provided by the head office, such as computer support or wholesale loan funds, the business unit has the autonomy to find these services elsewhere. This forces the head office to improve the quality and cost of its services, therefore improving the competitiveness of the entire company.

A business unit approach helps to keep as many people close to the customers as possible. These smaller units possess an economy of focus. They are knowledgeable about the local market, they are flexible, they have little if any decision-making hierarchy, and they tend to have a more favourable image in the local community than the head office. At the same time, business units are guided and supported by overarching objectives, policies, systems and values which glue the individual units together to create a coherent and productive whole. By building a structure based on business units, MFIs can organize themselves in the shape of a “solar system” rather than a pyramid or a flat line. They can be dynamic, yet ordered; multi-dimensional, yet efficient.

### Main Messages

1. There is no one structure that will be ideal for any MFI at all points in time. Build a structure that evolves as the institution evolves.
2. Build a structure that revolves around the customer, not a particular product.
3. Locating some functions outside the institution’s internal structure can generate efficiency improvements.
4. Build a structure that clearly guides the flow of information and accountability.
5. Consider using teams to overcome the main disadvantages of a functional organizational structure.
6. Build with business units as building blocks.
Recommended readings:


Using Organizational Architecture to Manage Growth

For MFIs, the traditional approach to managing growth relies on standardization and replication. Although this approach is valid — particularly for MFIs that do not operate in competitive markets — it is not sufficient. With increasing competition, as MFIs gain relatively equal access to capital, and as many technologies become widespread, organizations will gain a competitive advantage from their ability to deploy and leverage the efforts of the people in the organization.

This module uses the metaphor of “organizational architecture” as a framework for analysing three inter-related components that are essential to managing growth: (1) institutional culture; (2) human resource development; and (3) organizational structure. These are not the only issues affecting growth – governance, MIS, resource mobilization and financial management are fundamental issues that must also be considered, but they are not the focus of this module.

Managing growth, as defined by the three elements of organizational architecture, is the process of building solid and lasting institutions – literally, institution building. This module covers the following six topics:

1. Understanding growth
2. Growth strategies
3. Growth patterns
4. Growth at various stages of institutional development
5. Organizational architecture and growth
6. Planning for growth

17.1 Understanding Growth

To manage growth, it is necessary to better understand it. Is bigger better? What are the pressures to grow? Why is growth important to MFIs and what growth pattern is most appropriate? In trying to answer these questions, MFIs have to consider two dimensions: (1) what is their optimum size, since there are costs associated with being too small and too large; and (2) what is the right speed for growth, because there are costs from not growing fast enough and dangers from growing too fast.
**Bigger, Better or Both**

Microfinance is a high-growth industry. It is not uncommon for MFIs to grow exponentially. But not all growing MFIs succeed. Many experience cycles of high growth followed by periods of consolidation where they are forced to solve problems caused by growth. Some smaller MFIs never experience growth because they lack the managerial, technical and/or financial resources.

If there is one lesson to learn about managing growth, it is to focus on making the organization better, not just bigger. In their effort to increase market share and achieve sustainability, MFIs must ensure that they also sufficiently emphasize quality, exemplified by the pursuit of staff and customer satisfaction.

**Pressure to Grow**

MFIs must understand the pressures to grow — both internal and external — so they can plan and prepare for it, choose the right timing and control the speed of growth.

There are two primary internal pressures that push MFIs to increase their outreach: the imperative of sustainability and their institutional mission. Initially, MFIs have to grow. To cover their costs, MFIs need to take advantage of the economies of scale that result from better utilization of capacity. Growth is needed to spread fixed costs over a larger portfolio. However, MFIs need to be careful about assuming that growth will automatically dilute their fixed costs. When MFIs expand, they often increase rather than reduce their overhead, as they hire new personnel who are not immediately productive, as they open new offices and as they invest in infrastructure like computer systems to support growth.

Once an MFI reaches financial sustainability, does it need to keep growing? For many MFIs, outreach is an important part of their social mission, to provide financial services to as many low-income people as possible. Although this pressure affects them in varying degrees, institutions highly motivated by their social mission consider the enormous demand for microfinance services as a compelling argument to expand.

MFIs that focus on a commercial mission also feel pressure to grow. It typically comes from shareholders who want to see a greater return on their investment, but it can also come from managers who seek growth to keep ahead of the competition and avoid a loss of market share that could threaten long-term sustainability. Employees at any level may push for growth because they want more opportunities for promotion and career development or more attractive compensation packages.

**External pressures** also motivate the expansion of MFIs. Many MFIs operate in markets starved for capital. In that context, they can be overwhelmed with inquiries and applications. Growth begets growth to the point where momentum may carry the institution too far too fast. The resulting exponential growth may not be in the best interests of the organization, its employees or its customers.

Microfinance institutions have been socialized by donors and the broader microfinance community to be obsessed with growth. The primary statistic reported by most MFIs is the number of clients — and the outreach goalposts for MFIs keep moving farther away. In the past,
MFIs became significant when they had several thousand clients; but today, the microfinance community may not acknowledge organizations with fewer than 20,000 clients, and even larger in some Asian countries. Managers must avoid being overly influenced by these pressures.

**Sustainable Means Durable**

Economic and social development is about institution building, but this principle is often lost in the focus on growth. When the microfinance industry speaks about creating sustainable institutions, it usually means becoming independent of donor resources. But sustainable should also mean durable. MFIs must be careful about pursuing growth for growth's sake. Instead, if they focus on developing, serving and maintaining a loyal customer base, they are likely to experience a natural growth rate that is in step with the capacity of the organization and does not undermine its corporate culture.

Durable MFIs must have “being” goals rather than “doing” goals. Success should be defined as something that is sustainable over time, not something that gets very big very fast, or achieves excellent short-term returns. The establishment of a sustainable MFI requires more than a change from donor to commercial sources of funding. It also requires a change in attitude. A sustainable MFI must develop a long-term vision, which is reflected in the organization’s relationship with its key stakeholders, particularly its staff and customers. This vision must balance quality and quantity.

**17.2 Growth Strategies**

Microfinance institutions can grow in a variety of different ways. Insights into the range of growth strategies may help managers to lead their organizations onto a growth path that makes the most sense given their institution and the local market.

MFIs that pursue a **one-dimensional growth** pattern focus on one product or expand in one market. This risky growth pattern exposes institutions to concentration risk. Although an institution may have thousands of loans, natural disasters or changes in government regulations could affect the MFI’s entire portfolio if clients come from a single market segment. An MFI’s reliance on a single loan product would produce similar vulnerability, particularly if a competitor were to introduce a more attractive innovation.

To shield themselves from concentration risks, MFIs may choose a **diversified growth** strategy that broadens the institution’s product offering and/or geographic reach. However, there are management challenges associated with product and market diversification. MFIs court disaster when they stray from their core competencies by growing into areas where management does not have expertise. Success in one area may spawn overconfidence, which allows management to think it can accomplish anything.

An **intensive growth** strategy generates greater productivity or output from an organization’s existing capacity. This may be possible through technological innovations; improvement in the utilization of capacity, such as increasing loan officer productivity; or introducing new products. Generally, intensive growth is seen as a lower-risk strategy, and often a higher priority, than extensive growth. In many circumstances, it does not make sense to increase the
organization's capacity until its existing capacity is nearly fully utilized. For example, if branches are averaging 200 loans per staff member and the business model shows that the MFI needs 350 loans per staff member to break-even, then it may not be a good time to start opening new branches as well.

In contrast, **extensive growth** adds breadth by expanding the organization's capacity, such as hiring new staff and opening new offices. Extensive growth, also known as horizontal growth, is commonly associated with standardization and replication, and can be pursued in a variety of ways:

- **Branch-by-branch:** An MFI can open new branches one at a time in the most promising locations around the country. This approach can enable an institution to quickly cover a vast geographic territory and reach a large number of clients. However, it can be difficult to effectively monitor performance when branches are widely dispersed.

- **Amoeba:** With this strategy, an MFI would allow a branch grow to a certain size and then split it into two or three branches, or into a main branch and subunits or service points which may not be open full time until they reach a certain volume of activities. A major advantage of this approach is that new employees are hired to take on part of an existing portfolio, so as they grow they manage a mixture of new and repeat borrowers, which is much easier than managing only new clients.

- **Concentric expansion:** Unlike the branch-by-branch approach, concentric expansion gradually extends the territory covered by an MFI in a systematic manner. New branches would open in areas adjacent to those already served by existing branches, gradually pushing the geographic boundary of the MFI’s activities outward in concentric circles.

- **Exponential:** With this “big bang” approach, an MFI would open up many branches all at once. Fundusz Mikro in Poland used this strategy, but not many others have because of the significant investment required to open multiple locations simultaneously. This approach may become more feasible in the future, as MFIs begin to use mergers, acquisitions, partnerships and franchising to facilitate massive, rapid expansion.

### 17.3 Growth Patterns

Using any one or a combination of the strategies mentioned above, MFIs grow according to three general patterns: healthy growth, unhealthy growth and stunted growth. Each of these patterns is illustrated in Figure 17.1 and discussed below.
Unhealthy Growth

Portrayed by the experience of MFI A in Figure 17.1, unhealthy growth is generally characterized by a volatile pattern of rapid growth followed by a period of decline as an institution copes with the backlash of having expanded beyond its capacity. The most perilous period in a company’s development is when it starts to succeed wildly and expands rapidly. Rapid expansions are often followed by rapid declines, and MFI growth patterns frequently come to resemble roller coasters, escalating to peaks before plunging into troughs.

If growth causes an MFI to become a victim of success, it is likely to be due to at least one of the following five causes:

1. **Over-expansion.** MFIs that over-expand may open too many new offices or hire too many staff at one time. Over-expansion increases average costs — because new offices and new staff are not yet fully productive — while it increases the risks of delinquency and fraud. Because growth raises the percentage of new borrowers in the portfolio, who have smaller loans, over-expansion reduces the per unit return and increases the average cost per dollar lent.

2. **Premature expansion.** The timing of growth is also important. Premature growth occurs before an institution’s systems are in place or its procedures are sufficiently tested. The most common example of premature growth in microfinance is an organization that rolls out a credit product without a sufficient pilot test, only to realize later that the lending methodology has some significant flaws.

3. **Exhilaration.** When a company grows exponentially, problems may not appear until it is too late. The exhilaration of growth can occlude problems of morale, planning and institutional capacity created by it. Success may hide weaknesses that lay just below the surface, only to arise later with a vengeance and undermine the organization’s accomplishments.
(4) **Under-capitalization.** MFIs need reserve capital to absorb shocks. Management may underestimate the financial or human capital required to meet growth demands. This situation is particularly problematic when MFIs do not have sufficient funds to keep pace with the flow of applications and the demand for increasingly larger loans. If resulting cash-flow problems delay disbursements, the quality of the portfolio is likely to plummet because the primary motivation for repayment is the promise of future loans.

(5) **Ostrich management.** Managers engrossed in the daily demands of growth may be unaware of changes occurring around them, including the regulatory environment, demands of the market, competition and available technology. MFIs that have operated in monopoly markets may have difficulty adjusting to a competitive environment, especially if the competition utilizes a more attractive methodology.

**Stunted Growth**

As reflected by the experience of MFI B in Figure 17.1, some MFIs grow at such a slow pace that it can hardly be called growth. It is essentially stagnation. An MFI can have stunted growth for a variety of different reasons. Customer desertion is perhaps the most common cause as the MFI spins its wheels trying to replace lost clients. Other causes include: delinquency problems, since managers do not want to throw good money after bad; funding problems whereby the MFI is not able to attract sufficient resources to fund growth; as well as staff motivation and marketing challenges.

**Healthy Growth**

Healthy growth can resemble either of the experiences suggested by MFI C or MFI D in Figure 17.1. It is characterized by significant, relatively steady and sustainable expansion of outreach that balances quantity with quality. The curve and angle of a healthy growth pattern will vary depending on the level of an institution’s development (see Section 17.4), but the stable and generally positive trajectory of the pattern will always distinguish healthy growth from unhealthy, stunted or negative growth.

Every business has a natural rate of growth. If that rate is not reached, a business can shrivel. If it is surpassed, the business will struggle to keep pace. MFIs need to sense their natural growth rate and be prepared to speed things up or slow things down as necessary. Because extensive growth implies the creation of new capacity, such as opening new branches, and because of changes in seasonal demand, growth will invariably have a start-and-stop nature. However, the peaks and troughs should be tempered to create a healthy working environment and a sense of continuity among staff and customers. Fast growth and durability are often incompatible. Managers in pursuit of growth would be better off approaching their route as if they were running a marathon rather than a sprint; they will need to pace themselves.
17.4 Growth at Various Stages of Institutional Development

A key factor determining the growth strategy of an MFI is its stage in development. The three stages of institutional development shown in Table 17.1 are typically used to categorize microfinance institutions.

Table 17.1 Stages of Development for Microfinance Institutions

<table>
<thead>
<tr>
<th>Level</th>
<th>Stages of Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level I</td>
<td>Start-up Programmes. These MFIs are heavily subsidy dependent and require frequent injections of funds. If these injections are not forthcoming, the programme will quickly consume its capital in financing routine operations.</td>
</tr>
<tr>
<td>Level II</td>
<td>Programmes that Have Achieved Operational Efficiency but Not Full Self-Sufficiency. The range of MFIs at this level includes those that rely extensively on soft money as well as those on the verge of unsubsidized profitability.</td>
</tr>
<tr>
<td>Level III</td>
<td>MFIs that Have Achieved Full Self-Sufficiency. They generate enough revenues to cover both non-financial and financial costs, calculated on a commercial basis. Subsidies in the form of concessionary funds are no longer needed, and investors can expect a return on equity equivalent to returns available elsewhere in the private sector.</td>
</tr>
</tbody>
</table>

**Level I**

MFIs at Level I have not fine-tuned their lending methodology, and probably have not developed the institutional capacity to support growth. Level I is an experimental phase. Experiments should be kept small to allow for trial and error while keeping the losses from mistakes within bounds.

Level I institutions cannot afford the overhead expenses involved with opening up new branches or hiring new staff. These programmes should rely on intensive growth by finding ways to increase the productivity of their existing capacity. These organizations are probably not ready to implement major marketing strategies because they do not want to cultivate demand they cannot satisfy. Planning for MFIs at this level will remain short term because projections beyond one or two years will have no basis. They are also not prepared to introduce new products or enter new markets unless they have concluded that their current product or market will not be successful and they need to try a completely new approach.

**Level II**

The diversity of Level II institutions makes it difficult to generalize about their growth strategies. MFIs at the bottom end of the range may hire additional staff to increase the utilization of their existing branch capacity, but are not ready to open new branches. They are only able to consider short- and medium-term planning at this stage.

As MFIs move toward the upper end of the Level II spectrum — assuming they have perfected their methodology — then standardization and replication of their branch model become an option. Their market-penetration strategy requires that they have their staff training, management information and other operational systems in place to initiate an extensive growth strategy that replicates a successful branch model in new geographic areas. The plan-
ning horizon becomes longer as the institution is able to predict the outcome of hiring new staff and opening new offices.

MFIs at the upper end of this range will probably also increase their investments in research and development so they can prepare themselves for a competitive environment and can improve the quality of service they offer their clients. If the institution operates in a narrow geographic area, it may choose to invest more heavily in developing new products for new demographic markets rather than opening new offices.

MFIs at this level should be wary, however, of extensive growth, as it may increase overhead costs before existing overhead is fully utilized. Management ratios are usually smaller as the business replicates its branch model, whereas adding more staff per manager would increase management productivity. Horizontal expansion adds complications, particularly with regard to communication, that may undermine the success of the institution. MFIs that expand horizontally are usually rolling out one or two products on a large scale. An MFI that has expanded horizontally may find it difficult to introduce changes to its products, or to introduce new products.

**Level III**

Serious horizontal growth is possible only once an MFI reaches Level III. A Level III institution can leverage its equity to fund a more dramatic growth strategy that is likely to include opening a significant number of new offices. It is important for institutions at this stage to reduce their concentration risk by **diversifying their products or markets**. MFIs that reach this level are likely to become targets of smaller, but perhaps more innovative, competitors. A Level III institution must guard against ostrich management and complacency by continually striving for improvement and ensuring that it meets the needs of its market.

**17.5 Organizational Architecture and Growth**

Every successful business begins with one person, one idea and one location. The difference between a business that flourishes and one that withers is how it is managed. Growth rarely involves doing more of the same on a larger scale; it brings complexity and requires adaptations.

To manage growth, an MFI needs to be built in the same way an architect designs and constructs a building. As discussed in the introduction to this section, the concept of organizational architecture enables managers to take a holistic view of their organization and consider how the institutional culture, structure and human resources fit together.

**Institutional Culture**

As an MFI grows, what happens to the institution’s culture? Do the values need to change as it expands? How does the culture determine the types of growth strategies the MFI is willing to consider and the extent to which people are committed to implementing the strategies that are selected?
During the early days of an MFI, particularly those that begin as NGOs, the culture may be characterized as a family approach, complete with participatory management that promotes flexibility, creativity and innovation. These may be important characteristics for a young institution in an emerging industry, but can they be retained as the MFI expands? Growth may require a more structured approach, as was the case at BancoSol in Bolivia (see Box 17.1). The challenge is to combine the advantages of a young, entrepreneurial organization with the strengths of a more mature, professional institution.

Box 17.1 Changing Demands on Management at BancoSol

Rapid growth and transformation into a bank forced BancoSol to adapt its organizational structure and culture. During its NGO stage, the institution had promoted an informal office culture which encouraged innovation, commitment to the organization’s mission, and recognition of individual contributions to a team effort. The management hierarchy was simple and flat, relying heavily on interpersonal relations. This internal culture fitted well with a lending methodology based on trust between the organization and its clients.

The informal culture that had served the NGO so well became less suited to the demands of a larger institution. It proved difficult to integrate new staff and branches within the existing culture. Management needed improved information systems to cope with an expanding portfolio. BancoSol was simply becoming a larger organization that required more standard lines of authority and communication, and a more businesslike approach to decision-making.

BancoSol adapted by designing a stricter management structure, improved systems and new chains of command. Experienced bankers, human resource managers, experts in asset and liability management, and management information systems specialists were incorporated. In contrast to the necessary formalization of the institution’s structures, it retained the technology of personalized contact with the clientele, which includes simple procedures and instruments tailored to the clients’ demands.

This balanced approach to restructuring management was influenced by BancoSol’s Board of Directors. The Board represents shareholders who include NGOs, donors and individual investors. Collectively they are concerned with the safety of their investments, their reputation, and also with preserving the integrity of BancoSol’s original mission. The Board of Directors recognized the changing demands on management and demonstrated the political will necessary to make difficult decisions to improve BancoSol’s organizational structure.

Source: Adapted from Chen, 1997.

As in any service industry, one core value that has to be retained is the commitment to customer service. MFIs must retain their best clients because their larger loan sizes and the familiar relationship make it possible for the organization to balance outreach and sustainability.

Sustainable growth requires knowing how to adapt to circumstances that are constantly changing. The long-term winners are the best adapters, but are not necessarily the winners of today’s race for market share. Young MFIs are expert adapters. They constantly tinker with their lending methodology to perfect their approach, reduce delinquency and increase pro-
ductivity. But MFIs need to ensure that they do not lose their entrepreneurial adaptability when they standardize their procedures and scale up, suggesting a continued role for market research and product development.

An adaptable organization has adaptable employees. The atmosphere is tolerant of mistakes, which are viewed as opportunities to learn. **Productive failures** are mistakes that generate new insight and understanding. An adaptable organization utilizes failure as a clue that initial targets, and perhaps some of the assumptions behind them, need rethinking. It listens to employees, customers and the marketplace, and is willing to change directions in mid course if necessary.

**Human Resource Development**

The foundation of any MFI lies at the locus of interaction between the institution and its customers. This bottom-up view of the institution appropriately emphasizes the critical role of field staff as the foundation of microfinance, and places the institution's human resources as a top priority for managing growth.

As MFIs grow, the nature of their operations changes, as do their human resource needs. The relatively unsophisticated employee who filled the MFI's needs two years ago may not possess the skill sets necessary to manage a diversified portfolio in an increasingly competitive environment. MFIs should review their definitions of skill sets and job requirements on a periodic basis and update them as necessary. They should also consider external recruitment to bring into the organization people who have experience running much larger businesses and will not be intimidated by growth.

In general, a growing organization needs to hire at a pace that integrates three converging elements. First, the addition of staff must meet with the institution's ability to **train human resources**. An expanding institution requires systems to produce a large volume of well-trained front-line staff. Following the principles of standardization, the most recently hired staff must implement the same methodology as the first. To accommodate growth, training must also include grooming staff for management positions or increasing responsibilities without adding layers to the hierarchy. If MFI growth includes diversification, such as the introduction of new financial products, training needs to be designed to gradually provide staff with new skills, thus increasing their flexibility and productivity.

Second, the MFI must have the capacity to **manage and motivate staff**. Incentives, discussed in more detail in Module 19, are an important aspect of staff development. Managing growth involves identifying the right balance of monetary and non-monetary incentives, including base salary, individual- and/or group-based rewards, staff development opportunities, benefits, the possibility of developing new skills and the intangible benefits derived from the institution's culture. Financial incentives increase both costs and productivity. The challenge is to sufficiently increase productivity so that the incentives pay for themselves.

Third, the pace of hiring must coincide with the **demand for the institution's services**, which is largely determined by the firm's marketing and outreach efforts. The most successful MFIs invest in talent before they need it so the key people are in place and acclimated when the institution needs their knowledge, skills and experience.
Organizational Structure

Some MFIs use their social mission to rationalize the geographic dispersion of their activities. They argue that, by opening new offices, they can provide financial services to more low-income communities. However, from a social perspective, the overall impact of a programme is more significant if it maintains a geographic concentration of clients and branches. The depth of results achieved by an MFI that strives for market saturation in a specific region is more effective in poverty alleviation than an organization that has wide but thin coverage.

There are two reasons for this. First, by striving for market saturation, the MFI works harder on the social intermediation necessary to provide financial services to the more disadvantaged segments of the community. Second, an MFI that does not regularly replicate a standard model in new communities is more likely to channel resources into new product development to provide its market with a range of services to meet their needs. It is also worth noting that the breadth of relationship with customers and a geographic focus will help protect the institution from competitive challenges, whereas a one-product institution with wide coverage is more vulnerable to competitors and will respond with less agility. Institutions that find their intensive growth limited by funding or legal constraints should consider strategic partnerships (see Box 17.2 and the case studies in Module 3).

Once an MFI reaches saturation in its existing markets, or identifies increased geographic coverage as the best way to achieve a stable commercial position vis-à-vis the competition, an extensive growth strategy becomes attractive.

For an MFI to be durable, the decision about when and where to open new offices must be based on economic and strategic, rather than political, reasons. Often donors and influential persons try to convince MFIs to open offices in a particular community because this is consistent with the political agendas of external agents. The challenge for a growing MFI is to evaluate each potential site as an economic and not a political opportunity. If the MFI does not conduct a feasibility study, an initial grant may lure the institution into opening a new office in a community that ultimately does not possess a large enough market to support the overhead of the branch. The next year the political will may change, the grant money for the branch office may dry up and the branch will operate at a deficit.

Instead of opening offices in far-flung reaches of the country in response to political pressure, a more pragmatic business approach is for the MFI to gradually spread its influence through concentric expansion or an amoeba approach. When a branch reaches maximum capacity, it can split into two offices with different geographic focuses. If an MFI wants to pursue a branch-by-branch or exponential growth strategy, it must take care to ensure that the necessary resources and systems are in place to support growing operations in multiple locations, and to facilitate communication and coordination amongst them.
Box 17.2 Partnership for Growth in India

In 2003, CASHPOR, an MFI working in the poorest region of India, and ICICI Bank, India's largest private bank, entered into a mutually beneficial strategic partnership agreement to provide microfinance. CASHPOR, with its market knowledge of poor customers, originates and services loans, while ICICI, with its strong balance sheet and vast financial resources, provides capital for CASHPOR to carry out its work. Underpinning this agreement is CASHPOR's approval of loan proposals.

Early evidence is positive. David Gibbons, chairman of CASHPOR, notes that "in the first year, the strategic partnership achieved market penetration and business volume performances not attained by other Grameen-type MFIs, nor even earlier by a sister CASHPOR company". In the first year, it recruited almost 6,000 new customers and disbursed approximately Rs.3 crore (US$650,000) to them. Portfolio-at-risk at 30 days was 0.02 per cent.

From CASHPOR's perspective, the partnership has allowed the MFI to overcome two primary hurdles to reaching large numbers of poor customers: a lack of capital and legal/regulatory constraints. With access to needed financial resources, it is able to penetrate the market at an accelerated growth rate and also move towards its mission of maximizing poverty reduction profitably. Additionally, CASHPOR overcomes a regulatory hurdle that many MFIs interested in conversion often face: a high minimum net owned funds requirement. In the partnership model, CASHPOR does not operate as a regulated financial intermediary and thus is not subject to minimum capital requirements.

For ICICI, its initial interest in microfinance was to meet the Reserve Bank of India's requirement that private sector banks allocate at least 18 per cent of their net credit to the agricultural sector, including microfinance. Yet once involved, it saw a business opportunity, not an opportunity for charity. Over the next five years, ICICI plans to commit US$1 billion to the sector. As it does not have the branch infrastructure in rural India or market knowledge of poor customers, it is seeking to work with MFIs to tap this segment and has now adopted the partnership model with additional MFIs.

Source: Adapted from Meehan, 2005.

Once again, strategic partnerships or alliances between institutions may be worth exploring as additional avenues for expanding at a pace or in a direction that an organization's internal resources alone would not allow (see Figure 17.2). The choice of a particular approach will depend on the MFI's available options and strategic direction.
Growing Existing Operations and Restructuring
- Most MFIs expand by growing existing operations
- Legal restructuring allows product and market expansion
- Examples in microfinance include NGO transformation to regulated bank; transformation to holding company; service company model (where bank forms non-financial legal entity to serve MF clients)

Franchizing
- Way to expand without much up-front financing
- Franchising as it occurs in private sector (with franchisor using same name as franchisee) not currently found in microfinance
- Most common form is methodology replication (e.g. Grameen, ASA); however, “franchisees” use different name
- Franchising in microfinance—more mentor–mentee relationship without strict quality controls

Strategic Alliance
- Enables MFI to expand product offering without transformation
- Strategically beneficial for both parties; range from loose alliances (negotiating special prices, outsourcing) to front-end alliances (joint marketing) to close integration (joint ventures)
- Common form is strategic alliance between NGO and bank
- Numerous examples of MFIs allying with businesses (e.g., FinComun and BIMBO; CARE/Hindustan Lever)

Merger and Acquisition (M & A)
- Most intensive in terms of time and resources required; most difficult to implement; high risk
- Some organizations use strategic alliance as stepping stone for M&A
- Delicate cultural issues that require careful change management
- Regulatory issues depending on country
- Growing number of M&A in microfinance (most are called mergers, although “merger of equals” rarely exists)
- Examples include merger of XAC and GE to form XacBAnk; ProCredit acquisitions

Time and Resources Required; Difficulty to Implement
Rodrigues and Morente, 2005, adapted from Accenture Development Partnerships.

17.6 Planning for Growth

How did we manage growth? It wasn’t an accident. We planned it. Then the key is to manage that plan.

~ Esther Muiruri, Equity Bank

Too often, yesterday’s growth pattern drives today’s organization into the future. Instead, an MFI today must lay the foundation for tomorrow’s growth through planning.

Two dimensions of growth include direction and propulsion. Direction is generally set by the senior management team, and then refined through the planning process that involves the rest of the company.
Once a direction is set, energy must be marshalled to move the business forward – this is propulsion. To propel an organization towards growth, companies need to utilize all three components of the organizational architecture effectively. Managers may appeal to the institutional culture, to employees' sense of identity and idealism, by using a common vision of where the business is going. Growth-oriented companies garner propulsion from their human resources by selecting appropriate performance measures and coupling them tightly to staff incentive programmes (see Box 17.3). It is also necessary to ensure that barriers implicit in the organizational structure are removed to allow the company to propel itself towards growth. For example, if senior management is too far from the interaction between the company and its clients, communication bottlenecks may impede growth.

Box 17.3 Managing and Measuring Growth

Managing growth is a function of measuring growth. The indicators monitored reflect and reinforce the corporate culture and the firm's approach to expansion. If an MFI widely publishes its number of branches, it considers geographic expansion as a desirable growth strategy. If an institution uses its portfolio size as a key growth indicator, it may encourage increases in loan size at the expense of increasing the number of clients. If the company uses the number of clients per loan officer as a key performance indicator, it is probably concerned with productivity.

It is common to find an executive team trying to move a business in one direction, while the performance measures and incentives are motivating behaviour in a different direction. It is important for organizational architects to consider growth within the firm's big picture to ensure that performance indicators and incentives, organizational design and culture are aligned to achieve and reinforce common objectives.

Information flow plays a critical role in facilitating this alignment. Information technology can assist an MFI to adopt a flatter structure because the layers of middle managers who analyse and interpret data will become less necessary. Software that produces early warning signals and uses graphics to present easily understood tables provides senior management with information they can easily assess. At the same time, readily available and easily understandable performance data at the branch level are essential for field staff to monitor their own performance. It is not possible to succeed in microfinance if field staff do not have key portfolio information in their hands every day. If field staff have clear performance targets, and have access to and understand regular performance indicator reports, the MFI will have less need for middle managers to control their performance.

Planning identifies what needs to be done, when it needs to be done, who will be responsible for doing it, what resources will be required and how the resources will be funded. Imagine what the MFI will look like in three years. What financial services are offered? How many loan applications are processed each month? How many new field staff are trained each quarter? What systems need to be put in place now to achieve this vision?

Everyone knows how important planning is, but it often gets overshadowed by the daily demands of operations. It is impossible to prepare a three-year plan when today's priority is meeting the demands for tomorrow's loan disbursement. Many managers have a firefighting approach that never allows them to plan for the medium or long term. They will not be able to
manage growth. What could be more important for a CEO than identifying where the firm should be going and developing a path to get there? Management's job in a growth-oriented firm is to identify emerging opportunities and find ways of capitalizing on them.

Planning is a critical aspect of all three components of organizational architecture. For human resource development, planning determines hiring patterns, and affects performance reviews and rewards. It is possible to enhance the commitment of staff to growth by involving them in setting their performance targets. If employees are committed to the plan, the extent to which they achieve its goals must be linked to their rewards. Regarding the organizational structure, the planning process helps architects realize that a rapidly growing firm needs a dynamic design. The design can shape and direct the institution's growth pattern only if it is integrated into the long-term vision. With regard to institutional culture, the planning ethos must be firmly embedded in the consciousness of employees of a growing firm. All employees, from the top to the bottom, must consider planning a priority, although the time horizon perspective will vary depending on the staff person's level within the organization.

If an MFI does not set goals, managers cannot be accountable for performance. A plan is not a beautifully prepared document that just sits on the shelf. Managing growth requires managers to refer to their plans regularly, ensure that the necessary resources are in place as scheduled, guide staff in their implementation of the plans, compare progress and time frames to the objectives, and update or revise plans according to changes in the marketplace and in response to the learning taking place within the institution. The management of growth begins with planning, but it requires effort in all four areas of the manager's mandate. Table 17.2 highlights some of the initiatives that managers can take to effectively prepare their organizational architecture for growth.
Table 17.2 Managing Growth through Organizational Architecture

<table>
<thead>
<tr>
<th></th>
<th>Human Resources</th>
<th>Culture</th>
<th>Structure</th>
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<tbody>
<tr>
<td><strong>Planning</strong></td>
<td>• Make HR needs a top priority</td>
<td>• Identify the values that need to change and how to change them</td>
<td>• Design a structure that supports the long-term vision</td>
</tr>
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<td></td>
<td>• Review job descriptions and requirements, as well as existing skill sets</td>
<td>• Focus on long-term sustainability</td>
<td>• Keep it as flat, accessible and decentralized as possible</td>
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<td></td>
<td>• Craft an HR strategy that shows how to get the right people in the right place at the right time with the right skills to facilitate the growth desired</td>
<td>• Embed a planning ethos in the consciousness of employees</td>
<td>• Allow the structure to evolve as the institution evolves</td>
</tr>
<tr>
<td></td>
<td>• Think about succession</td>
<td>• Define specific activities, timelines and targets from the bottom up</td>
<td>• Use business units as building blocks</td>
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<td></td>
<td>• Agree on performance objectives and measurement indicators</td>
<td></td>
<td>• Computerize so not as many new staff need to be hired</td>
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<td></td>
<td>• Design rewards and incentives</td>
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<td>• Conduct feasibility studies for potential new locations</td>
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<td></td>
<td></td>
<td></td>
<td>• Establish appropriate internal controls</td>
</tr>
<tr>
<td><strong>Organizing</strong></td>
<td>• Hire the right people -- consider importing middle managers who understand growth</td>
<td>• Value clear, timely communication</td>
<td>• Create a growth management team</td>
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<td></td>
<td>• Develop existing staff for new responsibilities and a changing environment</td>
<td>• Set up systems that make cross-departmental communication a habit</td>
<td>• Clarify responsibility and lines of accountability</td>
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<td></td>
<td>• Use process maps to help deliver clear messages about what needs to change</td>
<td>• Introduce more predictable, perhaps more formalized communication</td>
<td>• Streamline systems</td>
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<td></td>
<td>• Ensure everyone understands their role and its importance to overall success</td>
<td>• Ensure feedback loops are being completed</td>
<td>• Ensure a strong MIS</td>
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<tr>
<td><strong>Leading</strong></td>
<td>• Ensure the desired direction and speed of growth are clear to all</td>
<td>• Proactively shape the culture rather than letting it evolve on its own</td>
<td>• Standardize and document policies and procedures</td>
</tr>
<tr>
<td></td>
<td>• Set priorities</td>
<td>• Nurture values that create growth rather than promoting growth itself</td>
<td>• Check that fluid and appropriate feedback loops exist</td>
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<td></td>
<td>• Motivate staff to accept growth challenges</td>
<td>• Set an example</td>
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<td></td>
<td>• Help people adapt and change</td>
<td>• Be inspirational</td>
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<tr>
<td></td>
<td>• Give feedback</td>
<td>• Create an environment that supports learning</td>
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<tr>
<td></td>
<td>• Consider temporary expert guidance from outside (e.g., a change management consultant)</td>
<td>• Ensure everyone understands their role and its importance to overall success</td>
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<tr>
<td><strong>Controlling</strong></td>
<td>• Implement standards and incentives</td>
<td>• Balance quality with quantity</td>
<td>• Coordinate the pace of implementation among different parts of the structure</td>
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<td></td>
<td>• Regularly monitor performance against plans</td>
<td>• Measure results compared to objectives</td>
<td>• Monitor communication effectiveness and make adjustments as required</td>
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<td>• Evaluate for the future, not for the past</td>
<td>• Listen and be willing to change direction as necessary</td>
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<td></td>
<td></td>
<td>• Encourage values and attitudes that support the growth plan; discourage those that do not</td>
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Organizational Architecture

Main Messages

1. Growth will not succeed without an organizational architecture that can support it.
2. Focus on making the organization better, not just bigger.
3. Instil values that create growth rather than promoting growth as a value in itself.
5. MFIs can grow via different strategies. Choose one that is appropriate given the institution's level of development.

Case Study: CorpoSol, Colombia

In 1996, Finansol, a regulated microfinancial intermediary in Colombia and an affiliate of ACCION International, experienced a crisis that caused a severe deterioration of portfolio quality. ACCION felt compelled to intervene in this crisis for two reasons. First, 40,000 microentrepreneurs and their families depended on the financial services provided by Finansol. Second, Finansol represents a model of microfinance that ACCION believes is essential to unlock resources for the large-scale provision of microfinancial services: the transformation of an economically viable NGO into a regulated financial institution. If Finansol was allowed to go under, as it appeared destined to do, it would have been a disaster for the microentrepreneurs of Bogotá and a major setback for microfinance.

With the assistance and collaboration from both the private and non-profit sectors, ACCION developed and implemented a recovery plan, which involved hiring new management and finding investors to recapitalize the institution.

Origins

Finansol emerged from Actuar Bogotá (hereafter referred to as Corposol), an NGO founded by influential local business persons with ACCION's support to provide services to microentrepreneurs in Colombia's informal economy. From its start in 1987, Corposol was noteworthy. It grew at an unprecedented rate, providing integrated training and access to credit to more than 3,000 clients in 1989, and escalating to nearly 25,000 active borrowers at the end of 1992. Corposol was also one of the first MFIs to initiate its lending activities by obtaining lines of credit from commercial banks, initially through the personal guarantees of the founders. However, these sources of capital were insufficient to sustain the institution's rapid growth. By 1992, Corposol began to explore ways to tap directly into financial markets by forming a regulated financial intermediary.

After examining the feasibility of a number of options, Corposol decided that a commercial finance company (CFC) was the preferred type of regulated financial institution. Not only would Corposol avoid raising the large minimum capital requirement (US$13.7 at that time) to create a bank, but it could purchase an existing CFC license and begin operations immediately. In October 1993, with 71 per cent of the shares, Corposol became the controlling owner of a CFC which was renamed Finansol. Joining the NGO as minority shareholders were ACCION International, Calmeadow, FUNDES, a local development bank and private individuals.
Deterioration

Finansol inherited a loan portfolio of excellent quality, a proven lending methodology, large volumes and consistent profitability. Nevertheless, a number of factors quickly led to the deterioration of Finansol’s financial position.

In the first place, the relationship between Corposol and Finansol was structurally flawed. Corposol, the NGO, retained the credit extension staff while Finansol, the financial institution, served only as a booking and financing agent. Since most of Corposol’s operating revenues were generated by training fees charged concurrently with loan disbursement, this created an incentive to disburse and a disregard for collection. In addition, Finansol was managed by a long-time associate and subordinate of Corposol’s President. Together, these factors left Finansol without the ability to control loan placement, nor the will to conduct independent action.

Secondly, Corposol became overly ambitious. Buoyed by its previous success, management set out to provide completely new services and expand quickly at the same time. Due to their entangled relationship, Finansol was dragged along as Corposol launched three untested microfinance projects: Mercasol, a chain of retail outlets for microentrepreneurs to purchase supplies with credit lines; Agrosol, a rural credit programme with larger borrower groups and different repayment schedules than the urban programme; and Construsol, a home-improvement loan scheme. In some cases, Corposol allowed two or three different loan products per client.

The results were dismal. The new products were largely unsuccessful; the MIS could not keep up with product diversification; and the institution lacked appropriate staff training for the new products. To stop the monthly profit and loss haemorrhage caused by provisioning for deteriorating loans, management launched a massive refinancing of the portfolio that included lengthening loan terms and rescheduling bad debts. This provided brief cosmetic relief at the huge cost of hiding and worsening asset quality. At the same time, loan officers came under intense pressure to increase loan volumes to generate revenue for Corposol, disregarding the past concern for credit quality.

Thirdly, management made poor decisions in response to banking regulations. In 1994, the Colombian Government attempted to control inflation by limiting the asset growth of regulated financial institutions to 2.2 per cent per month – an extremely low figure considering that annual inflation was in excess of 20 per cent. Finansol was affected, but as an NGO, Corposol was not. It became expedient for Corposol to retain a portion of the loans, which allowed the combined portfolio to grow at a faster rate than the regulated system. Thus began a practice of shifting portfolios between the institutions that lacked transparency.

Thus, the combination of a flawed structure, overly ambitious policies and poor decision-making led to the worsening of Corposol/Finansol’s financial position. The loan portfolio deteriorated; the credit methodology was weakened; and neither ACCION nor the Superintendency was able to get a clear picture of the situation.

The Turnaround

Although ACCION and the other outside directors sensed these problems, they found it difficult to analyse and tackle these issues effectively. By presenting its new projects and later reporting on them, shifting assets between the two institutions, and assuring critics that it was dealing with the problems, Corposol was able to delay effective review of its operations. In addition, a clean audit by a big six accounting firm bolstered its case.

In May 1995, after eight months of delays, ACCION prevailed upon Corposol to perform a CAMEL evaluation of the entire microlending operation. The results, reported in July,
identified worrisome trends, but because the CAMEL was restricted to a period ending 31 December 1994, it did not capture the true magnitude of the deterioration. However, the CAMEL was instrumental in effectively articulating the concerns of the outside directors and launching the move for change. After the resignation of Finansol’s president in September 1995, an open appraisal of the institutions occurred.

In October 1995, Finansol obtained the services of a prominent banking consultant to analyse the operations and design a corrective plan. The turnaround plan rested on a rigorous and uncompromising return to the basics. Finansol regained control over its loan portfolio by terminating new product offerings, returning to the basic loan model, severing most arrangements with Corposol and taking management responsibility for the credit extension staff. In March 1996, a banker with extensive local and international experience was hired as the new President of Finansol.

The problem was correctly diagnosed, a highly competent management took corrective measures, and the affected portfolio, although significantly worse than in the past, was no longer at the disaster stage.

Lessons Learned

A number of important lessons emerge from these events. First, the institutional relationship between ACCION and Corposol/Finansol must be taken into account. Typically, ACCION has co-founded institutions in its network with local partners drawn from leaders of the private business sector. While working intensely to establish new microfinance operations, ACCION does not involve itself directly on the Board to promote the involvement and sense of ownership of its local partners. ACCION believes that the development of these roots is an essential ingredient in the network's success in reaching self-sufficiency and scale. As a result, in the Colombian case, ACCION was on the Board of Finansol as an investor, but not on the Board of Corposol. Thus there was little opportunity to influence Corposol’s diversification into untested activities.

This aggravated a governance issue that arises from having an NGO parent as the majority shareholder of a regulated microfinance institution. While the problem is not impossible to resolve, an NGO parent nevertheless establishes a controlling party that is not bound to the same standards of economic performance or fiscal prudence that may be reasonably expected in the business sector.

Because of this possible tension, in the best cases the NGO parent must consciously guard that, in dealing with its regulated microfinance subsidiary, it sets fiscal standards appropriate to the financial sector, even if these are not applicable to its other activities. In the worst cases, the lack of shareholders at the NGO parent may translate into a disregard for economic performance that influences how it runs the MFI. Unfortunately, this was the case in Colombia where, in pursuit of its own aims and the maximization of its own income to cover operating deficits of its new initiatives, Corposol pushed for the expansion of services and the explosion of clients at Finansol.

The lack of management autonomy at Finansol aggravated this state of affairs. But even if there had been a will to oppose Corposol’s initiatives, the structural relationship between the two would have made it difficult to intercede. One direct result of this structural flaw was the dramatic distortion of the lending methodology. Under pressure from Corposol to increase clients, the credit officers allowed larger loans for longer terms, without the credit history from sequential lending. Even worse, management allowed loans to be refinanced to circumvent the provisioning requirements, solving a short-term problem, but creating the conditions for the future crisis. These resulting problems underline the fact that MFIs cannot relax standards under pressure to grow.
Given the CAMEL’s importance in mobilizing the Board of Finansol, it is clear that the application of such an analytical review even a few months earlier might have made a significant difference. This underscores the conclusion that an effective quality-control instrument, applied on a regular basis, is one of the best safeguards against this kind of institutional deterioration. In addition, the importance of such specialized reviews is heightened by the realization that neither external audits by prestigious accounting firms, nor the supervision of banking regulators, are sufficient assurance that an alarm system will be tripped, either at all (in the case of the faulty audit) or early enough (in the case of the Superintendency of Banks).

This case was adapted from a presentation given by ACCION International in Washington, DC, 1996.

Recommended readings:


Towards Greater Efficiency and Productivity
V Towards Greater Efficiency and Productivity

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Towards Greater Efficiency and Productivity

The last set of modules in this manual focuses on two critical issues for managers who want to make microfinance work: efficiency and productivity. In the quest to improve performance, there are no issues more important than these.

Improvements in efficiency and productivity make it possible for MFIs to achieve both their social and commercial objectives. Indeed, MFIs that increase their efficiency or productivity can improve any of the six degrees of outreach. By doing more with less, they create “resource savings” that can be used to reach poorer clients in more remote communities, provide additional services, lower the cost of existing services, and/or improve institutional sustainability. MFIs also put themselves in a better position for growth – more capable of leveraging scarce resources, accessing capital, satisfying regulators and staying ahead of the competition.

To introduce the concepts of efficiency and productivity, and to provide background for the issues discussed in the remainder of the manual, this module answers five questions:

1. What are efficiency and productivity?
2. How can inefficiency be identified?
3. What are the causes of inefficiency?
4. How can efficiency and productivity be improved?

18.1 What are Efficiency and Productivity?

Efficiency is a measure of how well an institution utilizes available resources (inputs) to maximize results (outputs), or as Brand (2000) says, to get “more bang for your buck”. In microfinance, the two primary inputs are human resources and financial resources, which are then used to achieve specific outputs, such as the number and value of loans, the number of depositors and, most importantly, income. In this module, efficiency refers to the use of financial resources while productivity refers to human resources.

Efficiency and productivity are measured using various ratios of outputs (numerator) per input (denominator), summarized in Table 18.1. In calculating efficiency ratios, the most commonly used denominators are (1) gross loan portfolio, (2) performing assets, and (3) average total assets. Most MFIs use the average gross loan portfolio because they calculate other ratios using this same denominator. However, there are strong arguments for using perform-
ing assets,\textsuperscript{11} which is the standard for the banking industry, or average total assets, which is the most easily measured of the three.

Average total assets is a more relevant denominator for financial intermediaries — MFIs that manage savings as well as loans — because they have many costs associated with their savings activities. If one looks at all their costs relative to the loan portfolio, the financial intermediary would be at a disadvantage in comparison with an organization that is only involved in lending.

Regardless, an MFI should be consistent in its use of denominator. To simplify the presentation, the gross loan portfolio is used below; however, the asterisk (*) in the denominator of several ratios indicates that average total assets could be used.

For productivity ratios, MFIs must also decide if they wish to use the number of personnel or number of loan officers as their denominator. The purpose for considering loan officers as a separate category is that they are usually involved directly in revenue-generating tasks (i.e., making and collecting loans), whereas other personnel are not. However, the use of total personnel in productivity calculations recognizes that loan officers cannot do their jobs without the support of others. Due to significant variations in lending methodologies, the number of loans per total personnel is a more effective comparison between institutions.

When using these ratios, or any ratio for that matter, it is important that the numerator and denominator come from the same period of time. The source data reflect either a stock or a flow. Stock data comes from a point in time, for example “at the end of the month” or the “at end of the fiscal year”. Flow data comes from a period of time, for example “a quarter” or “for 2004”. Consequently, ratios that involve flow data use the average for the period in the denominator.

\textsuperscript{11} Performing assets include the net loan portfolio and investments; non-performing assets include buildings, equipment, etc.
Table 18.1 Efficiency and Productivity Ratios

<table>
<thead>
<tr>
<th>Measure</th>
<th>Ratio</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Operating expense ratio</td>
<td>Operating expense</td>
<td>Includes all administrative and personnel expenses, and is the most commonly used efficiency indicator. Care must be taken when using this ratio to compare MFIs because institutions that provide smaller loans will compare unfavourably to others, even though they may be serving their target market efficiently. MFIs that offer savings and other services will compare unfavourably to credit-only organizations if gross loan portfolio is used as the denominator; therefore, average total assets are a more appropriate denominator for financial intermediaries.</td>
</tr>
<tr>
<td>2. Cost per borrower or client</td>
<td>Operating expense</td>
<td>Provides a meaningful measure of efficiency for an MFI, allowing it to determine the average cost of maintaining an active borrower or client. MFIs may choose to substitute number of active loans as the denominator to see cost per active loan outstanding. It is also useful to compare operating expense to GNP per capita to assess the MFI’s efficiency in the local context. Because these indicators count clients rather than amounts, they have the advantage of not prejudicing MFIs that offer smaller loans and savings accounts.</td>
</tr>
<tr>
<td>3. Staff productivity</td>
<td>Number of active borrowers</td>
<td>Measures the average caseload of each loan officer. This is a common ratio, but is difficult to compare across MFIs as their definitions of loan officer differ, and because the workload for different types of loans varies significantly.</td>
</tr>
<tr>
<td></td>
<td>Number of loan officers</td>
<td>Measures the productivity of the MFI’s total human resources in managing clients who have an outstanding loan balance and are thereby contributing to the financial revenue of the MFI. Alternatively, the MFI may wish to measure the overall productivity of the MFI’s personnel in terms of managing clients, including borrowers, savers, and other clients. This ratio is the most useful ratio for comparing MFIs.</td>
</tr>
<tr>
<td>4. Personnel Allocation Ratio</td>
<td>Number of Loan Officers</td>
<td>Measures what percentage of an MFI’s employees is focused on the activity that generates most of the income for an MFI: lending.</td>
</tr>
<tr>
<td>5. Client retention ratio</td>
<td>Number of follow-up loans issued (last 12 months)</td>
<td>As discussed in Module 9, MFIs need to monitor client retention to ensure that they are not experiencing dropout problems that would undermine efficiency.</td>
</tr>
</tbody>
</table>

Note: Expense ratios can be created for nearly any expense account on the income statement. The purpose is to allow the MFI or analyst to track the growth or decline of a particular expense over time or across a group.
18.2 How Can Inefficiency be Identified?

If an MFI can measure its efficiency and productivity, it can design strategies for improving its performance. But how can the MFI determine where it should start? How can it identify the areas in which it is relatively inefficient or unproductive, or where improvements most need to be made?

One way is to break down the operating expense ratio into its component parts, for example to see the share of different expenses to the overall ratio. How much of the costs come from salaries and benefits, rent and utilities, depreciation and so on? However, even when considering the component expenses, it is still hard to know whether those results are good or bad.

Ratios are a message that has to be interpreted. To interpret the message, one has to compare the results from your organization today to something else, a reference point, to know whether your performance is relatively better or worse. There are two common reference points to interpret these ratios, and MFIs should employ both approaches. The first is trend analysis, comparing the performance of the MFI (or the branch or the loan officer) during the current period to the performance in previous periods and to the projections.

The second approach, benchmarking, compares the MFI’s performance to other similar organizations. Trend analysis shows whether an organization is improving or not, whereas benchmarking shows how the MFI compares to its peers. Through benchmarking, an MFI can compare its performance to that of:

- its competitors;
- other MFIs with similar characteristics;
- an average standard for sustainable institutions; and/or
- leading MFIs internationally.

The best resource for benchmarking data is the Microfinance Information Exchange, better known as The MIX.12 The MIX manages the MicroBanking Bulletin, a semi-annual publication that organizes the performance information of leading MFIs into peer groups, based on their size, region and target market. For such a comparison across MFIs to be meaningful, it is necessary to compare apples with apples. Therefore the MIX’s financial analysts standardize the accounts and make adjustments to the data to see the full costs for MFIs that are subsidized or have access to capital at below market rates. When comparing performance ratios to MIX benchmarks, managers should ensure that they are defining the terms and calculating the ratios in the same manner.13

Benchmarking is also commonly used within MFIs, comparing the performance between branches. When doing so, similar peer group arrangements should be considered (if the MFI has enough branches), since it is inappropriate to compare the efficiency between, for example, urban and rural branches, or new and mature branches.

12 See: www.themix.org.

13 For MFIs that send in their data, the MIX analysts will send back a benchmarking report that compares the MFI’s adjusted results to the entire sample of participating institutions and to a peer group of similar institutions based on their region, size and target market.
Towards Greater Efficiency and Productivity

The reason for having so many efficiency and productivity ratios is that each one only gives part of the message (see Box 18.1). For example, the operating expense ratio is the most common measure of efficiency, but it has a bias toward MFIs that have larger loans since it uses average loan portfolio as the denominator – organizations with bigger loans will have a bigger denominator, and therefore a lower efficiency ratio (which means it is more efficient). If an MFI is particularly concerned about serving poorer clients, however, then it should look at the expense ratio in combination with the cost per borrower, which does not have the same bias against small loans.

Box 18.1 Lending Methodology and Efficiency

What about lending methodology? Does group lending produce more efficient operations than individual lending? According to Farrington (2000), MicroRate has found no indication that it does. A look at the three most efficient companies in MicroRate's database reveals a mix: FUCAC (Uruguay) makes individual loans; Genesis (Guatemala) does solidarity, individual and village bank lending; BancoSol (Bolivia) lends mainly to groups. In fact, many loan officers consider the costs of forming and maintaining borrower groups to be quite high. The multiple factors contributing to efficiency make generalizations pointless.

While Farrington's analysis may make sense when looking at individual institutions, when considering efficiency ratios for a couple of hundred MFIs the results look a bit different. Using the table below from the MicroBanking Bulletin (2005), analysis of the operating expense ratio suggests that MFIs with individual lending methodologies are more efficient than their group lending counterparts. This is partly explained by the lower salaries, but the real difference comes from the larger loan sizes. The average outstanding loan for village banking methodologies is just 16.5 per cent of GNI per capita, while at 67.2 per cent, the loan size of individual lenders is more than 400 per cent higher. However, if one considers the cost per loan and the productivity indicator of loans per staff member, then solidarity and village banking programmes appear to be more efficient.

<table>
<thead>
<tr>
<th>Units</th>
<th>Total Expense Ratio</th>
<th>Financial Expense Ratio</th>
<th>Loan Loss Provision Expense Ratio</th>
<th>Operating Expense Ratio</th>
<th>Average Salary/ GNI per Capita</th>
<th>Cost per Loan</th>
<th>Loans per Staff Member</th>
<th>Personnel Allocation Ratio</th>
<th>Average Loan Balance per Borrower/ GNI per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual (n=74)</td>
<td>26.2</td>
<td>5.4</td>
<td>1.2</td>
<td>16.4</td>
<td>5.3</td>
<td>82</td>
<td>102</td>
<td>53.2</td>
<td>45.1</td>
</tr>
<tr>
<td>Individual/Solidarity (n=96)</td>
<td>22.5</td>
<td>6.8</td>
<td>1.7</td>
<td>12.5</td>
<td>4.8</td>
<td>148</td>
<td>83</td>
<td>45.7</td>
<td>67.2</td>
</tr>
<tr>
<td>Village Banking (n=26)</td>
<td>23.4</td>
<td>4.7</td>
<td>1.0</td>
<td>16.6</td>
<td>5.7</td>
<td>93</td>
<td>94</td>
<td>56.7</td>
<td>41.9</td>
</tr>
<tr>
<td>Solidarity (n=35)</td>
<td>31.4</td>
<td>6.2</td>
<td>1.1</td>
<td>20.3</td>
<td>6.0</td>
<td>24</td>
<td>167</td>
<td>61.2</td>
<td>27.1</td>
</tr>
<tr>
<td></td>
<td>40.1</td>
<td>5.2</td>
<td>1.2</td>
<td>33.3</td>
<td>5.5</td>
<td>60</td>
<td>148</td>
<td>57.5</td>
<td>16.5</td>
</tr>
</tbody>
</table>

Note 1: When considering staff expenses across countries, it is useful to look at them in relationship to gross national income per capita to see if they are relatively higher or lower than the national average.
18.3 What are the Causes of Inefficiency?

This section briefly considers two ways of thinking about the causes of inefficiency. The first part looks at the issue from an historical perspective across the industry, while the second part considers the operational causes of inefficiency at an institutional level.

**Causes of Inefficiency in the Industry**

**Industry Roots.** Microfinance was born in a development rather than in a commercial context. Consequently, the main goal for many MFIs was to serve as many poor people as possible, not to control costs or maximize productivity. Indeed, the first question that most microfinance practitioners ask each other is: “How many borrowers do you have?” not “What is your efficiency ratio?” or even “What is your return on assets?” For MFIs that have not focused on cost control, inefficiencies and waste are likely to have become embedded in the organization. A different attitude and culture are required to improve efficiency.

**Donor Dependency.** Many MFIs started as donor projects, which means that they inherited a warped cost structure that is difficult to undo. As Farrington (2000) notes, donor dependency has two effects. First, high-cost MFIs shy away from commercial credit because of the additional cost of borrowing funds. Second, donor dependence breeds inefficiency; MFIs assured of funding do not need to subject themselves to the painful quest for efficiency.

**Economies of Scale.** Many small MFIs are serving too few clients to operate efficiently. One must recognize, however, that economies of scale are not a cure-all. Growth may produce cost savings for young MFIs as they build their client base. After they reach a certain size, however, efficiency improvements become drastically reduced — Brand’s (2000) analysis indicates that efficiency gains greatly diminish once an MFI has roughly 12,000 clients; Farrington (2000) estimates that the cut-off point is a loan portfolio of US$4 million. In other words, large MFIs with high cost structures are not going to solve their efficiency problems through growth.

**Non-competitive Environments.** Many programmes operate in monopoly-like conditions where there is little pressure to improve efficiency. Without competition, these organizations have not had to worry about cost control because they could cover — literally and figuratively — their inefficiencies with high interest rates.

**Excessive Credit Risk Controls.** Many efficiency problems stem from methodological rigidity. Some MFIs over-compensate for the fact that they are offering unsecured loans to persons without credit histories by layering on excessive controls for credit risk. This risk-averse approach includes an emphasis on detailed applications, loan use verification and assiduous delinquency management — all of which increase costs to minimize risk. Few MFIs, however, have analysed whether all of these elements are necessary and where efficiency can be improved without sacrificing portfolio quality.
Operational Inefficiency

Within individual institutions, the causes of inefficiency are varied. However, through brainstorming discussions with microfinance managers around the world, some common explanations emerge:

- **Staff problems**: Many managers are quick to point their fingers at lazy or unmotivated staff who waste their time reading the newspaper, lack initiative to find something productive to do during quiet periods and make too many mistakes with their documentation so things take twice as long as they should. Insufficient skills and high turnover are additional staff problems that undermine efficiency.

- **Workflow and communication bottlenecks**: Often things take too long because the person who has to make a decision or who has to approve a request is away on a training course or at a conference, and no one has been delegated authority to accomplish those tasks in the meantime. Bottlenecks also occur when the workflow processes are not designed to accommodate too many applications or receipts all arriving at once. Communication barriers also create inefficiency, especially when employees do not have sufficient or correct information to make decisions.

- **Paperwork**: Even though microfinance is supposed to have simple loan applications and minimal documentation requirements, it is rare to find an employee or a manager who does not complain about having too much paperwork. The higher one is up the ladder, the more papers one has to sign.

- **Lack of investment**: When MFIs do not have sufficient funds to make up-front investments in the tools of employment, such as computers or motorcycles, employees spend hours with manual accounts or waiting for a bus. Insufficient investments in staff training are often a significant problem as well.

- **Delinquency**: Although not generally applicable, MFIs with delinquency problems spend too much time chasing down bad borrowers (or so they say) and not enough time booking new loans.

- **Dropouts**: A major cause for inefficiency in many organizations is that field staff have to keep replacing clients who leave. Although there are no benchmarks for desertion (or retention) ratios, if an MFI has to replace 30 or 40 per cent of its clients every year, it will have difficulty being efficient.

- **Poor planning**: A lack of planning creates inefficiencies at many layers in an MFI: loan officers who do not plan their field visits so they can see as many clients in as short a time as possible; the branch manager who got called to a meeting at the head office at the last moment and did not have time to finish her voluminous paperwork or delegate authority; the finance manager who was not expecting quite so many loan requests this month, and since he cannot find enough funds to meet disbursement demands, the field staff have to spend many hours assuaging disgruntled loan applicants who have to wait until next month for their money.
18.4 How Can Efficiency and Productivity be Improved?

After identifying the specific causes of inefficiency, managers have to find ways to improve the situation. Several efficiency strategies have already been discussed in this manual, such as:

**Product Design.** Specialised products for low-risk borrowers can reward repayment performance and simultaneously lower administrative expenses. Some MFIs offer their best clients automatic renewals without requiring costly and time-consuming evaluations. Parallel loans, usually seasonal, allow clients with strong credit histories and sufficient repayment capacity to obtain additional short-term working capital. Longer loan terms and less frequent repayments can also improve efficiencies as long as they do not adversely affect portfolio quality.

**Customer Loyalty.** Repeat borrowers are considerably less expensive than new borrowers, and they should be less risky as well. Efforts to promote customer loyalty are likely to pay significant dividends in improved productivity and efficiency.

**Institutional Culture.** The organization's ability to motivate staff to achieve prodigious productivity levels depends partly on the institutional culture. If staff members feel that their efforts are contributing to a greater good, if their efforts are appreciated and recognized, they are likely to be more productive. Similarly, the institution’s culture can be used to spot inefficiencies, promote cost controls and support continuous improvements.

**Human Resource Management.** By recruiting the right staff and providing appropriate training, professional development opportunities, compensation and incentives, MFIs can encourage and empower employees to achieve superior levels of productivity, and to design and implement strategies that make their institutions more efficient. Staff members who understand their institution’s objectives, and who tie their own success to that of the institution, have a vested interest in helping their MFI to achieve its goals as quickly and as efficiently as possible.

**Organizational Structure.** The structure of work responsibilities should also contribute to efficiency. For example, some MFIs have loan administrators who manage the portfolios of good clients; these specialized loans officers can handle large volumes of loans. In addition, the geographic allocation of responsibilities to loan officers could lower transit times, improve portfolio monitoring and increase the employee's familiarity with the market.

The rest of this manual covers five additional ways of improving efficiency and productivity:

**Performance Incentives** (Module 19). A well-designed staff incentive scheme is a prerequisite for enhancing an MFI's productivity. In designing performance incentives, it is necessary to consider both financial and non-financial rewards, as well as to consider different sets of incentives for different layers within an MFI's hierarchy.

**New Technologies** (Module 20). MFIs may also generate greater productivity and efficiency through automation, improved access to information and other new technologies. This module looks at the potential efficiency contributions of personal digital assistants (PDAs), smart cards, ATMs, point-of-sale devices, mobile banking, biometrics and credit scoring.

**Managing Change** (Module 21). For MFIs looking to improve their performance, change is inevitable. Something about the way things have been done in the past must change to gener-
are greater efficiency or productivity in the future. Yet not all changes succeed, and the required adjustments are often difficult. This module explores strategies for approaching, directing and facilitating productive change.

**Costing and Pricing** (Module 22). A fundamental part of controlling costs is knowing where the expenses are. The module on costing and pricing covers several ways that MFIs could allocate and analyse their cost structures to identify where greater efficiencies could be wrung.

**Plans, Budgets and Reports** (Module 23). Managers can use planning, budgeting and reporting processes to identify inefficiencies, as well as strategies for improving performance. This module explores how plans, budgets and reports provide tools for defining and communicating performance goals and then tracking performance to ensure those goals are actually met.

**Main Messages**

1. To achieve their outreach objectives — to balance outreach and sustainability — MFIs have to find ways of doing more with less.
2. Use multiple ratios when analysing efficiency and productivity.
3. To interpret ratios effectively, one must compare apples with apples.

**Recommended readings:**

Performance Incentives

Several modules have mentioned the importance of incentives in motivating staff performance and commitment. Because of their critical role in improving productivity and efficiency, staff incentives are discussed here in more detail. This module introduces various incentive scheme options and identifies key characteristics of effective scheme design. Specifically, it addresses the following five topics:

1. Non-financial rewards to motivate performance
2. Introduction to financial incentives
3. Typology of incentive schemes
4. Incentives for different occupational groups
5. Key design issues for financial incentive schemes

19.1 Non-financial Rewards to Motivate Performance

Most of the literature on performance incentives jumps straight into discussions about financial incentives without acknowledging that non-financial incentives can have an even more powerful influence on staff behaviours, attitudes and results. People are not just motivated by their pay cheques (see Box 19.1). Employees may also be interested in challenging work, contributing to a greater good, recognition, opportunities for self-management, opportunities to participate in institutional decision-making, and professional growth.

Box 19.1 Two Perspectives on Motivation

Each human being is motivated by needs. Abraham Maslow’s Hierarchy of Needs and Frederick Herzberg’s Two Factor Theory help to explain how these needs motivate us all.

Maslow’s Hierarchy of Needs, first widely published in 1954, groups human needs into five categories or layers, with those at the bottom taking priority over those at the top (see figure opposite):

- **Physiological** – These are basic biological needs such as air, water, food and sleep. When these are not satisfied we may feel sickness, pain or discomfort which motivates us to get the needs met as soon as possible.
- **Safety** – When our physiological needs are largely taken care of, we become increasingly concerned with finding a safe environment, stability and protection.
- **Belonging** – If we are healthy and safe, the need for belonging becomes stronger. We want to be accepted, needed and loved by family and friends.

The sections of this module that deal with financial incentives were adapted from:

- Holtmann (undated).

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- **Esteem** – There are two types of needs at this level: the need for the respect of others (e.g., status, fame, recognition, dignity) and the need for self-respect (e.g., confidence, competence, achievement, independence).

- **Self-Actualization** – This is the desire to become everything that one is capable of becoming, to maximize one’s potential.

Maslow called the first four layers of the hierarchy “deficit needs”, because you feel a deficit if you don’t have enough of them, but you feel nothing when you have them – they cease to be motivating. The last layer, which consists of “being needs”, is different from the rest because these needs continue to be felt and are likely to become stronger as we “feed” them!

Frederick Herzberg’s Two Factor Theory resembles Maslow’s categorization of deficit and being needs. Herzberg was the first to show that satisfaction and dissatisfaction nearly always arise from different factors, and are not simply opposing reactions to the same factor. He showed that certain factors truly motivate employees to higher performance (“motivators”), whereas others (“hygiene factors”) are necessary to ensure an employee does not become dissatisfied (see figure above). Herzberg’s research proved that people will strive to achieve hygiene needs because they are unhappy without them, but once satisfied the effect soon wears off – satisfaction is temporary. Typical hygiene factors include salary, working conditions, the quality of supervision, job security, status, company policies and administration, as well as interpersonal relations. True motivators were found to be other completely different factors: achievement, recognition, work itself, responsibility, advancement and personal growth.

The work of Maslow and Herzberg has important implications for microfinance managers. First, knowing that employees are motivated by a range of needs, managers can design incentives that satisfy more than just the need for cash. Recognizing that satisfaction and motivation are not synonymous, they can avoid designing schemes that address hygiene factors only, as these will have a limited impact on satisfaction and may not motivate performance at all. From a broader human resource perspective, managers who realize that some needs take precedence over others are in a better position to understand why certain employees’ performance might be lagging behind and to find appropriate ways to support them as different needs take priority at different times.

Source: Adapted from Boeree, 1998 and Chapman, 2005.
Before progressing it is necessary to note that non-financial incentives are not necessarily free. Many of them cost the organization money, but they do not involve a cash payment to employees. An emphasis on non-financial incentives highlights that work is more than just an economic transaction. Non-financial incentives are also likely to give an MFI more bang for its buck, in other words that they may be a more cost-effective means of motivating employees and achieving desired outcomes, which is important for MFIs that already have pretty tight budgets.

At the most basic level, non-financial incentives can be used to recognize the contribution and value of employees, individually or in teams. For example, the staff in top-performing branches might be invited to lunch with the CEO. Outstanding credit officers might receive a day-off voucher, an employee of the month certificate, special acknowledgement in the staff newsletter, or a weekend away for two – incentives that directly benefit employee’s families are especially powerful because they reward families for the sacrifices they make on behalf of the organization.

Non-financial rewards are also used for staff development purposes. For example, the process of conducting performance reviews, setting goals and providing regular feedback on progress are key mechanisms for rewarding good performers, not with cash (although that might also be the case) but with praise and commendations. Staff development opportunities may also be effective rewards, such as training and lateral job moves. Job enrichment could be another form of reward, for example serving as mentors for new employees or participating on task forces. The latter can be particularly useful because they create a mechanism for staff to contribute to the organization’s decision-making process.

An organization’s communication mechanisms can also serve as a non-financial incentive – or rather poor communication can be a powerful disincentive. Employee newsletters, open-door policies, transparent business plans and accessible senior managers are all likely to motivate better performance. Staff support systems may also be important, such as an ombudsperson or social worker, and a toll-free phone number for problem resolution and staff support. It is also useful to give employees a voice in shaping their environment. Through staff surveys, employee advisory committees and open communication channels, MFIs can solicit opinions to improve their reward systems.

In designing non-financial rewards, MFIs should think carefully about staff retention. Indeed, organizations should view their best employees in the same way they view their best customers – once an MFI finds the right people, it should do everything possible to keep them. One strategy is to enhance the benefit package based on longevity. If labour laws allow, MFIs could link seniority to more vacation time, sabbaticals, staff development grants, employee loans or better health insurance plans. Time-linked benefits create incentives for staff members to stay and then, once they reach the milestone, disincentives to leave.

Finally, managers must avoid treating everyone alike. A reward for one person might be a punishment to another. People’s interests and preferences also change over time. Non-financial incentives are particularly helpful in customizing rewards to an individual’s preferences (although of course some people would actually prefer cash!).
19.2 Introduction to Financial Incentives

As important as non-financial incentives are, all other things being equal, the best people will work for the company that pays the most. Yet salaries are already the biggest line item in most MFI’s budgets — can MFIs really afford to pay more? In answering that question, institutions should consider the costs of losing good people, which includes hiring and training replacements, higher loan losses and lower productivity of novice employees, and the threat to the institution’s culture posed by staff turnover. They should also consider the benefits that could be generated by employees who are more motivated, efficient and productive.

To deliver value for an institution, a financial incentive scheme should be designed to achieve some or all of the following goals:

- **Align staff and company goals.** To achieve greater productivity and efficiency, MFIs have to increase management ratios. They cannot afford to pay layers of managers to cajole employees into performing. By aligning staff and corporate goals, financial incentives allow for greater self-management so that employees motivate themselves to achieve higher performance levels. For example, if an MFI is interested in extending outreach to poorer clients, it probably should not reward total portfolio size since that implicitly encourages larger loans.

- **Link institutional costs and performance.** If an organization is extremely productive, then it can afford to compensate staff accordingly; the converse is also true. Financial incentives allow MFIs to pay staff extra when the organization has extra to pay, which reduces institutional risks and smooths profit peaks and troughs.

- **Establish a common understanding of performance expectations.** Financial incentive schemes help to clarify performance expectations and ensure that there is a common understanding throughout the organization — staff realize that they are supposed to do as much as possible with as little as possible, and are rewarded for doing so.

- **Reward strong performers.** At an individual level, financial incentives compensate employees that do the best work.

- **Retain quality staff members.** Financial rewards also play an instrumental role in an organization’s strategy to retain its top performers.

For financial incentive schemes to be effective, they must be accepted by the persons that they affect. If employees do not buy into the scheme, it will not work. An effective incentive scheme therefore needs to be both transparent and fair. **Transparency** means that:

- Staff members understand how it is calculated – the system should not be too complex
- The scheme should contain primarily (or exclusively) objective indicators
- The rules should not be changed arbitrarily

To comply with the **fairness** requirement:

- The goals (or reference standards) set out by the scheme must be attainable for the average performer, at least in the medium term
- Better performers must be rewarded with higher bonuses – and this link between better performance and higher bonuses must be recognized by all staff members
• Everyone must be able to achieve a higher compensation by working better and harder
• The differences between the highest- and lowest-paid employees should be considered reasonable and appropriate

19.3 Typology of Financial Incentive Schemes

This section briefly considers eight different types of financial incentive schemes.

1. Individual incentives. Under an individual incentive mechanism, there is a direct link between individual performance and remuneration. Such incentives can lead to a rather narrow focus, however, and may reduce staff members' intrinsic motivation or could promote unhealthy competition. Furthermore, in some situations it is hard to distinguish properly between individual and group performance, which makes it difficult to design and implement a scheme that is transparent and fair. Individual incentive schemes are often used for credit officers.

2. Team-based incentives. Group incentive schemes are intended to foster staff cohesion, cooperation and teamwork. Among the most important drawbacks of such schemes is the free-riding effect: if the pay-out of the individual depends on the performance of the whole group, there is a huge temptation to reduce the individual contribution. Group incentive schemes are often used for branch-based activities such as savings mobilization.

3. Employee stock ownership plans (ESOPs). ESOPs may be attractive tools for motivating staff members because of their positive symbolic and motivational effect. Through an ESOP, employees become owners, so it should be easier for them to internalize the interests of the firm. Employee ownership can promote staff loyalty, but it comes with the risks associated with an equity stake. For an ESOP to be effective, employees typically purchase shares that the company matches at some predetermined ratio. If the MFI does well, there can be a significant upside to such an investment, but if it does poorly, the employees could see the value of their investment erode – there is a potential to lose money. To date, only a few ESOPs have been implemented in the microfinance industry, typically at the time of conversion from an NGO to a licensed financial institution. In such cases, the ESOP was seen as a useful instrument for broadening the shareholder base and for rewarding staff members for all the time and effort they invested during the early stages of the organization’s development.

4. Profit sharing. In profit-sharing schemes, employees receive annual bonuses that are linked to the company’s profitability. The better the MFI does, the more employees can earn. These schemes increase the sense of identification with the organization, and reduce barriers between employees and managers. To enhance staff retention, longer-term employees can earn a greater share of the profits than recent hires – for example, after three years they receive a quarter share, after five years a half share, and after ten a full share. But profit-sharing schemes also have a number of potential problems. The connection between an individual’s performance and the reward is quite weak. Individuals are not able to exercise direct control over the generation of the annual profit, and free rider problems invariably arise. For field staff, these obstacles can be partly overcome if profit sharing occurs at the branch level rather than for the institution as a whole.
5. **Gain sharing.** In a gain-sharing scheme, employees are tasked with the responsibility to find ways of saving the company money, through cheaper labour, capital, materials and energy, or through increased productivity. The company then shares the benefits of the gains with the employees, usually 50:50.

6. **Pensions.** Pensions and other social security contributions that a firm makes on behalf of its employees can also serve as a financial reward. Since pension benefits and contributions typically rise with tenure, they can help to reduce turnover and attract a more stable workforce. Intelligent benefit plans can also help to increase motivation and reduce turnover at the middle-management level – typically a scarce resource in microfinance.

7. **Special bonuses.** Financial incentives do not have to be based solely on performance formulas. Organizations can also offer special bonuses for individual or branch competition winners, for example the employees with the most innovative ideas. Another example is a “Go for Broke” competition in which employees submit suggestions for things that need to be fixed. Writers of the most original, humorous or best-conceived suggestion win a bonus. Special bonuses could also be used to reward customer service on an individual or group basis. The former could be based on the quality and quantity of comments, written or verbal, which get channelled through the complaint and suggestion system. The latter would reward branch staff based on the results from occasional customer satisfaction surveys. Special bonuses are valuable because they do not become seen as entitlements, and because they can generate more excitement than permanent incentive schemes for less money.

8. **Pay for knowledge.** Under this approach, instead of increasing salaries by promoting people to new positions, employees have the opportunity to increase their base pay by learning to perform a variety of jobs, which makes them more flexible and useful.

### 19.4 Incentives for Different Occupational Groups

Almost all of the attention given to financial incentive schemes focuses on credit officers or field workers. While these employees are an MFI’s revenue generators, they are not the only ones who can benefit from rewards. This section provides a short outline of incentive schemes for different occupational groups.

**Credit Staff**

Bonus schemes for loan officers typically include variables such as portfolio size and the number of loans (in each of these categories, both the stocks and the flows). In addition, there is normally a portfolio quality threshold such as the portfolio at risk (PAR), beyond which no incentives are paid. Other criteria, such as the percentage of new clients, can be added if necessary. Experience with incentive schemes for loan officers suggests that:

- linear systems are better than staged or stepped systems (see Box 19.2)
- the capping of bonuses usually generates negative incentives
- it is better to use reference levels instead of defining maximum performance levels (see Box 19.3)
- arrears should be heavily penalized
For other staff engaged in the credit process (such as support staff, data clerks, supervisors), it is advisable to align their incentives directly to those of the loan officers by paying them a certain ratio of the total incentive package received by the loan officers.

Box 19.2 Staged Schemes versus Linear Schemes

A significant percentage of incentive schemes encountered in practice are built around stages, which serve as triggers that are used to decide whether a bonus will be paid or what the bonus will be. For example, in an MFI that pays its loan officers a monthly bonus based on their “portfolio at risk”, bonuses might be awarded according to the schedule below.

The main argument in favour of staged schemes is their simplicity. A small table sends out a simple and easily understandable message to those who are affected by the scheme: “This is what we would like you to do”. There is no need to perform any complex calculations, and changes to the scheme can be introduced and communicated easily. But the virtue of simplicity can also become a disadvantage. Credit officers under this structure are likely to maintain PAR levels of just under 2 per cent but not much lower, since they would not receive any additional compensation for the extra work that they invariably would incur to achieve a lower PAR. Under a staged scheme such as this, staff members are tempted to maintain their performance close to whichever particular stage they find attainable.

One solution to this problem would be to introduce more stages, but each additional stage reduces the scheme’s simplicity. Thus, many institutions prefer to use a linear scheme instead. Linear schemes are based on a simple formula, such as $B = a \times X$, where $B$ is the amount of bonus earned; “$a$” is some output measure, for instance the number of loans granted; and could be a monetary value, such as US$2 for every loan disbursed. If a loan officer disburses 20 loans in the relevant period (e.g., one month), she will thus earn a bonus of US$40.

$$B = (\text{US}$2/\text{loan disbursed} \times 20 \text{ loans}) = \text{US}$40$$

With a linear system, even very small changes in the output of staff members have a perceptible economic impact for them. Therefore, employees have an incentive to improve their performance at all times, and not just whenever they are close to reaching a new stage. However, depending on the formula chosen, linear schemes can be difficult for employees to understand and the signalling function of such schemes might be lost.
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Box 19.3 Reference Performance Levels

Reference performance levels are the main instrument for calibrating bonus formulas and for avoiding excessive bonus payments. Instead of looking for some (actual or hypothetical) "best" possible output level, an MFI looks at what it considers to be a "solid" level of performance. For instance, for experienced loan officers engaged in individual lending one might find that it is reasonable to expect a monthly output of 50 loans, an outstanding portfolio consisting of 400 loans, and a portfolio at risk of 2 per cent. These values could be plugged into a bonus formula as base values against which we compare the real output of any given loan officer. Depending on whether individual performance levels are above or below the reference values, the corresponding bonuses would be higher or lower than the "reference bonus".

Staff Engaged in Deposit Mobilization

Deposit mobilization poses a number of challenges for incentive scheme design. Unlike credit delivery, it is difficult to identify individual contributions to savings promotion, so accountability becomes a problem. At the same time, there are substantial benefits from teamwork in deposit mobilization, so incentive schemes should ideally encourage cooperation between team members.

An appropriate incentive scheme for deposit mobilization would be team based with a monthly or quarterly payout to immediately reward good efforts. It could include variables such as: a) net increase in number of accounts, to prevent a focus only on new accounts without regard to good service to existing customers; and b) the outstanding balance of deposits at the end of the period. The group bonus could either be paid out to the individuals according to their base salary or be divided equally to foster an equitable team spirit.

These incentive schemes can usefully be combined with regular tournaments between branches. Such branch competitions would measure performance on a number of variables and then reward the best branches, the most improved branches or the steadiest performers.

Middle Management

Branch managers and other middle managers are probably the scarcest resource in microfinance. Given the special role of this occupational group in guiding a network of decentralized branch operations, it is surprising that most incentive schemes for middle managers are unimaginative, if they exist at all.

Because middle managers engage in longer-term planning, it is not appropriate to provide them with the same short-term incentives as the loan officers. Indeed, there is a good reason for paying decent base salaries and for a reduced bonus component in the total compensation package — but there is a role for a variable, performance-related element.

To address the operational role of branch managers, part of their incentives should be linked to their subordinates’ performance by paying managers a percentage of the total bonuses received by their staff members. Besides giving a special reward to the managers of larger branches, this arrangement also encourages supervisors to manage to the incentive
Managers should be able to help staff understand how much they might benefit if they issue one more loan or collect one more repayment, and then assist loan officers to achieve those goals.

For their management role, branch managers should earn a profit-sharing component based on branch profits. Middle managers have a considerable impact on overall profitability, so they should be given incentives to control costs and stimulate greater productivity. Additional goals might include market share, growth, and other items that are typically defined in the branch business plans. Finally, a subjective assessment could be added to account for soft skills such as human resources management, to which bottom-up performance reviews could contribute.

Quarterly or semi-annual payouts would be most appropriate. Managers need to focus on two different time horizons simultaneously. Optimizing branch performance requires careful planning over the medium term, while output maximization in branch retail operations is a short-term goal. Quarterly or semi-annual payouts are a compromise that avoids an undue emphasis of either of these goals.

Top Management

Incentive schemes for top microfinance managers are even less prevalent than for middle managers. One explanation may be that CEOs are supposed to engage in long-term planning and the formulation of strategies, which are tasks that are ill-suited for standard incentive schemes. Besides, the performance of senior managers is difficult to measure. Nevertheless, some organizations have begun to design incentive schemes for their top managers.

Typically, the weight of the bonus in total executive compensation would be more modest, for instance 10 to 20 per cent of total pay, and payouts would be made once per year. It is hoped that the future will bring more data and models for the performance-related compensation of senior managers in MFIs, as well as for board members.

There is certainly not a universal appreciation of incentive schemes. Some MFIs, such as Prodem in Bolivia, have eliminated individual incentives because they felt that it undermined the institutional culture. Research on incentives suggests that it is wise to move cautiously and to monitor the effects continuously (see Box 19.4).

Box 19.4 What the Sceptics Say about Incentives

Is it necessarily true that people will do a better job if they have been promised some sort of incentive? Some critics argue that it is not. In a Harvard Business Review article entitled, "Why Incentive Plans Cannot Work", Alfie Kohn maintains that "Rewards actually undermine the very processes that they are intended to enhance." He puts forward six reasons for why rewards fail:

1) Rewards rupture relationships. The surest way to destroy cooperation and, therefore, organizational excellence, is to force people to compete for rewards or recognition, or to rank them against each other. For each person who wins, there are many others who carry with them the feeling of having lost, and the more these awards are publicised through memos, newsletters, etc., the more detrimental their impact can be.
2) **Rewards ignore reasons.** To solve problems in the workplace, managers must understand what caused them. Yet relying on incentives to boost productivity does nothing to address possible underlying problems and bring about meaningful change. Often managers use incentive systems as a substitute for giving workers what they need to do a good job (e.g., useful feedback, social support, the room for self-determination).

3) **Rewards punish.** Identifying people doing something right and rewarding them for it is not very different from catching people doing something wrong and threatening to punish them if they ever do it again. By making rewards contingent on certain behaviour, managers manipulate their subordinates, and that experience of being controlled is likely to assume a punitive quality over time.

4) **Pay is not a motivator.** There is no firm basis for the assumption that paying people more will encourage them to do better work or even, in the long run, more work. Year after year employees are asked what motivates them, and year after year they reply: a sense of accomplishment in performing their work, recognition from peers and top management, career advancement, management support, and (typically fifth or sixth on the list) pay.

5) **Rewards discourage risk-taking.** Whenever people are encouraged to think about what they will get for engaging in a task, they become less inclined to take risks or explore possibilities. If you tell people that their income will depend on their productivity or performance rating, they will focus on those numbers. Sometimes they will manipulate the completion of tasks or even engage in patently unethical and illegal behaviour just to get the numbers.

6) **Rewards undermine interest.** The more a manager stresses what an employee can earn for good work, the less interested that employee will be in the work itself. If the goal is excellence, no artificial incentive can ever match the power of intrinsic motivation.

Here's what some of Kohn's critics had to say in response to his arguments:

- "Rewards reinforce a win-win environment. The objective of an incentive plan is not to ‘control or manipulate’ as Kohn intends. It is to provide focus and reward improved performance. Reward plans work when they are properly designed and supported." ~ L. Dennis Kozlowski

- "The problem is not that incentives can't work; it's that they work all too well. What Kohn says is absolutely true: if teamwork and compensation are desired, and the incentive plan rewards only individual results, then the plan will generate counterproductive results. However, a well-designed incentive plan that rewards team productivity not only will avoid such unproductive behaviour but also will induce employee cooperation." ~ Donita S. Walters

- The question is not, "How should we design our incentive system in order to obtain a desired behaviour?" The more important question is, "What role, if any, should incentive compensation play?" ~ Andrew M. Lebby

*Source: Adapted from Kohn, 1993.*
19.5 Key Design Issues for Financial Incentive Schemes

For MFIs prepared to implement or redesign a performance-based incentive scheme, the following design issues will need to be addressed or considered:

- **Timing.** In general, new staff members should only be eligible to participate in a financial incentive scheme once they have received sufficient training, six months or so after joining the organization. Before that, they should just receive a fixed (trainee) salary.

- **Simplicity.** Key indicators in the incentive scheme must be limited to those few factors that really matter. No more than five, and preferably fewer, variables should be selected. In microfinance, portfolio size and quality are obvious choices, but for senior management institutional factors such as profitability, number of clients and staff turnover may also be considered.

- **Avoiding entitlements.** The incentive payout will not motivate performance if it is construed by the staff members as an entitlement. There must be a clear understanding that the payout is entirely dependent on the performance of the individual (or group) during the period for which the bonus is awarded. The incentive formula should be elastic — i.e., it should react strongly to changes in output — so staff members will receive different bonuses from month to month, which reduces the risk of an entitlement mentality.

- **Weight of bonus in total remuneration.** It is important to avoid the extremes. If the variable portion of the monthly or quarterly salary is too large, it would create too much uncertainty for employees. As a consequence, extreme risk seekers would be attracted to the job, which is obviously not desirable for MFIs. On the other hand, if the potential incentive is too small, the bonus system will not influence the behaviour of the staff members, which is also undesirable. In practice, the weight of the bonuses for credit officers should range anywhere from 20 to 50 per cent of total compensation in effective incentive schemes.

- **No more merit adjustments to base salary.** Since the financial incentive scheme serves as the primary variable component of an organization's compensation package, its introduction means that the base salaries of persons at the same level in the organization should be roughly the same.

- **Relevance.** Incentives should reward people for issues that are within their span of control and for a behaviour that they can directly affect.

- **Realistic goals.** The targets set must be achievable and measurable. It is no use to select a variable that everyone agrees is very important, like customer service, but no one knows how to measure, or for targets to be set so high that they cannot be reached.

- **Not an expense.** A well-designed incentive scheme should contribute to profitability; it should not be considered an expense. Incentives should lead to stronger performance; the resulting financial surplus is then shared between the organization and the employees who contributed to it. If an incentive scheme does not pay for itself, it is poorly designed.

- **Tailor-made.** Incentive schemes must be fully integrated into the organization, which means that they are adapted to the MFI's culture, clientele, products and processes. One size does not fit all.
Adjust as needed. All incentive mechanisms should be reviewed regularly by management to understand: a) To what are incentives actually encouraging people to pay attention? and b) What are they actually encouraging people to do? Even the most carefully designed scheme is likely to have some unexpected and perhaps undesirable side effects. In addition, MFIs operate in dynamic environments, which necessitates changes to their operations and products. Invariably, such changes will also have effects on the incentive schemes. Adjustable incentive schemes also allow MFIs to reward current priorities – this year the organization may be suffering from repayment problems, but next year growth might be a priority.

### Main Messages

1. Non-financial incentives can be even more powerful than financial ones.
2. Incentives can promote or undermine your culture.
3. The ultimate purpose of incentives is to promote self-management.
4. Loan officers are not the only ones who can benefit from incentives. Incentives can motivate performance at all levels of the institution.
5. An incentive scheme must be both transparent and fair.

For additional information, see:

Microfinance institutions need to find cost-effective ways to serve the large, low-income market. Because MFIs only reach a small percentage of possible clients, the question of how to cost-effectively expand outreach is of paramount significance. Technology represents a possible solution to speed up services, increase output, and broaden or deepen access.

New technologies, which are redefining the financial service industry, present significant opportunities for microfinance. Some MFIs — even ones that serve the poorest clients — already use technology effectively. Other MFIs, however, are reluctant to apply new technologies. ASA in Bangladesh, one of the most efficient MFIs in the world, relies on simple systems and calculations, primarily done manually. So technology is not for everyone — at least not yet.

Since technology is expensive, and MFIs want to reduce costs, why choose automation? The two most important reasons to automate are to increase efficiency and to improve customer satisfaction. New technologies can yield efficiency improvements through streamlined systems, the reduction of errors and lower labour costs. They can also expedite service delivery and offer customers more flexibility and convenience. In addition, technology has tremendous potential for enabling MFIs to extend their reach into more challenging environments, such as rural or conflict-affected areas, where security risks, poor infrastructure or low population density have previously made service delivery unsustainable.

This module answers the following four questions:

1. What new technologies are relevant for MFIs?
2. What are the advantages of new technologies?
3. What are the disadvantages of new technologies?
4. How can an MFI make new technologies work?

20.1 What New Technologies are Relevant for MFIs?

Leading MFIs have been experimenting with new technologies for more than a decade. Learning from their experiences, this section summarizes how the following technologies might benefit microfinance institutions:

- Personal digital assistants (PDAs)
- Smart cards and credit cards
- Automated teller machines (ATMs)
- Point-of-sale (POS) devices

This module was adapted from:

Towards Greater Efficiency and Productivity

- Cell phone-based (mobile) banking
- Biometrics
- Interactive voice response (IVR)
- Credit scoring technologies
- Telecommunications and the Internet

**Personal Digital Assistants**

As illustrated in Box 20.1, personal digital assistants (PDAs) allow a loan officer to bring the MFI's information system into the field. A PDA is a small computer with limited memory that can download a loan officer's daily information requirements. Run on batteries, PDAs can support loan analysis software, employee timesheets and mathematical functions, all of which reduce risks associated with computational errors and the manual transfer of data from one ledger to the next.

Perhaps most importantly, PDAs allow loan officers to conduct automated loan analysis in the field using a decision tree to reach credit decisions. Most appropriate for individual lending methodologies, loan officers can use PDAs to disburse loans in one day instead of having to make a separate trip to disburse funds after a lengthy analysis at the branch. The time savings present an opportunity to sell products and services to other potential customers and, ultimately, to increase productivity.

A PDA is not a stand-alone efficiency solution. The technology relies on access to customer information, so successful implementation requires integration with the MFI's central management information system. Full integration also allows loan officers to generate credit reports and other statements directly from PDA-based software. In sum, the PDA streamlines the loan officer's job by concentrating customer and market data in one small device that has the capability to manage and analyse that data.

**Box 20.1 MFI Experiences with PDA Technology**

The use of PDAs has spread since 1999, when Compartamos and FinComun, both in Mexico, first implemented the technology. MFI satisfaction with PDAs has varied and has generated many lessons about the conditions under which the technology can be viable. Snapshots of several MFIs' experiences are provided below.

**ADOPÉM** in the Dominican Republic recorded dramatic improvements. Client retention improved significantly, and the number of days between application and disbursement dropped from five days to two. Expenses for paperwork dropped by 60 per cent and data entry expenses dropped by 50 per cent. Loan officer caseloads and other productivity measures increased by about 35 per cent.

In Mexico, **Compartamos** suspended its use of PDAs after deciding that it had higher priorities and acknowledging that the technology had not operated smoothly. Management believes that it may have implemented PDAs too early, when the software development tools were not mature enough. They also had difficulties with the interface between the PDAs and their MIS, a problem echoed by other MFIs.

(cont'd)
SKS Microfinance in India implemented PDAs to record transaction data during group meetings. After saving only about five minutes per client-centre meeting (a 10–12 per cent improvement), SKS discontinued use of the PDAs. SKS’s management believes the tool has reduced the scope for error and fraud, but has not been able to quantify this impact. Electronic transfer of data improved the timeliness of information available to management, but because SKS already had a sophisticated MIS, the time improvements were not dramatic.

At Banco Solidario in Ecuador and BanGente in Venezuela, ACCION’s PortaCredit programme enabled loan officers to disburse a new loan in nearly half the time it took using the traditional methodology. Branch managers have more complete and accurate information that facilitates the loan approval process and decreases the time spent searching and waiting for missing data. In addition, significant savings have been generated with respect to non-salary operational costs. BanGente reported savings of up to 20 per cent due to the elimination of office supplies such as paper, copiers, toner and file folders.

At SafeSave in Bangladesh, the direct expense per PDA transaction was estimated to be at least as much as paper and manual data entry, but internal control and service gains during the pilot test were expected to make the technology worthwhile. By having door-to-door collectors use Palm Pilots for transaction recording, SafeSave eliminated three to four hours per day of data processing and reduced the number of mistakes in recording transactions to one-tenth the frequency inherent in paper-based systems, thus allowing staff to spend more time with clients and reduce wait times in branches. The technology also made it possible to cut loan processing time in half (from two days to one), and increased adherence to product rules by preventing violation transactions. Further expansion will depend, among other factors, on the institution’s capacity to properly maintain the technology.


Smart Cards and Credit Cards

A smart card looks like an ordinary credit or debit card, but a microchip replaces (or sometimes complements) the readable magnetic strip. Because a microchip can hold up to 800 times the information of a magnetic strip, the smart card can simultaneously manage account information, personal information (e.g., health, insurance, personal identification via biometrics) and consumer information (e.g., membership and loyalty clubs, buying patterns). It can also store currency and function as a debit card and/or credit card. One important advantage of smart cards compared with other card-based technologies is that they can conduct transactions entirely offline, so full-time telephone or internet connectivity is not required.

The smart card’s ability to manage consumer information holds many long-term advantages for MFIs. Currently, MFIs use smart cards as “electronic passbooks” that hold customer account information, as off-line purchasing cards, or as a more secure version of an ATM card. Over time, the card can build a store of buying patterns to create a profile of customers, and this information can lead to new product development.

If smart card technology is not readily available or affordable, credit cards provide an alternative that reduces administrative work for the institution. For example, instead of applying
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for a new business loan of US$1000 every three months, a borrower with a solid repayment history could have a credit card with a US$500 monthly limit (i.e., a US$500 monthly credit line) that allows her to make business purchases and eliminates the need for a loan officer to frequently process loan applications.

Interest calculations and delinquency penalties are automatically computed and added to each month’s balance. For microfinance, this product offers credit that is more tailored to the customer’s needs than standard loans because the customer decides when to make use of the credit line, how much to access at a time, and how quickly to complete repayment. At any point in time, the customer can choose whether to repay the entire balance, just the minimum amount for that month (often about 5 per cent of the credit line), or something in between.

For example, if business is booming in January, the borrower can pay off his entire balance of US$375 (he didn’t use his entire available balance of US$500) and avoid all interest charges. If business is slow, he can decide to only pay US$250 of the US$375 that he spent on his credit card, and pay interest on the remaining US$125. But if business is bad, he can decide to only pay US$20, which is five per cent of his entire available balance of US$500, and pay interest on the remainder. Besides providing greater efficiency for the institution, credit cards offer customers increased flexibility.

Automated Teller Machines

An automated teller machine (ATM) holds cash in bills from which a user can withdraw based either on the current value of his or her account, or on credit. The ATM is equipped with a computer screen, a touch pad, and an electronic card scanner to complete transactions. The user must possess a smart card or debit card, and the ATM reader scans a magnetic strip on the card to identify the cardholder, and then asks for the correct personal identification number (PIN) to access his or her account.

The user can make a variety of transactions, including withdrawing and depositing funds, checking account balances, and transferring money from one account to another (e.g., from a savings account into a checking account, or from a checking account into a loan account). To withdraw funds, the user keys in the amount of currency to be withdrawn, and the ATM discharges the currency. To deposit funds, the user keys in the amount to be deposited, and the machine accepts the funds in a special envelope, to be processed later by a human teller.

The benefit of an ATM is that tellers do not have to be present for the transaction to take place, which reduces employee costs and increases hours of operation. Also, ATMs can operate away from a branch, so in a city where there is only one branch in the centre of town, customers who live on the outskirts can access a more conveniently located ATM.

ATMs introduce several practical challenges, however:

- Buildings may have to be modified to accommodate the machines.
- ATMs need to be protected physically, particularly for 24-hour availability.
- Cards and PINs need secure administrative procedures to protect against internal and external fraud.
- ATMs require maintenance and trouble-shooting services by reliable support companies.
• Cash replenishment requires security, set schedules and correctly denominated currency.
• Options to help illiterate clients may need to be designed (see Box 20.2 for an example of how one MFI met this challenge).
• Unless smart cards are used, the machines will have to be connected to the MFI’s database at all times, which will require reliable communications infrastructure.

**Box 20.2 Three Examples of Microfinance ATMs**

Serving 43,000 clients who live mostly in rural or semi-urban settings, Prodem FFP has installed 20 Smart Automatic Teller Machines (SATMs) inside its branches. These SATMs are unusual in that they incorporate fingerprint readers for client verification rather than use personal identification number (PIN) technology. They also use voice instructions in three languages to assist illiterate or semi-literate users. The touch screen display is colour-coded to help customers follow the verbal instructions (e.g., blue button for withdrawals, yellow for account inquiries). Prodem has saved about US$800,000 per year in Internet access charges by using smart cards instead of cards with magnetic strips, which require real-time connection. Smart cards also reduce the risk of fraud at Prodem’s central office because only the cards carry the client’s latest financial data. For Prodem FFP, the primary benefit of the ATM network was greater convenience for customers and increased deposit mobilization.

BancoADEMI partnered with A Toda Hora (ATH), an electronic funds transfer service provider that operates a network of 1,000 ATMs. Other banks own the ATMs supported by ATH, but cardholders of BancoADEMI’s debit card can use any ATM in the system. Clients pay a charge of about US$0.20 per transaction, which is shared by the ATM owner and ATH. BancoADEMI purchased and installed only one ATM in its largest office in order to learn more about ATM operations, but its partnership with ATH enabled it to offer its clients 24-hour access to funds via a wide network of locations, as well as more personalized service during business hours since staff spent less time on routine deposit-taking and balance-checking activities.

With more than 110,000 customers after only four years of operation, MEB Kosovo (now ProCredit Bank) turned to ATMs to help its overburdened network of seven branches. With little time to conduct research, it contracted a system integrator, Compass Plus of Russia, to design and implement an ATM network to support its rocketing client demand and provide 24-hour service. Since regional communications infrastructure was unreliable, MEB elected to use wireless connections to its central processing servers. It also installed ATM wall units rather than stand-alone models for greater security.

*Source: Adapted from Whelan, 2005.*

**Point-of-Sale Devices**

Point-of-Sale (POS) devices are part of broader electronic payments networks that may include ATMs and Internet-based systems, and facilitate the exchange of electronic value (see Box 20.3 for one example of a large-scale network that is under development for the microfinance industry).
Whenever customers use debit or credit cards to make payments to vendors, they are using a POS device. This requires no handling of cash by the customer or the retail outlet, although POS devices can be used to facilitate cash transfers as well. For example, a retailer may provide a customer with cash after receiving confirmation from the POS device that the customer’s transfer of funds from her bank account to the retailer’s bank account is complete. The POS device identifies and authenticates the customer and authorizes the transaction, but the cash counting, handling and storage are the responsibility of the retailer.

Using this approach, financial institutions could outsource a large number of routine banking transactions to retail outlets, reducing crowds in branches and freeing branch staff for more personalized tasks. It takes some effort to set up, mainly because the financial institution must ensure that the retailer is properly handling cash on its behalf, but it offers significant value to customers, who can transact at more convenient times and places. To be successful, of course, the partnership must also provide value to the retailer, either through a transaction fee or through profits generated by customers who purchase items from the retailer in addition to making their financial transactions.

Thus far, MFI experiments with POS devices have followed the approach described above. However, there is a “full-service” approach that is also being considered by some, which would provide the most convenience for poor people because it would bring the full range of banking services to retail or postal outlets that may be nearer to them. In addition to providing basic cash withdrawal and deposit services, the full-service model would permit customers to open new accounts and apply for loans from the retail agent as well. The processing, appraisal and monitoring of the loan would be done by the MFI.

**Box 20.3 A Data Transaction Backbone for the Microfinance Industry**

In August 2002, a consortium of eight institutions (the Hewlett-Packard Company, Accion International, Bizcredit, FINCA International, Grameen Technology Center, Freedom from Hunger, Global eChange and PRIDE Africa) came together to determine how technology could be applied to achieve a breakthrough in the scale of microfinance services. The team envisioned an end-to-end system that would create a link for microfinance clients to the formal financial sector, providing easier and more affordable points of access for customers. In addition, the system would provide timely and accurate transaction data for microfinance institutions, which would enable improved risk management, market segmentation and new product development.

The concept of a “Data Transaction Backbone” for the microfinance industry emerged which would support 100 million to 250 million customers. This processing backbone, similar to the credit card industry today, would allow microfinance transactions to be captured anywhere and transmitted to back-end systems, such as microfinance institutions’ MIS, central switches, credit reference bureaus, and other financial system and services.

In the two and a half years since the consortium was formed, the team has built and pilot-tested the first component of the Data Transaction Backbone, which is known as the Remote Transaction System or RTS. The RTS was developed specifically for the unique business needs of microfinance institutions and rural environments where there is limited infrastructure. The RTS solution utilizes smart cards, point-of-sale devices, a specialized software application for the POS devices, a transaction server known as the RTS server, and connectors to the microfinance institutions’ accounting and general ledger systems.
The RTS solution is currently enabled to process loan payments, as well as savings deposits, withdrawals and transfers. The solution leverages wireless connectivity to transmit transactions from the POS device to the RTS server, then local Internet access to the MIS application. The solution operates in either off-line or online modes. In the off-line mode, transactions are bundled and sent through in a single batch, decreasing the amount of time it takes to complete the transaction. In online mode, the solution confirms account balances prior to authorizing a transaction.

From January 2004 through March 2005, the RTS was piloted in Uganda in three MFIs. At Uganda Microfinance Union (UMU), one of the pilot MFIs, the RTS solution was tested with independent third-party agents who act as "human ATMs" or virtual extensions of UMU’s business providing financial services to UMU clients. The two current agents are local merchants who have some daily financial liquidity through their business operations. Each agent has a POS device and a special agent smart card, and transactions are handled predominately in an online mode. UMU clients travel to the agent where they perform financial transactions, all of which are captured electronically through the POS device. Cash is exchanged between the agent and the client depending on the type of financial transaction. Maximum and minimum limits are built into the system as they are in an ATM system to control the amount of money that can be withdrawn on a given account in a day.

When a transaction occurs, the agent is actually distributing and collecting cash, and a corresponding electronic cash transaction is executed at the microfinance institution. Client and agent accounts are debited and credited as the transaction requires. Since this is done within the financial institution, no clearing house authority or functionality is required. At the end of the day, all the transactions still on the POS device are uploaded to the RTS back-end through the cellular network. Since the agents are also UMU clients, funds are reconciled nightly through UMU accounting procedures. The management information system handles the transaction similar to a teller transaction.

Source: Adapted from Firpo, 2005.

Cell Phone-based (Mobile) Banking

One of the most recent technology developments for microfinance is mobile banking - using a mobile phone to execute financial transactions. In many developing countries, where mobile phone ownership is high and cellular phone networks have broad and ever-expanding coverage, mobile banking may prove to be an extremely efficient financial service delivery mechanism. It could help MFIs overcome poor transportation infrastructure and the security risks associated with the physical movement of cash. It could also drastically reduce the need for physical branch premises.

Using mobile technology, Ms A could give Mr B a cash payment; Mr B would then debit his bank account and credit Ms A’s account by communicating with his bank through his mobile phone. This simple transaction would eliminate the need for Ms A to physically make a trip to the bank or ATM to deposit cash. As another example of the potential utility of the technology for microfinance, consider how mobile banking could alleviate the security concerns previously associated with informal saving mechanisms. Clients may feel more comfortable handing over their deposit (or loan repayment) to an MFI representative who has come to
Towards Greater Efficiency and Productivity

their marketplace if they receive a text message on their cell phone confirming that the bank account in question has been instantly credited.

Mobile payment solutions are already operating in Zambia, South Africa and the Philippines, and are currently being tested in several other environments. The service provided by one South African company, Wizzit, allows users to make account transfers and balance enquiries using their cell phones, withdraw cash at a variety of retail outlets and ATMs using their debit cards, and deposit funds at any of the Post Office's 2,600 branches or ABSA's 800 branches. In the Philippines, one cellular phone company uses mobile banking to provide remittance services (see Box 20.4).

Box 20.4 Using Mobile Banking to Provide Remittances in the Philippines

In 1998, the largest mobile phone company in the Philippines, Smart Communications, introduced Smart Money, an electronic wallet account that allows Smart subscribers to make financial transactions through their cell phones. In 2004, it began to use the account to offer an SMS-based remittance service. Filipinos who work overseas can file their remittances at any of Smart's remittance partners, including Travelex Money Transfer, Dax, CBN Grupo and others. The remittance partner then sends a text message to the recipient in the Philippines, informing him or her of the transfer. The transfer is automatically reflected in the recipient's Smart mobile account, and the funds can be accessed immediately using a Smart Money card at cash machines across the country. If the recipient does not have a Smart Money card, he or she can pick up the money at any Smart office nationwide or at any of Smart's partners: McDonald's, SM malls, Tambunting pawn shops, SeaOil gas stations and, soon, 7-Eleven convenience stores. To make the service secure, the identities of both the sending and receiving parties are verified at both ends of the remittance process.

Source: Adapted from Conde, 2004.

Biometrics

Biometrics technology measures an individual's unique physical or behavioural characteristics, such as fingerprints, facial features or voice pattern to recognize and confirm identity. Although the technology is new, growing awareness of the importance of data security is steadily increasing its adoption. For some organizations, low-cost biometric solutions may be more convenient and secure than passwords and PINs. Fingerprint recognition, for example, can replace a 4-digit PIN with the equivalent of a 300-digit PIN.

The general purpose of biometric technologies is to capture information at an enrollment stage to compare at a later verification stage. In the capture process, software assigns values to a biometric image and stores these values in a template that requires far less storage than the image itself. During verification, when the client initiates a transaction, the system scans the client's biometric (e.g. retinal image, fingerprint, etc.), matches this scan against the stored template, and approves or rejects it. It sends this result to the business software to either pro-
ceed with or halt the client’s transaction. A secure audit trail is also recorded for each match attempt.

Biometrics could be an option for any organization that uses physical cards, documents, passwords or identification numbers to secure data stored in electronic format on a computer or ATM. Since biometric applications can be simple-off-the-shelf packages that are installed to restrict staff access to systems or files, the technology is available to almost any computerized MFI. However, institutions that wish to use biometrics technology to safeguard individual banking transactions across their network will need to invest in more extensive implementation.

Table 20.1 compares biometrics technologies and suggests why fingerprint technology is among the most commonly used applications.

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Fingerprint</th>
<th>Hand geometry</th>
<th>Retina</th>
<th>Iris</th>
<th>Face</th>
<th>Signature</th>
<th>Voice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ease of use</td>
<td>High</td>
<td>High</td>
<td>Low</td>
<td>Medium</td>
<td>Medium</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Reasons for errors</td>
<td>Dryness, dirt, age</td>
<td>Hand injury, age</td>
<td>Glasses</td>
<td>Poor lighting</td>
<td>Lighting, age, glasses, hair</td>
<td>Changing signatures</td>
<td>Noise, colds, weather</td>
</tr>
<tr>
<td>Accuracy</td>
<td>High</td>
<td>High</td>
<td>Very high</td>
<td>Very high</td>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>User Acceptance</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Required Security Level</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
<td>Very high</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Long-term Stability</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
</tr>
</tbody>
</table>


**Interactive Voice Response**

Interactive voice response (IVR) technology lets callers request information from, or conduct business with, an automated system by speaking into a telephone or inputting information through its keypad. The caller will hear a recorded voice providing information rather than a live attendant. In a microfinance institution, the recorded voice might instruct the caller to press “1” to learn about products, “2” to find the nearest branch location, or “3” to listen to account information. If she presses “3”, she will be asked to enter her account number and password (or PIN), after which the voice system could provide her loan account balance, next payment due, due date or recent transaction history. The client may be charged the cost of a local telephone call, or may dial-in for free if the MFI installs a toll-free access number.
Using this system, clients can quickly retrieve information without traveling to the MFI’s premises and waiting in line. The technology may be a viable solution for MFIs that seek to enhance customer service and reduce the bottlenecks that are caused when many clients request simple information from staff at branch offices (see Box 20.5). An investment in IVR technology would only be cost-effective for institutions that have a fairly large number of clients who have access to telephones and are comfortable with electronic technology. A management information system that includes a regularly updated, centralized database is a basic requirement because clients will need to retrieve accurate, current information through the IVR system. Some institutions may elect not to consider IVR because they value the frequent face-to-face interaction between branch staff and clients more than gains in efficiency through an automated voice system.

Box 20.5 Testing IVR in Peru

In 2002, EDYPEME Edyficar, a Peruvian MFI, implemented a pilot IVR system called EDYFONO, which was hosted by Voxiva, Inc. Within four months of launching the new service, Edyficar had received 1,500 calls per month, but only about 50 per cent of those calls were clients accessing account information. The other calls were from people seeking more information about Edyficar’s services and a significant percentage of these calls came from outside the geographic regions where Edyficar operates. If these inquiries had been made inside its branches, they would have increased Edyficar’s operating costs without providing immediate benefits.

Based on the results of the pilot test, Edyficar decided to purchase and install IVR technology in its main offices rather than pay Voxiva to operate it, which would have been more expensive. It could then prepare itself for expanding implementation to its other outlets over time. The main challenge was to create awareness and encourage client adoption of a technology that was new to Peru.

To overcome low-literacy levels among clients, Edyficar and Voxiva trained staff how to teach clients to use the service. The MFI conducted client demonstrations in branch office lobbies, and distributed pamphlets and cards with the IVR telephone access number and usage instructions. It also attempted to tie adoption of the technology to the loan cycle by setting a goal of issuing PIN access codes to all clients within one week of new loan disbursement. To reduce the chance of clients forgetting their PIN codes, Edyficar used the client’s government-issued identification document as the basis for the access code. Despite these efforts, Edyficar found that only 15 per cent of all clients that used the system were able to successfully follow instructions. These clients were typically those with higher loan balances and better economic standing.

Source: Adapted from Frederick, 2005.

Credit Scoring Technologies

Credit scoring technologies analyse historical client data, identify links between client characteristics and behaviour, and assume those links will predict how clients will act in the future. Based on an analysis of how an MFI’s clients have behaved, this technology can help an organization make more reliable loan decisions, devise more effective collections strategies, better target marketing efforts and increase client retention.
Scoring technology develops a scorecard that loan officers use by inputting client data to create “scores” that predict client behaviour. Different scorecards can be developed for specific purposes:

- **Credit scoring**: Automates the application approval process by predicting the likelihood that the applicant will develop repayment problems.
- **Visit scoring**: Enables loan officers to prioritize their efforts on clients most likely to respond to the MFI’s marketing effort.
- **Collections scoring**: Maximizes the effectiveness of the arrears recovery process by assigning collection strategies based on the client’s profile.
- **Desertion scoring**: Identifies customers most likely to leave the institution, enabling an MFI to proactively manage its customer relationships.

Of the four types of scorecards, credit scoring has been used most by MFIs. Instead of spending hours poring over client records, or struggling with whether the applicant’s character is conducive to prompt repayments, the loan officer can look at a few key variables, assign them a numeric value and assess the applicant. For example, an MFI’s credit scoring model might find that its borrowers without business experience have been more likely to default on loans. When the MFI’s loan officers use a credit scorecard to evaluate new applications, prospective borrowers without business experience would be given a lower score, making them less likely to qualify for a loan.

Most relevant for individual microlending, a credit scoring model may take into account repayment records, levels of indebtedness, length of time as a customer, net family income, net business income, and whether the applicant rents or owns his house or place of business, among others. For each indicator, the borrower is considered more or less risky depending on how his own behaviour relates to the MFI’s cumulative experience with similar customers over the years. All criteria are statistically weighed and balanced to determine how the customer measures up to the model.

Many MFIs use credit scoring to complement their regular loan assessment process, and still allow room for loan officer input. Automated scoring is possible only when an institution has an electronic customer database. This database can originate from the institution’s own customer records, or the MFI can use records from another database, such as a national credit bureau.

**Telecommunications and the Internet**

The most important benefit of telecommunications is rapid transfer of information. Access to the Internet, at a village kiosk or small business centre, could allow entrepreneurs to find the best financial services for the right price and, with the help of credit scoring, even apply online for a loan. Internet access could also allow farmers to learn weather forecasts that would help them plan their activities over the next several days. Automated bill payment could circumvent the problems inherent with undependable postal services, poor roads and long travel times. Although these applications are not all associated with microfinance delivery, the benefits they could bring to microentrepreneurs are significant.
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Few MFIs have experimented with the Internet as a front-line service delivery mechanism. However, pilot programmes such as the one launched by ICICI Bank in 2004 may suggest interesting options for the future. ICICI is using low-cost ATMs and cash agents to offer remittance and financial literacy services to rural clients in the southern state of Tamil Nadu in India. The ATMs were developed as a joint venture with the Indian Institute of Technology, Madras at a cost of just US$1,365 (compared with the US$25,000 price tag of traditional ATMs) and can provide basic deposit and withdrawal services using smart card technology. Internet kiosks that were already present in local ICICI centres and owned by local entrepreneurs were converted into cash agents and became distributors of remittance funds to the rural public. The kiosk owner maintains a working capital of approximately US$100 and generates daily MIS reports that are reconciled with bank data on a regular basis through the Internet.

20.2 Advantages of New Technologies

The use of new technologies to automate microfinance can yield a variety of benefits to MFIs and their customers. If implemented in a cost-effective and customer-friendly manner, automation can help microfinance systems to work more smoothly and efficiently, and can enhance products and services. The primary objectives most MFIs have for implementing new technologies are to reduce expenses, increase the breadth or depth of outreach, and improve customer satisfaction, which together help the MFI to improve its competitive position.

Increased Efficiency. Automating operations incurs substantial start-up costs in the short run. After a year or more of successful implementation, however, the cost savings can be dramatic. Technology, when successfully put to use, reduces time spent on everyday transactions and enhances communication, which also saves staff time. Extra time allows staff members to serve more customers per day, which can lead to increased income. At SKS, management predicts that with increased outreach due to its smart card system, it will reach financial self-sufficiency in 80 per cent of the time it would have taken otherwise.

Other cost savings are numerous. For example, PDAs can save time for loan officers by reducing the number of field visits that need to be made to complete the loan application and appraisal process. Credit scoring creates efficiencies by reliably categorizing customer risk, thereby cutting loan losses. An ATM can be installed instead of opening up a satellite office in a remote area, which reduces the need for extra infrastructure and staff.

Broader, Deeper Outreach. One of the challenges facing MFIs today is how to expand into difficult-to-reach markets, where the need for microfinance is great and competition is virtually non-existent. New technologies offer a range of innovative delivery channels that can help institutions lower their exposure to security risk, overcome literacy and language challenges, and provide regular service in areas that are frequently cut off by poor infrastructure. The increased efficiency of many new technologies will make it possible to serve isolated, rural and lower population density areas that were previously not sustainable through a bricks and mortar infrastructure that was expensive to build and maintain. The experiences of UMU, ICICI Bank, Wizzit and Smart Communications illustrate that it is becoming increas-
ingly possible for MFIs to provide financial services without having a physical presence in the community.

**Enhance Customer Satisfaction.** Customers at BancoADEMI expressed feelings of empowerment as a result of owning a credit card, while customers at Prodem reportedly felt proud to carry their smart card. ATMs that are open at all times of the day and night bring customer satisfaction as well as increased revenue. POS systems, with their capacity to conduct financial transactions anywhere electricity or solar batteries can keep them powered, together with mobile banking, dramatically increase the options for delivering microfinance in the communities where clients live and work.

The increased convenience, faster service and broader, more secure access facilitated by new technologies can significantly reduce transaction and opportunity costs for clients. Furthermore, if technology enables an MFI to become more efficient and the institution chooses to pass some of its cost savings on to customers, clients' financial costs are also reduced. This combination of improved service and lower costs can have a powerful impact on customer satisfaction and loyalty.

**Give MFIs a Competitive Edge.** Reduced costs, expanded outreach and fewer customer exits result in a competitive edge for institutions that successfully introduce innovative technologies. Promoting the time savings and security features associated with technology grabs attention and can be an effective marketing strategy that improves brand recognition. In general, customers perceive an MFI that is the first in a country to introduce new technology as an innovator and leader in the field. This image leads to greater publicity and attracts new customers. Once this image is created, however, institutions must do their best to uphold it. Technology requires increased controls to ensure that one glitch does not bring down all systems.

### 20.3 Disadvantages of New Technologies

Most people have a natural resistance to change, which can inhibit the introduction of a technology regardless of the potential benefits. For MFIs, fear of automation is most likely based on unfamiliarity and consequent mistrust. Management, staff, and customers may doubt the reliability of technology and the effect of automation on the MFI. Concerns expressed by microfinance practitioners include the fear that automation may:

- harm the loan officer–client relationship;
- cost more than it is worth; and
- scare away customers.

**Disintegrate the Loan Officer–Client Relationship.** When customers visit ATM machines instead of human tellers to withdraw money and repay loans, the personal element of microfinance begins to dissolve. That element — the relationship between loan officer and client — is a powerful force that positively contributes to portfolio quality.

For many institutions, technology does not replace the relationship between field staff and customers. In general, automation merely reduces the time spent servicing each customer; the face-to-face interaction still takes place, which makes it possible to maintain this relationship.
In some instances, technology reduces the time loan officers spend on paperwork, which allows them more time with customers.

The Costs may Outweigh the Benefits. In the short run, the costs of automation will certainly exceed the benefits. The costs for various technologies include: additional phone lines or cable lines; an Internet service provider; software design or modification; purchasing computers and other equipment; purchasing ATMs; smart cards; smart card infrastructure; smart card design; advertising; system upgrades and updates to the interface; a technology consultant, additional security; and training for staff, clients and management. See Table 20.2 for a sample of cost estimates for technologies discussed in this module.

Table 20.2 Sample Costs for Selected New Technologies

<table>
<thead>
<tr>
<th>Technology</th>
<th>Description</th>
</tr>
</thead>
</table>
| PDAs         | • Software costs range from US$20,000 to US$80,000, including development of the PDA application software, the interface between the PDA and the MIS, and adaptations to the MIS necessary to integrate the PDA technology  
• Hardware: from US$100 to US$200 per PDA  
• One MFI reported total cost (hardware, software and technical support) of US$15,000  
• Annual software maintenance costs: US$3,000 to US$10,000 per year |
| Smart Cards  | • Individual cards: from US$4 to US$10 per card (versus US$0.25 to US$0.50 for magnetic strip cards)  
• Each card reader: US$100 to US$300 |
| ATMs         | • Cost per machine ranges from US$1,365 to US$35,000  
• Installation, maintenance and communications costs (estimate unavailable)  
• Cost to join a third-party network: US$2,700 to US$10,000 initial fee plus annual membership fee of US$1,400 to US$2,300 |
| POS devices  | • US$2,300 to US$3,000 per retail outlet to get a device online  
• US$160 per month in connectivity charges |
| Biometrics   | • Basic fingerprint readers: US$60 to US$130  
• Combination fingerprint/card readers: US$100 to US$240 |
| IVR          | • A few thousand dollars for a hosted solution  
• US$10,000 to US$50,000 for an in-house system  
• Additional cost to establish a central system to manage PIN numbers |
| Credit scoring | • Scorecard development: US$10,000 to US$60,000  
• Outsourced project management of scoring implementation: from several thousand dollars to US$50,000 |

If a microfinance institution has carefully implemented a technology by conducting an analysis of current and future needs, a thorough cost assessment, pilot tests and appropriate staff training, it is less likely to experience a money-losing venture. Institutions that cut corners on analysis, testing and training are likely to experience significant difficulties down the road.

New technology expenses need to be carefully considered. Even well-managed technology projects are susceptible to cost overruns and, certainly, other costs may not show up on a standard analysis. Restricted flexibility is one such cost, resulting from the limitations of some
technologies. SKS, for example, had to reduce some flexibility on its loan products, since the handheld computer it used to retain loan information has limited memory capacity. Increased vulnerability to fraud is another potential cost. A full exploration of these potential side effects will minimize surprises and help determine the magnitude of the disadvantages.

**Technology Rejection.** Some microfinance practitioners worry that customers may reject a new technology. In the case of BancoADEMI, some customers did not trust the ATM to give them the correct amount of money and feared that they would not be able to prove a case of machine error. BancoADEMI branch staff found that most customer concerns could be overcome by simply showing the customer how the ATM works.

Nonetheless, MFIs need to allow sufficient transition time to accept a new technology. In some cases, they may need to run parallel systems so that customers have a choice between the old and the new technology. BancoADEMI encourages borrowers to accept the ATM technology by offering higher loan amounts to those who open a debit card account. Although there are some exceptions, most customers can be persuaded when a customer service representative assists them once or twice so they can see how the technology works.

### 20.4 How to Make New Technologies Work for MFIs

New technologies are certainly not for all institutions. Each MFI must examine its systems and operations to determine which technologies may help to solve specific problems, and then determine whether the benefits of automation outweigh the costs. Though technology can offer amazing benefits, adoption should be within the context of an appropriately managed project with clearly defined business strategies.

Over the decades, MFIs have learned that what works for one institution does not necessarily work for another. Although new technologies are exciting and potentially beneficial, there are many factors that must be weighed to assess the appropriateness for each MFI. These factors include: the relative costs; the feasibility of a technology given the environment; available resources; the size and experience of the institution; and the strength of the MFI’s existing back office computer systems.

There is no formula to determine whether a given technology will match the needs of an individual institution, so substantial thought, analysis, and pilot testing are essential. The pioneering work of the first institutions to automate microfinance provides a compass to guide other organizations. Some of the key lessons include:

**A Systematic and Organized Approach.** MFIs make two common mistakes when adopting more automated operations. The first is adding automation to inefficient, poorly managed business operations. The second is choosing a technology before identifying its purpose, and implementing it without thorough analysis of its impact on the institution and its customers.

Ineffective microfinance institutions will not benefit from automation, since poorly designed procedures, when automated, are still inefficient. In the exploratory phase of a transition to greater automation, management should closely scrutinize operations to ensure they are streamlined and fine-tuned. Re-engineering might be a prerequisite. **Process maps** are a
helpful visual aid, and employees can also help by noting to management the parts of their job they believe are merely an administrative hassle and serve no real purpose.

Too often, the attraction of technology captures management’s imagination, and before staff members know it, an expensive gadget has been thrown into operations only to compound existing problems. The issue is sequence. Problems should first be isolated, and then the appropriate technology, if any, should be identified to solve them — not the other way around. Technology should always be selected for a specific purpose, and tested before it is implemented to ensure that it supports and enhances an institution’s business strategy (see Box 20.6).

**Box 20.6 Systematic Approach to New Technologies**

1. Identify problems
2. Identify technologies that may solve the problems
3. Conduct thorough feasibility studies, including projected cost and benefits
4. Assess which, if any, of the available technologies can meet the institution’s needs
5. Pilot test
6. If successful, allow full implementation. If not, adjust and conduct second pilot test

Pilot testing is an essential element of introducing a new technology as it helps isolate and manage problems and flaws. BancoADEMI, for example, introduced its ATM machine in only one branch to test customer acceptance. Compartamos, likewise, introduced PDAs with only a dozen loan officers for the first year to test the technology’s usefulness and ease of operations. Introducing the technology to just a portion of the staff has the additional benefit of “selling” the technology to them, so that once they master it, they can promote it to their peers. Implementation will be smoother and faster if employees are supportive of the new technology, and understand its benefits and limitations.

**Economic Efficiency.** Technology may save an institution thousands of dollars, but it can also drain time and resources. One Asian MFI invested in computers for every office employee, only to return each computer months later after finding that the time savings were insufficient to make a difference in operational efficiency. In that case, a pilot test would have revealed the inadequacies of automation, saving substantial time and energy.

Cost projections require a systematic approach. A thorough analysis includes staff training costs, advertisements, technical assistance and all the start-up materials required by the technology, which can be numerous and expensive. Implementing the technology may also create knock-on effects, such as changes to the MIS, which are often more costly than anticipated.

Although technology may eliminate the need for some lower-level staff positions, which saves money, some extra positions may be needed for control (e.g., a night security guard or a technology director). A thorough cost analysis may expose many costly details, making the designated technology ineffective as an efficiency-builder. However, ruling out a certain
technology at present does not mean that it will not be useful in the future. For example, today's thorough customer database may enable credit scoring at a later date.

A Commitment to Flexibility. Technology is a dynamic force, and constant inventions promise new efficiencies through automation for years to come. A new technology today may be obsolete in five years. Management must keep track of and understand the changing face of technology to be resilient to its changes and receptive to its possibilities.

Staff must also be flexible. Employees who fear or shy away from new technologies may impede overall institutional acceptance and may encourage distrust of technology on the part of customers. Management can facilitate staff acceptance by providing training on the importance and benefits of technology.

As customers learn to trust technology, they will be more open to other advancements. Through complaint and suggestion feedback loops, staff can report common problems that customers face as they learn to accept new technologies. Management can then fashion a response to common problems by posting notices on branch bulletin boards or sending informational flyers to customers. (To put a monetary value on this fear of technology, some US banks now charge a fee to use a human teller, but using an ATM is free.)

For maximum benefit, the MFI as a whole should stand behind new technologies once they are fully launched. Customers will accept change gradually, and less than complete commitment from staff will slow this process.

Partnerships. The introduction of a new technology presents numerous opportunities for collaborating with technology service providers and other MFIs to spread the risk and cost associated with launching the new technology, to generate sufficient scale to make the technology cost-effective and to mobilize the varied skill sets required to successfully implement the technology. As suggested by many of the case studies presented above, an MFI could partner with a wide range of players including application or transaction service providers, retail merchants, government departments, communications companies and other financial institutions.

In microfinance to date, very few technology solutions have been successfully implemented without the assistance of a partnership, while some of the most innovative solutions have been successful precisely because of the combination of players that came together to create the solution. In addition to the RTS, ICICI Bank and Smart Communications examples already mentioned, there are many more successful partnerships, for example:

- In Senegal, AfriCap (a specialized investment fund for MFIs), FERLO (an application service provider) and ByteTech (an electronic payment system specialist) have developed an electronic payment platform that can be used by all MFIs in Senegal for a subscription fee.
- In India, BASIX is delivering a smart card-based loan product in rural areas through self-employed individuals who are authorized as local agents to run a BASIXPOT, which consists of a computer with a smart card reader and modem which can capture financial transactions and transfer them to BASIX. The agent disburses loans and collects payments making use of the local bank to withdraw and deposit funds.
- In 2005, No Borders, Inc. (a Nevada-based company) signed an agreement with the Mexican Government's US$300 million PRONAFIM Endowment Fund (which was estab-
lished to provide loans to microentrepreneurs) to deploy a stored value card platform via up to 150 of Mexico’s MFIs. MFI clients will be able to use the cards to receive and repay loans, purchase goods and services, receive international money transfers, and access ATMs and POS terminals.

Regardless of who is involved, the key to a successful partnership is making sure that each partner benefits from the relationship. As MFIs negotiate their technology solutions, they should look for partners with a profitable business model who can articulate how partnership with the MFI will support their business case. This is even more important in technology than many other types of partnership because MFIs will usually need long-term support for their technology solutions – not just an opportunity for experimentation. Partners that perceive long-term benefits of their own are more likely to be willing and able to provide that support.

### Main Messages

1. When properly applied, new technologies can increase efficiency, productivity, outreach and customer satisfaction.

2. First identify the problem to be solved, and then consider the technology to solve it.

3. What works for one institution will not necessarily work for another.

4. Pilot test.

5. Consider the impact of the technology on customers and facilitate an acceptance transition.

6. Poorly designed procedures, once automated, are still inefficient.
Recommended readings:


Managing Change

For MFIs looking to improve their performance, change is inevitable. Something about the way things have been done in the past must change to generate greater efficiency or productivity in the future. Yet not all changes succeed, and the required adjustments are often difficult. So what can be done to manage change in a way that produces positive results?

This module explores strategies for approaching, directing and facilitating productive change. In particular, it addresses the following topics:

1. Four general approaches to business change
2. Selecting the right approach
3. Change challenges
4. An eight-step process for managing organizational change
5. Dealing with resistance

21.1 Four General Approaches to Business Change

To improve efficiency within their organizations, managers typically pursue one of four main approaches to change: 1) gap analysis; 2) continuous improvement; 3) total quality management (TQM); and 4) re-engineering. Each approach is described briefly below.

**Gap Analysis**

*Gap analysis* is the process of comparing an institution’s current performance with its desired performance and then identifying ways to decrease whatever “gap” exists between where it is and where it wants to be. Of the four main approaches to business change, this is the least intrusive and easiest to implement. It can be inspired by ideas received from a variety of sources, such as the suggestion box, informal discussions among staff or formal strategic planning sessions.

Gap analysis assists planning and can be rapidly and locally implemented, but it tends to be isolated and limited to specific tasks or objectives. Thus, although it is commonly used, it is not the lowest risk strategy. Changes in one part of the institution may not be well coordinated with others; optimal alternatives may not be identified; and narrow or short-term solutions may be applied to problems that warrant more significant or long-term investment. If gap analysis is implemented by an individual manager making a personal assessment of the institution’s desired state, it will be less powerful (and riskier) than if it is implemented with reference to a commonly agreed upon “desired state” or if it is discussed among multiple managers. When conducted on a strategic level, gap analysis can result in a decision to employ one of the other business change approaches.

The content of sections 21.1 and 21.4 was adapted from:

- Brand and Gerschick (2000).
Continuous Improvement

Continuous improvement is a way of operating that encourages and supports ongoing innovation of existing business processes to achieve incremental efficiency improvements. Unlike gap analysis, the continuous improvement approach does not require definition of a desired or ideal state. What matters is the ongoing search for better ways of doing things. Efficiencies are usually gained through streamlining, standardizing or eliminating tasks, for example, by creating checklists or designing a computer interface that will automatically print a customer’s name and address on signature documents so that clients do not have to repeatedly supply this information.

What makes this approach challenging is its ongoing nature — effort must be made all the time, not just once or twice. However, precisely because it is an ongoing effort and staff are always looking for ways to improve, the approach tends to be the least risky of the four alternatives. The changes made are usually in line with the current strategy and direction of the organization and they leave basic structures intact. This makes implementation less demanding, less complicated and less stressful than other change approaches. The incremental nature of a continuous improvement approach also allows more employees to participate in the development of modifications, raising overall organizational commitment to the changes implemented.

The greatest risk associated with this approach is that by adopting an incremental approach to change, especially one that is focused on individual units or departments, an institution could embrace a relatively narrow vision of what is possible and fail to recognize the opportunities and/or demands for change at a broader, more strategic level.

Total Quality Management

Total quality management (TQM) is both a management philosophy and a method for achieving efficiency through continuous improvement focused on customer satisfaction. It seeks to prevent problems by doing the right things right the first time. TQM is more holistic than continuous improvement because it focuses on the institution as a whole and requires changes in attitude, systems and work organization, although it is not as overarching as re-engineering because it tends to be consistent with an institution’s existing strategic direction.

Developed initially by Edwards Deming and improved upon by others, TQM typically involves 14 steps that managers can take to implement a total quality management programme, as summarized in Box 21.1. Key components include employee involvement and training, problem-solving teams, statistical methods, long-term goals and thinking, and recognition that the system, not people, produces inefficiencies. Institutions that embrace this approach to change management sometimes do so in the context of ISO 9000 certification (see Box 21.2).
Box 21.1 Deming’s 14 Steps of Total Quality Management

1. Create **constancy of purpose** for continual improvement of products and service, allocating resources to provide for long-range needs rather than short-term profitability, with a plan to be competitive and stay in business.

2. Adopt the **new philosophy**. Management must undergo a transformation and believe in quality products and services.

3. **Cease dependence on mass inspection**. Inspect products and services only enough to identify ways to improve the process.

4. **End practice of lowest tender contracts**. The lowest-priced goods are not always the highest quality; choose a supplier based on its record of improvement and then make a long-term commitment to it.

5. **Improve constantly** and forever every process for planning, production and service. Search continually for problems to improve every activity in the company, to improve quality and productivity, and thus to constantly decrease costs.

6. **Institute on-the-job training** for all, including management, to make better use of every employee. New skills are required to keep up with technological change.

7. **Institute leadership** aimed at helping people do a better job. The responsibility of managers and supervisors must be changed from quantity to quality. Improvement of quality will automatically improve productivity. Management must take immediate action on reports of defects, maintenance requirements, poor tools, fuzzy operational definitions, and all conditions detrimental to quality.

8. **Drive out fear**. People often fear reprisal if they “make waves” at work. Managers need to create an environment where workers can express concerns with confidence.

9. **Break down barriers** between staff areas. Managers should promote teamwork by helping staff in different departments work together. Fostering interrelationships among departments encourages higher quality decision-making.

10. **Eliminate exhortations** for the workforce, such as demanding zero defects and greater productivity, without providing methods. Such exhortations create adversarial relationships; the bulk of the causes of low quality and low productivity belong to the system, and thus lie beyond the power of the workforce.

11. **Eliminate numerical quotas**. Quotas impede quality more than any other working condition; they leave no room for improvement. Workers need the flexibility to give customers the level of service they need.

12. **Permit pride of workmanship**. Remove barriers to pride of workmanship, and give workers respect and feedback about how they are doing their jobs.

13. **Institute a vigorous programme of education and retraining**. With continuous improvement, job descriptions will change. As a result, employees need to be educated and retrained so they will be successful at new job responsibilities.

14. Clearly define top management’s commitment to ever-improving quality and productivity, and their obligation to implement all of these principles. Create a structure in top management that will push every day on the preceding 13 points, and take action in order to accomplish the transformation. Support is not enough; action is required.

*Source: Adapted from Deming, 1986.*
Box 21.2 Certifying a TQM Approach through ISO 9000

International standards have been developed and published by members of the International Organization for Standardization (ISO) since it was founded in 1947. Its members from 132 countries are dedicated to promoting standardization of manufacturing and communication to simplify international trade. Funding is provided through memberships and sales of standards and publications.

More than 2,700 technical committees, subcommittees and working groups develop ISO standards that are later submitted as draft international standards. Once the technical aspects of the standard are agreed upon, the draft of the proposed standard must be approved by two-thirds of those involved in its development, plus 755 of all voting members. The agreed-upon text is then published as an ISO international standard. These voluntary standards are used to ensure that the materials, products, processes and services are suitable for their intended use.

In 1987, the ISO 9000 standards were issued in response to the need for a uniform quality management system; they were revised in 2000 to become ISO 9001. In the context of these standards, "quality" refers to all those features of a product (or service) which are required by the customer. "Quality management" means what the organization does to ensure that its products or services satisfy the customer's quality requirements and comply with any regulations applicable to those products or services. The standards provide guidelines on what institutions should control, but not how they should control.

Companies become certified to this series of standards following a quality system audit by an ISO 9001 accredited certification body, which audits and monitors quality management systems. After the initial certification, the registrar periodically performs surveillance audits to determine whether the company is maintaining and improving its performance as required by the standard.

In many regions, ISO 9000 certification is a prerequisite for trade, but the standards have not yet been used by the microfinance industry, most likely due to the lengthy and costly certification process. However, the Uganda Institute of Bankers and its Microfinance Competence Center achieved certification in 2004 as a strategy for distinguishing themselves in a highly competitive service provider market. Although the process was not easy, it made the organization more confident, increased its efficiency and enabled attitude changes that were necessary for quality services to be delivered. Perhaps it is a tool that quality-focused MFIs (or MFIs looking to attract quality-focused investors) might consider. For more information, see the ISO 9000 section at www.iso.org

Re-engineering

Re-engineering is the radical redesign of an organization's business processes to achieve dramatic improvements in critical measures of performance such as profitability, quality, service or delivery speed. It is about changing course, making discontinuous leaps and maximizing "out-of-the-box" thinking. It often draws upon best practices from unrelated industries and adapts them to the existing situation.

Re-engineering is a type of gap analysis, but it focuses on what could be rather than on what should have been. Its analysis seeks to identify the ideal environment, situation, process or
structure within an organization without being constrained by existing biases, habits or opera-
tional limitations. This vision is then compared to the existing state of affairs and the steps
required to move from the existing state to the envisioned ideal become the basis for the
re-engineering effort.

Of the four business change approaches, re-engineering is the most holistic and ambitious. It
is also, therefore, the riskiest. While the changes that result from other approaches can be
swiftly implemented, re-engineering will implement the greatest amount of change in the
shortest time. This is because it is typically inspired by a crisis or urgent need for change on
multiple fronts simultaneously. Unlike the other business change approaches, re-engineering
is typically driven by some external event or pressure. Most MFIs undertake a re-engineering
effort when they transform from one institutional type to another, or when they move from
manual to computerized operations.

21.2 Selecting the Right Approach

To select an appropriate business change approach, managers must consider the nature of the
change they want to make. This means understanding where their organization is at the
moment, how far it is from where it should be or from where they want it to be and how
urgent it is for the institution to get there. This requires being observant about the external
environment and the MFI's position in it, as well as the health and efficiency of internal opera-
tions.

In general, the larger the change required, the broader its scope and the greater its urgency, the
stronger the argument for re-engineering will be. If a specific, isolated action is desired, then
plans can simply be put in place to implement that action. If slow but steady improvement is
the goal, then a continuous improvement approach makes sense. However, if an MFI wants
to make a strategic shift in the way it does business, reform its culture, or simultaneously and
radically adjust many different processes at once, then a more holistic approach is necessary.

The choice of approach is not necessarily an either/or decision. Institutions may decide to
apply multiple approaches to accomplish their objectives, as did BancoSol, which chose
re-engineering as its primary and initial change approach, but then introduced TQM to
institutionalize the changes wrought under re-engineering (refer to the case study at end of
this module for details).

No serious analysis of how to implement change is possible without first identifying what kind
of change the institution wants to make. A variety of tools and strategies have been presented
in previous chapters that can help managers identify opportunities for improving perform-
ance and decide which should be acted upon with greatest priority. The most useful strate-
gies include:

• An annual strategic planning process — brings a variety of staff together to focus on the
  future
• Periodic performance reviews — can ascertain where performance is weak and what
  needs to be done to strengthen it
- **Customer feedback** – a complaints and suggestions database could pinpoint what clients most want to see changed
- **Market research** – especially focus group discussions
- **Product development committee** – a strategic mechanism for continuous improvement
- **Problem solving teams** – great for identifying possible solutions
- **Process mapping** – a tool that has not yet been discussed but can be very useful for identifying and implementing change efforts (see Box 21.3)

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**Box 21.3 Process Mapping in Practice**

Process mapping is a technique that makes workflows visible. The map itself is a flowchart that shows who does what, with whom, when, for how long and with what resources. It shows how operational decisions are made and the sequence of events.

![Process Mapping Diagram]

The four-tiered version of a process map will contain not only the flowchart, but also a written description of the process, the risks inherent in that process, and the controls that exist to mitigate those risks. This type of map enables efficiency and internal controls to be carefully balanced, to the benefit of the institution and its customers.

Process mapping can be used as a business planning tool, a communication tool and a management tool. To date, MFIs have used it to generate benefits in the following areas:

- **Change Management**: Process and many non-process areas that require change are identified; proposed changes can be analysed and tested prior to institution-wide implementation, thus increasing the chance of success
- **Customer Service and Cost Control**: Service levels can improve and/or costs can be reduced by examining processes for bottlenecks, delays, preventable errors, role ambiguity, duplications, unnecessary handovers, etc., and taking actions to remove these barriers.
- **Human Resource Management**: Process improvements can result in a more efficient or strategic allocation of staff.
- **Staff Performance and Training**: Once process maps clearly define what a process should look like and how long it should take, performance standards can be established and easily monitored.
- **Reduced Documentation**: Most MFIs report significant reductions in documentation as a result of process mapping.
- **Risk Management**: Risks are quickly identified and appropriate responses designed; risk-mitigation tactics can be monitored and assessed.
- **Standardization of Practices**: Process maps act as reference points for day-to-day work; they are easy to refer to, read, and understand.
- **Activity-based Costing**: A detailed understanding of processes facilitates the creation of an appropriate activity dictionary for Activity-based Costing (ABC).
- **Banking and MIS**: Process mapping is a frequent starting point for system audits; MFIs have used the maps to document and improve their disaster recovery procedures.
- **Product Development**: New product procedures can be easily adapted from existing maps.
- **Feedback Loop**: Properly drawn maps identify information flows to and from management, and can guide and improve decision-making.

*Source: Adapted from MicroSave, 2005.*

21.3 Change Challenges

Regardless of the approach taken, change management is not all that different from basic project management. There must be agreement on the nature of the project (i.e., the required change) and an implementation plan specifying the timing, activities, and resources. The plan must be communicated to those who will implement it and they must agree on the way forward. Management must then encourage and enable the project team, review progress, adjust plans as necessary, and inform others about the changes made. When the change is completed, managers should review and report on performance, as well as praise and thank the project team as appropriate.

There is a fundamental difference, however, between a project that asks people to implement something that is familiar and asking them to implement something new or in a new way. The latter requires not only management of the tasks at hand, but also the willingness and ability of those involved to embrace a new approach, concept, or system. Managers must understand the change that needs to be made and facilitate it in a way that others can cope effectively with it.

Interestingly, research shows that it is not the technical aspect of a change which poses the greatest challenge, but rather the social aspect that accompanies it (Goheer, 2005). “New things” are often introduced in an ambiguous way, which can lead to misunderstanding and
feelings of anxiety. Employees wonder what the change will mean for them. What will their jobs and relationships look like after the change? Will they have a job? Will they make mistakes as they learn the new way of doing things and lose their colleagues' respect? Will the change itself succeed or will the effort leave the institution worse off than it was before?

Because change is so unsettling, those who manage it need to find ways of reassuring staff and stabilizing their environment. If managers understand that individuals tend to respond emotionally rather than logically when facing a change, they will be in a better position to identify strategies for helping their employees deal with the change. In her assessment of the stages through which people generally pass as they respond to change, Elizabeth Kubler-Ross (1997) provides a useful tool for discerning where a particular person or group of people may be in their response to change at any particular time (see Figure 21.1).

**Figure 21.1 Stages of Response to Change**

The stages can be briefly described as follows:

1. **Shock** – being overwhelmed; there may be a large mismatch between high expectations and reality
2. **Denial** – ignoring the need for change; pretending that everything will be okay or deciding nothing can be done
3. **Awareness** – realizing that change is necessary, but frustrated about how to deal with it
4. **Incompetence** – feeling incapable of making the change
5. **Acceptance** – letting go of past attitudes and behaviours
6. **Testing** – searching for know-how and meaning in the changing context
7. **Adjustment** – understanding and beginning to “live out” the change
8. **Integration** – being comfortable with the change and making it the norm
Once a manager understands at which stage an individual or team finds itself, he or she can design targeted interventions that respond to the priorities and concerns characteristic of that stage. For example, if a new loan product is being introduced and staff are resisting it because they see no need for the new product, a branch manager might hold a meeting at which a summary of relevant customer complaints and suggestions is presented and explain how the new product will enable the branch to respond to that feedback. The manager may even invite a few clients to the meeting to share their stories about why the old product does not meet their needs. If, however, loan officers are resisting the new product because they do not understand it or feel uncomfortable explaining it to clients, then the manager would be better off organizing product knowledge or marketing training for staff.

Besides the “newness” challenge, there are two other significant challenges that face any change management effort. First, there is the challenge of full implementation. **Partial implementation** is a possibility not only because of resistance to change but also because of success. Small, early achievements may be perceived and celebrated as the achievement of the goal, when in reality integration has not yet occurred and the changes made may soon unravel. Partial implementation can also occur when a decision is made to change something incremental, rather than investing in the larger-scale or more systemic change that is required to really solve the problem or take the institution where it wants to go.

The third main challenge is related to the others—the challenge of mobilizing sufficient management leadership to ensure the change is implemented and sustained. Project management requires a competent coordinator, but change management depends on strong leadership, and the larger the scope of the change the more important this becomes. Successful change management requires leadership that can see the change through its various phases and craft appropriate responses during each phase so as to facilitate movement of a team, unit or institution to the desired conclusion.

### 21.4 An Eight-Step Process for Managing Organizational Change

The most famous set of guidelines for managing organizational change was laid out by John P. Kotter and developed over time. These guidelines build on sound project management principles while stressing the particular challenges of change. They can be used to direct the implementation of any change initiative, but are particularly useful for major change efforts.

**Step 1: Diagnose the problem.**

The first step is to bring key stakeholders together to identify the problem. Why is change needed and where is it needed? Any number of factors might motivate an MFI to believe change is necessary — new leadership, the uncovering of fraud, transformation into a regulated institution, increased competition — but none of these motivators is the MFI’s problem. If clients are leaving for another institution, for example, the problem is not competition; rather, it is the source of customer dissatisfaction with the MFI’s service or product.

MFIs must find the root cause or causes of their unsatisfactory situation. Only then can they begin to examine their operations to improve that reality. Numerous strategies for identifying problems have been discussed in previous modules: market research (Module 5), the measuring of
customer satisfaction (Module 7), feedback loops (modules 1 and 8), and the analysis of efficiency and productivity indicators (Module 18) are just a few of the strategies that can be applied.

Step 2: Establish a sense of urgency.

Once the problem has been diagnosed, someone must create momentum to do something about it. Identifying, or in some cases manufacturing, a sense of urgency is an effective tool for moving people out of complacency and beginning to break down resistance to change. A sense of urgency may be crisis driven, in which case it may require communicating facts not previously disseminated, such as operating losses, low customer satisfaction, high loss rates, or stagnant growth. Alternatively, urgency may be opportunity driven – by the concern that a lack of action will result in the MFI forgoing important opportunities. In either case, key stakeholders must be convinced that business-as-usual is no longer acceptable. They must believe that change is necessary.

Step 3: Form a powerful guiding coalition.

Once change is recognized as necessary, someone needs to lead the process. The assembled team must have sufficient power, credibility and expertise to guide and support the change effort. It need not be a large team, but it should not depend on a sole individual and it must be sufficiently strong and determined to see change through to completion. Leaders must make bold decisions for the good of the institution rather than for personal gain.

When the change being envisioned is major, support will be critical at two levels. The executive leadership (not only the CEO, but also the board of directors and, where relevant, the MFI’s donors) must fully back the change initiative. This includes maintaining morale when employees are let go, providing resources to sustain and implement changes, and enduring the interim upheaval and short-term losses that may result as longer-term goals are sought. Support must also develop among senior and, ultimately, middle managers because they are the ones who will implement the changes. Thus, the more they are involved in early decision-making, the greater is the chance of success.

Step 4: Create a vision of the future.

The next step is to define what kind of change is going to be made and what the future will look like once the change is successfully implemented. This vision of the future should inspire change and assist managers in directing the change effort. A clear and compelling vision will make it easier to develop strategies for achieving the desired change and to coordinate the people involved in it. This latter point is extremely important because the costs of coordinating change can be enormous, especially when many people are involved. As Kotter (1996) writes: “Without a shared sense of direction, interdependent people can end up in constant conflict and non-stop meetings. With a shared vision, they can work with some degree of autonomy and yet not trip over each other.” Managers and employees can figure out for themselves what to do without constantly checking with their supervisor or peers.

A critical element in this vision of the future is a clear definition of what will constitute success. How will staff know whether the change has succeeded? When can they celebrate their
accomplishments? The definition of success is important for at least two reasons. First, it provides clear benchmarks against which progress can be measured. Aggressive yet attainable goals — whether for portfolio size, processing time, assets managed per employee or the accuracy of data input into computers — establish clear objectives for staff. Linking the attainment of those goals to performance evaluations and compensation reinforces their significance and can motivate change.

The definition of success is also important because it specifies an end to what might be a painful process of adjustment. Having a “happy ending” or light at the end of the tunnel upon which to focus can be helpful in maintaining staff morale and commitment to full implementation.

**Step 5: Communicate for buy-in.**

The most critical lever for reducing anxiety about change is communication. Unfortunately, most managers underestimate the gap between their employees and themselves — a gap in vision, in understanding and in expertise. They often believe that their employees understand the organization’s vision and that the level of communication is adequate, while employees frequently complain about a lack of information and are unclear about the vision and how it impacts daily decision-making.

To ensure that staff understand the impetus for change, its importance, and how individual employees connect to and contribute to the future vision, managers must communicate constantly — not just once when the change is first launched. Otherwise, as shown in Box 21.4, messages about the change will easily be overwhelmed by other day-to-day communication.

**Box 21.4 A Failure to Communicate: How a Change Vision Gets Lost in the Clutter**

1. The total amount of communication going to an employee in three months = 2,300,000 words or numbers.

2. The typical communication of a change vision over a period of three months = 13,400 words or numbers (that is, the equivalent of one 30-minute speech, one hour-long meeting, one 600-word article in the firm’s newspaper and one 2,000-word memo).

3. 13,400/2,300,000 = 0.0058. The change vision captures only 0.58 per cent of the communication market share.

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<tr>
<th>Vision Communication</th>
<th>Other Communication</th>
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<td>0.58%</td>
<td>99.42%</td>
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The need for change may be urgent, but the change itself will not be successful unless time is taken for proper consultation and involvement. Managers need to check that people affected by the change agree with or at least understand the need for change, and have an opportunity to influence how it will be managed. If change is forced on people, problems will arise.

When communicating change, managers should recognize the potential negative effect of internal communications. The rumours that swirl about what might be happening are often more severe or troubling than the actual effect of re-engineering. To overcome this grapevine problem at CETZAM in Zambia, the board and senior managers developed a package of materials and a script to explain the organization's course of action. A management representative was then dispatched to each branch so that a presentation about restructuring could be delivered to all employees simultaneously.

Managers must also communicate the day-to-day decisions and the rationale behind those decisions, explain how certain tools or processes will be employed, and announce performance targets as they are set. Managers must communicate the “rules” of the new culture and what is expected from each employee. Each message should be prepared with some care, taking into account the strategies discussed in Modules 1 and 7, especially the need to consider one's audience and to use an appropriate channel. Communication via newsletters, email or other written notices can be helpful, but is extremely weak at developing understanding and handling more sensitive aspects of organizational change. Written communication must be augmented by face-to-face communication, and the modelling of new behaviours and attitudes.

Step 6: Empower broad-based action.

Empowering others to act on a vision is central to the fulfilment of that vision. The guiding coalition will inspire and monitor change, but implementation will almost certainly require the involvement of other staff. The sooner front-office employees, technical experts and middle managers are brought into the process, the better informed decisions will be and the stronger the commitment to and ownership of agreed-upon solutions. If major change is being envisioned, the guiding coalition should organize a broadly based implementation team as soon as possible and make sure that the team has support from senior management.

In empowering others to act, an MFI's value system is an important asset. Successful change programmes connect with staff through strongly held beliefs and principles, and they use this connection as the base from which to change behaviour. Once the future direction has been communicated and others have been invited to help design and implement the plans that will produce change, a manager's main task is the creation of an environment that will make change as easy as possible. Rather than tell employees what to do to achieve the goal, they can act to minimize the obstacles their team will face as they try to implement their own plans. This may include liaising with higher levels of management to ensure that necessary resources

The inclusion of our staff from the very beginning, and in particular the creation of an Employee Share Ownership Program was fundamental to capturing their enthusiasm.

~ In Channy, General Manager
ACLEDA Bank

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are in place at the right time, encouraging non-traditional thinking, and ensuring that specific objectives and action plans are appropriately defined with a fair allocation of responsibilities (see Box 21.5).

<table>
<thead>
<tr>
<th>Box 21.5 Practices that Promote Successful Change</th>
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<tbody>
<tr>
<td>• Start with a deep conviction of what you want changed.</td>
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<tr>
<td>• Know what you want to accomplish and how you will know that you have succeeded.</td>
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<td>• Keep focused on a big outcome, and reach out to the people and groups you need as partners to make this happen.</td>
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<tr>
<td>• Get outside help to augment your internal resources.</td>
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<tr>
<td>• Prepare for a marathon – the bigger the challenge, the longer the effort will take.</td>
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<tr>
<td>• Develop an operational plan with goals, benchmarks and a system of accountability.</td>
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<tr>
<td>• Get the right people in place to implement the plan, and empower them to implement.</td>
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<tr>
<td>• Set up cross-functional teams to gather data and make recommendations.</td>
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<tr>
<td>• As the leader, support your team so that the work can happen.</td>
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<tr>
<td>• Don’t confuse the need to “sell” the change under way with the need to make everyone happy about the change; be ready to manage conflict and resistance.</td>
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<tr>
<td>• Teach new behaviours by example.</td>
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<tr>
<td>• Involve team members in developing solutions to problems that arise.</td>
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*Source: Adapted from Romano, 2001.*

**Step 7: Plan for and create short-term wins.**

Major change efforts such as transformation or re-engineering typically take a long time and thus are implemented in phases. Given the challenges involved in implementing lasting change, it is easy for such an effort to lose momentum after the successful completion of a key stage. Staff and management may be so overwhelmed by or so pleased with the progress to date that they decide enough change has taken place, even though more is either necessary or beneficial.

A lull in momentum is often useful, allowing staff an opportunity to own the new structures and processes implemented, and to celebrate the benefits reaped. To avoid having the lull turn into a premature conclusion, short-term wins and milestones can be deliberately built into the implementation plan and linked to longer-term objectives that reinforce the overall effort. By pacing the breadth, severity and rapidity of change, managers can maintain a longer-term commitment to the change vision. Periodic mini-successes build confidence and morale; provide evidence that the sacrifices are worth it; raise both the credibility and visibility of the change initiative; and make it easier to justify costs. They also deflate resistance and make it harder for people to block further change.
**Step 8: Consolidate improvements and produce more change.**

Short-term wins serve as the basis for even more dramatic changes over the long term. Building on the increased credibility that is gained through early success, managers can move forward more easily, tackling more difficult challenges or taking additional steps to change systems, structures and policies that do not fit the new vision.

As the new vision of the MFI takes hold and as employees realize the benefits of change, internal momentum builds. The culture begins to transform and with this transformation comes enthusiasm for developing new ideas and experimenting with new approaches. The final challenge is to institutionalize the changes taking place and, perhaps, to institutionalize change itself as part of the organization's culture. Through ongoing training, continued efforts to remove obstacles, and the cultivation of a subsequent generation of leadership that believes in the new approach, MFIs can strengthen their ability to manage change and to improve their performance (see Box 21.6).

**Box 21.6 Anchoring Change in your Culture**

Culture is not something that you manipulate easily. Attempts to grab it and twist it into a new shape never work because you can’t grab it. Culture changes only after you have successfully altered people’s actions, after the new behaviour produces some group benefit for a period of time, and after people see the connection between the new actions and the performance improvement. Remember:

- Changes in norms and shared values come last, not first.
- Articulate the connections between new behaviours and organizational success.
- New approaches will not sink in until it is clear that they work and are superior to the old way of doing things.
- Cultural change may involve staff turnover; sometimes the only way to change a culture is to change key people.
- Ensure appropriate leadership development and succession – if promotion processes are not changed to be compatible with the new practices, the old culture will reassert itself.

*Source: Adapted from Kotter, 1996.*

**21.5 Dealing with Resistance**

Many elements in this eight-step framework can help institutions handle resistance to change and produce a positive outcome. For example, managers can establish a sense of urgency, communicate early and often to reduce anxiety, and involve middle managers in the guiding coalition to increase buy-in. They can articulate an inspiring vision of the MFI’s future. They can also break large, potentially intimidating objectives into smaller, more manageable goals and plan for short-term wins that will demonstrate some of the benefits of change. In general,
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it is much more effective to spend time and effort minimizing resistance from the outset, rather than trying to respond to it once it occurs.

One popular strategy for anticipating resistance and deliberately planning to minimize it is known as the “ABCD Approach”. It consists of four elements:

1. **Anticipate objections.** Consider who is likely to offer what objections to the change and then prepare to persuade resisters by citing precedents, providing statistics that illustrate trends, quoting senior management, and showing the resisters how widespread support for the plan is already.

2. **Benefitize.** The “What’s in it for me?” factor can exert a powerful influence on those who need to be won over. List benefits of the change for various individuals and groups within the institution, citing figures whenever possible to substantiate the advantages of change.

3. **Categorize.** Think of all the individuals, departments, groups, schedules, budgets, etc., that need to be considered and taken care of during the change.

4. **Develop plans.** Taking A, B and C into consideration, plan for the introduction and management of change. Remember to involve those who will be affected by the change as this helps to create a more credible and realistic strategy, and builds support for the plan’s implementation.

Other strategies for minimizing resistance have been discussed in previous modules. For example, **pilot testing** can limit the scope of change and allow a more focused application of resources. It can demonstrate feasibility and enable others in the institution to implement change with the benefit of lessons learned through the pilot. **Feedback loops** and open communication channels can reveal resistance early and allow action to be taken while grievances are still small. They might even shed light on what is needed for the resisters to feel comfortable moving forward or be willing to make the change. A **team-based** organizational structure can provide natural support for employees who are trying to learn new things. Finally, if an MFI has embraced **continuous improvement** as part of its culture, then employees will be more accustomed to change and should find it easier to accept and implement. They will have seen the benefits of previous changes and developed skills for coping with new things, which makes them more open to change and more capable of making it happen.

Once change is in process and resistance is encountered, there are fewer options for managing it. However, three general strategies can be employed. First, as mentioned in section 21.3, managers can identify how resisters are responding to change and apply different techniques and **management styles** at different stages of acceptance. For example, if people are resis-

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*Over time, the management style changed from being largely autocratic and command driven in the early 1990s, when the organization needed to be turned around. The autocratic management style made way for a more participative style in the middle to late 1990s, while a more remote style of management, more facilitative than participative, is evident now.*

~ Coetzee, et al. (2002)

"Understanding the Rebirth of Equity Building Society in Kenya"
ing change because they are unclear about how to get started, a charismatic manager could set an example of how the first steps can be taken. If employees are resisting because they feel incapable of adapting to the new environment, training or mentoring could be provided. In this case, a supportive management style would be more appropriate.

Second, managers can use incentives to reward compliance and penalize non-compliance. Even if resisters do not like the change taking place, they may find it in their best interest to go along with it. Once they experience the benefits of a change, they may accept it, or the new behaviour may simply become a habit over time.

Firing staff is the most severe form of penalty and can enable managers to remove resisters, but it is almost always a painful process that can adversely affect the morale of remaining staff. Resistance may continue, but it will go underground and be more difficult to manage. Furthermore, the MFI will have to recruit, hire and train new staff, which consumes additional resources. Staff dismissal makes sense only as a last resort, when the resister has had substantial opportunity and support to change, but has chosen to sabotage the change effort instead.

The third and most important strategy for managing resistance is to effectively communicate with resisters — to listen to what they are saying, understand the root causes of their resistance, and then respond in a way that directly addresses their concerns. As managers apply the communication techniques discussed in Module 1, they should be aware that simply pushing resisters harder will rarely solve the problem. Typically, the more resisters feel pressured, the more they will resist.

Managers will be more effective in dealing with resistance if they try to see things from the resisters’ perspective, and look for ways to understand and weaken the source of the resistance. Towards this end, it is helpful to consider both the real and the psychological losses that resisters may experience as a result of change and try to make up for those losses by gains elsewhere. For example, field staff might fear that they will work themselves out of a job if they successfully implement their MFI’s new computer system. A manager could respond by announcing the new positions or job responsibilities that will be created by the change, or by signing an agreement with employees that commits to staff retention provided certain performance targets are met. The idea is to create concrete benefits that can help offset whatever discomfort the change may create.
Main Messages

1. Identify the root cause of the problem before defining the required change.
2. Communicate a vision for the future that articulates what the change will accomplish.
3. Involve those who will be affected by the change in planning and implementing it.
4. Generate short term wins to demonstrate benefits and build credibility.
5. Cultivate a culture of continuous improvement so that radical change becomes less necessary and employees are better prepared to embrace it when it is required.
6. Strive to minimize resistance before it occurs.

Case Study: The Re-engineering of BancoSol

The Pre Re-engineering Scenario

The year 1999 represented a turning point for BancoSol. The results of a late-1998 marketing study highlighted shifting customer needs, including demands for larger loans and for individual, rather than solidarity, loans. BancoSol’s customer base was further threatened by increased competition from private consumer lenders and commercial banks. Intrigued by the strong profits earned by MFIs, commercial banks moved into the microfinance sector, offering a broad array of products, customer respect (making clients feel “important”) and lower pricing. This market entry had two important effects, creating a crisis for BancoSol:

- Desertion. Competition increased customer choice and expectations regarding service levels. Many of BancoSol’s best customers left, drawn to the aura and attractive pricing of commercial banks and the more client-tailored product of competing MFIs, such as Caja Los Andes, whose individual loans were better suited to BancoSol’s more established customers.

- Over-indebtedness. Many of the foreign financieras (finance companies) seeking to steal market share and earn quick profits engaged in predatory pricing with loose underwriting standards. Clients took on greater debt loads than they could ultimately manage, creating a system-wide increase in defaults. This crisis began after BancoSol initiated its re-engineering process, but it helped build support for the need to change.

To better meet customer needs, improve service and halt desertion, BancoSol embarked on its initial re-engineering project with an emphasis on the efficiency of the branch network. The main goals were to improve loan officer productivity, increase client retention, and reduce the cost to the client.

At the beginning of 1999, BancoSol was organized in a three-tier structure – the headquarters, five regional offices and 48 local branches, with staff complements of 64, 110 and 456, respectively. Of the total staff, 42 per cent were loan officers. Each region operated with a high degree of autonomy and maintained its own set of policies, procedures and forms, with regional office managers reporting directly to the CEO. The
regional office structures — which included a credit officer, a commercialization and marketing officer, and information technology, legal, finance and human resource staff — duplicated components of both the branch structure and the headquarters structure.

Branches were managed by a branch manager and staffed by a marketing and commercialization officer to whom all loan officers reported and an operations officer who oversaw administrative staff. Branch managers' responsibilities included inputting data into the MIS and significant data manipulation for reporting purposes. The high number of direct reports to the regional managers (averaging seven per regional office) and the high number of direct reports to the CEO (eleven) limited both the regional managers' and the CEO's abilities to develop and supervise standardized loan processes. The MIS system was made more complex by the multiple regional formats employed for similar data and processes. Despite a fairly large number of finance staff, little information existed regarding the cost to originate or maintain loans.

Policies and procedures required that loan officers spend a considerable amount of their client interaction at the client's place of business. In mid-1999, however, loan officers typically spent only 20 per cent of their time in the field. Loan officers lacked individual lending authority. The lending authority at the branch level was also limited. Each loan, regardless of size or degree of risk, went through a lengthy review process within the branch and then at the regional level. Renewals followed the same general process as first-time loans. Loan officers were responsible for all collection efforts, which increased in intensity toward month-end, often to the detriment of loan production.

The origination process was unusually taxing on the borrower. Frequently, the step lending methodology implemented years ago to facilitate client financial literacy resulted in loan amounts that were either inadequate or excessive for borrower needs. Worse, prospective clients visited a BancoSol branch four to five times prior to being approved for the loan. Each visit lasted an average of two to three hours, much of which was spent simply waiting to be served. Delinquencies at some branches peaked at 12 to 14 per cent. Although part of this spike was caused by the national credit crisis, delinquency was also the result of non-standardized and inadequate collection procedures.

**The Re-engineering Process**

To initiate the re-engineering process, a multidisciplinary team was created, led by an outside consultant steeped in both microfinance and commercial business practices. Team members were drawn from across the organization and from within and outside the bank. Members included an MIS specialist, the head of BancoSol's organizational development department, a staff person from the national operations department, a loan officer new to the organization (with former banking experience), and a representative from ACCION's consulting staff. All were trained in process re-engineering by the team leader. The team undertook a staged re-engineering process, beginning with a pilot analysis of one region in June 1999; the operations of the remaining regions were reviewed between August 1999 and August 2000.

A thorough review of processes, responsibility allocations and the degree of synergy between skill sets and job requirements was undertaken within each branch and its regions. As is common, the re-engineering team identified multiple factors at work simultaneously that, individually and collectively, were reducing the efficiency of BancoSol's operations. The primary problems identified and solutions implemented at the branch level included reinstating existing policies regarding how much time loan officers spent in the field generating new loans. Rather than spending 80 per cent of their
time in the branch, loan officers were expected to spend 80 per cent of their time in the field. To effect this transition, other measures were required and implemented:

• A three-tier loan approval process was established, empowering loan officers and branch managers to make the majority of credit decisions.

• Perhaps most importantly, the cultural orientation of BancoSol regarding the customer was transformed. The onus historically placed on customers to visit BancoSol multiple times throughout the application process and to wait until loan officers were available to assist them was removed and replaced with a new and more competitive customer service. This orientation, along with the implementation of changes in processing and field/office time allocation, required a reassessment of loan officer skill sets to ensure that they could embrace and implement the changes wrought by the re-engineering process.

• The stepped lending process was, in many cases, replaced by a cash flow approach to loan size determination and the borrower’s capacity to repay, creating a better match between client need and amount disbursed. This alignment, in turn, reduced overall risk levels.

• Greater emphasis was placed on product development, especially the development and delivery of loans to individuals. Underwriting procedures and forms were standardized and streamlined. The extent of financial analysis and the breadth of the information required were narrowed to include only the most essential information. This change in underwriting required modifications in management information systems. Important components of the underwriting process, such as borrower guarantees, were analysed and evaluated for creditworthiness for the first time.

• Responsibilities were shifted to increase reliance upon lower-cost staff and to free loan officers and branch managers to focus on customer procurement and customer service (e.g., administrative staff were given responsibility for data input and report generation).

• Loans were classified according to risk, collections officers installed and collection processes standardized. The highest-risk loans were transferred to collection officers.

• An activity-based costing system was implemented to capture and measure the cost of loan origination and maintenance.

Like all re-engineering processes, however, inculcating these changes — in particular, the cultural change in orientation toward the customer — was not always easy. To further cement the changes, the overall organizational structure was modified. In some instances, it was decided that certain loan officers did not or could not fulfil the new objectives or execute the new policies and procedures. In other situations, senior and middle management were hired from the commercial banking sector to assist in the overall development and implementation of a more efficient, customer-oriented MFI.

To facilitate the transition and ensure the establishment of new routines, key performance indicators were established down to the loan officer level, and supported through the implementation of an incentive scheme that rewarded branches for attaining production thresholds. To sustain the re-engineering, BancoSol implemented a process team, trained by the re-engineering team, to review and analyse processes and procedures on an ongoing basis. Thus, a process of continuous improvement was implemented.
Summary of Results

The results of this first phase of re-engineering are noteworthy given that the effort coincided with a huge competitive and macro-economic crisis in Bolivia. The percentage of individual loans in the portfolio increased from 2 to 35 per cent. The number of days from application to disbursement dropped from a range of 9 to 12, to a range of 2.5 to 7 days, depending on the type of loan. The portfolio managed per loan officer rose 23 per cent, while the number of loans managed per loan officer remained constant. The lending cost to the client was cut drastically, including a reduction in required office visits by one-third.

As encouraging as these results are, however, this phase of re-engineering represents only a first pass at strengthening the organization. BancoSol's re-engineering efforts left the administrative functions of the regional and national offices virtually untouched. Given that these functions constituted 29 per cent of the total bank staff in December 1999, work is now underway to identify additional opportunities for streamlining. The restructuring of the national structure was one of the first steps in initiating this next re-engineering phase. Additionally, the branch structure employed at BancoSol includes 121 administrative staff out of a total branch staff of 439 (in December 1999) responsible for finance, payment processing, MIS maintenance and building maintenance. The replication of this administrative staff at every location represents a significant expense for BancoSol, one that might benefit from greater consolidation and centralization, without a significant impairment in decision-making and customer service.

This case study was adapted from:

- Brand and Gerschick (2000).

For additional information, see:

**22 Costing and Pricing**

To manage an MFI efficiently, managers need to develop a good understanding of their operating costs. How do costs vary according to what products and services are offered? How do changes in the way work is organized affect costs? How do changes in costs affect the prices of products and services?

This module introduces techniques for costing and pricing for microfinance products. It covers the following areas:

1. How costing and pricing can contribute to improving MFI efficiency and productivity
2. The two principal approaches to costing, and their respective advantages and disadvantages
3. Applying costing techniques to arrive at interest rates for loan products using the CGAP formula
4. Product pricing strategies and common pricing mistakes

### 22.1 Costs and Sustainability

In Module 1, the trade-off between cost (charges to clients) and length (profitability and sustainability) was mentioned in relation to Schreiner's (2002) *six degrees of outreach*. Cost in Schreiner's model refers to the level of client charges (as well as the transaction costs), and length refers to how long an MFI will be able to provide financial services to the poor. Higher charges are one way to generate greater profits and ensure sustainability, creating a trade-off between minimizing costs to clients and institutional sustainability. This dilemma can be partly mitigated through raising efficiency and productivity.

Schreiner uses "cost" from the client's perspective, which is different from the way the term "costs" is used in this module. From the MFI's perspective, it is the price of a product that matters. Prices of products depend on the MFI's cost structure. The higher the costs of running an MFI, the higher will be its prices (interest charges, fees, commissions). Unless there are operating subsidies, costs and prices are inextricably linked.

To achieve self-sufficiency, an MFI needs to generate enough income to cover all its expenses, i.e., operating costs, provisions for loan losses, and cost of funds. To ensure long-term sustainability, an MFI needs to generate surpluses for investment in new or expanded services. MFIs therefore price their products not only to cover costs, but also to include a profit margin. Changes in costs feed directly into prices. The implication for managers is that cost control is fundamental for the long-term development and survival of an MFI. To achieve cost control, managers must have a good understanding of their organization's cost structure.

**Understanding MFI Costs**

For many years accountants have sought to devise techniques for allocating costs to products for the purposes of calculating prices. The challenge is to strike the correct balance between accuracy and complexity. To achieve accuracy, costing systems must identify the factors that
relate outputs (products) to inputs (costs). However, these factors can be complex and dynamic, so developing a workable costing model for an MFI requires some degree of compromise between perfect accuracy and practical application.

Costs can be categorized as direct or indirect. **Direct costs** are expenses that are specifically attributable to a particular product or service. For example, the salary of a loan officer is attributable to a loan product. **Indirect costs** relate to the organization as a whole (e.g., governance expenses), or concern two or more products. The challenge for cost accountants is to determine how indirect costs are apportioned between different MFI products for the purpose of carrying out costing and pricing calculations.

Both direct and indirect costs can be further categorized as either fixed or variable. **Fixed costs** remain unchanged for relatively long periods of time, such as office rent and fixed asset depreciation charges. **Variable costs** rise and fall with the level of activity, for example travel expenses to meet with clients.

Some costs are neither completely fixed, nor do they vary smoothly with changes in activity levels, as depicted in Figure 22.1. These costs go up in **steps**. In other words, they are stable until a certain threshold of activity triggers a steep rise in expenses, for example, when a new teller or loan officer is needed because transaction volumes have risen beyond what existing staff can handle, or a new branch office is opened to satisfy a growing demand from clients in a particular district. Step costs are a feature of the cost structure of growing MFIs.

![Figure 22.1 Types of Costs](image)

Because the total costs of an MFI are a mixture of fixed, variable and step costs, the dynamics of cost changes are not uniform. A small change in the volume of transactions may have little or no effect on total costs. Conversely, when a step cost threshold is reached, a marginal change in the transactions volume, or the introduction of a new product line, may trigger a sharp rise in overall costs. Calculating **marginal costs** is another costing tool for management decision-making. For example, it is insightful to examine the effect of a new service or a new branch on the total costs of the MFI.
Budgets

Budgets are the starting point for all costing systems. A budget is a future financial plan that contains details of all costs incurred in operating the MFI, plus all its sources of income. Budgets are generally prepared annually, though they are usually subdivided for monthly or quarterly reporting purposes. Preparing a budget involves calculating the expected expenses and projected income. The process of determining future expenses involves identifying and calculating all the operating costs, the financing costs and costs due to loan losses. The MFI budget is where managers will find a list of expenses to use as a baseline for the product costing exercise.

22.2 Approaches to Product Costing

The two main approaches to product costing are cost allocation and activity-based costing (ABC). Cost allocation organizes costs into categories as they appear in the expense portion of the income statement, while ABC organizes costs by activity as shown in Figure 22.2. Both methodologies then assign costs to individual products, but they often produce different results. Thus, it is important to understand the advantages and disadvantages of each method in order to choose an appropriate approach.

Figure 22.2 Two Approaches to Product Costing

![Loan Product Costs (Cost Allocation)](image1)

<table>
<thead>
<tr>
<th>Staff costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Postage and communications</td>
</tr>
<tr>
<td>Transportation</td>
</tr>
<tr>
<td>Rent and utilities</td>
</tr>
<tr>
<td>Materials</td>
</tr>
<tr>
<td>Maintenance</td>
</tr>
<tr>
<td>Other</td>
</tr>
</tbody>
</table>

![Loan Product Costs (ABC)](image2)

<table>
<thead>
<tr>
<th>Making loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Servicing existing loans</td>
</tr>
<tr>
<td>Handling cash transactions</td>
</tr>
<tr>
<td>Sustaining activities</td>
</tr>
</tbody>
</table>

**Cost Allocation Method**

The simpler approach to costing is the cost allocation method. Costs are distributed between products using the most reliable indicator available. Direct costs are straightforward, simply allocated to the product to which they belong. However, indirect costs need to be apportioned between different products using the fairest method possible. Proxy indicators for “belonging to products” are employed to allocate indirect costs. The most common bases for indirect cost allocation are staff time, portfolio volume, number of transactions and number of clients (Helms and Grace, 2004).

The advantage of the cost allocation method is that it is fairly easy and quick to apply. It can be done without too much research, using a spreadsheet to carry out the calculations. This method is how accountants have traditionally approached costing. Understandably, the basis for allocating indirect costs has always been the topic of much debate, since most methods are chosen on the grounds of simplicity and practicality with less attention to reliability and accuracy. Here lies the disadvantage with the cost allocation method. There is no detailed analysis of cause and effect, so the resulting allocation may not reflect the true relationship between products and costs. Costs calculations are, at best, approximate, and, at worst, inaccurate. Consequently, pricing decisions based on the cost allocation method suffer similar drawbacks.

Table 22.1 illustrates a cost allocation method for an MFI with a single office and two products: saving deposits and microloans. The steps are as follows:

a) A detailed breakdown of costs is extracted from the annual budget
b) Where necessary, budgeted costs are adjusted to reflect any cost changes that are known about since the budget was created
c) Direct costs are allocated to their respective products
d) For indirect costs, the best proxy indicator is selected to reflect the “consumption” of each cost item by the products concerned
e) The indirect costs are allocated to products using the selected indicator
f) The total administrative costs per product are calculated

In this example, the total administrative expense allocated to the savings product is US$23,200, whereas the allocation for loans is US$29,800. These figures can then be used to price each product.
Table 22.1 Illustration of Cost Allocation Method for an MFI with Two Products

<table>
<thead>
<tr>
<th>Type of administrative costs</th>
<th>Budget (US$)</th>
<th>Basis for cost allocation</th>
<th>% ratio</th>
<th>Savings allocation (US$)</th>
<th>Loans allocation (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan officers staff costs</td>
<td>10 000</td>
<td>Direct cost</td>
<td>100% loans</td>
<td></td>
<td>10 000</td>
</tr>
<tr>
<td>Teller staff costs</td>
<td>8 000</td>
<td>Staff time</td>
<td>80% savings 20% loans</td>
<td>6 400</td>
<td>1 600</td>
</tr>
<tr>
<td>Accountant staff costs</td>
<td>3 000</td>
<td>Transactions</td>
<td>80% savings 20% loans</td>
<td>2 400</td>
<td>600</td>
</tr>
<tr>
<td>Secretary staff costs</td>
<td>2 000</td>
<td>Portfolio volume</td>
<td>30% savings 70% loans</td>
<td>600</td>
<td>1 400</td>
</tr>
<tr>
<td>Director staff costs</td>
<td>6 000</td>
<td>Portfolio volume</td>
<td>30% savings 70% loans</td>
<td>1 800</td>
<td>4 200</td>
</tr>
<tr>
<td>Office costs</td>
<td>20 000</td>
<td>No. of clients</td>
<td>50% savings 50% loans</td>
<td>10 000</td>
<td>10 000</td>
</tr>
<tr>
<td>Travel costs</td>
<td>3 000</td>
<td>No. of clients</td>
<td>50% savings 50% loans</td>
<td>1 500</td>
<td>1 500</td>
</tr>
<tr>
<td>Miscellaneous expenses</td>
<td>1 000</td>
<td>No. of clients</td>
<td>50% savings 50% loans</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Total administrative expenses</td>
<td>53 000</td>
<td></td>
<td></td>
<td>23 200</td>
<td>29 800</td>
</tr>
</tbody>
</table>

Activity-based Costing Method

The activity-based costing method is linked to the notion that processes (not products) give rise to costs. The ABC analysis starts by identifying the core processes in an MFI, and the activities that form part of each core process. For example, in a typical MFI, “making loans” would be a core process and the activities might include: a) marketing; b) application preparation; c) screening applications; d) disbursement; e) repayments and f) delinquency management. The units of analysis for costing purposes are the activities inside each core process. The idea is to allocate all the costs of the MFI to a complete list of activities, and then to aggregate these activity costs into process costs.

To relate the costs of different activities to products, the ABC method uses the concept of cost drivers. Cost drivers are actions that are related to products and initiate processes and activities, e.g., a loan application starts the process of making a loan. Since cost drivers are linked to products, this allows costs to be identified with their respective products.

The theory is that by analysing the activities that make up the core processes in an MFI, managers will obtain more accurate information on costs. ABC not only leads to more accurate costing, but also helps managers identify areas where cost efficiency can be improved through re-engineering the way work is carried out.
Activity-based costing requires more information than the cost-allocation method, and hence more research is involved. What are the core processes in the MFI? What are the activities in each core process? How do staff distribute their time between different activities? What non-staff costs arise as a consequence of carrying out each activity? Which actions drive these processes? Which of these cost drivers can be related to which products?

Helms and Grace (2004) identify the following six core processes in a typical MFI:

1. Making loans
2. Servicing existing loans
3. Opening savings deposit accounts
4. Servicing savings deposit accounts
5. Handling cash transactions
6. Sustaining activities

Most of these core processes are client related; however, the sixth one refers to internal functions that require some explanation. Sustaining activities cover all the general management, accounting, reporting, governance and other activities that an MFI must undertake regardless of what products it offers or how many clients it has.

Each core process consists of a series of activities, which need to be costed. These activities are initiated by a specific action, which is the cost driver, and the cost drivers are used to apportion costs to products. The steps in undertaking an activity-based costing exercise are the following:

1. Identify the core processes in the MFI
2. Identify the activities that make up each core process
3. Determine in detail how staff distribute their time between the identified activities
4. To ensure that all staff time is accounted for, include an activity called “general administration” to “mop up” any time not specifically dedicated to the other activities
5. Allocate non-staff costs to activities using staff time as the best proxy of “usage”, or alternatively, if more accurate, select another allocation method
6. Identify the cost drivers that set off the activities inside each core process and can be related to products
7. Use cost drivers to allocate activity costs to products
8. Allocate sustaining activities to products in a manner similar to indirect costs under the cost-allocation method (i.e., using portfolio volume, number of clients, or in proportion to staff time)
Box 22.1 Theoretical Example of Applying Activity-based Costing

The simplicity of the PRIDE model makes it easy to replicate. First, a PRIDE credit officer hosts a community meeting where Enterprise Groups (EGs) of five interested residents are formed. Once ten EGs are created, they join together in a Market Enterprise Committee (MEC). The MEC’s Executive Committee is composed of the chairpersons and secretaries of each EG, and is responsible for electing a three-person management committee to liaise with the PRIDE credit officer.

One week after registration each client begins paying US$2 a week into a Loan Insurance Fund (LIF), which is held as security until they exit the programme. Eight weeks after registration, the first loans of approximately US$100 are made to two members of each EG. Four weeks later, two more members receive their loans. Sixteen weeks after registration, the EG chairpersons receive their loans. Fixed repayments including principal, interest, and LIF contributions are made until the loan is repaid in full. At this time the client is eligible for a larger loan. The first loan must be paid off in 25 weeks, the second in 50 weeks, and each subsequent loan within 100 weeks.

After nine months of successful repayments, the EG chairperson takes over responsibility for all financial transactions and monitors loan repayments, and the frequency of MEC meetings is reduced to once a month.1

There are several core processes evident in the above description, such as: (1) making loans; (2) servicing and monitoring existing loans; (3) servicing savings in the LIF and (4) handling cash transactions.

Under ABC the activities of the credit officer and other staff are categorized under the relevant core processes. For example, under the core process of “making loans”, the following activities can be identified:

- Organizing community meetings
- Forming Enterprise Groups and Market Enterprise Committees
- Liaising with the Management Committees of MECs over loan applications
- Carrying out loan disbursement administration

The next step would be to cost these different activities by reference to how the PRIDE Tanzania’s staff members utilize their time.

Note 1 Pride Tanzania webpage: http://www.bellanet.org/partners/mfn/

Source: Adapted from Helms and Grace, 2004.

Figure 22.3, taken from Helms and Grace (2004), illustrates the differences between cost allocation and activity-based costing. It also highlights the two-stage approach involved in the ABC method.
Figure 22.3 Graphic Depiction of Cost Allocation vs Activity-based Costing (ABC)

**Cost Allocation**

- **Income and Expense**
  - **Allocation Bases**
    - Staff Costs
      - Staff Time Sheet
    - Non-Staff Costs
      - Portfolio Volume
  - **Product Costs**
    - Loan Product #1
    - Loan Product #2
    - Savings Product #1

**Activity-based Costing**

- **Income and Expense**
- **Staff Time Allocation**
- **Activities**
  - Core Process A: # of loan applications
  - Core Process B: # of transactions
  - Core Process C
  - Sustaining Activities
- **Drivers**
- **Product Costs**
  - Loan Product #1
  - Loan Product #2
  - Savings Product #1

*Source: Helms and Grace, 2004.*
Efficiency Gains and Costing Methods

A thorough and well-conducted costing exercise should lead to better insights by managers about how to improve efficiency and reduce costs. For example, according to Brand and Gerschick (2000), recent activity-based costing studies reveal that the costs of lending are concentrated in the repayment process, which marginalizes the cost savings impact of streamlined applications for repeat borrowers. This finding has led many MFIs to reduce the repayment frequency — and hence the costs associated with the repayment activity — for low-risk repeat borrowers.

Activity-based costing is an investment in efficiency improvement, not simply a method for setting product prices. ABC should lead to management action to reduce costs through re-engineering for greater productivity and efficiency. The initial results of an ABC exercise will require adjusting to take account of the cost savings brought about by changes to activities and core processes.

Though ABC is preferred for cost-efficiency reasons, many MFIs continue to use the simpler cost-allocation method for product pricing because ABC requires a time-consuming costing study of work processes. Table 22.2 summaries the advantages and disadvantages of the two methods.

Table 22.2 Advantages and Disadvantages of Costing Methods

<table>
<thead>
<tr>
<th></th>
<th>Cost Allocation</th>
<th>Activity-based Costing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pros</strong></td>
<td>• Fewer steps</td>
<td>• Traces (rather than allocates) costs in a</td>
</tr>
<tr>
<td></td>
<td>• Quicker, simpler and less expensive</td>
<td>cause and effect relationship</td>
</tr>
<tr>
<td></td>
<td>• Consistent with income statement</td>
<td>• Allows management to understand how</td>
</tr>
<tr>
<td></td>
<td>• Can be powerful when used to target</td>
<td>and why costs are incurred</td>
</tr>
<tr>
<td></td>
<td>additional investigations</td>
<td>• Focusses on activities that are meaningful</td>
</tr>
<tr>
<td></td>
<td></td>
<td>to staff and management</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Identifies drivers of costs and the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>circumstances or requirements that</td>
</tr>
<tr>
<td></td>
<td></td>
<td>cause an activity to take longer</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Allows management to focus on where to</td>
</tr>
<tr>
<td></td>
<td></td>
<td>reduce costs through reviewing the key</td>
</tr>
<tr>
<td></td>
<td></td>
<td>points and expensive activities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Helps management better understand</td>
</tr>
<tr>
<td></td>
<td></td>
<td>business processes</td>
</tr>
<tr>
<td><strong>Cons</strong></td>
<td>• Relies on subjective input</td>
<td>• Incorporates an additional step of</td>
</tr>
<tr>
<td></td>
<td>• Simplistically allocates costs</td>
<td>allocating costs to activities</td>
</tr>
<tr>
<td></td>
<td>• Volume-related allocation bases fail to</td>
<td>• Is more complex, time-consuming and</td>
</tr>
<tr>
<td></td>
<td>account for product diversity and</td>
<td>expensive to implement</td>
</tr>
<tr>
<td></td>
<td>overburden &quot;large&quot; products</td>
<td>• Relies on subjective input</td>
</tr>
</tbody>
</table>

Source: Adapted from Helms and Grace, 2001.
22.3 Product Pricing

The CGAP Formula for Microcredit Interest Rates

Many MFIs are established with donor funds, which are given as a grant or loaned at concessionary interest rates. Thus the real cost of funds for a young MFI is normally very low. Loan losses in the early years are also usually low, and well-run MFIs try to maintain the loan loss rate in the range of 1 per cent to 2 per cent of the loan portfolio.

By contrast, with few clients, the administrative expenses expressed as a percentage of the loan portfolio will be very high for new MFIs. As Rosenberg (1996b) points out, economies of scale tend to be mostly captured by MFIs as they grow to reach between 5,000 and 10,000 clients. So growth is important for efficiency and sustainability reasons. CGAP therefore recommends setting interest rates to cover total costs plus an added rate for capitalization (Rosenberg, 1996b).

These are the main elements of the interest rate pricing formula – each expressed as a percentage of the average loan portfolio:

- Cost of funds (CF)
- Operating expense rate (OE)
- Loan loss rate (LL)
- Capitalisation rate (K)
- Investment income rate (II)

The cost of funds refers to the interest that the MFI pays (or would pay) for the funds it uses for lending if it had to raise these funds commercially. It is the market cost of funds, and should always be equal to or higher than the inflation rate so that the real value of the MFI's capital is maintained.

The operating expense rate includes all of the MFI's personnel expenses and administrative expenses divided by the average loan portfolio.

The loan loss rate will be based on past experience concerning unpaid loans. Since loan losses vary from year to year, an average figure should be taken. As with the other elements in the CGAP formula, average loan losses are divided by the average loan portfolio to calculate the loan loss rate.

Well-managed MFIs finance at least part of their growth through retained earnings. The capitalization rate reflects an MFI's profit target for its microcredit products. The budgeted profit on microlending activities is divided by the average loan portfolio to arrive at the capitalization rate.

In the CGAP formula, there is a fifth element called the investment income rate (II). This refers to the amount of income earned by the MFI from its bank deposit accounts and other investments. For MFIs that have substantial investments, the II figure can be significant. It needs to be included in the interest rate calculation to avoid over-charging microcredit clients.
Towards Greater Efficiency and Productivity

CGAP Microcredit Interest Rate Formula

\[ R = \frac{OE + LL + CF + K - II}{1 - LL} \]

Where:
- \( R \) = Effective interest rate
- \( OE \) = Operating expense rate
- \( LL \) = Loan losses rate
- \( CF \) = Cost of funds rate
- \( K \) = Capitalization rate
- \( II \) = Investment income

Source: Rosenberg, 1996.

To give an example, suppose an MFI has the following figures:

- Average loan portfolio: US$ 2,000,000
- Operating expenses: US$ 350,000 per annum
- Average loan losses: US$ 10,000 per annum
- Market cost of funds: US$ 200,000 per annum
- Profit target for microcredit: US$ 100,000 per annum
- Investment income: US$ 20,000 per annum

The five elements for the CGAP formula are:

- \( OE = 350,000 / 2,000,000 = 0.175 \)
- \( LL = 10,000 / 2,000,000 = 0.005 \)
- \( CF = 200,000 / 2,000,000 = 0.1 \)
- \( K = 100,000 / 2,000,000 = 0.05 \)
- \( II = 20,000 / 2,000,000 = 0.01 \)

The effective interest rate “\( R \)” is calculated as follows:

\[ R = \frac{0.175 + 0.005 + 0.1 + 0.05 - 0.01}{1 - 0.005} = 0.32 / 0.995 = 0.32 \text{ (i.e., } 32\%\) \]

The effective interest rate calculation takes into account all of the revenue an MFI should earn from a particular loan product, including interest, fees and any income from the investment of mandatory deposits associated with the loan.

Pricing savings products requires a different approach, although it too has to take into account the costs associated with managing the savings account, as described in Box 22.2.
Box 22.2 Pricing Savings Products

The interest rate paid on deposits is based on the prevailing deposit rates of similar products in similar institutions, the rate of inflation, and market supply and demand. Risk factors such as liquidity risk and interest risk must also be considered based on the time period of deposits. Finally, the costs of providing voluntary savings also influence deposit pricing policies. MFIs incur greater operational costs to administer highly liquid accounts and thus the interest rates are lower. Fixed-term deposits are priced at a higher rate, because the funds are locked in and are not available to the depositor. Thus they are of lower risk to the MFI, and as a result term deposits are a more stable source of funding than demand deposits.

Savings products need to be priced so that the MFI earns a spread between its savings and lending services that enables it to become profitable. Labour and other non-financial costs must be carefully considered when setting deposit rates. However, there are a number of unknowns at the beginning of savings mobilization. For example, a highly liquid savings account that is in high demand can be quite labour-intensive and thus costly, especially if there is a large number of very small accounts.

Source: Adapted from Ledgerwood, 1998.

Pricing Strategies

Product costing is critical to effective pricing, but there is more to pricing than costs alone. The pricing strategy for a microfinance product needs to be coherent with the overall market positioning and marketing strategy of the MFI.

MicroSave (2003) identifies eight pricing strategies that are commonly used by MFIs:

- **Customer-oriented pricing** starts with client perceptions of the relative value of different products and includes higher or lower profit margins according to demand. This sophisticated pricing strategy requires market research.

- **Mark-up pricing** is a common formula in many business sectors, including microfinance. The mark-up is the profit percentage that is added to the costs of a product to determine its price. It is simple to apply and understand, but takes no account of demand factors.

- **Target return pricing** is similar to the CGAP interest rate formula. It works out the profit element of the price by determining a desired target rate of return on the capital employed in the balance sheet of the MFI.

- MFIs that charge higher prices during the initial stages of a new product’s introduction pursue a **skimming the cream** strategy. This may be done to enable an institution recover its initial investment quickly or to restrict demand to a level that the MFI can easily satisfy.

- When the market is highly competitive and the product is not significantly differentiated from competing products, an MFI may simply fix its price at the **competitive level**.

- A **penetration** pricing strategy is appropriate in expanding markets. An MFI will keep its profit margin very low and may temporarily fix prices below the competitive level in order to develop the popularity of its brand and prevent the entry of competitors, especially
while new products are being introduced. Up-to-date market research is necessary to support this strategy, as it may be difficult later to increase the product price.

- Well-established MFIs may need to adopt a pricing strategy to fend off competition. This approach involves pricing products at very attractive rates so as to deter clients from switching to competitors. It may involve offering discounts or other incentives to maintain client numbers.

- A survival pricing strategy is only viable in the short term. The price reflects what an MFI must charge for loans, or offer on deposits, to attract customers. It is the minimum acceptable price to keep the MFI afloat until market conditions improve.

The pricing strategy actually employed will depend on the situation of the market, the objectives of the MFI and the reaction of competitors. Strategies that fix prices below the market level should be applied with extreme caution because they could provoke a price war and result in an unprofitable product.

**Common Pricing Errors**

In the experience of *MicroSave* (2003), pricing is both critical to the life of an MFI and ranked high among the challenges faced by MFI managers, especially those with responsibility for marketing or business strategy. Yet many MFIs do not give sufficient attention to their method and strategy for pricing, and this leads to the common pricing errors described below.

**Error 1:** Competing on price alone. The danger with this approach is that there may always be another MFI that is more efficient and cheaper. Quality of service mixed with competitive pricing is a better strategy.

**Error 2:** Determining prices only on the basis of cost. Costs play a large part in determining prices, but market positioning and the rates charged by competitors are also important.

**Error 3:** Not revising prices when market conditions change. To remain competitive, an MFI’s prices need to respond to changes in demand, supply and, importantly, risk. Yet many institutions build fixed prices into their MIS or print tariff information in their product brochures (instead of producing a separate tariff sheet), and this restricts their ability to adjust prices as necessary. Even institutions that have the ability to make price changes frequently lack systems for communicating changes to staff and clients in a timely manner or in a way that can help them understand why the changes need to be made.

**Error 4:** Setting prices without reference to the marketing mix. As presented in Module 7, price is only one of the eight aspects of a product that customers care about. They are also interested in how well a product’s design meets their needs, how conveniently it is delivered, how clearly it is explained, etc. Prices need to be set at a level that corresponds with the benefits being delivered through the other seven Ps.

**Error 5:** Insufficient price differentiation. Related to the previous pricing error, MFIs have a tendency to charge similar prices for different products and to different clients. A better strategy is to set different prices for different market segments taking into account the cost and risk of delivering a product to each segment, as well as the benefits that customers in that segment associate with the product. Repeat clients, for example, might be given a discount over first-time clients since they cost less to serve and generate greater benefits for the
MFI. Borrowers with a history of mild delinquency problems might be charged a slightly higher rate to cover the additional risk.

22.4 Conclusion

High prices resulting from cost inefficiencies are no route to long-term sustainability. As an MFI grows in increasingly competitive markets, its pricing policy should be coherent with its overall marketing strategy. However, prices must cover costs and include a profit margin. These two aims — pricing for market position and profitability — will be much easier to achieve for MFIs that achieve maximum efficiency through careful monitoring and control of their costs.

Costing is an essential part of sound financial management. The techniques available for costing allow data to be gathered for both setting product prices and for identifying cost inefficiencies. MFI managers have a responsibility to use costing data to improve MFI performance.

<table>
<thead>
<tr>
<th>Main Messages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The best way to manage the trade-off between institutional sustainability and cost to the customer is to increase efficiency and productivity.</td>
</tr>
<tr>
<td>2. Cost inefficiencies can be identified using Activity-based Costing.</td>
</tr>
<tr>
<td>3. Prices should be set mainly as a function of costs.</td>
</tr>
<tr>
<td>4. Ultimately, pricing decisions will be based on profitability considerations and marketing strategy.</td>
</tr>
</tbody>
</table>

Recommended readings:


The old management saying, "What gets measured gets done", holds true in microfinance just as in any other business. Plans, budgets and reports provide managers with tools for defining measurable performance goals and then tracking performance to ensure those goals are actually met. They are invaluable tools for improving efficiency and productivity, as well as fulfilling the four functions of management more generally.

This module explores how microfinance managers can use plans, budgets and reports to improve performance within their branches, departments and institutions. It addresses six main themes:

1. Types of planning
2. Styles of planning
3. Two approaches to budgeting
4. Using plans, budgets and reports to improve performance
5. Deciding what to monitor
6. Analysing for improved performance

**23.1 Types of Planning**

As discussed in Module 1, planning is a critical management function. It involves setting priorities, allocating resources, defining goals and measures of success. A wide range of plans are used by microfinance institutions, but all fall into one of four general categories: strategic plans, operational plans, financial plans or business plans. Each of these is explored below.

*Strategic Planning*

A strategic plan articulates broad institutional goals and an overall strategy for achieving those goals. It is generally developed every three to five years, although some institutions have a "rolling" strategic plan that is updated annually and extended for one more year.

The strategic planning process begins with some reflection on the institution’s vision and mission — what it ultimately want to achieve — and the clients or market it wants to serve (see Modules 4, 5 and 7). This may involve additional research into particular market segments or the characteristics of the clients the institution most wants to reach in the period covered by the plan.

**Parts of this module were adapted from:**

Towards Greater Efficiency and Productivity

Once an institution’s mandate is clear, the next step is typically a “SWOT” analysis. The MFI takes a hard look at its existing internal capacity (its Strengths and Weaknesses) as well as its external environment (the Opportunities and Threats). The internal assessment is best carried out after the external assessment, so that the institution can evaluate its ability to meet client needs in the context in which it operates. Box 23.1 provides a summary of the key issues that need to be considered during this analysis.

Box 23.1 Key Issues to Address during SWOT Analysis

<table>
<thead>
<tr>
<th>Internal Assessment (SW)</th>
<th>External Assessment (OT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Can we meet the needs of our clients with our given resources (products, personnel and facilities)?</td>
<td>• How can we best operate given the external challenges of our environment?</td>
</tr>
<tr>
<td>• What are our strengths and how can we capitalize on them?</td>
<td>• Who are our competitors and what are they doing?</td>
</tr>
<tr>
<td>• What are our weaknesses and where do we need to focus development efforts to transform them into strengths?</td>
<td>• Who might collaborate with us (investors, technical assistance providers, institutions with complementary services)</td>
</tr>
<tr>
<td>• Given recent and projected trends, which areas require the most attention?</td>
<td>• How do current and proposed regulatory policies restrict or encourage the institution’s operations (or those of its clients)?</td>
</tr>
<tr>
<td></td>
<td>• What economic, societal, political or technological conditions affect the institution or its target market?</td>
</tr>
</tbody>
</table>

The SWOT analysis involves a fair amount of trying to predict the future. All MFIs operate in dynamic environments, and therefore the strategic planning process strives to anticipate what might happen in the next two or three years. Strategic planners that are good at peering into their crystal balls and seeing the future can position and prepare their institutions accordingly, and be proactive rather than reactive.

Based on the results of the SWOT analysis, an MFI can define future goals that will move it closer to achieving its mission and vision, as well as an overall strategy for achieving those goals during the period of the plan. This strategy should make the most of promising opportunities while also defending the institution against competition and other external threats. It should articulate which products the MFI will develop for which markets (recall the Ansoff matrix presented in Module 6), and which areas of the institution need to be strengthened to ensure that it can do this. In general, it is wise to limit the number of objectives to the four to eight that are most important, since taking on too much could prevent the institution from implementing any of its desired improvements.

Once high-level objectives have been set, it is helpful to define the core activities that will enable the MFI to achieve those objectives. These will become the basis for operational planning. Box 23.2 provides an example of an objective that might be found in a strategic plan, together with its associated activities. The strategic plan may also include an overall budget, which would not be detailed, but would project the MFI’s level of financial activity and growth, and provide a general guideline as to the level of funding necessary to reach the stated goals.
Box 23.2 Sample Strategic Planning Objective

Objective
Develop voluntary savings products that respond to clients’ needs and that can serve as a source of portfolio financing.

Activities
1. Follow the development of legislation on non-bank financial institutions and apply for status as such an institution, to be effective for fiscal 2006.
2. Conduct market research to assess clients’ savings needs.
3. Develop savings product parameters.
4. Train staff to implement the savings programme.
5. Educate clients about pending savings services.


Operational Planning

Operational plans create a framework for implementing the strategic plan. They are typically developed on an annual basis, although more detailed plans for guiding the implementation of specific objectives or activities may be created on a quarterly, monthly or sometimes even daily basis. For example, weekly work plans are used in many MFIs to organize the movement of staff within a unit’s operations. The plans specify who will meet with which groups, visit which clients, and serve at which teller station on each day of the week.

Sometimes referred to as “Action Plans”, detailed operational plans specify who will do what, when and with which resources in order to implement the strategic plan. They are often accompanied by detailed financial projections that clarify the institution’s assumptions and targets with respect to activity levels, growth, current capabilities, human resource requirements, product development and marketing channels.

Financial Planning

Financial plans tell an MFI how much money is needed to implement strategic and operational plans. They allow an institution to identify the sources, flows and costs of the funds required. As noted above, the financial plans that are developed to support strategic plans are more general than those developed to support operational plans. The latter require more specific estimates of credit and savings activity, case loads, expected loan losses, revenue and expenditures. They also involve more detailed costing of funds, liquidity and investment analysis and, perhaps, financial modelling to project and plan for several different scenarios that could occur during the period of the plan.

Financial plans, in the form of budgets, are the only plans prepared by some MFIs. They are also the plans with which managers at all levels are most likely to be involved, and the ones most often used to monitor performance. Thus, the budgeting process is looked at in more
detail in Section 23.3. Managers interested in more advanced financial planning may find the Excel-based financial model, Microfin, helpful. Financed by CGAP and Women’s World Banking for use by MFIs, Microfin is supported by a handbook and website\textsuperscript{14} that guide users through the process of developing operational and financial projections using the Microfin software, which can be downloaded free of charge.

**Business Planning**

Business plans incorporate elements from all three of the plans discussed above. By combining strategy, operations and budgeting into one document, the business plan provides managers with their most powerful planning tool. An effective business plan will clearly define the institution’s market and objectives; provide both quantitative and qualitative measures of success; and identify how human and financial resources will be sourced and deployed to best serve the institution. Box 23.3 summarizes a general outline of a business plan.

<table>
<thead>
<tr>
<th>Box 23.3 Business Plan Outline</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Summary</td>
</tr>
<tr>
<td>II. Introduction and description of the business</td>
</tr>
<tr>
<td>III. Market analysis – findings and implications</td>
</tr>
<tr>
<td>IV. Internal situation analysis</td>
</tr>
<tr>
<td>V. Marketing plan – how will you meet the needs of your customers</td>
</tr>
<tr>
<td>VI. Operational plan – key performance indicators</td>
</tr>
<tr>
<td>VII. Service targets</td>
</tr>
<tr>
<td>VIII. Financials</td>
</tr>
<tr>
<td>IX. Resource requirements – staffing and structure</td>
</tr>
<tr>
<td>X. Training requirements</td>
</tr>
<tr>
<td>XI. Budget</td>
</tr>
<tr>
<td>XII. Appendices</td>
</tr>
</tbody>
</table>

Because the business plan presents strategic, operational and financial plans in one package, it is also an MFI’s most valuable tool for monitoring and communicating performance, both internally and externally. A clear business plan with comprehensive financial projections can strengthen an institution’s negotiating position with donors, commercial banks, investors and even regulatory authorities.

\textsuperscript{14} http://www.microfin.com
23.2 Styles of Planning

No matter what type of plan is being created, there are a variety of ways to approach the planning process. Different organizations adopt different styles, for example:

- With a top-down approach, plans are set centrally and cascade down the organization. Those receiving the plan and its targets are rarely consulted, and end up trying to achieve something that they have neither bought into nor developed. Not surprisingly, this type of planning is the least effective, especially if the planners do not take into account the circumstances of those executing the plans. Outreach targets and timelines can easily be set at unachievable levels, causing problems for those who implement the plan.

- In a bottom-up approach, planning starts with the lowest unit and then combines plans to ultimately yield a final plan for the whole organization. A set of guidelines is usually established (though not always), and units produce their own plans within this framework. The strength of this approach is that it involves everyone, but it can take a long time and be repetitive. Also, the process is often numbers based (see below) and can lead to conflict if units try to set easy targets that do not match organizational needs.

- A blended planning style combines the previous two approaches. A general plan is constructed at the top level and then merged with the results of a bottom-up exercise. Usually there is a central coordinating body that conducts research, gives macroeconomic forecasts, and sets general guidelines for using the framework. The results are then reviewed, challenged, altered and consolidated.

- Informal planning is the style that is usually found in small- and medium-sized organizations where, for example, the directors simply meet and agree on next year’s targets and goals. This approach is often found in successful entrepreneurial organizations. The key advantage is that it is not a time-consuming exercise, and is very flexible. Problems arise, however, when the business environment becomes more complex, and this type of planning proves inadequate for control and measurement. For growing MFIs, the consequences of informal planning can be disastrous unless they move smoothly to other, more disciplined methods of planning.

- The numbers-based planning style is probably the most common. It gives great comfort to people because, by concentrating on the quantitative rather than the qualitative, it appears more certain. It is easier to produce a cash flow than to understand the likelihood of people preferring your product over that of the competition. In adopting this approach, an MFI can lose sight of the bigger picture. All plans involve an element of numerical analysis, but relying wholly on numbers has been largely discredited and a broader perspective is recommended.

- Scenario-based planning involves agreeing on likely future scenarios, analysing the impact of each on the institution, and articulating the action required to counter adverse consequences. The scenarios can be weighted by probability and a future strategy can be charted between those scenarios most likely to occur. It is an excellent method of quantifying uncertainty, but often involves the use of complex models and analysis techniques looking far into the future. It is therefore inappropriate for small MFIs and is more strategic than tactical. When large capital investments are planned, however, this method can yield substantial benefits.
• The balanced scorecard approach blends quantitative and qualitative analysis. It encourages managers to view their organization from four perspectives, and to translate its vision and mission into action by developing objectives, measures, targets and activities for each. The four perspectives are:

1. *The financial perspective:* What does the MFI need to achieve in terms of cost, return on assets, profit, income, etc.?
2. *The customer perspective:* What would satisfy customers, improve loyalty and increase market share in targeted segments?
3. *The internal process perspective:* What internal processes does the institution need to improve to meet customer and investor requirements?
4. *The learning and growth perspective:* How will the MFI develop its employees and its culture to support change and performance improvement?

The four perspectives are connected – learning and growth lead to better business processes, which increases value to the customer, and then improves financial performance (see Figure 23.1). In organizations that adopt this approach, the scorecard will drive the shape of all plans, since each must address all four aspects.

**Figure 23.1 The Balanced Scorecard Approach**

*Source: Arveson, 1998.*
23.3 Two Approaches to Budgeting

As noted above, a budget is an important management tool, not only for planning but also for reporting and controlling, and making sure that planned objectives are actually achieved. In general, the preparation of a budget involves three steps:

- Allocating resources (funds, staff, offices, equipment, travel funds, etc.)
- Forecasting future trends in income and expenses
- Setting targets

There are several ways to approach the budgeting process, all of which incorporate the above three steps. This section compares the traditional budgeting process with an activity-based budgeting process to illustrate how a methodology can significantly influence the utility of the budgeting tool.

A Traditional Approach to Budgeting

The traditional way to prepare a budget is to start with past income and expenses, and then to extrapolate forward to the new period. To illustrate this process, consider a simple set of accounts for the Tuku branch of Community Financial Services (CFS) in 2005, as shown in Boxes 23.4 and 23.5.

### Box 23.4 Theoretical Example – Tuku Branch Income Statement 2005 (US$)

#### Accounts for last year

<table>
<thead>
<tr>
<th>INCOME STATEMENT OF TUKU BRANCH</th>
<th>US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>INCOME</td>
<td></td>
</tr>
<tr>
<td>Interest on loans</td>
<td>8 200</td>
</tr>
<tr>
<td>EXPENSES</td>
<td></td>
</tr>
<tr>
<td>Salaries &amp; benefits</td>
<td>4 000</td>
</tr>
<tr>
<td>Travel</td>
<td>1 000</td>
</tr>
<tr>
<td>Rent</td>
<td>1 200</td>
</tr>
<tr>
<td>Administration expenses</td>
<td>600</td>
</tr>
<tr>
<td>Depreciation</td>
<td>500</td>
</tr>
<tr>
<td>Other (training, etc.)</td>
<td>200</td>
</tr>
<tr>
<td>TOTAL OPERATING EXPENSES</td>
<td>7 500</td>
</tr>
<tr>
<td>PROVISION FOR LOAN LOSSES</td>
<td>200</td>
</tr>
<tr>
<td>SURPLUS</td>
<td>500</td>
</tr>
</tbody>
</table>
Box 23.5 Theoretical Example – Tuku Branch Balance Sheet 2005 (US$)

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>3,000</td>
</tr>
<tr>
<td>Loans receivable</td>
<td>21,000</td>
</tr>
<tr>
<td>Less provision for loan losses</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td>25,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Creditors for operating expenses</td>
<td>500</td>
</tr>
<tr>
<td>Loans from head office</td>
<td>10,500</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES</strong></td>
<td>11,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EQUITY</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>15,000</td>
</tr>
<tr>
<td>Accumulated deficit (prior period)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Surplus (current period)</td>
<td>500</td>
</tr>
<tr>
<td><strong>TOTAL EQUITY</strong></td>
<td>14,000</td>
</tr>
<tr>
<td><strong>TOTAL EQUITY AND LIABILITIES</strong></td>
<td>25,000</td>
</tr>
</tbody>
</table>

To construct a budget for 2006 using the traditional method of budgeting, CFS would start by asking the following questions:

- What extra funds are available to increase the Tuku branch’s loan portfolio?
- What increase in expenses can be foreseen owing to inflation, or changes in staff remuneration?
- What additional equipment needs to be purchased for the Tuku branch?
- Will interest rates stay the same?
- How much extra loan loss provision is needed?

Suppose that it answers these questions as follows:

- Head office can advance a further US$2,000 for new lending
- Inflation is 10 per cent and staff remuneration will also increase by 10 per cent
- Tuku needs a new computer at a cost of US$1,000 (25 per cent depreciation applies)
- Interest rates will remain at 41 per cent average
• Loan loss provision should be 6 per cent of the total loan portfolio

With this information, the historical figures for Tuku branch can be adjusted to arrive at the budget shown in Box 23.6.

### Box 23.6 Theoretical Example – Tuku Branch Budget 2006 (US$)

**Budget for new year – Tuku Branch**

<table>
<thead>
<tr>
<th>Description</th>
<th>US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on loans (41 per cent times US$3,000)</td>
<td>9,430</td>
</tr>
<tr>
<td><strong>Expenses:</strong></td>
<td></td>
</tr>
<tr>
<td>Salaries &amp; benefits</td>
<td>4,400</td>
</tr>
<tr>
<td>Travel</td>
<td>1,100</td>
</tr>
<tr>
<td>Rent</td>
<td>1,320</td>
</tr>
<tr>
<td>Administration expenses</td>
<td>660</td>
</tr>
<tr>
<td>Depreciation (500 + 25 per cent times US$1,000)</td>
<td>750</td>
</tr>
<tr>
<td>Other (training, etc.)</td>
<td>220</td>
</tr>
<tr>
<td>Provision for loan losses</td>
<td>380</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>8,830</td>
</tr>
<tr>
<td><strong>Budget surplus</strong></td>
<td>600</td>
</tr>
</tbody>
</table>

**Activity-based Budgeting**

The traditional method of budgeting used above is not geared to improving efficiency. It simply builds on the status quo. A more advanced method of budgeting uses activity-based costing (see Module 22) to analyse how costs relate to the delivery of services, and then reviews how to apply the available resources to achieve greater efficiency.

For example, assume the Tuku branch offers solidarity group loans using a stepped lending methodology, and it also offers individual loans to clients who have successfully repaid four group loans. There are three main services offered by the Tuku branch:

- Forming and supporting new solidarity groups in preparation for the first loan cycle
- Servicing existing solidarity groups with second and subsequent loan cycles
- Appraising and servicing clients who have graduated to individual loans

Assume that for this theoretical example, a study of income and expenses related to these three activities revealed the following information for 2005:
1. The active loan portfolio of US$20,000 is divided into 10 per cent for new solidarity groups, 70 per cent for repeat loans for existing solidarity groups, and 20 per cent for individual loans. US$1,000 is in arrears and subject to the loan loss provision.

2. There are 300 clients, of whom 30 are individual borrowers and the remainder are organized into solidarity groups of 10 borrowers.

3. The staff of the Tuku branch estimate that they spend 30 per cent of their time supporting new borrowers and forming new solidarity groups, half their time servicing existing solidarity groups, 10 per cent serving individual borrowers and 10 per cent of their time chasing delinquent borrowers.

4. Delinquent borrowers represent 5 per cent of the individual borrowers, but none of the group borrowers are in arrears. A full 100 per cent provision for loan losses is applied to delinquent loans, and no unpaid interest income is taken as revenue.

This information generates a more detailed analysis of income against expenses using an activity-based costing method, as shown in Table 23.1.

<table>
<thead>
<tr>
<th>Type of client</th>
<th>New borrowers</th>
<th>Existing groups</th>
<th>Individual borrowers</th>
<th>Delinquent borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>820</td>
<td>5,740</td>
<td>1,640</td>
<td>0</td>
</tr>
<tr>
<td>Salaries, etc.</td>
<td>(1,200)</td>
<td>(2,000)</td>
<td>(400)</td>
<td>(400)</td>
</tr>
<tr>
<td>Other expenses*</td>
<td>(1,050)</td>
<td>(1,750)</td>
<td>(350)</td>
<td>(350)</td>
</tr>
<tr>
<td>Loan losses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>(200)</td>
</tr>
<tr>
<td>Surplus/(deficit)</td>
<td>(1,430)</td>
<td>1,990</td>
<td>890</td>
<td>(950)</td>
</tr>
</tbody>
</table>

*Other expenses have been allocated in the same proportion as staff time because this seems the simplest and fairest method.

Looking at Table 23.1, it is clear that existing solidarity groups with repeat loan cycles are the source of Tuku’s surplus. They generate better income, are less costly to serve and have zero delinquency. By contrast new groups are expensive to form and support, and the losses from delinquent individual borrowers exceed the net income from the reliable majority, who repay their loans.

The results of this analysis raise the following questions, which should be addressed in the planning and budgeting process:

- How can the costs of forming new solidarity groups be reduced?
- How can one retain borrowers in existing solidarity groups to reap the efficiency gains of repeat borrowing?
- Should Tuku branch continue with individual lending?
- What investment — such as in information systems, training or staff incentives — is required to reduce the delinquency rate?

The answers to these questions should be fed into the budgeting process and result in new performance targets and changes in the way resources are allocated.
23.4 Using Plans, Budgets and Reports to Improve Performance

Plans, budgets and reports are discussed here in one module to emphasize the interconnectedness of these three tools. Outreach goals must be supported by activity plans and by budgets that provide sufficient resources to implement those plans. Yet even with high-quality planning and adequate resources, goals will not necessarily be achieved unless managers are also able to respond to changes in the internal or external environment that were not anticipated in the original plans. Reports make it possible for managers to identify when changes have occurred, or where optimal results are not being achieved, so that plans can be adjusted as necessary to achieve desired results.

Recognizing the relationship between plans, budgets and reports can assist managers to use each of the three tools more effectively to manage performance. For example, the previous section described how activity-based budgeting can guide a more strategic selection of goals and implementation priorities. Fourteen more ideas for strengthening the relationship between the three tools and maximizing the usefulness of plans, budgets and reports are described below.

1. **Encourage participation.** Design planning and monitoring activities to draw upon the experience and perspective of everyone in the institution – including board members, staff at all levels, key consultants, and even clients. The more participatory the process, the more comprehensive the identification of challenges, opportunities, risks and solutions will be. Furthermore, managers can use planning and monitoring processes to focus and motivate staff, as well as to build consensus and a sense of ownership over goals, plans and results. This sense of ownership is essential for successful implementation. In many MFI s, regular monthly management meetings are used to review performance with contributions from all major perspectives and to agree on how best to adjust performance when necessary.

2. **Take a phased approach.** Do not expect to develop a plan in a single meeting. Effective plans are shaped in phases or stages, a process which requires time to reflect on the implications of a particular set of decisions, and to consult others about the feasibility of a proposed plan’s implementation. If, for example, branch managers propose activities and a budget that the MFI cannot finance, it is important to have time built into the planning schedule to allow activities to be refined or goals to be scaled back through a consultative process that results in broad endorsement of the ultimate strategy.

3. **Set specific, measurable standards and targets.** When defining goals, objectives and activities, make sure they clearly state who is responsible for achieving what by when. Set a standard or a target that can be measured, so that everyone can easily see whether the desired results have been obtained, or whether appropriate progress is being made toward that desired result. If measurable targets are set, they can be easily used to track progress and hold staff accountable for performance. For example, a standard that states: “the average time a customer spends to make a payment at the teller window should be less than three minutes,” is much more useful than “all customers should receive speedy service at the teller window”.

4. **Avoid unrealistic projections.** The most useful plans represent an achievable picture of the institution’s future. Objectives, activities and financial projections need to be realistic and firmly grounded in the institution’s past achievements and current capacity. Overly optimistic
projections can set an institution up for failure and de-motivate staff when they cannot meet expectations.

5. **Link external and internal analysis.** Most institutions conduct some kind of SWOT analysis during their strategic or business planning process, but too often the identified opportunities and threats are simply listed as factors that were taken into consideration during the preparation of the plan. Managers can get more out of the SWOT analysis by clearly articulating the implications of the opportunities and threats for the institution (see, for example, Table 23.2, which presents a selection of SWOT analysis findings for a fictitious MFI known as FEDA). This process helps to clarify where the institution is vulnerable and what needs to be done to mitigate specific risks. It can also help guide monitoring and reporting priorities.

<table>
<thead>
<tr>
<th>Findings</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>There are six other microfinance institutions in the country with more than 3,000 clients each, two of which operate in Liberty.</td>
<td>Competition is not a significant factor now, although the MFIs operating in Liberty should be monitored, especially their choice of markets. If they enter FEDA's markets, competition could become a serious factor.</td>
</tr>
<tr>
<td>The microfinance institutions operating in Liberty offer products and services similar to FEDA's, though in different areas of the city, with effective interest rates about six percentage points higher. Each has about 5,000 clients.</td>
<td>A review of the pricing structure may be appropriate.</td>
</tr>
<tr>
<td>Legislation now being developed would authorize non-bank financial institutions (NBFIs) to collect savings from their clients.</td>
<td>Adopting the legal structure of a non-bank financial institution could offer an opportunity to respond to clients' interest in savings services, thereby also providing an additional source of lending funds.</td>
</tr>
<tr>
<td>The inflation rate was 10 per cent in 2006 and is projected to be 8 to 10 per cent for the next three to five years.</td>
<td>Although the inflation rate is stable, its effect should be factored into salaries, loan amounts and interest rates.</td>
</tr>
</tbody>
</table>

Source: Adapted from Lunde, 2001.

6. **Specify which performance indicators will be monitored.** Make it clear how the institution will hold itself accountable for achieving a certain type and level of performance. Performance indicators help communicate objectives clearly and make reporting on the plan easy because everyone knows from the beginning what needs to be reported.

7. **Be selective.** Do not try to report it all. Managers need to identify the most relevant performance indicators and request regular reporting in those areas. Staff members who create reports should focus on providing information as clearly and concisely as possible. Including too much data in a report wastes time, can cause confusion and is more likely to lead to inaction.

8. **Report with a two-part format.** A data table can clearly and concisely communicate results, but important information about why or how those results were achieved, as well as recommendations for moving forward, will be lost if there is no room for qualitative commentary.
Dividing a report into two sections, one that summarizes performance through figures and ratios, and another that provides a short written commentary, can help avoid this danger.

9. **Standardize reporting formats.** Regardless of the format used, if it is standard, readers will become familiar with it and can quickly locate the details they need.

10. **Report on the plan.** Include columns in the data table that remind the reader what performance was expected based on the plan, as well as the result that was actually achieved during a given period. In the narrative section of the report, draw attention to significant variances (both positive and negative) and recommend what actions need to be taken.

11. **Report trends.** Other columns in the data table can report on performance during the previous period and the same period one year ago. This allows managers to consider not only the level of performance, but also whether performance is improving or deteriorating. It is important because a plan that is improving weak performance may not need to be changed, while a plan that is causing strong performance to weaken may need adjustment. If the report looks only at absolute performance, it could lead managers to change the plan that is actually improving areas of weakness and leave intact plans that are damaging areas of strength.

12. **Use graphics to highlight important information.** When communicating a plan or a report, charts, graphs, coloured highlights and symbols can help to draw attention to the items that most require the reader’s attention. For example, if key indicators within an acceptable range are highlighted in green, those on the borderline of acceptability are in yellow, and unacceptable results are shown in red, decision makers can easily see where the problems are.

13. **Regularly review and update plans.** Effective planning is not a once-a-year project. Plans provide the basis for day-to-day operations and decision making, but to remain effective over time they need to be adjusted based on the feedback received from regular reports. For example, if a branch experiences larger than expected demand, plans will have to be changed to mobilize additional resources, or to use those that exist more efficiently to meet the demand.

14. **Communicate decisions with reference to plans and reports.** Performance monitoring should generate conclusions and decisions which lead to actions that improve performance. Managers can facilitate this progression by using performance reports and adjusted plans to communicate to others (e.g., superiors, subordinates, clients or investors) the necessary changes and why they need to be made. As discussed in Module 21, change of any kind can be unsettling. Clear communication of the rationale for the change minimizes resistance. Reports help demonstrate that there is a need for action, while well-articulated plans help individuals, teams and departments to coordinate their actions as they implement the change.

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Analysis ➔ Conclusions ➔ Decisions ➔ Action
23.5 Deciding What to Monitor

Different managers will want to track different performance indicators depending on their specific responsibilities, the age, size and sophistication of their MFI, and its information systems. As highlighted in the previous section, a manager’s plans provide the best tool to guide decisions about what to monitor and report. In general, microfinance managers pay attention to performance in five main categories:

1. Profitability and sustainability
2. Portfolio quality
3. Efficiency and productivity
4. Financial management/structure
5. Growth and outreach

These five categories are reflected in the instruments most commonly used to monitor the performance of financial institutions worldwide, including CAMEL and PEARLS (see Box 23.7), as well as in the performance monitoring systems most widely embraced by the microfinance industry to date. The indicators used to monitor performance in each of the five categories vary, but there is significant consensus around the primary indicators, as shown in Table 23.3.

### Box 23.7 Performance Monitoring Tools

CAMEL and PEARLS are acronyms for instruments used to monitor performance of financial institutions. CAMEL was first introduced in 1978 by regulators to measure the soundness of US commercial lending institutions. Fourteen years later, ACCION International undertook a project to modify the CAMEL tool so it would be relevant to MFIs. The CAMEL acronym describes the five performance areas measured by the tool: Capital adequacy, Asset quality, Management, Earnings, and Liquidity. ACCION’s CAMEL comes complete with a manual that describes the rating scheme, weights for each indicator and adjustments to the financial statements.

PEARLS is an indicator report of the World Council of Credit Unions (WOCCU) used to monitor performance and provide comparative data for credit unions. PEARLS stands for the following categories: Protection (loan-loss reserves and write-offs), Effective financial structure, Asset quality, Rates of return and costs, Liquidity and Signs of growth.

Although CAMEL and PEARLS are the most well-known performance monitoring tools used by the microfinance industry, other schemes exist as well. Pro Mujer uses CCREP, which translates from Spanish to represent portfolio quality, growth, profitability, financial structure, and productivity. In Uganda, 15 different donor agencies worked together with local MFIs to develop a joint reporting instrument known as the PMT (Performance Monitoring Tool). What is interesting about this tool is its ability to meet the reporting requirements of many different entities in a single quarterly report. The five-page report includes selected items from an MFI’s financial statements, detailed portfolio information, and 38 performance indicators that monitor profitability, liquidity, portfolio quality, operating efficiency, loan officer productivity, capital ratios and outreach.

*Source: Adapted from Natilson and Bruett, 2001, and Duval, 2003.*
### Table 23.3 Key Performance Indicators in Microfinance

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Indicator</th>
<th>WWB</th>
<th>AFIN</th>
<th>MBB</th>
<th>Micro-Rate</th>
<th>ACCION</th>
<th>GIRAFE Planet Finance</th>
<th>WOCCU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outreach</td>
<td>No. of active borrowers</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x²</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>No. of active savers</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Loan portfolio</td>
<td></td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>outstanding</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Savings portfolio</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Ave. loan size/average</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>loan balance</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Efficiency and productivity</td>
<td>Operating expense</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Caseload</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Portfolio quality</td>
<td>Portfolio at risk</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Loan loss reserve ratio</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Write-off ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Loan loss provision</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sustainability/</td>
<td>Operational self</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>profitability</td>
<td>sufficiency</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Financial self</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>sufficiency</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Adjusted return on</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Adjusted return on</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Capital structure</td>
<td>Debt to equity ratio</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital to asset ratio</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Leverage - capital to</td>
<td></td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>equity ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity</td>
<td>Current ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td></td>
<td>Liquidity ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
</tbody>
</table>

**Note**
1. Definitions may vary from one network or agency to another but the same terminology for the indicator is used.
2. MicroRate has used number of loans, but which is equivalent to number of active borrowers.

Source: Adapted from Women's World Banking, 2002.

Most key performance indicators are expressed in the form of ratios, since ratios allow comparisons to be made with other MFIs, and also against international benchmarks for good performance. Many of these ratios have been introduced in previous modules, but they are summarized below for easy reference, with formulas provided in Table 23.4. For more detailed information on how to calculate or use these ratios, refer to additional resources cited at the end of this module.

**Profitability and Sustainability**

Profitability and sustainability ratios are the most comprehensive and reflect the ability of an MFI to continue operating in the future. It makes no difference whether an institution is
non-profit or for-profit; all reputable MFIs are striving for sustainability, and investors and
donors look for those institutions with sustainability potential. There are five basic profitabil-
ity/sustainability ratios:

1. **(Adjusted) return on assets** measures the net operating income as a percentage of aver-
age total assets. It reveals how well the MFI uses its assets to generate a profit. In other
words, for every dollar of assets, how many cents (or dollars) does the MFI generate? The
difference between return on assets (ROA) and adjusted return on assets (AROA) is the
adjustments made to take into account the effect of subsidies, inflation, non-performing
loans and foreign exchange gains or losses on net operating income.\(^{15}\)

2. **(Adjusted) return on equity** measures the net operating income as a percentage of aver-
age total equity (or net assets). In a for-profit company, this is the most important ratio
because equity contributors or shareholders monitor the company's ROE to determine
the returns on their equity investment. In a non-profit organization, the ratio becomes
less meaningful, as no returns (or dividends) are paid to the contributors. Still, the ratio
reveals how well the non-profit has used its contributions.

3. **Operational self-sufficiency (OSS)** measures operating revenue as a percentage of
operating and financial expenses, including loan-loss provision expense. If the ratio is
greater than 100 per cent, it means that the MFI is covering all of its costs through its own
operations and is not relying on contributions to survive.

4. **Financial self-sufficiency (FSS)** is similar to operational sustainability; however, the
ratio also includes inflation and subsidy adjustments.

5. **Profit margin** measures net operating income as a percentage of total revenue. This ratio
shows how much of the revenue earned goes to the bottom line. In other words, for every
dollar received as revenue, how many cents (or dollars) remain at the end of the day after
all expenses are paid?

**Efficiency and Productivity**

As discussed in Module 18, there are five main indicators for measuring performance in this
category:

1. The **operating expense ratio** measures operating expenses as a percentage of average
portfolio, revealing how much the MFI spends to maintain its outstanding loan portfolio.
The higher the figure, the less efficient the MFI.

2. **Cost per borrower** shows how much it costs an MFI to serve its average loan client. To
calculate this cost, simply divide operating expenses by the average number of clients for
the period.

3. **Staff productivity ratios** are vital indicators because salaries are usually the largest oper-
ating expense. Two important ratios calculate the size of the caseload (the number of

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The explanations of ratios in each of the five categories are adapted from:


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\(^{15}\) See pp. 13-17 of the CGAP/SEEP publication, 2003.
active clients) each staff person carries, as well as the size of the portfolio managed by a single employee. The higher the ratios, the more efficient the MFI.

4. **Personnel allocation ratio** measures the percentage of an MFI’s employees that is focused on lending — the organization’s primary source of revenue — by comparing the number of loan officers to the total number of personnel.

5. **Client retention** is not tracked as frequently as some of the other ratios mentioned, but can be a valuable indicator of efficiency since repeat clients are less expensive to serve than new clients and usually generate more revenue through larger, longer-term loans and the use of multiple services.

Table 23.4 Selected Performance Ratios and Definitions

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profitability and Sustainability</strong></td>
<td></td>
</tr>
<tr>
<td>1. Return on assets</td>
<td>(Net operating income – taxes) / average total assets</td>
</tr>
<tr>
<td>2. Return on equity</td>
<td>(Net income – taxes) / average total equity</td>
</tr>
<tr>
<td>3. Operating self-sufficiency</td>
<td>Operating revenue / (Operating expense + financial expense + loan loss provision expense)</td>
</tr>
<tr>
<td>4. Financial self-sufficiency</td>
<td>Adjusted operating revenue / (operating expense + financial expense + loan loss provision expense + expense adjustments)</td>
</tr>
<tr>
<td>5. Profit margin</td>
<td>Net operating income/operating revenue</td>
</tr>
<tr>
<td><strong>Efficiency and Productivity</strong></td>
<td></td>
</tr>
<tr>
<td>1. Operating expense ratio</td>
<td>Operating expenses / average gross loan portfolio</td>
</tr>
<tr>
<td>2. Cost per borrower</td>
<td>Operating expenses / average number of active borrowers</td>
</tr>
<tr>
<td>3. Loan officer productivity</td>
<td>Number of active borrowers / number of loan officers</td>
</tr>
<tr>
<td>4. Personnel allocation</td>
<td>Number of loan officers / number of personnel</td>
</tr>
<tr>
<td>5. Client retention</td>
<td>Number of follow-up loans issued during the past 12 months / number of loans paid off during the past 12 months</td>
</tr>
<tr>
<td><strong>Portfolio Quality</strong></td>
<td></td>
</tr>
<tr>
<td>1. Portfolio at risk (X days)</td>
<td>Value of outstanding balances of all loans in arrears for X days or more / value of loans outstanding</td>
</tr>
<tr>
<td>2. Risk coverage ratio</td>
<td>Loan loss reserve / value of outstanding balances of all loans in arrears</td>
</tr>
<tr>
<td>3. Write-off ratio</td>
<td>Amount written off / average gross loan portfolio</td>
</tr>
<tr>
<td><strong>Financial Management</strong></td>
<td></td>
</tr>
<tr>
<td>1. Portfolio yield</td>
<td>Cash financial revenue from loan portfolio / average gross loan portfolio</td>
</tr>
<tr>
<td>2. Current ratio</td>
<td>Short-term assets / short-term liabilities</td>
</tr>
<tr>
<td>3. Asset productivity</td>
<td>Gross loan portfolio / total assets</td>
</tr>
<tr>
<td>4. Leverage ratio</td>
<td>Total liabilities / total equity</td>
</tr>
<tr>
<td>5. Capital adequacy</td>
<td>Total equity / gross loan portfolio</td>
</tr>
<tr>
<td>6. Funding expense ratio</td>
<td>Interest and fee expenses on funding liabilities / average gross loan portfolio</td>
</tr>
<tr>
<td>7. Cost of funds ratio</td>
<td>Interest and fee expenses on funding liabilities / average funding liabilities</td>
</tr>
</tbody>
</table>

*Source: CGAP/SEEP, 2003.*
Portfolio Quality

As discussed in Module 18, the main indicator of portfolio quality is portfolio at risk (PAR), but two other indicators are commonly used to gauge the health of a portfolio and the degree to which an institution is controlling the risks associated with it.

1. **Portfolio at risk** measures the value of loans at risk against the value of the total loan portfolio. Loans at risk consist of the outstanding balances of all loans that are either in arrears of more than 30 days, or have been restructured.

2. The **risk coverage ratio** measures the capacity of an MFI to absorb losses on loans at risk. It is calculated as the loan loss reserve or provision in the MFI balance sheet divided by the total loans at risk.

3. The **write-off ratio** measures actual loan write-offs as a percentage of the average gross loan portfolio. It is necessary to look at this ratio in conjunction with PAR since a low portfolio at risk can be achieved through heavy write-offs.

Financial Management

The basis of financial intermediation is the ability to manage assets (the use of funds) and liabilities (the source of funds). Seven common indicators to measure performance in this area are described below.

1. **Portfolio yield** measures the gross loan portfolio’s ability to generate financial revenue from interest, fees and commissions. Managers can use this ratio together with the operating expense ratio to compare the expenses of the MFI with its revenue. For instance, if the portfolio yield is 50 per cent, then the MFI should strive to have an operating expense ratio lower than 50 per cent.

2. **Liquidity ratios** (such as the current ratio) measure how much cash an MFI has available or “liquid” to cover its short-term obligations. MFIs that are regulated or have accessed capital markets must pay close attention to this ratio, as lack of cash is the primary reason for the failure of financial institutions.

3. **Asset productivity** ratios measure the efficiency of an MFI’s financial structure. Generally, loans are the most lucrative account on the balance sheet because they generate a high rate of financial income. Thus, MFIs want to maintain a high percentage of their assets in the loan portfolio.

4. The **leverage ratio** measures how much debt an MFI has relative to its equity. In other words, it shows how many additional dollars (or other currency) have been mobilized from commercial sources for every dollar’s worth of funds owned by the MFI. MFIs will want to leverage their equity to increase the size of the loan portfolio that can be financed and to provide a higher return on equity, but it must also be careful not to take on so many liabilities that it might be unable to repay them.

5. **Capital adequacy**, the amount of equity (capital) that an MFI has to support its assets, is a major concern of banks. In other words, what cushion does the MFI have should its outstanding loans not be repaid before it must default on its obligations (liabilities)?
6. The funding expense ratio measures an MFI’s cost of funds in relation to its gross loan portfolio. It is calculated by dividing the financing expenses in the income statement by the average gross loan portfolio.

7. The cost of funds ratio measures the average cost of the funds that the MFI has obtained and shows as liabilities in its balance sheet. These borrowed funds include client savings. MFIs will want to manage their liabilities to keep this ratio as low as possible.

Growth and Outreach

Depending on its outreach objectives, an MFI can monitor performance in any of the six degrees of outreach introduced in Module 2:

1. **Breadth**: Typically measured by the sheer number of clients served, breadth of outreach can also be monitored within particular market segments to gauge, for example, the number of clients served by gender, age, geographic location or type of business activity.

2. **Depth**: Average loan size (sometimes measured as a percentage of GNP per capita) is the indicator commonly used to measure depth of outreach, despite its imperfections. A smaller average loan size is assumed to reflect an ability to reach lower income, more vulnerable clients. When comparing depth between MFIs, it is useful to consider the average loan size in relation to the average loan term, since many small, short-term loans (e.g., consumer finance) can make an MFI look as if it is serving a poorer market than it is.

3. **Scope**: A simple count of the number of services offered can describe the scope of an MFI’s outreach. This indicator should also be seen in conjunction with breadth since an MFI might appear to offer many products, but some only reach a handful of clients. In addition, some MFIs may have very specialized products that can all be addressed by a more general product from another microfinance institution.

4. **Cost**: To monitor cost from the customer’s perspective, MFIs can track the absolute price of their products and compare it to the competition. This is an imperfect indicator, however, because it fails to take into account clients’ transaction and opportunity costs. Market research would be required to establish and monitor cost indicators more holistically.

5. **Length**: The profitability and sustainability indicators listed above can be used to monitor growth in this area of outreach. In addition, managers can track growth in equity, as this is the foundation for future asset growth.

6. **Worth**: Repayment and retention rates provide MFIs with significant insight into clients’ willingness to pay for services. These rates cannot, however, convey the negative impacts that may result when clients repay loans even when their businesses fail and much hardship results. Impact studies and social performance management systems (see Box 23.8) are being used by an increasing number of MFIs to better understand why clients are willing to pay; to identify ways of making their services even more valuable; and to minimize the potential negative impacts that their services could produce (e.g., growing client indebtedness, increases in child labour).
Improvements in any of these outreach areas can be calculated using the following simple formula:

\[
\text{Percentage growth} = \frac{(\text{final amount} - \text{initial amount})}{\text{initial amount}}
\]

**Box 23.8 Managing Social Performance**

Most microfinance institutions have a social mission. They may seek to reduce poverty, to reach people excluded from financial services, to empower women or to promote community solidarity. Social performance is the effective translation of an institution’s social mission into practice. Social performance management (SPM) helps an organization set and achieve its social goals by tracking social performance and using this information for decision-making that puts learning into practice.

An SPM system can help you assess and improve your social performance in three areas:

1. **Client outreach:** Who uses and who is excluded from using your services, and do you reach your target market?
2. **Client needs:** How well do your services meet the needs of your clients? What are the characteristics of your clients and why do some leave or fail to make full use of your services, while others remain active clients over many years? Which products and services are useful and effective for your clients?
3. **Benefits to clients:** What changes are happening in your clients’ lives? What is the relationship between these changes and your services? How does your work relate to broader social and economic factors?

*Source: Adapted from Imp-Act, 2005.*

**23.6 Analysing for Improved Performance**

Regardless of the specific indicators chosen to monitor performance, reported results will be of limited use unless they are put into some kind of context. For a manager to interpret the results, numbers and ratios need to be examined with reference to past performance, expected results or benchmarks.

The process of comparing today’s actual performance to some other standard is often referred to as **variance analysis.** When conducting this analysis, managers look for the differences between current performance and the standard, and then try to explain why that difference exists. It is important to consider both positive and negative variances because lessons can be learned from both.

The main questions to ask when analysing performance results are:

- **Projections:** How does performance compare against the business plan and budget?
- **Trends:** How does performance in the current period compare with performance in previous periods?
- **Internal benchmarks:** How does performance in one unit or branch compare with others?
- **National benchmarks:** How does performance compare with other MFIs operating in this market?
- **International benchmarks:** How does performance compare against international standards for good performance?

This analysis can be greatly facilitated by reports that succinctly bring together the information required to conduct the analysis, as illustrated in Table 23.5. Each column in the table facilitates a particular kind of analysis:

- Comparing last year’s and last month’s actual results to this month’s actual results allows managers to look at trends over time, taking into account seasonal differences that may exist from one month to the next.
- Comparing actual performance to projected performance for the month allows managers to gauge whether targets are being met. If not, adjustments will have to be made to get performance back on track. If performance is exceeding expectations, adjustments may still need to be made to ensure that the necessary resources are in place to support that level of performance in the future.
- Comparing actual performance to a benchmark allows managers to assess whether their performance is in line with an internal or external standard. Managers can be proud of their performance in areas that exceed the standard, and focus their resources on improving performance in areas of weakness. Benchmarks can be extremely useful in helping managers identify what the areas of weakness are and prioritizing which ones should be dealt with first.
- The final column reminds managers to ask the question, “Why?” Too often, the narrative of a performance report simply describes trends without analysing why they have occurred or what should be done about them. For example, “Portfolio quality went up; growth in number of clients went down.” To make reports effective management tools, managers should also describe the story behind the numbers.

**Table 23.5 Sample Monthly Performance Format**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Actual</th>
<th>This month projected</th>
<th>Benchmark</th>
<th>Reason for variance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>One year ago</td>
<td>Last month</td>
<td>This month</td>
<td></td>
</tr>
<tr>
<td>Active clients</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expense ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PAR &gt; 30 days</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
A variety of benchmarks could be included in an MFI’s reporting table. It could compare, for example, the performance of each rural branch against the performance of the highest rural branch achiever. It could compare the institution’s overall performance with that of similar institutions in the region, or to the highest standards of international performance. The difficult part about the latter type of benchmarking is selecting indicators that make cross-country comparisons valid. Indicators such as average loan size as a percentage of GNP per capita normalize results for different price and income levels and, thus, are preferable to absolute indicators such as average loan size.

But where do MFIs find this benchmark data? The most up-to-date, comprehensive and widely circulated compilation of comparative MFI data is the MicroBanking Bulletin, which analyses, adjusts and reports on data from more than 230 MFIs in an aggregate format on a semi-annual basis. Although the Bulletin does not independently verify the information it receives, it does grade the quality of the information according to whether its questionnaire is accompanied by audited financial statements, annual reports, independent evaluations, and recent in-depth financial analyses conducted by independent entities.

The MicroBanking Bulletin creates peer groups based on geographic region, scale of operations, target market, age of institution, lending methodology, level of financial intermediation, charter type and profit status. These peer groups enable MFIs to compare their performance with that of other MFIs with similar characteristics. Institutions that report to the Bulletin receive a confidential performance report free of charge, which makes performance comparisons even easier.

A second source of benchmarking data is networks. Many geographic and technical assistance networks collect data from members and use it to help member institutions assess their performance, plan for the future and mobilize resources to implement their plans.

A third source of reference data comes from rating agencies. These private companies can be contracted to provide external analysis and perspective, as well as industry benchmarking. Three of the best-known specialized rating agencies operating in the microfinance industry are MicroRate, M-CRIL and PlaNet Finance. Each uses its own standardized approach to evaluate MFIs (see Table 23.6).
### Table 23.6 Microfinance Rating Agencies

<table>
<thead>
<tr>
<th></th>
<th>MicroRate&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Micro-Credit Ratings and Guarantees International Limited&lt;sup&gt;2&lt;/sup&gt;</th>
<th>PlaNet Finance&lt;sup&gt;3&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Geographic Scope</strong></td>
<td>Mostly Latin America,</td>
<td>15 countries in South, South-East and Central Asia and the Pacific</td>
<td>35 countries in Africa, Middle East, Latin America, Eastern Europe, Asia</td>
</tr>
<tr>
<td></td>
<td>Sub-Saharan Africa</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Number of Institutions Rated</strong></td>
<td>200 (since 1997)</td>
<td>306 assessments of more than 97 MFIs (since 1998)</td>
<td>57 (since 1999)</td>
</tr>
<tr>
<td><strong>Methodology</strong></td>
<td>This methodology analyses five core areas of financial and operational performance: Management and Governance; Management Information Systems; Financial Conditions; Credit Operations; and Portfolio Analysis.</td>
<td>The rating instrument uses minimum financial and other performance conditions in addition to scoring on governance aspects (13%), management factors (38%) and financial performance (49%) to arrive at a risk grade.</td>
<td>The 26 indicators are grouped under six areas (GIRAFE): Governance; Information; Risk Analysis; Funding, Efficiency and profitability. There are two stages to the rating process: evaluation and formal rating.</td>
</tr>
<tr>
<td><strong>Rating Scale</strong></td>
<td>Does not actually rate institutions, but offers opinions of creditworthiness by marking an evaluation with “Recommend”, “Watch” or “Caution”.</td>
<td>From a+++ (highest safety, excellent systems – most highly recommended) to a (highest risk, poor systems – not worth considering).</td>
<td>A global rating is given, from G1 to G5, along with a composite rating, scoring the six areas of assessment from “e” to “a”.</td>
</tr>
<tr>
<td><strong>Approach Bias</strong></td>
<td>Strong on financial track record and benchmarking against peers.</td>
<td>Strong on capacity constraints based on specific issues.</td>
<td>Strong on management, governance, and best practices.</td>
</tr>
</tbody>
</table>

Note:  
<sup>1</sup> www.microrate.com  
<sup>2</sup> www.m-cril.com  
<sup>3</sup> www.planetrating.com

Source: Adapted from Women’s World Banking, 2002.

### 23.7 Conclusion

The purpose of monitoring and reporting is to guide decision-making processes so that new plans lead to actions which bring an MFI closer to achieving its mission and vision. By viewing plans, budgets and reports as integrated components of one performance management system, managers can increase the effectiveness of each tool as an instrument for achieving this purpose. They can fulfil their planning function in collaboration with their subordinates, being informed by past reports and jointly defining relevant and realistic goals for the future. They can organize their staff using plans (including budgets) that guide actions, as well as the structure of monitoring reports. They can lead their team to achieve defined objectives and motivate continuously improving performance using reports that recognize accomplishments and highlight areas in need of attention. Last but not least, they can control progress by...
Towards Greater Efficiency and Productivity

articulating the connections between projected and actual results, and by leading the effort to plan and organize future activities to ensure objectives are achieved.

**Main Messages**

1. View plans, budgets and reports as integrated components of one performance management system
2. Set measurable targets.
3. Design budgets based on future requirements rather than past performance.
5. Analyse trends and compare results with internal, national and international benchmarks.

**Recommended readings:**


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Managing Performance

Having worked through 23 modules of tips, tools and techniques for improving performance, how can managers possibly process all that input and use it to manage for improved performance? How can they bring the content of this manual together in a sufficiently coherent way to help them fulfil their mandate as managers and deliver increasingly attractive results?

This final module seeks to answer these questions by:

1. Revisiting the four functions through which managers achieve their mandate
2. Exploring how the tips, tools and techniques introduced during the course can assist managers in fulfilling each function more effectively
3. Considering some of the most common challenges that managers face as they try to improve their performance; and
4. Suggesting strategies for facing those challenges as part of the performance management process

24.1 Fulfilling the Manager's Mandate

As discussed in Module 1, the manager’s mandate is to produce results. Microfinance managers, like managers in any other industry, fulfill this mandate by carrying out the four main functions of management: planning, organizing, leading and controlling.

The Planning Function

The first step in improving performance is to know what performance you want to improve. Managers have two ways of finding this out: 1) either they can be told what results others want them to produce; or 2) they can be part of the process of determining what results should be produced. Even if the expected results are dictated to them, chances are they will be involved in (and perhaps even lead) the process of determining how those results will be achieved. In either case, the actions managers take fall under the planning function.

In the context of managing for improved performance, the planning process essentially consists of three steps:

1. Identifying opportunities for improvement
2. Prioritizing those opportunities and selecting the improvements that will be made
3. Deciding how the improvements will be made

This course has introduced a number of tools and concepts that can assist managers in completing each of these steps, as summarized in Table 24.1.
### Table 24.1 Planning Tools

<table>
<thead>
<tr>
<th>Tools for identifying opportunities for improvement</th>
<th>Tools for prioritizing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• SWOT analysis (Section 23.1)</td>
<td>• Vision and mission – which opportunities will best help you achieve your goals (Module 4)</td>
</tr>
<tr>
<td>• Market research (Module 5)</td>
<td>• Values – which opportunities support what is important to your institution (Module 4)</td>
</tr>
<tr>
<td>- FGDs</td>
<td>• Six degrees of outreach – which are most important to your institution? (Section 2.4)</td>
</tr>
<tr>
<td>- PRAs</td>
<td>• Available resources – do you have the funds to take on ambitious opportunities?</td>
</tr>
<tr>
<td>- Mystery shopping</td>
<td>• Urgency – are some opportunities perishable? Will the benefits of acting upon them significantly diminish if you act later?</td>
</tr>
<tr>
<td>- Customer advisory board</td>
<td>• Risk – what is the cost of not improving in a particular area?</td>
</tr>
<tr>
<td>- Interviews</td>
<td>• Value triangle – which opportunities will help position you where you want to be? (Section 7.2)</td>
</tr>
<tr>
<td>- Surveys</td>
<td>• Standards – which opportunities will help you achieve your desired level of quality?</td>
</tr>
<tr>
<td>• Market segmentation (Section 7.1)</td>
<td>• Feasibility – which are you most likely to be able to implement successfully?</td>
</tr>
<tr>
<td>• Competition analysis (Handouts 7.1 and 7.2)</td>
<td>• Resistance – which are likely to meet opposition?</td>
</tr>
<tr>
<td>• Setting standards (Section 8.4)</td>
<td>• SWOT analysis – where can you leverage internal strengths to take advantage of external opportunities?</td>
</tr>
<tr>
<td>• Complaint and suggestion system (Section 8.4)</td>
<td>• Cost to benefit ratio – which option gives you more value? (Section 7.2)</td>
</tr>
<tr>
<td>• Exit interviews and other methods of monitoring client loyalty (Section 9.3)</td>
<td></td>
</tr>
<tr>
<td>• Comprehensive risk framework (Module 10)</td>
<td></td>
</tr>
<tr>
<td>• Internal and external audits (Section 12.4)</td>
<td></td>
</tr>
<tr>
<td>• Staff performance appraisals (Section 14.5)</td>
<td></td>
</tr>
<tr>
<td>• Culture questionnaire (Figure 15.1)</td>
<td></td>
</tr>
<tr>
<td>• Benchmarking (Section 18.2)</td>
<td></td>
</tr>
<tr>
<td>• Ratio Analysis (Sections 23.5 and 23.6)</td>
<td></td>
</tr>
<tr>
<td>• Process mapping (Box 21.3)</td>
<td></td>
</tr>
<tr>
<td>• Gap analysis (Section 21.1)</td>
<td></td>
</tr>
<tr>
<td>• Costing (Module 22)</td>
<td></td>
</tr>
<tr>
<td>• Performance reports (Module 23)</td>
<td></td>
</tr>
</tbody>
</table>
Table 24.1 (cont’d)

<table>
<thead>
<tr>
<th>Tools for defining a strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Mission, vision and values (Module 4)</td>
</tr>
<tr>
<td>• SMART objectives (Section 4.4)</td>
</tr>
<tr>
<td>• Market research (Module 5)</td>
</tr>
<tr>
<td>• Market segmentation (Section 7.1)</td>
</tr>
<tr>
<td>• Competition analysis (Handouts 7.1 and 7.2)</td>
</tr>
<tr>
<td>• The 8Ps (Section 7.2)</td>
</tr>
<tr>
<td>• Value triangle (Section 7.2)</td>
</tr>
<tr>
<td>• Preparing a message (Section 7.3)</td>
</tr>
<tr>
<td>• Marketing Communications Mix (Section 7.4)</td>
</tr>
<tr>
<td>• Setting standards (Section 8.4)</td>
</tr>
<tr>
<td>• Process mapping (Box 21.3)</td>
</tr>
<tr>
<td>• Activity-based budgeting (Section 23.3)</td>
</tr>
<tr>
<td>• Balanced scorecard (Section 23.2)</td>
</tr>
<tr>
<td>• Types and styles of planning (Sections 23.1 and 23.2)</td>
</tr>
<tr>
<td>• Performance equation (Section 14.1)</td>
</tr>
<tr>
<td>• Sample HR policy manual table of contents (Box 14.1)</td>
</tr>
<tr>
<td>• Sample recruitment and selection policy (Case study module 14)</td>
</tr>
<tr>
<td>• 8-step hiring process (Section 14.2)</td>
</tr>
<tr>
<td>• Setting effective performance objectives (Section 14.5)</td>
</tr>
<tr>
<td>• Annual staff performance plans (Section 14.5)</td>
</tr>
<tr>
<td>• Pricing strategies (Section 22.3)</td>
</tr>
<tr>
<td>• Transformation decision checklist (Box 3.4)</td>
</tr>
<tr>
<td>• Managing growth through organizational architecture (Table 17.2)</td>
</tr>
<tr>
<td>• Preconditions for product development (Section 6.3)</td>
</tr>
<tr>
<td>• Product development process (Section 6.4)</td>
</tr>
<tr>
<td>• Framework for product analysis (Table 6.2)</td>
</tr>
<tr>
<td>• Seven-step marketing process (Part II introduction)</td>
</tr>
<tr>
<td>• Improving customer service (Section 8.4)</td>
</tr>
<tr>
<td>• Framework for designing a premium loyalty strategy (Section 9.4)</td>
</tr>
<tr>
<td>• Six-step risk management process (Figure 10.2)</td>
</tr>
<tr>
<td>• Risk management roles and responsibilities (Figure 10.3)</td>
</tr>
<tr>
<td>• Strategies for preventing credit risk (Section 11.1)</td>
</tr>
<tr>
<td>• Strategies for managing delinquency (Section 11.2)</td>
</tr>
<tr>
<td>• Strategies for controlling staff fraud (Section 12.3)</td>
</tr>
<tr>
<td>• Two perspectives on motivation (Box 19.1)</td>
</tr>
<tr>
<td>• Key design issues for financial incentive schemes (Section 19.5)</td>
</tr>
<tr>
<td>• 20 ways to shape the institutional culture (Section 15.3)</td>
</tr>
<tr>
<td>• Systematic approach to new technologies (Box 20.6)</td>
</tr>
<tr>
<td>• Process for managing organizational change (Section 21.4)</td>
</tr>
<tr>
<td>• 14 steps of total quality management (Box 21.1)</td>
</tr>
</tbody>
</table>
The Organizing Function

Once a manager knows the performance that he or she is expected to produce, the next step in the performance management process is to organize the necessary resources to put those plans into action. This includes communicating the plans, defining more detailed implementation schedules, distributing and coordinating tasks, and training staff. In fulfilling this function, managers can draw on some of the tools mentioned above, namely:

- The 8 Ps, which can be used to train staff, to design promotional literature and frequently asked question sheets, to test product knowledge, to develop new products and to prepare marketing messages, among other things.
- “Should Be” process maps can be used for training purposes, as well as provide a useful reference for how the work flow should be organized on a day-to-day basis.
- Institutional values and culture define the norms and principles according to which resources should be organized.
- The mission, objectives, plans, budgets, timelines and service standards provide guidance with respect to how things should be organized and towards what end.
- The performance equation reminds managers that they must put together both a skilled and motivated team.
- Twenty ways to proactively shape the institutional culture can help managers to eliminate areas of the existing culture that may not be appropriate for the implementation of future plans, and to maintain areas of strength that are expected to play an important role in supporting implementation.
- The eight-step hiring process can help managers recruit wisely should they need to hire new staff.
- An annual performance plan for each employee, which managers can use to help staff understand what is expected of them and how the contributions they make will affect the overall success of the institution.

There are other course tools, tips and techniques that managers can drawn upon as well, some of which are uniquely designed to assist managers to improve their performance as they carry out organizing activities:

- Questions for branch managers as they organize (Box 1.2)
- Management styles analysis (Table 1.1)
- Making communication more effective (Table 1.2)
- Seven ways to use teams to organize staff and functions (Section 16.3)
- Job descriptions (Section 14.2)
- Deciding what to delegate (Box 1.5)
- In-service training (Section 14.3)
- Partnership and outsource arrangements (Sections 3.1, 3.2, 16.3, 17.5)
- Plans and budgets (Module 23)
- The feedback loop (Box 24.1)
Among this list of tools, the feedback loop is particularly useful because it brings together all of the manager’s core responsibilities into a performance management system. As explained in Box 24.1, the feedback loop describes the way information moves through an organization, ideally facilitating action that produces desired results. Its name highlights the importance of returning to the original providers of information, so that they can see the impact of their contributions and be encouraged to continue being part of the performance improvement process in the future.

**Box 24.1 The Feedback Loop**

The feedback loop describes the stages that information moves in an organization from its initial generation to the implementation of changes in products and services. By following the different phases of the loop, managers are more likely to consider all the issues involved in decision-making and implementation, and make more effective use of the information collected. The eight steps of the loop are as follows:

1. **Information Collection:** Data is gathered formally and informally.
2. **Information Consolidation:** Raw data are turned into a usable form.
3. **Analysis:** Information is formally assessed in terms of client and institutional needs, and this forms the basis for recommendations to satisfy those needs.
4. **Reporting:** The analysis is summarized in written or verbal form for ease of decision-making.
5. **Decision-making:** Decisions are made based on data and recommendations from the reporting phase.
6. **Delegation:** After a decision is made, the person responsible for implementing it must be fully aware of all requirements.
7. **Communication:** Preparations are made for implementation, including the development and communication of plans, the training of staff and the internal marketing of changes to be made.
8. **Implementation:** Changes to products or services are pilot tested, and based on this a decision is made with respect to full implementation.

Once the process has been completed, it is necessary to return to the information collection stage to gauge the level of client satisfaction and the effectiveness of the changes made, and to provide feedback to the providers of the information.

*Source: Adapted from Imp-Act, 2003.*
Managers carry out activities in many steps of the loop, but in their capacity as organizers they have responsibility for making sure the loop is functioning effectively within their area of operations, regardless of who is actually carrying out each step.

In building effective feedback loops, managers may find the following lessons useful:

- **Focus on collecting data that the institution can use.** If staff is gathering data, but there is no capacity to follow through on the loop, the institution is wasting time and money. For example, many MFIs request a lot of information from loan applicants that is neither considered in the application process, nor entered into a database for analysis. Instead, after clients and staff have spent valuable time answering the questions, the data languish in a filing cabinet.

- **Look out for places where information gets stuck.** Take actions to unclog the blockage and, if necessary, establish an alternative communication channel that can be used until the barrier can be removed. In some MFIs, branch managers are notorious for receiving memos that they never share with the branch staff.

- **Watch for steps that are being left out.** Try to find out why they are left out and develop plans for getting them put back in. Skipping steps may help move information faster around the loop, but often generates sub-optimal results. For example, when customer complaints and suggestions are not analysed before being passed to decision-makers, the raw data can mislead managers into making wrong decisions.

- **Use pilot testing as an alternative to several rounds of theoretical research.** Once a reasonable decision can be made, move forward. Too many MFI managers make the mistake of waiting until they have perfect information to take a decision. This may reduce certain operational risks, but can increase other types of risk instead (e.g., competition, strategic or reputation risk).

- **Make sure tasks are delegated with guidance and with the authority to accomplish those tasks, so that the person accepting responsibility is clear about what is being expected and by when, and feels confident that he or she can complete the task as required.** Then hold the implementing person responsible for actually completing the task as requested.

- **Pursue strategies that accelerate the movement of information around the feedback loop.** Some of the strategies that MFI managers have found successful include: computerization; holding 15-minute “morning meetings” with staff at the branch or unit level; building a corporate culture that values communication; making sure that multiple communication channels are accessible to all employees; and introducing a product development committee or a client-information focal point who coordinates the consolidation, analysis and reporting of client data.

The manager’s responsibility for facilitating communication cannot be underestimated. Whether managers are planning, organizing, leading or controlling, their ability to convey information is key to improving both individual and institutional performance. With particular reference to the organizing function, managers must establish channels through which others can productively communicate, and keep information flowing so that those who provide it and those who act on it understand the impact of their contributions.
One organizing strategy that is extremely valuable for facilitating effective communication is the documentation of plans, mission and vision statements, service standards, policies, job descriptions, and so on. Putting such information in an easy-to-understand format and widely distributing it can greatly improve awareness of what needs to happen, when, by whom and why. If these documents are user-friendly and easily accessible, they can serve as reference material during routine operations and at decision-making points, helping to ensure that plans are carried out as designed, greatly reducing confusion about what might have been said or intended, and increasing everyone’s focus on the priorities that really matter, thus greatly increasing the likelihood that objectives will actually be achieved.

Of course, once plans and strategies are put into writing, they cannot be left alone. They should be regularly reviewed to ensure that they continue to be accurate and relevant. Managers who are working with existing documentation — rather than creating their own plans, mission statements and standards — should put the review of this documentation high on their list of priorities, before they start using them as tools to facilitate their organization efforts.

The Leadership Function

Once plans are made and resources are organized to implement them, managers must guide and support the implementation of the plans to produce the desired results. This includes coaching and guiding staff, motivating their performance, and creating a work environment that makes employees want to contribute to organizational goals. Tools from the course that can assist managers in this effort include:

- Twenty ways to proactively shape the institutional culture (Section 15.3)
- Two perspectives on motivation (Box 19.1)
- Non-financial incentives and (perhaps) financial incentives (Modules 9, 14, 15 and 19)
- New employee orientation (Section 14.3)
- Setting priorities (managers can use the same techniques for establishing implementation priorities as they did in establishing planning priorities above)
- Techniques for providing feedback to employees about their performance (Box 14.7)
- Feedback loop — if managers do all they can to complete their own feedback loops, they can show others how to do it and perhaps even inspire them to do the same (Box 24.1)
- Strategies for creating a work environment that brings out the best in staff (Modules 14, 15)
- A framework for designing a premium loyalty strategy — managers can use this framework to help them create staff loyalty, not just client loyalty (Module 9)
- Mentorship programmes and career development (Sections 1.4, 14.3, 14.4)
- Annual staff performance appraisals (Section 14.5)
- Managing growth through organizational structure (Table 17.2)
- Top ten places to put your vision, mission and values in writing (Figure 15.2)
- Fourteen steps of total quality management (Box 21.1)
- Practices that promote successful change (Box 21.5)
A microfinance manager's challenge of getting things done "with and through other people" is more visible in the leadership function than any other. To make the most of the resources that have been brought together and organized, managers must not only inspire their team and show them how they would like results to be achieved, but they must also make others want to achieve those results. A manager's responsibilities as a leader have a lot to do with influence — not making people do things, but convincing them they want to do things (see Box 24.2).

**Box 24.2 Leadership Tips**

- Tell people what you want, not how to do it
- Get out of your office
- Lead by example
- Show respect for people
- You can't listen with your mouth open
- Practice what you preach
- Use influence rather than authority to persuade others
- Learn from the mistakes of others
- Train your supervisors
- Publicize and celebrate success
- View information as a tool to be used, not as power to be hoarded
- You have to make a difference; the group you manage has to be more productive with you there than it would be if you were not

*Source: Adapted from F. John Reh, 2000.*

Thus, other than providing an inspiring vision, perhaps the most important effort a manager can make is to involve all members of his or her team in planning and organizing activities — defining team goals and prioritizing their own activities in pursuit of those goals. As discussed in Module 21, this is a process that creates buy-in. Buy-in matters not only when radical changes are taking place, but also at any time that a manager is trying to mobilize others to accomplish objectives that lie beyond their own self-interest. If managers solicit input and allow everyone to feel a sense of ownership and responsibility for achieving institutional results, then performance is bound to improve, both at the individual and the institutional levels.
The Control Function

Under the leadership function, managers do their best to guide and encourage the kind of performance that will produce desired results. To fulfill that function effectively, managers must also be capable of fulfilling the control function because through control they will know whether the desired results are, in fact, being achieved. If they are not, managers can try alternative strategies for motivating performance; they can adjust plans; or they can reorganize the way resources are used to get existing plans on track.

While managers are not the only persons to fulfill a control function, they cannot afford to wait until others complete this function for them. They need to be constantly monitoring performance and making adjustments to ensure that goals are achieved. Of course, managers can and should draw on the resources of the internal and external auditors, but should not depend entirely upon them. Some of the other tools, tips and techniques that managers can use to support their control efforts include:

- Service standards, commitments, timelines, milestones, etc. — provide indicators against which performance can be measured and analysed (Section 8.4)
- Performance ratios (Tables 18.1 and 23.3; Box 11.3)
- Performance reports (Sections 23.4 and 23.5)
- Peer group benchmarking tables (Handout 18.3)
- Variance analysis — to explore why there is a discrepancy between planned and actual results (Section 23.6)
- Exit interviews (Section 9.3)
- Complaint and suggestion systems (Section 8.4)
- Performance appraisals — if based on well-defined plans, these can easily and productively be linked to salary increases or bonuses (Section 14.5)
- Financial and non-financial incentives — rewarding and disciplining performance based on results provides a self-control mechanism because it establishes clear expectations about what staff will receive if they contribute to institutional goals (Modules 9, 14, 15, 19)
- Six-step risk management process (Figure 10.2)
- Risk management self-assessment (Handout 10.5)
- Three strategies for preventing credit risk (Section 11.1)
- Seven strategies for managing delinquency (Section 11.2)
- Nine strategies for controlling staff fraud (Section 12.3)
- Four techniques for detecting fraud (Section 12.4)
- External risk mitigation strategies (Table 13.2)
- Feedback loop — disseminating information about the results achieved so that everyone is aware of the impact of their decisions and actions and can respond (Box 24.1)

In general, if smart and energetic people are put into a supportive environment, they will figure out a way to reach the goals that they helped set and will not need to be controlled every moment of the day. Indeed, in the microfinance environment, managers cannot afford to micro-manage staff activities — the cost would be unsustainable. This does not mean that
microfinance management must be strictly "hands off", as the risk of fraud would skyrocket if there were no controls in place. It does mean, however, that managers need to know when to step in and when to step back. By demonstrating trust in employees and giving them room to manoeuvre, all members of the team will have the freedom to develop their own innovative solutions for improving performance.

24.2 Facing the Challenges

As managers reach the end of this course and consider the possibilities for implementing the tools, tips and techniques mentioned above, they often raise concerns about the challenges they expect to face as they attempt to put these new concepts into practice. Some of the most common concerns have already been addressed in other modules and are worth referencing here as resources for managers, as they seek solutions in their own local environment:

- Resistance to change (see Module 21)
- Motivating change (see Module 21)
- Lack of skilled staff (see Module 14)
- Limited information (see Module 5)
- Motivating without financial incentives (see Modules 9, 14, 15 and 19)
- Political interference (see Module 13)
- Legal barriers or restrictions (see Module 13)

There are, however, three additional challenges that have not been explicitly addressed elsewhere in the course. These are: 1) finding time; 2) finding funds; and 3) getting support from supervisors and higher levels of management. This section briefly addresses these three challenges with the aim of providing some parting guidance to keep these challenges from interfering with efforts to improve performance. The tips and strategies suggested below have been collected from various modules and from MFI managers across the globe who have participated in the course to date.

Finding Time

The challenge of finding time is a challenge of time management and prioritization. The useful question to ask is not where to find the time to implement changes, but rather how to make time to implement changes. Consider the following ideas:

1. Reduce time spent on unproductive meetings
2. Use the Pareto Principle to focus on the 20 per cent that matters most (see Box 24.2)
3. Allocate time to activities in preference of priority
4. Stay focused on established goals or expected outputs
5. Start the day by identifying the three most important things to accomplish that day
6. Improve time management practices in your office
7. Be on time for appointments, keep to the schedule and move on when time is up
8. Delegate
Towards Greater Efficiency and Productivity

9. Make appointments with yourself
10. Have a “half-open door” policy or “drop-in” hours to create uninterrupted office time
11. Demand concise reporting
12. Handle each piece of paper only once
13. Standardize some processes or reporting
14. Manage actions instead of managing “stuff”; start every item on your “to do” list with a verb
15. If something can be done in two minutes or less, take the necessary action immediately

Box 24.3 The Pareto Principle (80/20 Rule)

In 1906, Italian economist Vilfredo Pareto created a mathematical formula to describe the unequal distribution of wealth in his country, observing that 20 per cent of the people owned 80 per cent of the wealth. After Pareto made his observation and created his formula, many others observed similar phenomena in their own areas of expertise and soon Pareto’s Principle, also known as the 80/20 Rule, became a popular management tool.

The 80/20 Rule suggests that in any scenario, a few (20 per cent) are vital and many (80 per cent) are trivial. In Pareto’s case, it meant 20 per cent of the people owned 80 per cent of the wealth. In the work of quality management pioneer Dr. Joseph Juran, 20 per cent of the defects caused 80 per cent of the problems. The rule can be applied to almost anything. 80 per cent of your sales will come from 20 per cent of your sales staff. 20 per cent of your staff will cause 80 per cent of your problems, but another 20 per cent of your staff will provide 80 per cent of your production. It works both ways.

The value of the Pareto Principle is that it reminds managers to focus on the 20 per cent that matters. Of the things you do during your day, only 20 per cent really matter. Those 20 per cent produce 80 per cent of your results. Identify and concentrate on those things. When the fire drills of the day begin to sap your time, remind yourself of the 20 per cent you need to focus on. If something in the schedule has to slip, if something isn’t going to get done, make sure it’s not part of that 20 per cent.

Source: Adapted from F. John Reh, 2002.

Finding Funds

Often blamed for managers’ inability to implement new ideas, the lack of funds is a real but not insurmountable challenge. Microfinance managers who meet this challenge tend to spend more time on the planning function than others, either building relationships, plotting small steps towards a larger goal, or convincing their institutions to make relatively small investments today that could provide more significant financial support in the future. Very few are lucky enough to stumble upon a large pot of donor money to support them in their efforts to improve performance. Some of the strategies they are pursuing include:

1. Using efficiencies gained through one activity to finance another
2. Reducing costs by revisiting the budget, perhaps by applying activity-based budgeting

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3. Establishing relationships with a few commercial lenders, no matter how small
4. Being transparent about current and past performance so as to create a track record that could be used to attract investors in the future
5. Looking for ways to motivate staff without financial incentives, for example, building loyalty based on social ties, recognizing achievements, creating a social infrastructure that is supportive of all staff, giving every employee a voice and encouraging teamwork
6. Budgeting for depreciation of existing assets to create contra-asset accounts with funds reserved for replacing/updating those assets in the future
7. Leasing equipment rather than buying it
8. Finding a sponsor who will let MFIs borrow or use its assets for free or at a subsidized price
9. Outsourcing tasks that are more expensive to supply internally
10. Partnering with other institutions that already have the needed expertise so the MFI can avoid developing it internally
11. Partnering with institutions that can provide MFIs with the economies of scale required to keep their costs down
12. Recruiting interns or volunteers
13. Hiring temporary or part-time support
14. Introducing profit sharing so that branches have funds of their own to work with
15. Socializing and networking to build contacts, referrals or future partnerships
16. Attending stakeholders’ workshops and meetings to be “in the know”
17. Involving staff in watching out for fund-raising opportunities, perhaps offering an incentive for bringing in funds
18. Preparing for voluntary savings

Getting Support

Last but not least, managers at all levels struggle with the challenge of getting support from their supervisors to implement ideas that they believe will improve performance. Careful and thoughtful planning seems to help MFI managers with this challenge as well. Rather than rushing to the top filled with excitement for a new idea, managers will have greater success if they pick a strategic moment and format for their presentation. Listed below are some of the tactics they recommend:

1. Find a way to introduce ideas that does not threaten those above
2. Double check that your message is clear and attractive
3. Prove your case; argue persuasively that your idea is feasible and there is a need for it
4. Develop influence skills; don’t use the lack of authority as an excuse for not taking action
5. Find the right time and place to present your recommendation
6. Clearly explain the benefits for the institution
7. Send your supervisor to visit an institution where your idea has been implemented successfully
8. Present your proposal in a less formal environment; socialize informally to plant ideas
9. Negotiate when your supervisor is in a good mood
10. Do not try to take credit for the recommendation
11. Go straight to the point
12. Have important data at your fingertips to support your recommendation
13. Listen to find out why your superior is resisting and try to find common ground
14. Make suggestions through the suggestion box
15. Use examples of the institution's current state or past experience to build your case
16. Demonstrate an urgent reason for needing to make a change
17. Have high-level leaders make your case for you
18. Consider the audience – make sure your language, level of detail and tone are appropriate
19. Know your objectives
20. Do some advance research on the subject you want to discuss
21. Cite real examples to support your argument; try using clients' own words to support your case
22. Cite precedents
23. Cite figures whenever possible to substantiate your argument
24. Prepare written materials to back up your oral communication
25. Know your competition
26. Avoid behaving like a "Mr. or Ms. Know it All"
27. Show respect
28. Seek the support of your peers and make a collective case
29. Call on external partners to help you communicate a message
30. Be flexible – it is all about negotiation; be willing to take one step back in order to take two steps forward, or to compromise somewhere else in exchange for winning here
Main Messages

1. The first step in improving performance is to know what performance you want to improve.
2. Make sure the feedback loop is functioning effectively within your unit and use it as a tool for managing performance.
3. Document and regularly review plans, service standards, policies, job descriptions, etc., to facilitate effective communication of what needs to happen, when, by whom and why.
4. Involve all members of your team in planning and organizing activities so that everyone can feel a sense of ownership and responsibility for achieving results.
5. Constantly monitor performance and make adjustments to ensure that goals are achieved.
6. Avoid using challenges as excuses for not improving performance.

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