

TOWARD A PERFORMANCE ASSESSMENT OF MICROFINANCE INSTITUTIONS IN EUROPE

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Toward a Performance Assessment of Microfinance Institutions in Europe

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Dans les pays en développement, les institutions de microfinance (IMF) peuvent s'inscrire dans une transition vers les services financiers traditionnels. Dans cette perspective, l'accent est mis sur la promotion et la création d'initiatives financières viables, avec des indicateurs de performance semblables à ceux qu'utilisent les banques.

Although many of the issues of microfinance in the developed world are similar to those in the developing world, the policy motivations behind the funding and support may result in alternative methodologies being established. For example, Western governments' usually provide extensive Welfare State networks for the poorest members of their societies, while sophisticated financial systems mean that the majority of the population are served by mainstream financial providers. Thus, funding for microfinance generally aims to either encourage entrepreneurship among the socially excluded or address issues of financial exclusion.

The 'gap targeting support'

This 'gap targeting support' differs sharply from much of the funding of microfinance in the developing world where microfinance institutions can be viewed as part of an evolution towards a mainstream financial services' network. Consequently, there is an emphasis on championing and establishing viable financial institutions, with performance indicators similar to those used by mainstream financial institutions.

This is not to say that such an approach is not sought in Europe, indeed, the European Commission is currently funding a project to identify core performance indicators for microfinance institutions. However, this approach may be inappropriate where the microfinance provider is merely a conduit for government social policy (the use of non-state actors to deliver state policy has a number of challenges).

This paper will discuss such a scenario in the UK and will outline the approach we employed to gauge performance.

Financial inclusion and enterprise development

Since the election of the Labour government in the UK in 1997, there has been a commitment to developing microfinance providers, notably through a relaxation of the legal constraints on credit unions, accompanied by greater accountability to the financial regulator. Meanwhile, a special fund was established to support the development of Community Finance Development Institutions (CDFIs), which were tasked with providing affordable loans to entrepreneurs. Although hybrid organi-

Cela ne veut pas dire que cette approche n'est pas aussi applicable en Europe. En effet, la Commission Européenne finance actuellement une étude pour identifier les indicateurs de performance les plus appropriés aux IMF.

Au Royaume-Uni, depuis l'arrivée au pouvoir des travaillistes en 1997, les IMF ont pu proposer leurs services aux microentrepreneurs tout en comptant sur l'aide gouvernementale, mais sans objectifs clairs quant à leur propre viabilité financière.

sations were created (Dayson *et al.*, 1999), generally, credit unions focused on personal lending and CDFIs on enterprise activity. In addition, credit unions were proud of their independence and sustainability, while the CDFIs' status and financial objectives were more nebulous, with some prioritising their independence and others being ciphers' of the local state or enterprise agency.

However, it is necessary to emphasise that the Government's prime objectives were to address financial exclusion and enterprise development in deprived areas, hence the support for credit unions and CDFIs respectively.

Though an ambition for sustainable institutions was articulated, there was also opinion that most microfinance institutions working in this field have been unsustainable (Copisarow, 2000). Research studies have indicated that this is predominantly connected to the perception of micro borrowers' risk and creditworthiness, and the diseconomies of scale in making small loans (Quach, 2005).

In the UK another factor are constraints surrounding interest rates. Curiously, credit unions are the only financial institution in the UK that has an interest rate cap, which was set at 12.68% APR (Annual Percentage Rate) on declining balance basis, while the social imperative of the CDFIs work led to interest rates being set at an average of 16.67% (McGeehan, 2005). Whether it was possible to develop a sustainable

institution at these rates and serve the most deprived people in society remained a debatable proposition (Collard and Kempson, 2005; Dayson, 2005).

High operational costs and operational inefficiencies

Another consideration is that most UK microfinance institutions endure high operational costs and suffer from operational inefficiencies (Gibbons and Meehan, 1999). For example, at the start of its operation, a microenterprise lender called Street UK (2004) reported that it cost them £8 to lend £1. This figure subsequently decreased, but it remained high at £2.80. In Street's business plan for period 2004-2005, for their retail lending operations in Birmingham, it showed a cost of 63 pence per £1 lent on lending activities and 95 pence on business support, i.e. a total of £1.58 per £1 lent. The implication of this is that Street UK would have to charge an interest rate of over 60% to cover their costs of lending from interest revenue alone, which is considerably greater than the industry norm.

Linked to the issue of operational costs was the relatively small size of the majority of credit unions (Goth *et al.*, 2006), hence they were unlikely to have sufficient scale to significantly contribute towards addressing financial exclusion. To address this matter the lead trade association (Association of British Credit Unions Limited – ABCUL) undertook a series of initiatives to improve the

Pour souligner la nécessité d'une amélioration, le gouvernement a annoncé une stratégie d'intégration financière, qui comporte une somme de 36 millions £ affectée à un Fonds de développement de l'intégration financière. Afin de préparer les critères d'évaluation, le Département du Travail et des Retraites (Department of Work and Pension - DWP) a demandé un rapport sur l'efficacité des systèmes actuels de prêts.

management of credit unions (Jones, 1999 & 2005), with an emphasis on rapid growth and employing professional staff. Thus both credit unions and CDFIs sought to reduce the impact of high operational costs.

The subsequent question is whether these seemingly 'structural' inefficiencies should be funded by the client group (Gibbons and Meehan, 1999). However, there are relatively few studies that have detailed operational cost analyses to enable practitioners to fully understand the structure and causes of their costs, whether at the branch, product, or client level. Moreover, the availability of methods used for those purposes is rare, which causes microfinance providers difficulty in understanding the true costs associated with their operation.

Financial Inclusion Growth Fund

Heightening the necessity for improvement was the Government's announcement of a Financial Inclusion Strategy in 2004, which included £36 million to develop a Financial Inclusion Growth Fund for credit unions and CDFIs: '[...] the Government will set up a growth fund for third sector lenders, within the Financial Inclusion Fund, to boost the coverage, capacity and sustainability of the sector in providing a source of affordable credit for the financially excluded. The Government will invite bids to the Fund from third sector lenders. Support for credit unions will be granted on the basis of credit

unions' business strategies for further growth and sustainability. Support for CDFIs will be made up of a mixture of revenue and capital support, focused on establishing brand new personal lending CDFIs, supporting enterprise-lending CDFIs expanding into the personal lending market and providing ongoing support for existing organisations.' (H.M. Treasury, 2004, p.36).

The Growth Fund was to be managed by the Department of Work and Pensions (DWP) and applications were received up until April 2004. As part of the preparation for the assessment criteria, the DWP instructed the authors' of this article to report on the efficiency of the current lenders.

Past findings on efficiency of microfinance lenders

Evidence of research into efficiency of microfinance lenders engaged in policy implementation was difficult to locate. Apart from the researchers' weakness in performing the literature search, it could be partially because the global microfinance sector has been concerned predominantly with debates of subsidy versus no-subsidy (Rhyne, 1998; Robinson, 2001; Gonzalez Vega, 2001), with respect to impacts (Morduch and Haley, 2002).

Of the very few studies, Dayson (2005) undertook an analysis of four CDFIs, which included a review of their financial performance and an analysis of how staff spend their time over a three week period. The result indicated that on average almost

Il a été difficile de trouver des données sur les instituts de microfinance engagés dans la mise en œuvre d'une telle politique. L'étude de Dayson (2005) attribue certaines déficiences des IMF au besoin d'accompagner les clients de leurs conseils. Il apparaît clairement que les besoins en la matière sont insuffisamment couverts ou de façon inappropriée. En conséquence, plusieurs institutions communautaires de développement financier prévoient un soutien à titre bénévole.

L'étude de Dayson a également relevé de grandes inégalités au niveau d'autres indicateurs d'efficacité, comme le temps passé aux tâches administratives. Ces résultats peuvent aider les IMF à rationaliser les processus et à réduire les coûts.

half the time (49%) was spent on the loan process and administration functions, with 19% spent on advice and support, 19% on enquiries and 13% on arrears management.

Operational costs: inflated by business support provision

The study by Dayson also reveals that most microfinance institutions believed the main reason for 'inefficiencies' was the need to undertake advice and support work with customers.

For example, Street argued that about 60% of their lending staff's time was spent on business support, thereby limiting other activity. There was also an effect of issuing many smaller loans which require more work than fewer larger loans. Dayson concluded that: 'the 19% of time spent on advice related tasks supports the case that CDFIs are engaged in what should be other organisations' tasks' (2005).

However, business support and advice are a necessary part of serving 'hard to reach' clients, but as the CDFI sector has grown, it has become increasingly clear that the quality of generic coverage is patchy and/or inappropriate. Consequently to ensure their own business development, many CDFIs undertake unfunded business support. Confirmation of this came with a Community Development Finance Association - CDFI (2004) report which found that of 50 CDFIs who responded to a questionnaire, 64% offered finance

and business support - a significantly larger proportion than the 35% found in 2003. The most common support offered was informal advice during loan processing (88%), followed by informal telephone advice and mentoring.

Extensive savings are possible

Though operational costs are inflated by the provision of business support, Dayson (2005) also found wide variations in other efficiency 'indicators', such as the time spent on administration. The most 'efficient' CDFI spent 35% on general administration and loan processing, compared to 66% at the least 'efficient'.

It was suggested that this may be attributed to some having more efficient systems enabling them to spend more time promoting their services, resulting in more enquiries. Furthermore, these differences indicate that extensive savings are possible.

Such findings can help microfinance institutions (MFIs) managers streamline processes and reduce costs, but to date these operate at the organisation level. If, for example, MFIs offers more than one product or service, further analysis including a product costing system to determine whether their products and services are viable is important. Better management information on products contributes to better decisions on product design, delivery mechanisms, and pricing.

L'étude conduite pour le DWP a eu deux objectifs : comprendre le processus de prêt et évaluer son efficacité. Il a fallu pour cela utiliser un modèle de fixation des coûts de produits CGAP (Consultative Group to Assist the Poorest). Dans notre modèle, nous avons préféré l'approche basée sur l'évaluation de l'activité (Activity Based Costing), parce qu'elle fournit des renseignements plus complets sur les processus et leurs coûts.

A costing exercise can also raise awareness of the cost components of different products, including hidden costs.

Performance assessment approach adopted

The research conducted for DWP had two main objectives: to understand the lending process and its efficiency. This involved utilising the product costing model, as suggested by the Consultative Group to Assist the Poorest - CGAP (2004). From an accounting perspective, this model is considered as a cost allocation method, whereby indirect costs are assigned to individual products, customers, branches, etc. as defined by an organisation. Many, if not most, non-financial costs in a financial services institution are indirect, requiring some sort of allocation system if management wants to analyse product costs.

Several methods exist for allocating costs among products. In general, a reasonable allocation method should have the goal of minimising cost distortions and improving overall institutional performance through more efficient use of common resources (indirect costs).

In fact, the widely used allocation methods include the *Traditional Cost Allocation and Activity Based Costing* (ABC). In our study, we employed the Activity Based Costing approach for the reasons that it provided much richer information about the processes and the related costs (CGAP, 2004).

Using a survey of microfinance providers and a timesheet analysis of staff activity from a sub-sample, we traced costs to specific activities, such as loan processing, opening a savings account, etc. The identification and categorisation of specific activities were the first step in this method. These activities were then 'used' or 'consumed' by the different products, depending on specific attributes that drive activity costs (e.g. number of loans/savings accounts). A given product consumes many different activities. When these activities are added up, the total cost of delivering the product is revealed. Identifying activities that link employee costs to the products they deliver is a very important distinction in product costing analysis.

Activity Based Costing

Our study involved categorising activity into five core groups: personal loans, business loans, savings, administration, governance and others. In each core group, specific activities were identified. All specific costs within personal and business group were transferred to the estimation model of personal and business loan as direct costs, while the specific costs within other core groups were allocated as indirect costs. The direct and indirect costs then constituted the total cost for personal and business loan.

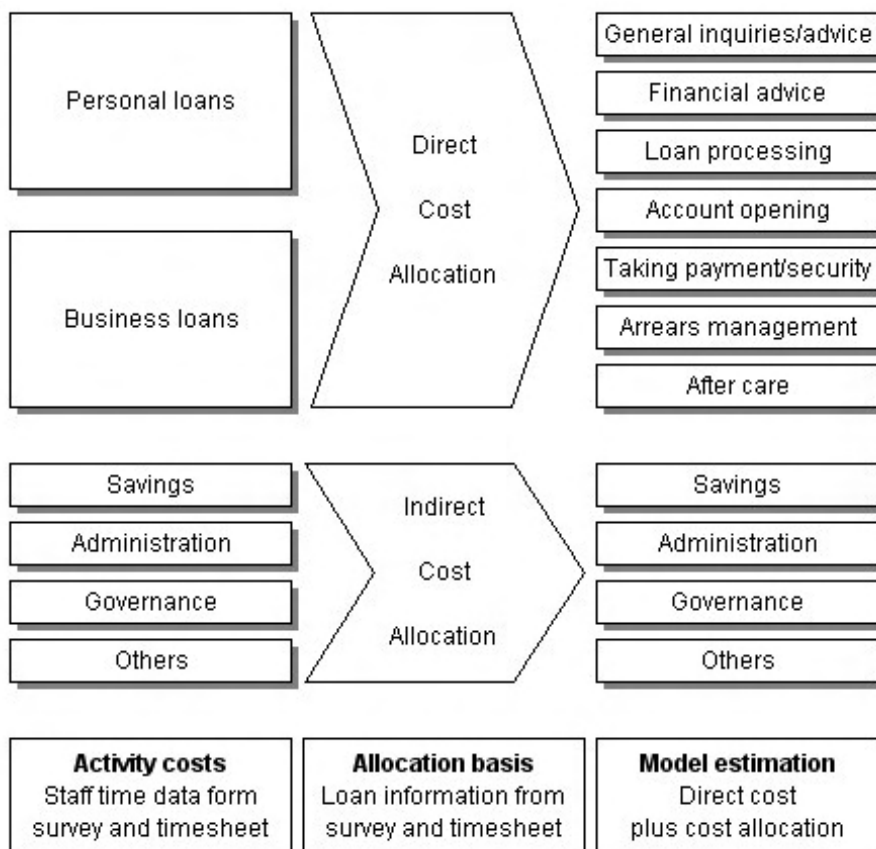
The estimation model required three stages: identification of activity costs, allocation basis and model estimation. First, all costs had to

Dans le cadre de notre étude, chaque activité a été mise dans l'un de 5 groupes (crédits à la consommation, crédits aux entreprises, épargne, administration, gouvernance et autres). Il a ensuite fallu calculer le coût de chaque activité, puis le temps par unité de personnel, pour pouvoir finalement construire le modèle d'estimation décrit dans le schéma.

be identified. This stage was undertaken by using the aforementioned questionnaire survey and timesheet exercise. The key data collected will be staff and non-staff costs, time per activity, financial performance, etc. The second stage involved a staff time allocation basis. The key data used in this stage also derived from

the survey and timesheet, which included number of loans, amount of loans and staff time spent in each of specific activities. Data from the first and second stage was then computed and entered into the estimation model with relevant assumptions. The estimation model is depicted in Figure 1.

Figure 1. Cost estimation model



Un modèle d'estimation des coûts, mettant en rapport les flux, la comptabilité interne et les temps de travail, offre aux institutions de microfinance un support leur permettant de chiffrer les produits et d'évaluer leur efficacité.

Dans les pays développés, où le financement des IMF est lié à des objectifs de politique sociale, il se peut que certains services ne soient jamais rentables.

For financial performance, apart from the indicators used in normal financial analysis, we were also interested in comparing budgeted and actual performance, as we believed this would provide an insight into the quality of the management and the business strategy adopted. Another issue of interest was the possibility of variance between groups of microfinance providers, particularly as there was considerable debate about the relative merits of credit unions and CDFIs. Also, we expected to draw a common picture on how the lending process is implemented in the community finance sector.

Timesheet exercise

The timesheet exercise aimed at finding the actual staff time spent on daily activities of microfinance providers. From this we sought to identify what is the structure of staff time actually spent in a typical week? And what is the performance during the week? This exercise would serve not only as a benchmark for the operation of a typical microfinance provider, but also as a basis for the estimation of lending cost.

For the purpose of studying the efficiency of staff time spending, we adopted a distinction between: (i) working hours and (ii) office hours. Working hours imply the actual time spent on microfinance providers daily activities and office hours are the standard working time which is assumed to be 7.5 hours a day. Therefore, the total working hours are not necessarily equal

to the total office hours. Moreover, because we had three types of staff completing timesheets, including fulltime, part-time and volunteers, we make further assumptions on the working hours and office hours for each type of staff. The full-time staff and part-time staff are assumed to have 7.5 office hours' a day. The total office hours in a week depending on the number of days they actually work. We believed this was a reasonable assumption, as during the observed period some staff may not be working (e.g. holidays). The office hours for volunteers' was assumed to be equal to the number of working hours, which meant that we expected that the volunteers would spend all their volunteer time on the microfinance provider's activities. All participants completed a timesheet and an activity monitoring form every day during a given week. To aid analysis, the day and, by extension, tasks were divided into 15 minute blocks. Thus we were able to measure what any given member of staff did and for how long, and combine this with the questionnaire to assess the theoretical (budget and management estimation of staff activity) and actual (current financial results and staff timesheets) performance.

Demonstrate efficiency and efficiency savings

The method outlined above was in response to a specific request by a government department and consequently comparison between institutions may not be available. However,

D'où la nécessité de pouvoir faire apparaître les efforts entrepris pour améliorer l'efficacité, de manière à continuer de bénéficier d'un soutien.

we would argue that a cost estimation model, through the use of a process flowchart, internal financial records, and timesheets, offers a means for microfinance providers to cost products and assess their organisational efficiency.

In our view the debate about subsidy is sometimes secondary to whether the funder is satisfied with their investment. In nations where funding is connected to social policy objec-

tives, it may be that some services can never be profitable, thus the importance of efficiency, and demonstrating on-going efficiency savings, is crucial to continued support. Not only is this important for the microfinance provider, but it is also necessary for the funder to understand and acknowledge that certain products and services are unlikely to be self-sustaining. •