Case Study

A Successful Non-profit MFI Considers Commercialization

FATEN, a Palestinian MFI

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For the ESAF Project

February, 2010

ESAF

The USAID-sponsored Expanded and Sustained Access to Financial Services Program (ESAF) Program is managed by the Academy for Educational Development (AED).

The Expanded and Sustained Access to Financial Services program (ESAF) supports USAID in its efforts to build a more inclusive financial sector that increases the sustainable access to financial services for Palestinian households and micro, small and medium enterprises. Through a variety of interventions, ESAF is addressing weaknesses in the financial system at all levels, from banking to the financial industry to regulatory environment.

ShoreBank International

ShoreBank International is a subcontractor to the ESAF project, providing technical assistance to microfinance institutions in Palestine with a view toward enhancing their institutional capacity to provide micro, small and medium enterprise financial products to eligible borrowers.

ShoreBank International Ltd. (SBI) delivers a broad range of financial services to financial institutions and their funders globally, dedicated to expanding access to capital for small businesses, entrepreneurs and households. Within our core sectors of small business finance, microfinance and housing finance, SBI develops innovative solutions to catalyze the financing of entrepreneurial and housing investments around the world by working with interested financial institutions and by introducing independent platforms.

Introduction

Today, commercialization is considered a potential key to MFI growth, and donors are recognizing the benefits of weaning MFIs off donor funding, such as increased outreach. A palpable shift in microfinance appears to be taking place, away from the donor-based model of microfinance and towards the capital markets model. But there are challenges to the MFIs involved:

1. Commercial MFIs may face additional reporting requirements: to regulatory agencies, to their board, to shareholders, etc.

2. When an MFI is accountable to shareholders or must repay a loan, it has to have very tight, efficient, professional operations. Donors expect accountability as well, but there's a significant difference between accountability to a grantor and accountability to someone holding your debt or to a shareholder. MFIs must learn to balance a "double bottom line" of profit and social accountability, maintaining profits and efficiencies while avoiding social mission drift.

3. Commercialization may require new software for portfolio tracking and reporting and this software can be very expensive.

4. The role of the CEO and governance of the MFI shifts dramatically when MFIs commercialize. The CEO is no longer the "number one" of the MFI – he or she must now report to a board. But governance also has impacts at the board level, as the board becomes responsible to shareholders. It also affects reporting, the role of internal audit, and transparency.

5. Internal controls frequently must be strengthened, with higher standards of transparency and accountability demanded by regulators, owners, and creditors.

In 2008, FATEN, one of the largest non-profit Palestinian MFIs with operations in the West Bank and Gaza, seemed a prime candidate for commercialization. It had ambitious growth targets, however, the MFI would need funds to achieve them. FATEN had already identified funds to hit its 2009 target of $16 million, but beyond that, it was unclear where future money would come from. The MFI did not have enough projected retained earnings to hit its growth targets, and failure to achieve them could mean lost market share and damage to its reputation if they were forced to deny larger, repeat loans, or even new loans to clients due to lack of capital.

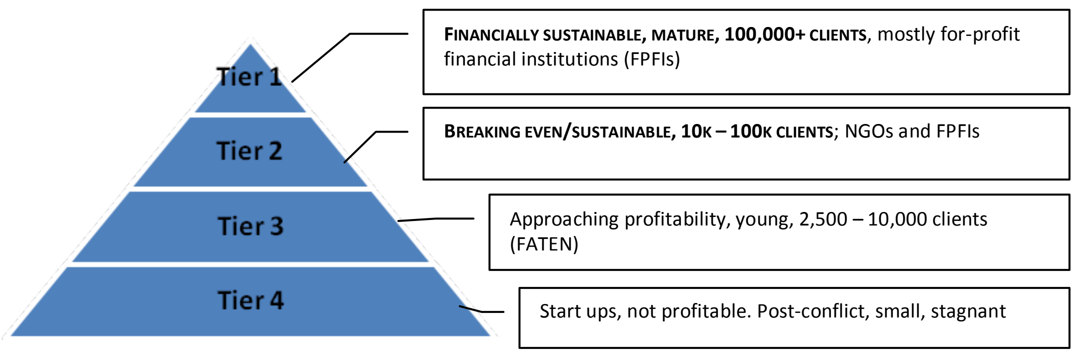
The ESAF/SBI consultants offered to help prepare FATEN to "commercialize" in order access commercial bank funds. For the purpose of accessing finance, commercialization made sense. But FATEN's organizational culture was non-profit, and the big steps SBI suggested would have to be approved by a board more familiar with the non-profit, donor-funded microfinance model. Could or even should FATEN commercialize?

Background

FATEN began operating as a financial service institution in the West Bank and Gaza in 1995. It achieved operational self-sufficiency ten years later, in 2005, managing to navigate Palestine's tumultuous economic and political landscape while introducing multiple microloan products. By Nov, 2008, FATEN was one of the top three MFIs in Palestine, trailing behind UNRWA and highly competitive with CHF. FATEN was projected to end the calendar year with a $12 million portfolio. The MFI's board and managers had reason to be proud of the MFI's accomplishments, and they wanted to stay at or near, the top of Palestine's microfinance providers. But just what did that mean?

FATEN had a fair-sized portfolio, but since its loan sizes were relatively large[1], averaging over $600, it had less than 5,000 clients by year-end 2008. It was operationally sustainable but not financially sustainable. According to standard definitions, the MFI ranked as a Tier 3 MFI (see Fig. 1, below).

FIGURE 1



Estimates in a 2007 study by the IFC[2] placed the total number of micro-entrepreneurs in Palestine at just over 200,000 persons, and not every micro-entrepreneur would want a microloan. The same report estimated only 56% of micro-entrepreneurs in the West Bank and 57% in Gaza had a need for loans, translating to roughly 75,000 potential borrowers in the West Bank and 48,000 in Gaza[3] to be divided up amongst multiple MFIs. Given the relatively small size of the Palestinian market, Tier 1 status was probably not reasonable, but could Tier 2 be achieved?

According to FATEN management, the MFI had enough funds (both on hand and through an approved "soft" loan from UNDP) to achieve a $16M portfolio by fiscal year end 2009. However, after 2009 the funding picture grew murky. In a gap analysis facilitated by ESAF and SBI consultants in December, 2008, managers expressed targets of reaching a $20M portfolio by year-end 2010, and $26M by 2011. How would they get there?

[1] Large for the world of microcredit – loan sizes were fairly average for Palestine and in particular, the West Bank.

[2] International Finance Corporation (IFC). Microfinance Market Survey in the West Bank and Gaza Strip. Washington, DC. May, 2007: 16.

[3] Ibid.

The MFI appeared to have the human resources and institutional capacity for such growth; what they lacked was the money to fund it. FATEN would need to source additional financing; if it chose to do so at a commercial level, the MFI would need to increase its profitability.

FATEN's Road to Commercialization

For FATEN, commercial funding appeared to be a good alternative, or at least supplement, to donor funding. But to access it, FATEN would need to improve its risk management to provide a higher comfort level to investors, to gain the support of the board for acquiring commercial financing, and to actively court local and international banks. FATEN had a good reputation, but although it was sustainable, its financials weren't quite up to the stringent requirements of commercial lenders. Its legal status as a non-profit and its position as a Tier 3 MFI restricted its financing options. Commercial debt and equity is more readily available to commercial MFIs in the Tier 1 and Tier 2 categories (see Table 1, below).

Table 1: An MFI's Tier and Access to Funding

Type of financing available	Tier 4	Tier 3	Tier 2		Tier 1	
	NGO	NGO	NGO	FPFI	NGO	FPFI
Public						
Grants	X	X	X	X	X	X
Subsidized loans	X	X	X	X	X	X
Guarantees		X	X	X	X	X
Private debt						
Commercial loans			X	X	X	X
Guarantee funds			X	X	X	X
Bonds				X		X
Securitization				X		X
Commercial linkages			X	X	X	X
Private equity				X		X

To increase the MFI's profitability, FATEN's strategic plan called for focusing on its line of smaller-sized loans, which had higher yields. However, while the interest rates on these loans were higher than FATEN's larger-sized loans, this plan assumed that these smaller loans were also more profitable. Were they?

Having never undergone a product costing exercise, it was unclear if this assumption was correct. Therefore, the SBI consultants recommended a product costing exercise to determine how the expenses of different-sized products compared. The consultants also suggested increasing the number of borrowers per loan officer to increase efficiencies. At the time of the gap analysis by the ShoreBank team in December, 2008, the MFI averaged 159 borrowers per loan officer. The consultants felt, and FATEN management agreed, that 250 borrowers per loan officer was a rational and obtainable target (see Table 2, below).

Increasing efficiencies appeared to be a significant issue for Palestinian MFIs. Palestine's relatively small market size made the achievement of economies of scale difficult. Its MFIs also faced economic and political uncertainties unique to the Palestinian situation, all of which tended to increase costs. Gaza and the West Bank were not only separated geographically, but also working under two different governments. The Palestinian microfinance industry's comparatively high level of portfolio at risk (see Table 2, below) has resulted, largely, from the difficulties associated with the continued Israeli occupation. Added to the mix was the general uncertainty surrounding Palestine's economy – business owners became more risk averse as uncertainty rose, and borrowing became less palatable, further shrinking the microfinance market. The donor community had also been feeding Palestinian MFIs grants for decades, reducing the incentive for efficient, sustainable operations. Had some or a combination of these factors increased the cost of lending in Palestine, making it higher than in other parts of the Middle East (see Table 2, below)? Or was that particular comparison unfair? In several respects, Eastern Europe actually made a better benchmark for the Palestinian microfinance sector. Like Palestine, several Eastern European countries, most notably Bosnia, were dealing with the aftermath of conflict and border uncertainties, and the incomes and microloan sizes in Palestine and in Eastern Europe were a closer match, with loan sizes going well beyond $1,000. Still, even compared to Eastern Europe, Palestinian MFIs did not compare well in terms of efficiencies and costs. Could taking a more commercial approach to pricing, operations, and profitability help Palestinian MFIs bridge the gap?

TABLE 2: A MEASURE OF EFFICIENCIES[4]

Region	Cost per loan	Loans per loan officer	PAR_{30}
Palestine	$ 290	110	11.8%
Middle East and North Africa	$ 66	207	1.9%
Africa	$ 114	244	4.8%
Asia	$ 36	236	1.7%
Latin America & Caribbean	$ 146	242	3.2%
Eastern and Central Europe	$265	149	1.2%

Year One: October, 2008 – September, 2009

FATEN managers agreed to a proposal by the SBI/ESAF team for SBI's consultants to conduct risk management assessments and trainings, facilitate a strategic planning workshop for the board, and arrange for study trips to a commercial MFI, Mi-Bospo, in Bosnia, and to the National Microfinance Bank (NMFB) in Jordan. The latter two were perceived by SBI consultants to be the most critical – the board was rightfully concerned about mission drift and uncertain as to whether the very real trade-offs they'd experience as a commercial entity would be worth it.

[4] Note: The annual cost per borrower for Palestine is a 2008 figure based on data reported to the Palestinian Network for Small and Microfinance. The regional benchmarks are for year 2007 as reported in "The MicroBanking Bulletin" of the MIX (Microfinance Information Exchange).

Unfortunately, the three board members tapped for the study trip to Mi-Bospo were ultimately unable to attend, leaving FATEN's General Manager to visit the Bosnian MFI on his own. However, the Mi-Bospo trip provided some valuable lessons, according to FATEN's General Manager, Anwar Jayousi. At the time of the visit, Mi-Bospo was experiencing significant delinquencies, partially due to the banking crisis at that time but also due to uncontrolled growth. "High growth is not always good," reported Anwar, "controlled is important. This is the approach which FATEN will be taking – managed portfolio growth." Anwar also noted that although Bosnia had a higher standard of living than Palestine, the costs of lending were lower, and he took away from the trip some lessons in how to increase efficiencies.

The visit to the NMFB in Jordan had very different outcomes. The topics covered in this visit focused on growth through access to commercial finance – an important issue for FATEN's board. Commercial finance was a cornerstone of NMFB's strategy, which was based upon shunning donor funding in lieu of commercial loans. Fortunately, most of FATEN's board members were able to attend this crucial discussion, though the members of the board from Gaza were unable to participate due to travel restrictions.

July, 2009 was the first month in which FATEN showed both financial sustainability – a stricter definition than operational sustainability, and which takes inflation and the cost of finance into account. By year end, managers were also closing in on a key efficiency target: borrowers per loan officer had increased from 159 to 216, a 73% increase. More importantly, in 2009 FATEN began taking steps to access commercial funding.

However, in meetings with SBI consultants, the board expressed discomfort with perceived shifts in FATEN's character and direction. FATEN was a non-profit and they were wary that further commercialization would expose the MFI to the threat of mission drift.

Year Two (October, 2009 – September, 2010)

As FATEN began to go through the commercial underwriting process, its managers realized the need to address some costing and strategic issues to make them more attractive to potential lenders. Were the products priced for profitability or were the margins too thin? Was their business plan realistic? FATEN worked with the ESAF/SBI team to develop a technical assistance plan more focused on prepping the MFI to access commercial finance.

The Year Two work plan for FATEN, therefore, included:

- **Strategic & business planning**: Near the end of 2009, SBI consultants facilitated a business planning exercise, with a three year financial projections plan which included raising $7 million from a variety of sources including debt, microfinance investment vehicles, and savings, newly allowed under the regulation of the Palestinian Monetary Authority. The plan was slated for board review in early 2010.

- **Product costing/pricing exercise**: ESAF/SBI consultants would work with FATEN management to gather financial and operational data for each loan product, and analyze the cost per product. The aim of this activity was to determine the true cost for the various loans FATEN offers, and in turn to assist with loan portfolio allocation and pricing decisions.

- **Communications strategy:** FATEN would recruit a senior manager to lead all public relations and communications activities. Depending on the successful candidate's skills and experience, SBI would provide training and mentoring to help this individual create and implement an effective communications strategy for all FATEN stakeholders and future investors.

- **Branch manager & auditor training:** While FATEN's strategic focus remained on micro business loans under $5000, a significant number of loans would continue to be made to small businesses. In order to ensure the continued quality of the loan portfolio, branch managers and loan officers would receive training on the analysis of small business loan applications. SBI would also offer modules to Branch Managers on employee supervision, in order to increase the effectiveness of supervising loan officers.

- **Savings mobilization planning**: In expectation of the PMA authorization for MFIs to mobilize savings FATEN would require careful assessment as to whether savings mobilization made sense for the MFI and planning if FATEN decided to move forward. Deposit taking would not be without risks and would require a number of physical and operational changes. SBI would provide assistance to identify gaps between FATEN's current operations and FATEN as a potentially deposit-taking institution. The output of the TA would be a plan for implementing the necessary organizational changes and building staff capacity.

Conclusion

Year Two of technical assistance got off to a strong start. By the end of 2009, managers were closing in on a key efficiency target: borrowers per loan officer had increased from 159 to 216, a 73% increase. FATEN had also negotiated a $500,000 loan with Triple Jump and another $500,000 credit line from Quds Bank. The balance sheet was looking promising (see Table 2, below) – FATEN appeared to be closing in on its aggressive growth targets.

Table 3: FATEN's Balance Sheet

	2008	2009	2010 - Forecast
Assets (USD)			
Portfolio outstanding	$10,449,569	$14,269,069	$17,460,526
Other assets	5,044,660	3,041,815	1,849,159
Total assets	15,494,229	17,310,884	19,309,685
Liabilities (USD)			
Concessional loans	1,207,000	2,024,956	1,844,085
Commercial loans	0	0	876,667
Other	1,859,387	2,445,374	2,545,374

Total liabilities	3,066,387	4,470,330	5,286,126

2010 will be a critical year, with the board review of FATEN's new business plan, addressing the need to attract additional funding – possibly from commercial sources and/or through FATEN converting into a for-profit entity. Would the potential gains of commercialization outweigh the threat of mission drift?