



# MICROFINANCE

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Europe

## *Sustainability of Microfinance in Europe*

### **Sustainability of Microfinance in Europe: a general reflection**

*By Klaas Molenaar and Stefanie Lämmermann, European Microfinance Network*

### **The Debate**

*By Geert Jan Schuite, Triodos Facet and Eric Duflos, CGAP*

### **Can MFIs in Western Europe be Sustainable?**

*Dr Karl Dayson and Mr Pål Vik, Community Finance Solutions at the University of Salford*

### **Microfinance in Western Europe and sustainability: dream or lack of ambition?**

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### **The road to sustainability**

*By Emmanuel Landais, Adie*

### **The Microfinance Operations Sustainability's Triple Bottom Line Characteristics in Eastern Europe : A Case Study on the Romanian Microfinance Sector**

*By Maria Doiciu, Eurom Consultancy and Studies SRL*



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# “Microfinance Europe”

is the bi-annual EMN magazine. It provides clear insights into European microfinance programmes, with a specific focus on policy measures that could support the development of the sector. Its in-depth articles offer an up-to-date commentary on what is happening in the different European countries, how policies and practices are implemented and evolving and what recommendations can be made by practitioners, researchers and academics to promote microfinance and microenterprise development in the European Union.

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EMN would like to thank all the authors of the various articles for their contributions.

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# MICROFINANCE

## Europe

### “Sustainability of microfinance in Europe: a GENERAL reflection”

In the coming years, microfinance practitioners in Europe will be challenged by both policy makers and the general public. How significant are you? What have you achieved? What is your future? What impact do you have? In brief: how big are you? And will you survive? The answers to those questions may determine our future as well. And seeking answers to the questions will lead us undoubtedly to ask ourselves whether we succeed in growing and in becoming sustainable.

Inducing growth and working towards sustainability are two leading themes for EMN this year. And “Does sustainable microfinance in Europe make sense?” was the question posed in the online forum run by EMN during three weeks in March and April 2009. Two opposing views were brought forward at the 2008 EMN International Conference:

- Faisal Rahman, Director of Fair Finance (UK), underlined his opinion that MFIs in Europe imperatively need to be sustainable, sustainability being a pre-condition for their independence and long-term existence;
- Michel Genet, former Director of Crédal (Belgium), pointed out that in Western Europe sustainability is determined by the belief that all stakeholders have in an organisation, and the existing strong social security system in Europe restrains people from leaving benefits behind.

Visitors to the forum were challenged to give their view, and the way they reacted reflects the importance of the issue of sustainability for the microfinance community. The discussions at the forum revealed that “sustainability” is a manifold term that encloses diverse concepts. To avoid unwanted misunderstanding in the debates, we need to be clear and transparent to each other about what we mean by “sustainability” before discussing if and how it should/can be achieved. Hidden behind many views are political convictions and views on how society needs to be organised or develop. We may opt for a neo-liberal approach leaving all to market parties and asking clients to pay for all the costs involved. But we can also follow a social-economic line of thinking, asking ourselves how the public sector can support economic development and assist people in building up their lives. Or are we concerned about our common future and seek a balance between the interests of people, planet and profit? Or is it that we just try to make the bottom of the pyramid our common market?

A statement made at the forum that maybe embraces it all was “The ability to keep going for a long time” a new kind of synonym for “sustainability” - referring to MFIs, to the microfinance sector as a whole and to the clients.

Many different suggestions are made on how to reach this “ability to keep going for a long time” in the European context. One way would be the “financial sustainability” of the MFI, i.e. its consistent profitability and - associated with it - total



# “SUSTAINABLE MICROFINANCE IN EUROPE: A GENERATION OF LEADERS”

Klaas Molenaar, Stefanie Lämmerman

independence from government/donors. Many activities in (Western) Europe would never have been feasible if we had asked (or expected) the final beneficiaries of a service to pay for the full costs of the service. For moral, ethical but also clear economic reasons we cannot charge clients with the full costs e.g. charging interest rates that cover all costs. It will create an unlevel playing field for the micro-entrepreneurs. Still they need viable microfinance institutions that will not disappear after a few years.....

MFIs have to become sustainable.... so, when clients cannot pay for all costs, some of these costs need to be paid by third parties. A very normal phenomenon in Europe where we benefited for decades from the Rhineland principle: as long the various stakeholders are convinced of the need and necessity for the existence of a programme, an institution or an organisation and as long as they are willing to pay for part of the costs the sustainability of such entities is guaranteed. That is something that followers of a neo-liberal approach have difficulty in accepting but it is how many things have come alive and to fruition in Europe.

There is thus a fundamental difference between the belief that clients of MFIs need to pay for all costs and the conviction that the sustainability of the clients is as relevant as that of the instrument. No, we cannot charge interest as high as in Kenya or Bolivia but yes, we are living in a rich society where we can take the right measures to channel funds to activities that support the socially excluded but enterprising individuals in becoming active partners in society again.

But sustainable development asks for a broader view these days. It is not that simple anymore. Striking balances between social, economic, ecological, and cultural objectives has become the new challenge. Nowadays, we are rightly more concerned about the need to initiate processes that contribute to, boost and lead to sustainable development.

And the time has come to abolish the idea that there is one single solution, one single approach, one single model. The

diversity of thinking in Europe is our strength... This diversity is reflected in the specificities of microfinance in Europe (with or without non-financial services, recent nature of MFIs, unequal demand depending on regions, characteristics

of the target group, different economic views). Accepting this also implies favouring alternative ways of measuring the sustainability of microfinance in Europe that go beyond simple “financial sustainability”.

- The – apparently opposing but in many aspects quite complementary - views

expressed by Geert Jan Schuite (Triodos Facet) and Eric Duflos (CGAP) reflect this new line of thinking.

- And the conviction that full self-sustainability can not be achieved in many European Countries is supported by Karl Dayson. His team comes to the conclusion that MFIs can become financially sustainable to a certain degree; but there are limits as well if it is at the expense of the sustainability of the clients.
- This view is also partly shared by Michel Genet, who at the debate on sustainability started in Nice during the Presidential debate presented the audience with another way of looking at the issue. Very correctly he asked us to look beyond the borders of the Microfinance institutions: clients cannot pay the full costs, so all stakeholders must be willing to cover part of the costs.
- Even ADIE, a strong advocator of fully self-sufficient MFIs, admits that such will not be possible without clear segregation of functions. Emmanuel Landais explains how some of them (more specifically training, advisory services, mentoring and coaching) will always need support from other public and private partners; others (the financial services) can eventually be paid by the client. But the client must agree to pay a high price for it. And one may wonder to what extent the less privileged will accept that. Lessons can be drawn from many developing countries: once the clients become

## FROM THE FORUM

What I am interested in, is what definition is used for sustainable. Do you mean sustainability of the MF institutions, the sector or the clients? (Pieter Bas Schrieken, INHolland University for Applied Studies, The Netherlands)

# LIABILITY OF MICROFINANCE RAL REFLECTION”

more aware of the real costs of borrowing and indebting themselves, they will speak out.

- Our MFIs will also be asked to what extent they meet the standards linked to sustainable development. Maria Doiciu presents a good insight into the struggle of many Rumanian MFIs with this new demand. Once started in the traditional way” just making a profit out of micro-lending” and being successful at that (e.g. reaching high levels of financial sustainability) they are now seeking ways to measure and report on their social impact.

The issue is complex and simple at the same time. Developing microfinance in Europe is not just needed to create jobs for the unemployed. One can not get away with simple calculations. The average public cost for one unemployed person in Germany for example is €17,900 per year. From a State/community perspective, it should be a “profitable” investment if, for example, €2,000 is used to support an MFI in bringing an unemployed person into self-employment. But is that what we wish to achieve? Is the sustainability of the MF sector determined by this dependency?

The objectives of MFIs in Europe are manifold and the objectives in one country are certainly different from those in other ones. But what they all have in common is that we want to reach out to people, either to assist them in their effort to set up viable enterprises or participate in society; either to reduce social and cultural exclusion or to promote a more entrepreneurial or enterprising attitude.

We believe that the microfinance sector in Europe can play a stimulating role in thinking along different lines about the relationship between people and money. The sector worldwide has demonstrated that being vigilant about preserving a clear relation between lender, financial organisation and depositors is the basis for sustained growth and development. Clients will not easily run away and stakeholders will continue to support the organizations.

One forum participant underlined that “any MFI should strive for the highest possible rate of self-sustainability without losing its mission.” It was also one of the key points discussed in the sector survey we published last year. Therefore, “there is no other way than to grow and to develop the professional institutional capacities”. This implies a clear mid- and long-term funding strategy. An essential element of such a strategy will be to define the sustainability of the organisation: how will it be funded and by which (public or private) institution can it or ought it be supported?

If European MFIs and their clients are “to stay with us for long”, there needs to be further discussion about the sustainability of microfinance in Europe. Developing a set of common standards to measure diverse forms of sustainability of microfinance in Europe could be a tangible result of this debate. The EMN online forum was a first step in this direction. This magazine is the second one. It will be followed up by debates at the 6th EMN Annual Conference on “Microfinance and its Growth in Europe” and far beyond it. The outcome? At least more transparency in the debate and eventually a wider acceptance of the belief that a diverse Europe will be better off with a diverse set of microfinance initiatives provided they are visible, in other words grow and develop and “be able to keep going for a long time”.

## FROM THE FORUM

*In our current economic reality, which is more sustainable: the Royal Bank of Scotland or the Red Cross? (Allan Bussard, Integra, Slovakia)*

For the present article, EMN asked the representatives of two well-known organisations active in the field of microfinance to answer seven questions about the sustainability of microfinance in Europe with the aim to compare two different views on the issue.

**GEERT JAN SCHUITE** is a consultant with TriodosFacet (the Netherlands). He has an educational background in Environmental Management and Engineering. At TriodosFacet, he works as a consultant for the Sustainability and Corporate Social Responsibility (CSR) unit.

**ERIC DUFLOS** is Senior Microfinance Specialist at CGAP. He is based in CGAP's Paris office where he works on aid effectiveness and on policy issues in microfinance. Duflos has spent seven years in Laos, where he has worked with the United Nations and the World Bank to help set up microfinance institutions and policy frameworks. He has a master's degree in Management from the Lyon EM and a master's degree in Economics and International Relations from Johns Hopkins University.

## WHAT IS YOUR DEFINITION OF SUSTAINABILITY?

**GEERT JAN SCHUITE:** Sustainability means long-term continuity in the key activities of an institution, while recognizing the economic, social and environmental effects of its activities, both for its internal and external stakeholders.

Even if a microfinance institution performs well in financial terms, there is no sustainability if its employees are under continuous stress, or clients are not aware of the costs of credit, or the soil is poisoned by clients that use too many pesticides. An MFI should have a 'triple bottom line' business orientation, balancing its economic, social and environmental policies and performance.

It is easy to see the lessons from the global financial crisis: there is no better illustration of the relationship between the ethical behaviour of financial institutions and their financial sustainability. There is no sustainable perspective for financial institutions that forget about their social responsibilities with only a one-dimensional commercial focus.

**ERIC DUFLOS:** The idea of "sustainability" in microfinance is broadening all the time. Originally it meant only financial sustainability. CGAP's definition of sustainability traditionally addressed microfinance institutions' ability to stand on their own feet financially after a period of operations. To become financially sustainable requires an institution to cover all its costs (administration costs, cost of default, cost of funding, and reserves for expansion). And at this stage in their evolution, there is now widespread agreement that microfinance institutions should pursue financial sustainability by being as efficient as they can and by charging interest rates and fees that will cover their costs.

But today we talk more about the triple bottom line of "people, profits and planet"... by which we mean of course social performance – are microfinance institutions serving the needs and improving the lives of poor clients? And environmental impact: how are microfinance institutions impacting the world around them?

So today the concept of sustainability for microfinance institutions has become much more holistic, and it really addresses the range of ways in which microfinance touches people and the world around us.

## DOES SUSTAINABLE MICROFINANCE IN EUROPE MAKE SENSE?

**GEERT JAN SCHUITE:** In order for microfinance in Europe to make sense (which I think it does), it must have sustainable objectives. It is debatable if European Microfinance programmes or projects, with a mid- or short term focus, can become sustainable in the financial sense of the word. However, subsidies can also be considered as a sustainable source of income for an MFI: as long as an MFI can convince donors that their funds yield desired results and impact, subsidies are a sustainable source of income.

Any professional organisation should focus on integral sustainability, aiming for a balanced commercial, social and environmental performance. This is equally the case if a programme or project is concerned. After all, the clients of the MFI themselves have the intention of building sustainable businesses, focussing on their long-term continuity!

# THE DEBATE

The business case is clear: a financial organisation that forgets about its responsibilities to its clients (fair and transparent treatment) or gets connected to unethical (direct or indirect) social or environmental activities, will lose trust (as recently happened with the corporate banks). If the microfinance sector in Europe pro-actively engages in becoming sustainable, and if it is able to communicate triple bottom line performance, then the market will develop, both in terms of clients and investors.

**ERIC DUFLOS:** CGAP has mostly worked in developing countries since its creation in 1995. While administration costs are much higher in Europe than in many developing countries, we do know of several MFIs in the ECA region that have reached financial sustainability such as Prizma and MI-BOSPO in Bosnia for example which have both a financial and a social bottom line.

The argument for financially sustainable microfinance is that microfinance providers will be able to serve their clients without needing ongoing infusions of subsidies to do so. Ultimately, we believe that this will be necessary if microfinance is to have the kind of widespread impact that is needed – remember that globally we are still talking about billions of people excluded from formal financial services. Not all of them will be reached by profitable institutions, but many will. And we think that many more stand a chance of being reached if we can create effective intermediation between poor people's own savings and the other financial services they need. Nobel Prize winner Muhammad Yunus always points out that Grameen Bank in Bangladesh relies on poor people's own savings, rather than foreign aid money, to provide loans to other poor people.

Finally there are many ways microfinance institutions can contribute to environmental sustainability. CGAP has just published a focus note that shows how MFIs are addressing climate change, including the need to reduce emissions (see <http://www.cgap.org/p/site/c/template.rc/1.9.34043/>)

## WHAT DO YOU THINK MICROFINANCE PROGRAMMES SHOULD DO TO BECOME SUSTAINABLE?

**GEERT JAN SCHUITE:** A key element is that an MFI should get ownership of its own triple bottom line performance. A lot of MFIs are completely emerged in their 'first' bottom line: financial performance. They leave the other bottom lines to external consultants, Technical Assistance programmes, donors, raters, auditors, and so on. It is useful to get initial

support with these issues, but the goal has to be that the organization takes care of its own triple bottom line business model. Only then does the MFI become truly sustainable.

MFIs need to define clear triple bottom line policies and targets, they need to implement monitoring systems to evaluate performance and dilemmas and, above all, they need to become transparent and start communicating with their stakeholders (including awareness raising among clients).

Managers often assume that Loan Officers and other staff are not trained well enough to address labor issues, health and safety aspects or environmental effects of their clients' activities. I disagree with this perception. Most Loan Officers understand the concept of the triple bottom line amazingly well. To improve the business of their clients, and make them better professionals is in their own interest. I don't think we need to transform MFI staff into social or environmental experts. The only thing they need is some simple tools (information sheets) to understand the key elements at client level, and common sense. It is good to interact frequently on these issues, sensitize them and include the view of Loan Officers in an MFI's triple bottom line focus.

**ERIC DUFLOS:** Usually microfinance programmes cannot become sustainable unless they are integrated within a legal institution. Therefore it is best for any programme to focus on the creation or the development of an existing institution specialized in providing financial services to poor people. There are several possible legal options depending on the country such as NGO, licensed commercial bank, financial company, or cooperative.

To become sustainable an institution needs to have a solid legal structure but it also needs to become financially independent. To become independent from donations, the institution needs to make a profit or at least break even. There are two main ways of making a profit: reducing administrative cost and increasing revenues. To increase revenues, an institution can expand and create new products that are adapted to its clients (e.g. housing loans, transfers, etc). To reduce costs, an institution can use technology (front and back office) and branchless banking business models, and increase the productivity of its staff, through incentives for example. But really it's about meeting the needs of poor clients.

## WHAT SHOULD BE THE ROLE OF THE GOVERNMENT AND LOCAL AUTHORITIES IN THIS PROCESS, ESPECIALLY IN THE CURRENT SITUATION OF FINANCIAL AND ECONOMIC CRISIS?

**GEERT JAN SCHUITE:** First of all the government should make laws and enforce them. Laws on financial sector institutions, environmental and health and safety issues do exist but enforcement is not always ensured. Besides it is important that governments/authorities support the efforts of the MFIs. In these difficult times, authorities could promote self-employment and entrepreneurship, especially regarding social or 'green' initiatives. The government supports MFIs when fostering entrepreneurship development programmes linked to schools or employment agencies because these programmes yield future clients for the MFIs.

**ERIC DUFLOS:** With rising un-employment globally, the social protection role of government will be critical. Governments have a crucial role to play in social transfers which may be more appropriate than loans for very poor people. When it comes to microfinance, which is only one small piece of the picture, governments should focus primarily on protecting clients and ensuring the stability of the financial system. This means that its priority is to ensure macro-economic stability and protect clients' deposits through appropriate supervision.

Governments can also promote more transparent lending to avoid over-indebtedness, promote financial education, and encourage the creation of credit bureaus to reduce the risk that one client borrows from many different sources. Governments will significantly contribute to sustainability by providing an adapted regulatory framework for institutions that want to take deposits from the public.

When no other possible source of re-financing is available for MFIs, governments may provide funding in the form of loans as was the case recently with SIDBI in India. However in developing countries, this approach requires caution as such a practice has sometimes prevented commercial actors from funding microfinance institutions (e.g. Sri Lanka and Pakistan).

## WHAT SHOULD BE THE ROLE OF THE PRIVATE SECTOR AND ESPECIALLY THE FINANCIAL SECTOR?

**GEERT JAN SCHUITE:** To put it simply: microfinance has typically a direct (one-on-one) relationship with its clients, who are active in the 'real economy': farming, production, trade. The private sector might be very interested in linking their assets to these real economy activities by investing or partnering with MFIs. Microfinance clients are actual or potential customers of the private sector, and over the past years the microfinance industry has proven to be a very interesting and promising investment opportunity. In addition, the private sector needs to show its own ethical and triple bottom line responsibility to its stakeholders and the wider public. For them (especially the financial sector), it can therefore be very interesting to link up their activities with the sustainable microfinance sector.

**ERIC DUFLOS:** The main role of the private sector is to provide financial services in an efficient and equitable manner. In times of crisis, the private sector needs to (i) survive and (ii) better understand the situation of its clients. We often say at CGAP that the crisis provides an opportunity for MFIs to strengthen their fundamentals (e.g. governance, staff, and management systems).

The crisis also calls for what we would call more 'responsible finance'. MFIs and investors increasingly care about social performance, and the Social Performance Task Force (SPTF) agreed on a new reporting framework including social, ethical and environmental disclosure standards. MFIs have started to report on these indicators to the Microfinance Information eXchange (MIX).

Many investors have already endorsed the Six Client Protection Principles, and we hope that these principles will lead to a greater awareness of ethical behavior in the sector, for example by avoiding over-indebtedness and displaying pricing transparently. (See [www.campaignforclientprotection.org](http://www.campaignforclientprotection.org)) Certainly the financial crisis is making people reassess the role of financial institutions and their responsibilities in relation to poor clients, and really consider how important consumer protection is, which is a positive outcome of all this.

## AIMING AT FINANCIAL SUSTAINABILITY - ISN'T IT A THREAT FOR REACHING SOCIALLY EXCLUDED PERSONS?

**GEERT JAN SCHUITE:** It is a challenge, for sure. Often, microfinance clients are vulnerable and illiterate; however they should be treated as entrepreneurs and not as socially excluded. The activities undertaken by the MFI clients should enable them to repay the credit. As explained earlier, in my view financial sustainability does not mean 'operating without subsidies'. As long as funding yields results in an efficient and effective manner, then financial sustainability is achieved. An organisation that makes sure that each year a certain number of people do not fall into the social benefit system because of their enterprise income, can justify a subsidy to its donors.

**ERIC DUFLOS:** CGAP has always considered that financial sustainability and reaching socially excluded people were compatible. Take the example of CARD bank in the Philippines. It serves landless women and it has become financially sustainable within a few years. ASA or BRAC who serve millions of poor people are also financially sustainable. Some people worry that poor people living in rural areas will be left behind if we focus too much or exclusively on financial sustainability. In the end we need a full range of institutions if we want to reach everybody, and some institutions working in rural areas might take longer to become sustainable than others. Microfinance institutions also need to think about the kinds of investors they attract, and make sure that the mission of those investing in their institution fits their social mission.

## IS IT POSSIBLE TO HAVE A SUSTAINABLE APPROACH TO THE PROVISION OF NON-FINANCIAL SERVICES AS WELL AS FINANCIAL SERVICES?

**GEERT JAN SCHUITE:** A financial institution has to stick to its core business, which is delivering financial services. With providing non-financial services they become involved in their clients activities, and this can cause problems if this goes along with a credit provided by the same institution. A conflict of interest can occur. Having said this, it can be very useful to educate clients in terms of financial literacy or awareness relating to health and safety, environmental aspects, but these are additional to the MFI core financial services, and should not become an additional source of income.

**ERIC DUFLOS:** The jury is still out. BRAC is probably one of the most advanced models. In my opinion one way to do it is to have a vision of offering more than finance—microfinance plus—and cross-subsidize non-financial services. In cooperation with BRAC and the Ford Foundation, CGAP is currently piloting projects aimed at reaching extremely poor people who are not being reached by traditional microfinance institutions. The project usually provides non-financial services to these people to prepare them to graduate to financial services progressively. We have very encouraging initial results from Haiti for example. But there are many other interesting models out there, and right now the important thing is to try different approaches to gain traction in this area: it is too important not to really focus our efforts, and there is huge pot.

### FROM THE FORUM

If one wants to build a strong and long-lasting microfinance sector, there will be a need for this sector to become sustainable. Although, in my opinion, in the European culture, some government support will always remain in such initiatives. *(Pieter Bas Schrieken, INHolland University for Applied Studies, The Netherlands)*

# CAN M EUROPE BE S

*Dr Karl Dayson and Mr Pål Vik, Community Finance Solutions at the University of Salford*

FOUNDED IN 1999 COMMUNITY FINANCE SOLUTIONS (CFS) IS A RESEARCH AND DEVELOPMENT UNIT ENGAGED IN PROMOTING AND DEVELOPING INTEGRATED SOLUTIONS FOR FINANCIAL AND SOCIAL INCLUSION, AND COMMUNITY ASSET OWNERSHIP. LOCATED WITHIN THE UNIVERSITY OF SALFORD, CFS OFFERS INDEPENDENT RESEARCH AND ADVISORY SERVICES TO SOCIAL LANDLORDS, LOCAL AUTHORITIES, NATIONAL GOVERNMENT, CHARITIES AND OTHER ORGANISATIONS AND AGENCIES.

THE FOLLOWING ARTICLE IS DRAWN FROM THE PAPER WHICH WON THE EUROPEAN MICROCREDIT RESEARCH AWARD 2008

The notion that MFIs should strive towards full sustainability – the ability to cover their operating and capital costs with income from interest rates and fees – is today an almost unquestionable part of the microfinance paradigm guiding both funders expectations and business models. To fulfil this expectation, MFIs are encouraged to embrace non-concessionary interest rates reflecting the costs of delivery and, at least to a greater degree, rely on loan capital raised from commercial loans or from deposits from clients. Available data from the Microfinance Information Exchange suggest that the sustainability paradigm influences lending methodologies and business models of several hundred institutions serving millions of low-income households.

However, European microfinance has a more complex trajectory and while the east has generally followed the developing world approach, with an emphasis on expansion and sustainability, this has not been the case in west. It should be noted that the sector in Spain stands astride these approaches, and even has regional banks involved in delivery of services. By contrast in much of Western Europe the sector can be described as 'para-public' in that many delivery agencies are predominantly funded by the state even though they were established and are managed by non-state actors. As a result there has been a focus on issues related to social inclusion, such as getting people back to work or promoting entrepreneurship, even if this is at the expense of sustainability. This does not mean MFIs in Western European have not taken sustainability serious; rather they have not had the freedom to pursue complete sustainability. Partly this is because of government constraints on what is deemed appropriate (limits on interest rates), but also some MFIs have been under-financed and have insufficient resources to effectively market their services. Consequently, there has been a general focus on the cost-effectiveness of microfinance compared to state-run welfare programmes.

First though it is necessary to assess whether sustainability is possible in Western Europe. After all it may be that highly developed Welfare States limit the potential market, meaning no attempt of work will produce self-sustaining institutions. As the UK has the most liberal policies on interest rates and MFI development we drawn on an in-depth analysis of the sustainability of the business models of five organisations, all which are involved in both personal and business lending. (The methodology and findings of this research project is detailed in Lloyds Operational Sustainability Research Project – Final Technical Report available at [www.communityfinance.salford.ac.uk](http://www.communityfinance.salford.ac.uk).)

## FROM THE FORUM

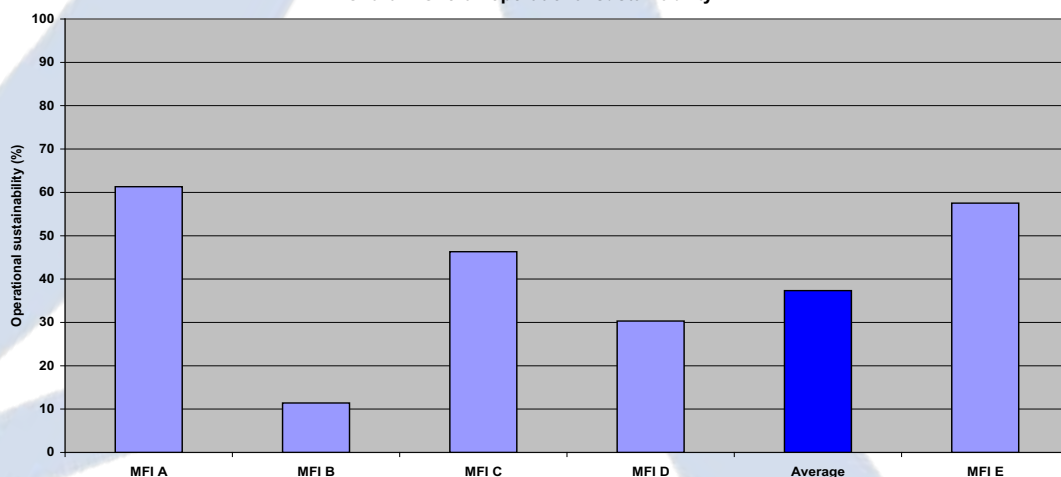
In Western Europe we simply lack sufficient demand. And the main reason for this is: highly developed social security systems and welfare traps. My way out of this West European dilemma would be: We have to make use of our weaknesses and convert them into challenges or even strengths. [...] Help the municipal authorities to implement the task of supporting entrepreneurship - this could be a business case for Western Europe in the future. (*Jan Evers, EVERS&JUNG, Germany*)

# MFIs IN WESTERN SUSTAINABLE?

## SUSTAINABILITY OF THE UK MICROFINANCE SECTOR – LESSONS AND IMPLICATIONS FOR EUROPE

Chart 1 shows the degree to which the MFIs are operationally sustainable.<sup>1</sup>

Chart 1: Overall operational sustainability



Source: Audited accounts for the calendar year of 2006 or for the financial year of 2006/2007

The MFIs are some way away from covering their costs exclusively through the income generated from their loan portfolios. The average for the personal lending MFIs is below 40% and the most sustainable MFI has an operational sustainability of just above 60%.

MFI A and MFI E are the most sustainable MFIs in that they are able to cover around 60% of their income through interest rates, fees and bank interest earned. The low level of operational sustainability of MFI B is largely explained by its reliance on contractual income to fund its money advice programme.

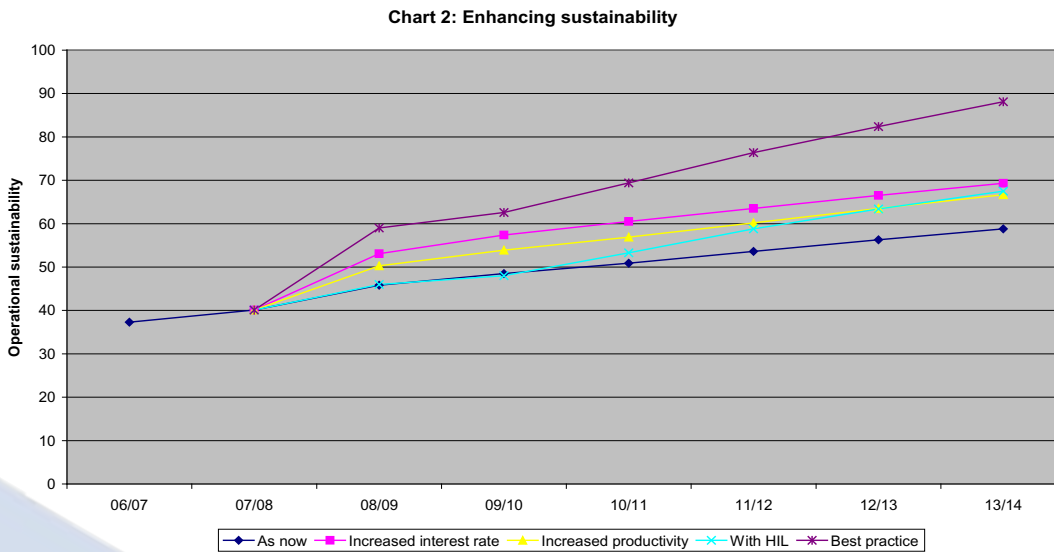
So far we have examined the current level of operational sustainability of the MFIs. However, given that the personal lending MFIs are relatively young organisations at an early stage in their development trajectory, a more interesting question may be how far along the sustainability continuum they can progress over the next few years. Therefore, we project several possible future development trajectories for the MFIs.

Drawing on the basic cost structure, loan and product portfolio mix, and capital and funding streams of the MFIs for the financial year of 2006/2007, we made projections about the future growth and performance of the MFIs for the following seven financial years: 2007/2008 through to 2013/2014. We hypothesise that the MFIs can alter their level of sustainability by increasing loan officer productivity (increased productivity), raising the interest rates charged (increased interest rates) and by adding higher-ticket loans (with Housing Improvement Loans - HIL<sup>2</sup>).

<sup>1</sup> This is measured as total earnings (fees and interest income, and bank interest earned or paid) as a percentage of total overheads (staff, overhead and governance related costs).

<sup>2</sup> Housing Improvement Loans. Hereafter HIL, are loans given to enable repair and enhancement of property. Usually connected to bringing homes up to minimum European standards, this product serves clients where a grant from the state is insufficient to complete necessary repairs. The loan is invariably delivered following a recommendation from the local authority.

Chart 2 shows the average operational sustainability ratio for the MFIs under each of these scenarios.



Generally, providing that they can ensure portfolio growth at the rates given above, the MFIs appear to be gradually enhancing their ability to cover their operating costs with income from fees and interest rates in all scenarios including the scenario “as now.” The results of the financial modelling indicate that over time the MFIs are improving their performance even if they make no changes to the way they operate (as now), providing they can grow their personal loan portfolio at 10% and keep their business loan portfolios constant.

That said the MFIs can make considerable improvements by using any of the abovementioned levers. Raising interest rates to the highest charged in the peer group and introducing an up-front administration fee on personal loans constitute the single-greatest improvement to operational sustainability. In particular, the introduction of an upfront administration fee for personal loans has positive implications for operational sustainability as it is not affected by arrears and can give a disproportionate boost to income. For MFIs A and D, who operate with an upfront administration fee of 5 and 3% of the loan value respectively, the administration fee income constitutes around 40% of total activity earnings.

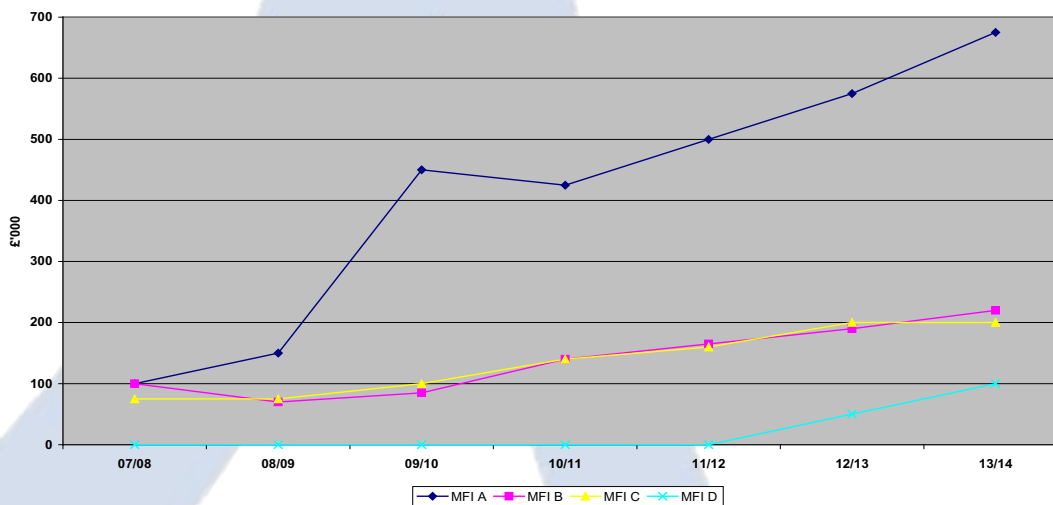
Raising loan officer productivity to the highest level among the participating MFIs (400 loans per year per full-time loan officer) also makes a considerable contributing increasing operational sustainability on average by nearly 10% within the first year.

Finally, adding a higher-ticket, low-risk loan product in the form of the home improvement loan can make a significant contribution to the long-term sustainability of the MFI sector as shown in the graph above. We assume that the MFIs make 41 home improvement loans at an interest rate of 8% and at an average value of £5,500 in their first year of operation (2009/2010). As suggested by Chart 2 even a modest higher-ticket loan portfolio can make a considerable contribution to raising sustainability, assuming a 10% annual growth.

However, the effectiveness of each of the levers outline above for the individual MFIs depends on the starting point of the MFIs (i.e. interest rates charged, current loan officer productivity) and product mix (i.e. a high reliance on contractual income negatively affects the operational sustainability ratio).

A potentially very important barrier for the expansion and future sustainability of the sector may be the availability of lending capital. Chart 3 displays the size of the gap in funding (expressed in £'000) to support a 10% annual growth in their personal loan portfolio using best-practice approaches (e.g. in terms of interest rates, productivity and home improvement loans), once the MFIs have recycled their existing loan capital (i.e. the opening balance at the beginning of 2007/2008). The capital requirements for the home improvement loan are excluded given the particular funding arrangements.

Chart 3: Future capital requirements



The chart reveals that even if the MFIs were to implement best practice in terms of interest rates, product mix and loan officer productivity there would still be a considerable funding gap for all MFIs.<sup>1</sup> The data suggest that a recapitalisation strategy based exclusively on recycling existing loan capital is not a viable means of supporting the expansion of the sector.

## STAFF EFFICIENCY AND PRODUCTIVITY

As part of the in-depth analysis of the five UK MFIs, we also analysed the efficiency and productivity of their staff members. The findings suggest that one of the MFIs was considerably more productive as measured in loans per full-time loan officer (Table 1). The estimates on number of loans per full-time loan officer suggest that this enables MFI A interview and process 40% more loan applicants compared with the second-most productive MFI.

**Table 1: Personal loans officer productivity**

	MFI A	MFI B	MFI C	MFI D	Average score
Annual # of loans process per FT loan officer	440	308	205	253	320

Notes: Estimated based on number of loan applicants seen during timesheet exercise

Assumes 60% success rate based on data from MFI B

Source: Timesheets submitted by MFI employees for the period 25.06.07-13.07.07

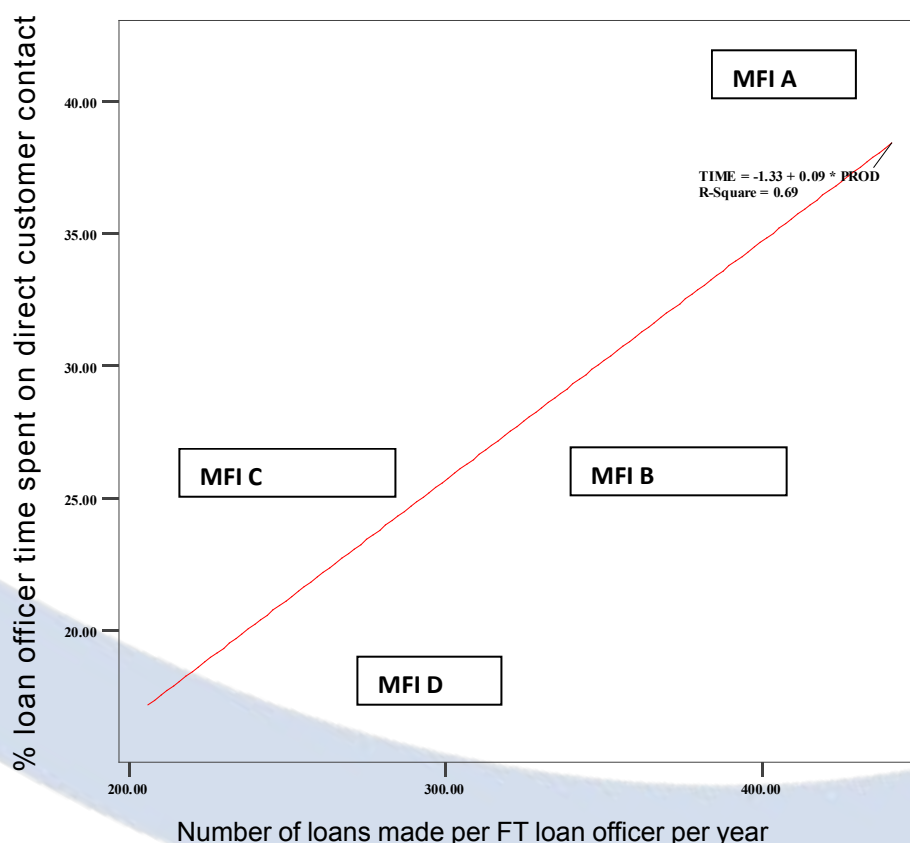
Three factors appear to explain the variation in loan officer productivity. First, the number of applicants a loans officer can interview is conditional on the availability of appropriate meetings rooms. In the case of MFI B, two loans officers and two debt advisors share one meeting room, limiting the number of loan applicants a loans officer can see in the course of a working day.

Second, the data also suggest that a high proportion of repeat business is conducive for loan officer productivity as they are considerably less costly to process and generally less risky. MFI A which displayed the greatest loan officer productivity also had the greatest proportion of repeat clients: 56% of loans issued in the financial year of 2006/2007 were to repeat customers, compared to 7% (MFI B), 33% (MFI D) and 52% (MFI C).

Finally, the timesheet data suggest that there is a link between the proportion of productive time spent on seeing clients and loan officer productivity as depicted in Figure 1. Personal loans officers at MFI A spend around 45% of their time dealing directly with clients compared to approximately 30% (MFI C), 25% (MFI B), 15% (MFI D) and less than 10% (MFI E) for the other MFIs. The MFI A model centre on maximising the loans officers' exposure to clients by assigning most other tasks not directly linked to the loan interviews to the administrators and to the management. MFI A also has an automated arrears monitoring system freeing up loan officers time.

<sup>1</sup> MFI D first experiences funding shortages in year 2011/2012 because of its slower projected volume growth in personal loans and considerable reserves.

Figure 1: Direct customer contact and loan officer productivity



## CONCLUSIONS: TOWARDS A EUROPEAN MODEL OF SUSTAINABILITY

The results from our study on five UK MFIs suggest that it is possible for MFIs, even in Developed country context, to become more sustainable. Sustainability can be improved by charging interest rates that more closely reflect the costs of delivery. Further, MFIs can take steps to maximise lending staff's exposure to potential customers which in turn is likely to lead to enhanced staff productivity. Funders and policy-makers also have a role to play, through offering development grants to stage-manage productivity improvements and launch new products, especially higher-value loans.

Although there is a potential for the Western European microfinance sector to move towards greater sustainability, there is a broader question on whether full sustainability is possible or even desirable. There are numerous potential trade-offs between social and financial outcomes. For example, charging higher interest rates may help cover costs, but too high interest rates may also negatively impact upon the businesses and individuals served. An excessive focus on financial sustainability at the expense of social outcomes may lead to mission drift.

On this basis we would argue that Western European MFIs should pledge to become as sustainable as possible, given local circumstances. To achieve this requires more extensive and sophisticated pan-European benchmarking. To do this and ensure that MFIs perform both on their social and financial indicators there needs to be greater transparency. Therefore, we suggest that EMN works with the European Union to create a European sub-section within the global Micro Banking Bulletin, which is produced by the Microfinance Information Exchange and covers in excess of 200 MFIs across the world. The Micro Banking Bulletin is an independent and internationally recognised source of performance indicators for MFIs. The financial information collected for and disseminated by this bulletin is based on a set of definitions agreed by experts and practitioners from a range of international organisations and development agencies. To ensure reasonable comparisons, the MFIs are organised into regional peer groups and the Western European microfinance sector could form such a peer group.

Based on the evidence we do not think it will be possible, or sometimes desirable, for all MFIs in Western Europe to be financially sustainable. However, methods need to be developed to ensure they continue to provide social benefit in the most cost-effective way.

# MICROFINANCE IN WESTERN EUROPE AND SUSTAINABILITY: DREAM OR LACK OF AMBITION?

Michel Genet, European master in Microfinance - University of Brussels

DIRECTEUR OF CRÉDAL FROM 2000 TO 2008, SOCIAL CREDIT COOPERATIVE ACTIVE IN MICROFINANCE SINCE 2001 IN BELGIUM

The concept of Sustainability, when applied to microfinance, often relates to the possibility or the need for an MFI not to depend on external and supposedly non-perennial funding sources. Much used within the southern context of microfinance, this concept has been discussed for quite a few years within Western Europe but is becoming more real as important players like Adie in France are making a short term objective out of it. Is it feasible or even desirable?

The rationale is quite simple: while offering financial services to deprived people, MFIs should at least be sustainable because Donors will end up getting tired and finding other priorities to support than microfinance. Conceptually, one cannot disagree with what seems perfect logic. The problem arises when we put the mission of any MFI and the reality next to each other.

As far as MFIs in southern countries are concerned, sustainability is far from being the standard for many of them, even if the introduction of Comportamos on the New York Stock Exchange has set its mark in the world of MFIs.

It is the essence of microfinance to combine an economic with a social approach and it is a real challenge to become sustainable while staying as inclusive as possible to the largest possible public. We will come back to this very 'philosophical' reflection, but before that, let us go through the different factors that make financial services delivery sustainable and that can be observed within the mainstream financial institutions or within MFIs from the South.

## TRANSACTION COSTS AND MICROCREDIT

One knows that the challenge at the heart of microfinance is to master the transaction costs that come from the asymmetry of information between the lender and the borrower (the famous economic "agent-principal" concept). This asymmetry of information translates itself into two main and well-known problems: risk aversion and moral hazard. The first notion refers to the fact that lenders want to avoid risk by screening the borrower's profile, which can be an extensive and costly task and even outrageously costly compared to the amount lent in microfinance. The way 'normal' banks deal with that cost has been to use scoring methods, when possible (for consumer loans, for example). Many MFIs in the South have been delegating the responsibility (and thus the cost) of screening to peers, that is, people from the same community who know each other.

Moral hazard refers to the fact that the borrower, once the money granted, can do whatever (s)he wants with it without the lender knowing it. The main way to deal with this for a lender is to demand collateral of different kinds whose value can be related to the amount lent. This collateral system can only be implemented in a context of a stable legal system where transfer of private property is possible and when the total value of that collateral is higher than the sum of the amount lent plus the transfer and registration costs. The former is definitely a problem for microfinance (as far as the financial value of a collateral good is concerned), while the latter can be a hurdle in some countries as well. Through peer lending again, microfinance has found a cheap way to sort out the asymmetry of information problem, using the social pressure that peers exert on one another, this time to make sure that the borrower will pay back the loan. Another innovative way brought up by microfinance has been the progressive amount approach: the borrower first gets a limited amount of money that he has to fully pay back before getting a higher amount. This progressive approach gives a strong incentive to the borrower to pay back if he wants to borrow more money.

So microfinance has found ways to offer financial services to customers that banks reject because they consider them too risky (no collateral available) or not profitable enough or not profitable at all (borrowed amount too limited to cover the transaction costs).

But even with these approaches, the transaction costs remain high and have to be added to the funding costs, e.g. the cost of capital that the MFI has to borrow to lend to its customers and the loss rate: this is the reason why interest rates can be quite high for microcredits. The income side is also important in contributing to sustainability. In non-regulated markets in developing countries, interest rates as high as 20 to 60% or more can be observed and are considered normal.

So, we now have an overview of how microfinance has found ways to deal with the high transaction costs that keep banks from serving deprived people and to potentially reach sustainability.

## AND IN WESTERN EUROPE?

Even though we have seen that sustainability is not a reality for many MFIs in developing countries, we can start from the different solutions brought up by these MFIs to see to what extent the Western context could allow the same approaches.

We can first list some obvious differences: first, the volume of microentrepreneurs in the Western world is nothing compared with the number of microentrepreneurs in the developing world. Why is this so? Because the Western world has reached a level of development such that the status of 'employee' is dominant and considered "natural" while market saturation is so high that it does not offer many business opportunities to microentrepreneurs. When one adds to this a social security safety net that gives jobless people the possibility to survive without working, it is in strong contrast with situations in developing countries. Most of the time, highly developed markets with social security schemes are also strongly regulated, which is totally different from the large informal markets in non-Western countries. As a consequence, microcredits in the Western world are mostly targeted at start-up enterprises.

The relatively low volume of microcredits in the Western world prevents MFIs from benefiting from any kind of economies of scale, in regard to transaction costs: a standardized approach is impossible, scoring even less. The required work is quite labour-intensive, especially with start-up microentrepreneurs.

The social context with loose links between people prevents any recourse to peer pressure or intervention to decrease any kind of costs.

Finally, the possibility of collateral call generates legal costs that might be disproportionate to the loan amount.

On the income side, there is a clear case for high interest rates from a purely economic point of view: the borrower does not care about paying too much as long as (s)he gets access to a loan that will allow him/her to make a living. This is even truer when one considers the amounts at stake. The opportunity cost is economically quite acceptable, but in a developed world, it might be culturally shocking to ask for 10 or 20% in interest from a small 'poor' microentrepreneur, while some large corporations, in comparison, get a 3 to 4% interest rate: one could say that it's morally unacceptable that the poor pay more than the rich. The case for a high interest rate can be difficult in this context.

## LET US TAKE ANOTHER LOOK

All these different elements make Western microfinance hardly sustainable. Now, it is relevant to look at it from an efficiency point of view and even more from a social efficiency point of view: the Social Return on Investment approach looks at how much one euro of public money returns back to the community. Such an exercise has been made for the microfinance activity of Credal in Belgium and the result was a ratio of 1 to 3. In other words, one euro of subsidy from the Belgian government generates three euros of taxes paid by microentrepreneurs and/or less social/unemployment allowances to be paid by the same government.

As such, this result positions microfinance as a very efficient tool for putting people back to work.

### FROM THE FORUM

There is nothing wrong with depending to a certain degree on public or philanthropic money when we aim to re-integrate very excluded target groups. [...] We just have to be careful that we do not use this as an excuse to be inefficient in our work. Any MFI should strive for the highest possible rate of self-sustainability without losing its mission. *(Martin Jung, EVERS&JUNG, Germany)*

## CONCLUSION

In my analysis, the factors that have made microfinance innovative in keeping transaction costs as low as possible can hardly be implemented in Western markets. But effectiveness and efficiency of any microfinance programme in these markets should be the rule, anyway.

In addition to these elements of conclusion and given that the debate within the microfinance world is so hot, one has to ask oneself about the deep motivation for his/her opinion on sustainability.

As far as I am concerned, I can only see the social aspect of microfinance, the market gap that it fills and the fact that it has to stay away from current market trends that push profitability to its utmost: the current financial crisis shows some clear flaws in that system.

But one also hears from “sustainability supporters” that the case for sustainability is also a drive for ambition and innovation in the way we run our microfinance programmes.

So, yes, let us try to reach sustainability, but let us keep in mind that if we do not make it at the end of the day, well, it is not such a big deal after all...

# THE ROAD TO SU

By Emmanuel Landais - Adie

ADIE WAS CREATED IN 1989 BY ADAPTING THE PRINCIPLE OF MICROCREDIT TO THE FRENCH CONTEXT. SINCE ITS BEGINNING, THE ASSOCIATION HAS FINANCED CLOSE TO 55,000 MICROENTERPRISES, GENERATING MORE THAN 65,000 JOBS.

Adie's goal is to cover all costs related to its lending activity by 2013. A first clarification is necessary here: due to its target clients, that is start-ups, and the complexity of the microenterprise environment in France, it has been necessary, since the creation of Adie, to implement support services to help entrepreneurs start and grow their businesses. This special feature, and the cap on interest rates which limited them to around 7%, have long prevented any realistic prospect of self-sufficiency. The cap on interest rates was cancelled in 2005 and the organizational change implemented over the last year, based on the creation of specialised units, one in the credit area and the other in the support area, have changed the situation.

The primary objective of this new organisation was to improve the effectiveness of the actions undertaken in each area, but it also allows their respective costs to be better differentiated. If support activities, which aim to support the creation of businesses and jobs at a competitive cost to the community, can legitimately be funded by grants, sponsorship, services and the contributions of volunteers, the microcredit activity strictly speaking is, on the other hand, meant to eventually become self-sufficient. This is the objective that Adie has included in its 2008-2011 strategic plan with an extension up to 2013.

## HOW IMPORTANT IS THIS ISSUE?

It is simply vital: the demand for microcredit is growing very quickly (+30% every year) and to respond to and fulfill its mission to provide access to credit to the greatest number, Adie must double its business within 3 years. The objective is to deliver 45,000 microloans in 2011. However, the public and private partners of the association are not able to increase their funding in the same proportions, particularly because of public deficits, not to mention the effects of the current crisis.

Even if it were possible, it is not advisable to depend too heavily on external grants, which are always uncertain and sometimes generate constraints on the choice of locations, the content of certain actions or the priorities given to certain clients targeted. In 2008, 80% of Adie's income came from subsidies. It is expected that this will only represent 50% in the coming years, mainly to cover the Business Development Services. To become self-sufficient would allow not only the sustainability and the development of microcredit in France to be ensured, but would also guarantee Adie a greater independence in its strategic choices.

## WHAT ARE THE OBSTACLES FOR AN MFI IN A COUNTRY LIKE FRANCE?

First of all, the market is not as favorable as it is, for example, in developing countries. Even if more people want to create their own jobs, employment remains dominant and the potential microcredit clients are more difficult to reach. This is particularly true as social protection systems and insertion schemes do not encourage business creation. Finally, the micro-entrepreneur who launches his/her business faces many obstacles: administrative formalities, accounting requirements, business regulations, social security contributions. Hence, many entrepreneurs-to-be give-up their project or prefer to conduct their business informally. Since early 2009, the situation has changed significantly with the introduction of a new statute for entrepreneurs: the "auto-entrepreneur" (the "self-entrepreneur"). With this statute anyone can become an "auto-entrepreneur" and the social and fiscal taxes are limited and payable only if there are some revenues. This new statute has been extremely successful as, in a few months, more than 100,000 people have registered as "auto-entrepreneurs".

# USTAINABILITY

The other factor that has to be taken into account is the role of banks: a large majority of French people have a bank account and banks finance most operating businesses. However, banks are very little involved in business creation, especially in the microenterprise field with which they are unfamiliar and which does not interest them given the sums involved. This is precisely the market niche targeted by Adie but, unlike MFIs in developing countries, it does not intend to retain its customers but seeks to lead them gradually to the banks so that they can provide increased funding and the whole range of financial services.

Therefore, Adie's positioning involves three handicaps that have to be overcome:

- The main task is to find new customers, which is obviously very expensive;
- The amount of the loans, and hence the interest received, are very low (less than 3,000 euros, or 10% of per capita GDP);
- The customers, who are all unemployed or on welfare benefits, are also new entrepreneurs and therefore have greater risks than for existing businesses. There is thus a need to be relatively selective in the processing of applications.

These three factors are the most important obstacles to building a viable microcredit model, but one can add the issue of labour costs, very high in France and which weigh heavily in Adie's core costs, and that of interest rates, now free for business loans but which remain a very sensitive issue for partners, the media, the general public and even for Adie's employees (but much less for customers however!).

## DESPITE THESE OBSTACLES, THE GOAL OF COST COVERAGE IS NOW QUITE REALISTIC.

The first step was taken thanks to legislative progress achieved after many years of lobbying: on the one hand, an amendment to the Banking Law, passed in 2001 allows associations to borrow in order to lend and thereby generate a margin that the old system of partnership with banks forbade because it was the bank that managed the loan and was paid for it. On the other hand, the abolition of usury rates for business loans has enabled Adie to raise its interest rates (currently 9.71% plus a commission of 5% up-front).

But to reach credit cost coverage, the two main levers to operate are the growing number of customers and the improvement in productivity.

Productivity improvement is an ongoing process linked to the experience accumulated by the organisation over 20 years, the use of more efficient information and telecommunications systems, in-house training, but also the reform of methods and organisation. In 2008, each loan officer managed an average of 125 active clients, against 106 the year before.

In a service activity, productivity gains are mainly represented by time saving. The good news is that not only this is not in contradiction with the association's mission, but that such an objective is also in the interest of the customer: when he/she contacts Adie, he/she wants to have a meeting quickly, a response almost immediately, a disbursement as soon as possible. In 2008, the average time between the first contact and the release of the loan was 32 days. The objective is to reduce this by half. Therefore, it is not a question of reducing the time spent with each client, but of reducing delays at each step to limit the number of appointments, to concentrate on the essentials. Above all, it is necessary to assess as soon as possible the likelihood that the credit request will be accepted. It is indeed unnecessary to waste the client's and the credit agent's time if from the beginning the chances of reaching an agreement are very low. The approach adopted by Adie is to work every step of the credit cycle: the welcome, which is undoubtedly the most important step and which is now organized through a national call center with specialized reception counselors who orient the clients over the phone, the processing of applications, which is now carried out in one meeting, the decision to grant the loan, which is backed by a scoring tool and greatly simplified procedures at the latest one week after the appointment.

### FROM THE FORUM

We often focus on the sustainability of the institutions, whereas it should be the sustainability of the client that is focused on.  
*(Pieter Bas Schrieken, INHolland University for Applied Studies, The Netherlands)*

Much has been done on these various steps in recent years and, if there is still room for improvement, the main challenge to be faced in terms of productivity lies in the prevention and treatment of delinquency. The write-off rate is less than 3%, but this good result is obtained at the cost of considerable time spent by credit agents and supervisors, as well as by headquarters' services, in dealing with reimbursement incidents, regularisations, using all possible means: phone calls, letters, appointments with clients. These actions are time-consuming and disrupt the work of the teams as it is always necessary to be very reactive when there is an incident. Besides, it appears that the branches that have the best repayment rates also have the highest productivity. The objective of doubling productivity, which is necessary to cover costs, cannot be achieved if the rate of incidents is not halved in the coming years.

The other challenge to be taken up relates therefore to the increase in demand. The development of self-employment and the demand for microcredit correspond to structural changes in western economies and societies, but, for the reasons outlined above, it is difficult to bring out the potential demand. We must reach out to potential customers, by being present in the neighborhoods and markets, by using word of mouth, but also by having communication campaigns and using the Internet. The current crisis, coupled with measures taken by the Government to encourage the creation of small businesses, should also contribute to the increase in this demand. But Adie also needs to change its marketing strategy by being more proactive and visible.

## CONCLUSION

If Adie can capture these potential clients, the tools and methods put in place, combined with the quality of teams recruited and trained, will allow the association to improve productivity and achieve its objectives. Already, several credit agents and some pilot projects are close to the threshold at which loan incomes cover direct core costs.

Finally, it has to be stressed that Adie has no ambition to become a bank. Its current status gives the association enough flexibility to complete its activity and is consistent with its primary mission to help poor people create their own employment by giving them access to credit and by supporting them. It has no shareholders to pay and acts disinterestedly. In modern economies, especially in a country where the redistribution is very significant, no organisation actually works according to pure market logic. To achieve coverage of its costs, Adie will also need to benefit from a favourable cost of refinancing from banks or solidarity-based investors, from the payment of some of its delinquent loans by public guarantee funds or by its banking partners, but also from some public or private funding to cover the additional costs inherent in certain geographical areas (e.g. rural areas) or to finance new actions. The search for financial sustainability is not therefore linked to ideological considerations, but is simply the condition for the development of microcredit in France.

# THE TRIPLE BOTTOM LINE CHARACTERISTICS OF SUSTAINABILITY IN MICROFINANCE OPERATIONS IN EASTERN EUROPE

## A CASE STUDY ON THE ROMANIAN MICROFINANCE SECTOR

*Maria Doiciu - Eurom Consultancy and Studies SRL*

EUROM CONSULTANCY AND STUDIES IS A ROMANIAN FIRM OFFERING A VARIETY OF SERVICES IN TRAINING, RESEARCH AND ADVISORY SERVICES. IT HAS LED KEY RESEARCH AND TRAINING IN MICROFINANCE AND SMEs DEVELOPMENT IN ROMANIA, CENTRAL & EASTERN EUROPE AND CENTRAL ASIA REGION, SUCH AS PERFORMANCE ASSESSMENT AND BENCHMARKING MICROFINANCE PROVIDERS IN ROMANIA 2005-2007, MARKET STUDY ON MICRO LENDING IN ROMANIA 2009, TRAINING IN RISK MANAGEMENT AND PORTFOLIO MANAGEMENT FOR MICRO FINANCE PROVIDERS.

### INTRODUCTION

Since the beginning of the sector, early 1995, the aim of the donors and founders was to establish microfinance institutions to serve the underserved Romanian entrepreneurs, and in time, become self sustainable.

How they succeeded? What barriers and difficulties they faced and which are the challenges ahead?

This article is an attempt to present the experience and the factors that influenced and contributed to the achievement of Sustainability of the of Romanian microfinance institutions.

### MICROFINANCE SUSTAINABILITY IN EASTERN EUROPEAN COUNTRIES - OVERVIEW

The generally accepted definition of Sustainability is as repeating Performance in the future, Performance meaning: progress in reaching the mission of microfinance. (Mark Schreiner, 1996)

The mission of the mature Romanian MFIs is to provide suitable financial services to the underserved entrepreneurs, farmers, family business, professionals, and to make the lives of underserved people and families better by producing outreach, mainly micro loans for their commercial activity, specialized technical assistance and recently, consumer credits for their personal use.

Measuring performance, create standards and benchmarks in order to improve performance, matters to the stakeholders grouped five categories: customers, society, donors, managers, and investors. Each group has its own goals, so each group asks its own questions about performance.

Initially the first benchmarking exercise in Romanian was undertaken with the support of ShoreBank Advisory Services within the microfinance Coalition component of the Economic Development and Strengthening Programme funded by USAID in 2004 – 2005.

An attempt to develop a framework for performance measurement of the European MFIs was initiated by the Benchmarks and Performance Measurement working group within “From Exclusion to Inclusion Through Microfinance: Learning From East to West and West to East Project” funded by European Commission in 2006-2007.

Three basic financial indicators and three basic social indicators were developed based on the work already being carried in particular regions by the MFI trade associations – MFC, cdfa and EMN, focusing on social performance and looking at proving social impact of microfinance, treatment of indicators is simple in order to make them useful for non-specialists stakeholders: consumers and society. Based on the new European framework, the sector's performance was evaluated in 2006 and 2007.

## ROMANIAN MICRO FINANCE SECTOR'S SEGMENTATION

Romanian MF sector diversity in stages of MFIs development and practices leads to diverse performance figures. There are a number of key factors bringing about this varying performance, identifying and analysing particular peer groups, capturing both socio-economic data as well as more qualitative assessments of the operating environment for MFIs, it is vital to understand these factors and how they affect performance in order to realistically measure the relative performance of individual or groups' of MFIs.

The three key characteristics based on which the MFIs are grouped into different segments are:

### INSTITUTIONAL TYPE: LEGAL STRUCTURE OF THE MFIs

In Romania the new legal framework requires the registration and licensing of the MFI as Non-Bank Financial Institutions – Microfinance Companies, with the Central Bank. CDE, as microfinance foundation, is excepted as long as they are administrating exclusively public funds, recently (beginning of 2009) CDE initiated the process to re-register as non bank financial institution. An enable legal framework is needed to support development and protect both the MFIs and beneficiaries.

### MFIs MISSION, TARGETED MARKET AND SERVICE OFFERED

Due to increased competition, commercialization is the strategy of almost all medium and large MFIs. However there is a number of more targeted initiatives that may take a different, more focused path, e.g. Farmers (FAER- LAM), former miners (CDE and Express Finance), Professionals (OMRO-CDE) etc. The specialized technical assistance provided to the customers was separated from the financial activities and in most of the cases is co - financed from the profits yield by the financial activity.

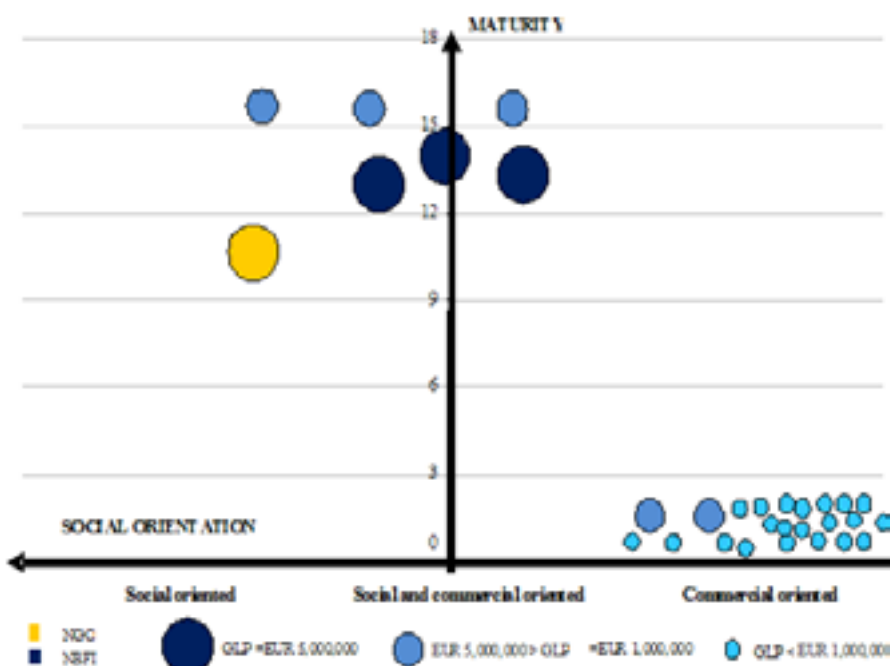
### MFI FUND SIZE AND MATURITY

One of the most significant factors affecting the performance of the Romanian MFIs is the market or type of customers they serve. This, in turn, is affected by the MFI's mission and orientation. How large the market is, its geographical distribution is contributing to the optimization of costs and to the effectiveness of credits monitoring activity.

These factors are strongly connected and influence the MFI size and their average loan size, both having a bearing on its financial and social performance.

Therefore, the Romanian MFIs were segmented in three categories: social oriented, social and commercial oriented and commercial oriented.

Graph 1. Microfinance sector segmentation



Source: Eurom Consultancy and studies- Benchmarking Romanian MF Sector 2007

The MFIs, included in this study, are those established more than ten years ago initially with initial support , in term of seed capita and technical assistance, from the international microfinance organizations and/or specialize investors/ donors. They are currently registered as Non-Bank Financial Institutions - Microfinance Companies: CAPA Finance, Express Finance (Former CHF Romania), Opportunity Microfinance Romania (OMRO), ROMCOM, LAM, FAER and Center for Economical Development (CDE) Foundation.

## OPERATIONAL AND FINANCIAL SELF-SUFFICIENCY OF THE MF INSTITUTIONS IN ROMANIA

Among the performance indicators, Operational self sufficiency, defined as the point at which the MFI can meet the operational cost with the operational income (interest earned from the operational loan portfolio), is identified as one of the most relevant in assessing the sustainability of the MFI and of its intervention, mainly by the donors and investors.

2004 – 2005 was the period when the first Romanian MFIs reached operational self-sufficiency, in 2007 all Romanian mature MFIs were both operational and financial self-sufficient.

Financial self-sufficiency translates the ability of an MFI to operate at a certain level of profitability that allows it to provide quality services with no dependence on donor inputs. Being financially self-sustainable was essential for the Romanian MFIs as the donor funds were less available. As such, they will need to continue shifting to a more commercial orientation, which will allow them to support their activity and further develop from these commercial funding sources.

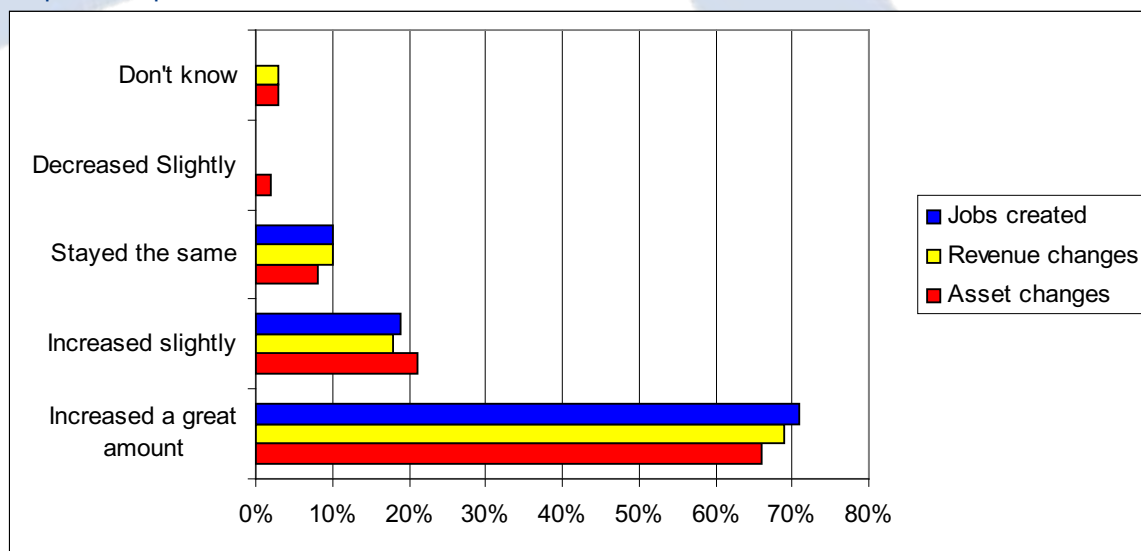
## SUSTAINABILITY OF THE ACTIONS AT THE LEVEL OF BENEFICIARIES AND COMMUNITIES

### SUSTAINABILITY OF THE ACTIONS AT THE LEVEL OF BENEFICIARIES

Although it is very important for microfinance organizations to measure the social impact of their activity, most of the Romanian MFIs, both mature and young ones, do not currently have the necessary tools and resources to measure this.

Until now, only few of the large and medium mature MFIs have hired external rating agencies to measure their social impact. However, the donors (USAID, UNDP) interested in assessing the development impact of the funds administrated by the MFIs, on the targeted beneficiaries as well as on the MFI's performance, covered the cost for independent performance and impact evaluation for more than 75% of the sector.

Graph. 3. Impact on the Beneficiaries



Source: Banyan Global, Impact of USAID's ten years of assistance in micro- lending, 2007

The majority of the clients interviewed reported as an impact if the finance provided to their business the assets and revenues of their business increased in a great amount, but the largest increase was registered in the number of jobs created.

Romanian MFIs are well-regarded and often referred to as the lender of choice because:

- Loan products meet clients' working capital needs and are offered at competitive interest rates.
- Customer service is good. Loan officers are polite and respectful and sometimes provide invaluable business advice to the business owners, and MFI's decision to lend is based more upon the character of the borrower (such as ability to manage and entrepreneurial spirit) and potential of the business, than on a strict analysis of the financial viability of the business from financial statements, which they see as positive aspect of MFI's lending operations.
- The waiting time from loan application to disbursement is short, especially compared to that of banks.
- MFIs are transparent about the interest rates and fees charged. In Romania, clients are loyal to MFIs the average % client retention rate in 2007 was around 65% . In focus groups, clients stated that MFIs issued credit to them when they most needed it and were unable to access financing from other sources. Because of this loyalty to MFIs, many clients want the institution to grow with their financing needs. Some entrepreneurs stated that the maximum loan sized offered is too small to allow them to take on large, longer term investment projects—such as housing construction, equipment purchasing.

#### SUSTAINABILITY AT THE LEVEL OF COMMUNITY

More concern with the overall impact of the financial intervention at the level of communities where the MFIs clients are operating, the Romanian MFIs are using part of the “profits” gained from the financial activity for the development of social intervention at the level of the communities.

As an example, in 2007, FAER successfully implemented projects on the rehabilitation of five village primary school infrastructures, water and heating system, toilets and lavatory, library and sport yard, located in Mures county, and improvement of the home care services

#### FROM THE FORUM

An MFI without independence makes no sense.  
*(Marcelo Abbad, Marcelo Abbad Consultoria, Spain)*

The projects were implemented in partnership with the local communities and specialized humanitarian associations. FAER financed 50% of the rehabilitation costs and provided logistics support to its partners. Another outcome of the intervention was the transfer of ownership of the intervention results through the involvement of the local communities and local authorities in the selection, implementation and maintenance of the rehabilitated school facilities and of the home care services.

The maintenance and future improvement of the rehabilitated social infrastructure as well as replication of the intervention in other communities was secured by transfer of ownership for intervention results. Local communities and local authorities were involved in the selection, implementation and maintenance of the rehabilitated school facilities and of the home care services.

### ENVIRONMENTAL IMPACT OF THE MICROFINANCE INTERVENTIONS – A CHALLENGE AHEAD

It seems that the commercialization strategy pursued by most of the MFIs since 2004 is beginning to pay off. The development of the sector measured in terms of geographical outreach, increased efficiency, productivity and profitability, are good indicators that the strategy adopted by these MFIs is working. However, faced with the need to be more and more profitable, a large number of MFIs are struggling to maintain their social orientation.

#### BARRIERS AND DIFFICULTIES FACED

**THE LEGAL FRAMEWORK:** The microfinance sector was not regulated before 2005, well regulated with the promotion of micro finance companies law and currently over regulated and supervised by the National Bank of Romania, that increased the operational costs and forced the MFIs to invest in new and more sophisticated Management Information systems and to specialize the personnel in reporting. As a consequence, at the end of 2007 the first Romania MFI, specialized in lending to women entrepreneurs and family business handled over the license and stopped the crediting activity.

**ACCESS TO FINANCE:** One of the key challenges, that Romanian MFIs have to face, is the difficulty to increase their lending base, in order to serve the high client demand for funds that exists in the market, graph 1 offers a fair picture of the situation in the market. Large MFIs, that already have a significant capital base, are attractive to investors and/or lenders as they are seen as stable and mature institutions.

On the other hand, medium and small MFIs need funds in order to grow, increase outreach and serve their clients, but their small size makes it difficult to attract new funds.

The high debt ratio of the Romanian microfinance sector ( 320% in 2007) requires equity or quasi-equity investment.

## CHALLENGES AHEAD

Additionally, after Romania's accession to the European Union( 2007) and within the current financial crisis , the sector is facing new challenges.

There is an increased demand for financial services from the Micro and Small Enterprise sector. This demonstrated through the estimated unmet demand for 2007 which is projected at over 700 M€. Given the MFIs fragile capital base, to find sources of equity and quasi equity investments, in order to stabilize the mature large and medium MFIs, was the main priority of 2007, several new investors were providing financial resources and existing funders converted the loans into equity.

Moreover, the achievement of the triple bottom line, through a continuous improvement of the quality of services provided to targeted clients, social responsibility towards the staff, clients, community and environment, is the challenge that makes the Romanian microfinance sector European.

## LESSONS LEARNED

There is not a single model or a certain procedure to be followed by MFIs in order to become self – sufficient, and this article's goal is not to do to offer solutions or guidance to the MFIs, but from our experience there are factors that are contributing to its achievement:

- Becoming self-sufficient should be part of the development strategy of the MFI, communicated properly to the beneficiaries: "We are here to partner our customers in development", as well as assumed and promoted by the MFI's staff.
- An enable legal framework that supports development, investment in the sector and protects both the MFIs and beneficiaries, that contributes to the increase of transparency through adequate reporting requirements.
- An optimum level of supervision, that allows a certain level of self governance, establishment of internal risk management and monitoring procedures adapted to the market and to the targeted customer' characteristics.
- Adequate financial sources, a suitable mix of seed funds, equity, debt, with costs and conditions that allows to the MFIs to serve the customers at suitable costs and terms, associated with specialised technical assistance and an efficient Management Information system.
- Well trained and dedicated staff, properly motivated and managed.
- Refocus the interest on the social performance, financing investment in the development of the social infrastructure of the communities and lately a few MFIs go beyond social performance measurement and also include their clients' impact on the environment are few examples of cooping strategies to maintain their initial social orientation and mission.

Achievement of the development impact on their targeted beneficiaries, contributing to the social development of the communities, and lately getting involved in the environmental protection campaigns in the regions they are activating, within the current context of financial crisis, was possible due to the fact that achieving operational and financial self-sufficiency was just a first step in the development strategy of the Romanian MFIs

### FROM THE FORUM

For me this is what sustainability is all about: not mere profitability (though this is one aspect of the measure of sustainability) but relevance.  
*(Allan Bussard, Integra, Slovakia)*



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