Why Scale is Important
and How to Achieve It

Stephen Hodgson of Redport Strategic Consulting writes about the reasons why scale matters in an industry such as microfinance and provides tips on how institutions at various stages of their life cycle can go about achieving scale.

Providing the best product at the lowest cost to the most underserved people has long been the goal of the microfinance industry. One of the most effective ways for an institution to achieve this goal is to build and maintain an efficient, scalable operating platform. Efficient operating platforms lower costs, enable effective servicing of customers and ease expansion into underserved markets. However, for microfinance institutions (MFIs), credit unions and other non-profit financial institutions, market distortions and a lack of incentives will continue to make achieving economies of scale an elusive goal.

Scale in Competitive Markets

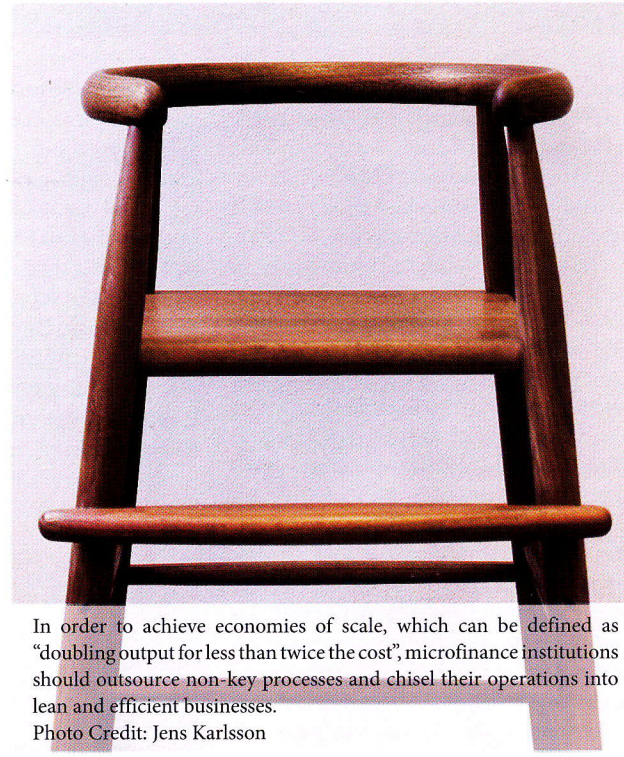
Operating "at scale" - the level where the average cost of producing each unit of output is minimized, is a primary goal for institutions serving competitive markets. And, constantly lowering the cost of delivering services is central to achieving maximum profits. This activity of seeking scale is never-ending and in places where financial services markets are open and well served, achieving maximum operational efficiency is critical to a firm's financial viability. There are many benefits that arise from efficiencies resulting from scale. These benefits are achieved in competitive markets where consumers have the ability to choose between multiple providers and market forces ensure that most of the gains from scale result in lower prices.

Underserved Markets

Underserved markets are different. To the extent that these markets are served at all, providers often enjoy monopoly positions or are otherwise protected from competitive market forces, leaving institutions with few incentives for obtaining the best possible operating efficiency. Instead, the protected nature of these institutions enables them to maintain pricing at levels that would not be sustainable in competitive industries.

For the past several years I have studied the phenomenon in non-profit financial institutions and have identified several core reasons for this inefficiency. Some of these are structural and require large investments or changes in government policy to fix. Others, however, are easily addressed within individual institutions.

Market distortions: The main reasons for the lack of scale in non-profit financial institutions are market distortions that reduce the need for operational efficiency. One of the most important market distortions arises from tax policy when governments do not tax non-profit institutions or tax them at a lower rate than comparable commercial institutions. Not having to pay taxes reduces the need to build efficient organizations. The impact of this effect can be best seen in the credit union market in the United States where, despite a highly competitive commercial financial services sector, more than 7,500 credit unions - most of them very small institutions - get away with running inefficient operations.



In order to achieve economies of scale, which can be defined as "doubling output for less than twice the cost", microfinance institutions should outsource non-key processes and chisel their operations into lean and efficient businesses.
Photo Credit: Jens Karlsson

Another market distortion can be inadvertently caused by NGOs that subsidize nascent financial industries. While these subsidies may be necessary to jump-start a market, if they are kept in for too long they risk "crowding out" competitors, which in turn reduces any incentive to build efficient operations.

Variety in value propositions: One of the most cited reasons for not using measures that help scale derives from the inconsistency in the value propositions being delivered to unique customer niches. Institutions often believe that the way they interact with their customers is "different" and that it requires a unique operating platform to support. When asked why they don't utilize the solutions available in the market, they often reply that these solutions will not support the delivery of their value proposition.

At times I agree with this argument, as many scale solutions fall under the one-size-fit-all category and do not adapt well to support multiple operating models. Often, however, the reasons given for not utilizing scale solutions are the result, in my opinion,

of an institution reluctant to give up control or not having a very clear understanding of how they truly create unique value.

Stakeholder conflict: At the outset, most non-profits are operated for the benefit of their customers. However, over time, for many institutions using cooperative and mutual ownership models, the dilution of ownership across hundreds or thousands of customers weakens owner engagement. At this point, management and employees become the most interested stakeholders.

To the extent that the owners and management are the primary stakeholders, achieving benefits of scale becomes difficult as the actions necessary to achieve this scale often mean outsourcing and loss of control – both of which are not likely to be in the best interests of the organization's management and employees.

Insufficient infrastructure: In many cases, the infrastructure required for scale doesn't exist in a particular area. Scale often means shared operations, which need leadership, expertise and especially capital to get off the ground. Efficiently tapping into this scale may need a level of connectivity that is just not possible in isolated markets.

Cultural barriers: Cultural characteristics of non-profits are often barriers to achieving scale. Many non-profits have warm family-oriented internal cultures and the dislocations inherent in seeking scale may create significant damage. Likewise, non-profit boards may not adequately incentivize managers to achieve financial goals, which can reduce their focus on operational efficiency. Another example of a cultural barrier to efficiency can often be seen in institutions that serve union members who will likely recoil at the thought of off-shoring activities.

Lack of understanding where the institution clearly creates value: Finally, many institutions fail to take advantage of scale solutions because they do not have a clear view of where they create unique value – their knowledge and relationship with the customer. Instead of focusing on the front-end of their business, many of my clients build and manage back-office operations that often can be more efficiently run by third-party providers.

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Prescription for Change

Despite the challenges, there are ways to improve operational efficiency. At the policy level, governments and funders of non-profits should examine how existing incentives create barriers to achieving efficiency. If the management team has no incentive to build in efficiencies, you can be assured that they will spend their time on other activities. At the firm level, I often recommend a program of incremental change. Rather than radically restructuring or outsourcing operations at the outset, institutions should consider a gradual start by implementing the following ideas:

1. Understand where unique value is created: The first step in any efficiency program is to develop a nuanced understanding of where the business creates unique value for its customers. Without this step, efficiency-enhancing operations risk damaging the entire operation. A thorough examination of the value chain will often reveal areas that can be outsourced to lower-cost scale providers.

2. Start small: Rather than starting with a radical restructuring of an institution's operating platform, taking smaller steps such as forming a "buyers club" with like-minded institutions to amass purchasing power can have a large impact on overall efficiency.

3. Focus on core operations: Non-core operations or operations that have the least impact on delivering the institution's value proposition are great places to look for efficiencies. Outsourcing of tasks like accounting and employee benefits processing can bring huge efficiencies at little risk to the customer franchise.

4. Consider shared-ownership models of peripheral products and services: Shared ownership models that deliver non-core products and services such as insurance, card processing, ATM and other non-core services are another way to achieve scale benefits without risking disruption of a firm's operations. In developed markets, organizations like The Co-operators in Canada and PSCU Financial Services in the U.S. have built scale operations of their own, amassed buying power for credit unions, and often have put a culturally compatible "face" on large-scale commercial operations that underlie their solutions. In the microfinance industry, large microfinance networks often play the same function.

5. Finally, consider outsourcing of operations to scale providers: Most institutions operate their own back office, and maintain full IT and operations staffs. A clear-headed view of how an institution creates unique value will often reveal that large portions of an institution's operations have little to do with differentiation at the customer's level. Partnering with the right service provider can often preserve the institution's value proposition while dramatically decreasing costs. Recently introduced solutions such as IBM's Microfinance Processing Hub hold great promise for creating economies of scale in this area.

Conclusion

Improvement in the overall efficiency and the eventual realization of commercially comparable economies of scale will come to the microfinance industry as the financial downturn drags on and as the industry's success brings in more competition. As we are seeing now in developed markets, non-profit financial institutions will, over time, be compelled by market forces to run efficient operations or risk obsolescence. Unfortunately, protected markets and a lack of incentive for change will continue to allow sub-scale operations to exist for some time. However, for those institutions prepared to proactively strive toward achieving the scale necessary to provide the best product at the lowest overall cost to the most underserved people, the tools are here today. •••

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