Down-Scaling Commercial Banks into MFIs

A Case Study from Kazakhstan

Taken From CGAP.ORG Case Study "Scaling Up Poverty Reduction: Case Studies in Microfinance"

Consultative Group to Assist the Poor:

World Bank Financial Sector Network

Reasons for this Case

- Thus far, focus has been on growing smaller NGOs into MFIs – we should understand both sides.
- In thinking about final deliverable, we may be considering case study.
- Kazakhstan is particularly relevant considering recent current events.

Background

- Kazakhstan Small Business Programme (henceforth known as “The KSBP”) is the second programme to try to “downscale” commercial banks as a means of delivering micro and small enterprise (MSE) loans.
- It began in 1998 and serves as “the model” for introducing microfinance to commercial banks.

Reasons for Formation

- Government tried to institute a failed credit line for small and medium enterprise loans.
  - Previous Program: SME credit line provided by EBDR and guaranteed by the Kazakh Government (1993).
  - By 1997, less than 1/3 of the guaranteed $122.6 million had been disbursed.
  - Poor Portfolio Quality (One bank actually lost an entire $9.7 million portfolio that forced the Govt to honor its guarantee)
- It was established by EBDR (European Bank for Reconstruction and Development) in response to the government’s plea
  - Remaining funds taken out of the failed credit line to be devoted to this project.
- Partnered with:
  - USAID
  - EU
  - Government of Kazakhstan

Structure

- Modeled after the Russian Small Business Fund
  - KSBP teams up with “Partner Banks” to create independent MSE departments within each bank.
  - They have their own loan officers and financing sources, but they reach a broad audience by using infrastructure that is already developed.
- Slow Growth Plan: Expansion (such as to new regions, poorer market segments, or other partner banks) was slow so that the program could rely on training and learning.
- KSBP was also in a favorable macroeconomic environment…

Macroeconomic Environment

- Stable macroeconomic environment (ie, no huge gains or losses – normal business cycle).
- Government Political Support (reduces political risk which is a huge considering when investing across borders)
- Capitalistic Principles: The government supported KSBP from the beginning, but "resisted the temptation to intervene in the program."
- Liberalized financial market that was well regulated and supervised.
- Strong competitive pressures on banks as the sector consolidated (=M&A? Not sure…)

Structural Considerations

- Major Advantage to KSBP: Could learn from the past failures.
  - Understanding that the problem with the first program was a deficiency in supply side rather than lack of demand.
    - Partner Banks lacked the interest or know-how to issue SME loans. This was a structural fault of the old program.
    - Purpose of KSBP: Not only to provide funds, but to transfer know-how and **create incentives to build up a viable supply-side.**
    - Kazakh Government sponsored a “technical cooperation package.”

Growth Phases

- Start Up Phase
- Expansion Phase
  - Regional Expansion
  - Product Expansion
  - Adding New Banks
- Institutionalization

Start Up Phase

- Five Partner Banks who met strict eligibility requirements were selected.
  - Full Banking License
  - Approval by the NBK
  - IAS Audit
  - Program-Compatible Strategy
  - Committed Bank Management
  - Financial Stability
  - Strategic Geographic Location
- Four of the banks were private, while one of them was public (it converted to become private in 2001).
- Foreign experts were hired to train loan officers and run the local branches.
- It started with eight branches in the two major cities, Almaty and Astana. The first products were micro-loans in both tenge and dollars.
- Focus was on perfecting organizational structure of these banks: MIS Systems, developing MSE lending guidelines, incentive-based pay schemes for loan officers. The purpose was to establish **independent and specialized MSE loan departments.**

First Expansion Phase (1999)

- Once the program was developed, KSBP expanded in two dimensions:
  - **Horizontally:** Building MSE departments in new banks and expanding into new cities.
    - By 1999: Reached 6 more cities.
  - **Vertically:** Training staff of other non-MSE departments within the banks and influencing the regulatory environment (collateral requirements)

Second Expansion Phase (2000-2002)

- Regional Expansion
  - Focus on Urban MSE Market
  - MSE Departments set up in the Banks of all major cities. By 2002, there were 117 lending outlets.
- Product Expansion
  - Moving Downmarket
    - The focus had previously been on micro/small business but not yet market traders who needed small “working capital” loans.
    - New Product: **“Express Micro Loan”**
      - **Easier Collateral Requirements (Moveable, Unregistered Assets)**
      - **Faster Disbursement (24 hours)**
      - **Special MSE Outlets**
- Partner Bank Expansion
  - Within the partner banks, higher levels of management were created for microfinance to integrate these MSE departments higher into the organizational structure.

Second Expansion Phase (2000-2002)

- **Expansion of Training and Monitoring**
  - Seminars, Consultant-Development,
  - By 2002: Banks were training their own microloan officers, investing their own funds into microfinance, and hiring KSBP staff to work in more senior positions (especially in risk management)
  - They reduced the number of foreign-hired “experts.”

Institutionalization (2003-2004)

- This was a very successful organization:
  - In all cities of Kazakhstan (100,000 population)
  - Intense Penetration in the Lower End of Market
    - Express loans accounted for 50% of the loan portfolio in 2004.
    - Partner Banks finance about 40% of the MSE business with their own resources and MSE products are regularly marketed.
    - Power over MSE Departments is moving from the KSBP to the banks themselves.
- Focus is moving towards streamlining partner banks’ operations, auditing, and advanced training of organically grown professionals.

Impact Analysis

- Defining Impact:
  - In the case of a down-scaling operation, impact should be measured by more than just poverty reduction (= income and consumption increase).
  - Really, should focus on “can this program build and maintain sustainable institutional structures after donors’ money is gone?”
- KSBP’s Sustainability
  - Not clear completely – lack of transparent financial data on a bank-by-bank basis.
  - PAR (Portfolio at Risk) is typically low at around 1%. Even during the Russian Financial Crisis in 1999, it was only about 4%.

Impact Analysis

- Reaching the Right Clients
  - KSBP’s Portolio Growth was **not** a result of moving up-market and abondoning the original target group.
  - Average loan size decreased throughout program as the total loan portolio increased. The median client had a loan of about $2000 (still rather large).
  - Working Capital Loans accounted for almost 80% of the clients in 2004.

Loans were focused down-market

Table 2: Distribution of Loans by Loan Amount (February 2004)				
Loan Amount in US$	Number	Percent	Volume	Percent
< 1000	6,904	19.59	3,039,038	1.87
1001-2000	9,959	28.26	10,191,287	6.26
2001-5000	9,543	27.08	21,941,387	13.49
5001-10000	4,346	12.33	24,495,695	15.06
10001-20000	2,384	6.77	27,404,825	16.84
20001-30000	933	2.65	18,686,632	11.49
30001-50000	652	1.85	20,831,178	12.80
50001-70000	199	0.56	9,370,367	5.76
70001-100000	194	0.55	13,232,331	8.13
> 100000	124	0.35	13,505,302	8.30
Total	35,238	100.00	162,698,041	100.00

Driving Factors

- Commitment to Political and Economic Change
  - Worked to change both legislation and economic structure.
    - Legislation: Changing the definition of collateral.
    - Interest rate ceilings had been abandoned, two-tier banking system, push towards privatization.
    - Economic: Mission focused on downmarket clients.
- Institutional Innovation
  - Downscaling from Banks rather than Upscaling from NGOs
    - Performance Based Incentives
    - Assessment of Cash Flow
    - Recruitment/Training Methods
  - Integrating MSE Departments into Banks
  - Pilot Testing and Launching New Products (Express Micro Loans, Agricultural Loan)

Take-Aways

- Intelligent project design is key to success of any downscaling project.
- Conditions for success of downscaling:
  - Economic/Government Stability
  - Liberal financial market
  - Competitive Banking Sector (especially for lower-market)
  - Market for MSE loans not over-saturated by NGOs (which offer the same product cheaper)
- Profit-Center Accounting should be used
- Downscaling should be tried first