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Making European microfinance more sustainable – lessons from Britain

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Abstract: This paper identifies and analyses best practice in promoting sustainable microfinance institutions (MFIs) based on an in-depth analysis of five UK MFIs. The study focused on the effectiveness of MFI partnerships, staff efficiency and loan portfolio profitability, which previous research suggests are the key pathways to enhance sustainability. Situated between the Western European model of state-subsidised enterprise support and the Eastern European sector focusing on scale and efficiency, the UK microfinance sector may offer important lessons in balancing efficiency and social impact.

We conducted a benchmarking study of five UK MFIs, part of which we analysed and modelled the past and future performance of their loan portfolios, their partnerships, and the way in which their staff members spent their time and the processes and structures driving this time-use.

We found that the MFIs are still some way away from covering all their costs with income generated from their core activity of lending. The results of the analysis of the loan portfolio suggest that they can increase their sustainability considerably through charging interest rates which more closely reflect the costs of delivery and by organising staff to maximise loan officer exposure to potential customers. The degree to which the MFIs can boost the sustainability of their operations depend on their starting point (i.e. interest rates charged, initial loan officer productivity), product mix and cost structure. We argue that the funders and policy-makers can aid the sector move towards greater sustainability through ensuring that loan capital is available to underpin portfolio growth and through providing development grants to stage-manage productivity increases.

We hope that our findings and recommendations will enable funders and policy-makers support the UK and European microfinance sector in a more effective and progressive manner. In addition to highlighting best-practice in MFIs operations, our hope is that the research instigates greater cooperation and sharing of best practice across the sector. Building on the experience of sharing data and practices as part of the research project, the five participating MFIs are now cooperating on a wider range of issues through a newly established user group.

Key Words: Microfinance, operational sustainability

Introduction

Achieving sustainability is today a key aim of the global microfinance movement alongside its social and economic objectives. Sustainability is seen as important because sustainable Microfinance Institutions (MFIs) "meet their goals now without harming their ability to meet their goals" in the future (Schreiner, 2000, p.425)

There are two specific definitions of sustainability: operational and financial. Operational sustainability refers to the ability of an MFI to cover its costs with income from its core activities (i.e. fee and interest rate income from its loan portfolio), whilst financial sustainability refers to the ability to cover its costs if it had to raise 100% of its loan portfolio through recycling existing funds and through borrowing funds at the market rate (CGAP, 2003; CDFA, 2006).

Sustainability rose to prominence in research and policy debates following the theoretical and empirical critique embodied in the research by a group of researchers at the Ohio State University on subsidised agricultural programmes operating in Latin America in the 1960s and 1970s (Adams, 1972; Von Pischke and Adams, 1980). Their criticism of these programmes was twofold. First, they argued that the concessionary terms of lending distorted the potential economic and social impacts by enticing higher-income individuals to take out the loans. Second, their limited capacity to reuse loan capital, owing to high cost/income ratios, translated into short life-spans stifling ability to capitalise on staff and institutional learning.

However, the emphasis placed on sustainability of microfinance programmes by policy-makers and practitioners across the expanded European Union has been highly uneven. The Eastern European microfinance sector has generally followed the current microfinance orthodoxy in focusing on sustainability, profitability and scale (Bateman, 2003; Hartarska et al, 2006). The non-bank MFI sector in Central and Eastern Europe as a whole is self-sustaining according to figures from the Microfinance Information Exchange (2006, 2007).

Conversely "Western European microfinance has…a strong focus on social inclusion and pays less or almost no attention to its profitability" (Evers and Jung, 2007, p.10). For reasons of a difficult and little developed market place, sectoral immaturity and the presence of subsidies, there has not been a considerable move towards sustainability (Evers and Jung, 2007; Guichandut and Underwood, 2007). This is evidenced by the apparent lack of consolidation of the sector in Germany where the number of institutions is increasing whilst the number of customers is decreasing (Evers and Lahn, 2007). Instead, there has been a general focus on the cost-effectiveness of microfinance compared to state-run welfare programmes.

The UK microfinance model finds itself somewhere between the Eastern and Western European models. As in the case of Western Europe, there is a strong focus on social inclusion, as evidenced by the assignation of funding based on reaching target groups, predominantly very low-income households. On the other hand, the UK government has stressed the importance of scaling up MFIs to serve excluded communities, especially in the case of personal financial services (HM Treasury, 2007). Moreover, indicators relating to financial sustainability, such as minimum interest rates for personal loans and maximum loan delinquency rates, are also often attached to grant funding.

Situated between the Western European model of state-subsidised enterprise support and the Eastern European sector focusing on scale and efficiency, the UK microfinance sector may thus offer important lessons in balancing efficiency and social impact. This paper analyses the degree to which the UK sector has managed to pursue operational sustainability, whilst meeting social targets tied to funding, through an in-depth benchmarking study of five UK MFIs.

Previous research into the UK MFI sector has identified three pathways of improving financial and operational sustainability (Forster et al, 2004; New Economics Foundation, 2004; Dayson, 2005; Dayson, 2006): staff productivity and efficiency, effective partnerships (to reduce costs and increase client base) and an appropriately mixed loan portfolio. Hence, in this paper we conducted a benchmarking study of five UK MFIs, as part of which we analysed and modelled the past and future performance of their loan portfolios, their partnerships, and the way in which their staff members spent their time and the processes and structures driving this time-use.

We found that the MFIs in our sample are still some way away from covering all their costs with income generated from their core activity of lending. The results of the analysis of the loan portfolio suggest that they can increase their sustainability considerably through charging interest rates which more closely reflect the costs of delivery and by organising staff to maximise loan officer exposure to potential customers.

The remainder of the paper is organised as follows. The second section outlines the methodology and the participating MFIs. The third presents the findings of the analysis of staff productivity, partnership effectiveness and profitability of loan portfolio. The fourth concludes and discusses the implications of the findings for European microfinance.

Methodology

The case study methodology applied for this study consisted of three components. First, we analysed the use of time by MFI staff members, recorded through a timesheet filled in daily for a three week period by the staff members, in order to ascertain the staff productivity and efficiency. In addition to recording minutes spent on tasks (e.g. loan interviews, opening up of loan accounts), loans officers were asked to record number of loan applicants seen. Based on the latter data, we were able to make estimations about annual loan officer productivity, which in turn fed into the loan portfolio analysis. We also conducted qualitative interviews with 16 staff interviews to explore the drivers and causes of time use.

Second, in order to analyse the effectiveness and nature of partnerships formed by the MFIs, their partner organisations filled in an online questionnaire. This questionnaire contained questions concerning three potentially performance-enhancing aspects of partnerships: increasing customer base (through referrals and marketing), transferring costs and accessing funding.

Finally, to determine the profitability and sustainability of the portfolio of products and activities of the participating MFIs, the following data was collected and analysed for business loans (including social enterprise loans), personal loans and home improvement loans for the financial year of April 2006 to March 2007:

- Size of loan book (number of loans, value of loans);

- Income from interest rates and fees;
- Staff and overhead costs for delivery;
- Loans written off, arrears and capital at risk;
- Capital available to lend (including sources of funding)

Five MFIs covering England were included in the study (Table 1).

Table 1: The MFIs studied

	MFI A	MFI B	MFI C	MFI D	MFI E
Number of employees (FT positions)	10	12	5	11	5
Total value OLP (£ '000)*	951'	202'	554'	444'	520'
Financial products (% of OLP)	PL (74) BL (26)	PL (37) BL (34) SEL (29)	PL (54) BL (46)	PL (58) BL (41) HIL (1)	HIL (100)
Loans granted by product	PL: 1262 BL: 78	PL: 202 BL: 46 SEL: 2	PL: 310 BL: 23	PL: 562 BL: 41 HIL: 4	HIL: 89
Other services	SP	DMA	..	DMA	..
Branches	3	2	2	2	1

Source: Loan portfolio data provided by the MFIs for the financial year of April 2006 to March 2007
Notes: * Assessed on March 31 2007
Abbreviations: PL = Personal loans, BL = Business loans, SEL = Social Enterprise Loan, HIL = Home Improvement Loans, SP = Savings products, DMA = Debt and Money Advice, FT = Full-time, OLP = Outstanding loan portfolio

The MFIs differ in terms of their business strategies and product portfolio. MFI E is a specialised home improvement loan lender and was included as a point of reference for long-term performance of the product and for administrative and technical requirements for introducing the home improvement loan.

MFI A specialises in personal finance and has since April 2007 stopped offering business loans. Conversely, MFI B, MFI D and, to a lesser extent, MFI C offer a wide range of services to households, social enterprises and small businesses, including advice and home improvement loans. Nevertheless, because personal loans constituted the single greatest number of loans and greatest value of the outstanding loan portfolio for MFIs A to D, we will in this paper refer to these MFIs as personal lending MFIs.

Findings

This section presents the main findings of the case study research and is divided into three sections. The first discusses the findings from the analysis of the use of time among MFI employees. The second analyses the effectiveness of partnerships, whilst the third examines the level of sustainability of the loan portfolio.

Staff productivity

Increasing the efficiency and productivity of MFI employees is a potentially powerful determinant of sustainability, potentially determining the number of loans a loan officer can make and the amount of time the organisations can spend on reducing loan losses through monitoring and debt collection.

In order to ascertain the level of staff productivity and efficiency staff members filled in a daily timesheet over a three-week period. In total, 48 out of 51 MFI staff members submitted timesheets (Table 2), and semi-structured interviews were conducted with 16 staff members from the 5 MFIs.

Table 2: Participating staff members

	MFI A	MFI E	MFI C	MFI D	MFI B	Total
Total staff	7	5	6	11	6	**48**
Admin	2	1	1	2	1	**7**
Lenders	3	3	3	6	3	**18**
Management	2	1	2	3[1]	2	**10**

The data was weighted according to the normal distribution of staff across the staff categories to ensure that non-participating staff members did not skew the results. Because MFI E is a specialised home improvement loan provider, the tables displays the averages for the personal lending MFIs, and much of the analysis will centre on differences and similarities in the use of time between these MFIs.

Table 3 displays the weighted timesheet data according to activity by MFI for all staff members. Each activity consists of numerous tasks. For example, making loans consist of loan interviews, reviewing application, issuing of loan and loan administration. A key distinction made is the distinction between the time spent on sustaining activities – tasks not easily linked to the provision of financial products – vs. time spent on core activities directly linked to the provision and monitoring of loans.

Table 3: Proportion of time spent by all staff by MFI (% of productive time)

	MFI A	MFI B	MFI C	MFI D	Average score	MFI E
Loan enquiries	7.1	2.5	8.0	3.5	**5.3**	0.4
Money advice	1.9	0.3	0.8	0.1	**0.8**	0.5
No shows	2.7	0.1	0.0	1.0	**1.0**	0.1
Making loans	31.4	33.7	21.9	29.2	**29.1**	39.1
Month-end reports	4.3	1.7	4.6	2.2	**3.2**	1.3
Servicing loans	2.7	2.4	5.1	3.8	**3.5**	0.7
Delinquency control	7.9	10.0	13.3	12.6	**11.0**	2.6
Promotional activities	3.5	9.7	11.5	17.0	**10.4**	14.4
Office management	36.6	36.9	33.9	29.1	**34.1**	37.1
Other activities	1.9	2.7	0.9	1.5	**1.8**	3.8

Notes: Reported as percentages based on weighted data
Source: Timesheets submitted by MFI employees for the period 25.06.07-13.07.07

The MFIs appear to spend their time on four activities. First, tasks relating to office management constitute the single biggest activity for all the personal lending MFIs with the exception of MFI D. There seems to be a certain minimum time a MFI has to dedicate to general office tasks (a minimum of 5%), staff meetings (around 5%), queries (4-6%) and report preparation (3-5%).

Second, tasks involved in making a loan constitute the second most time-consuming category, hovering between 20 and 40% of productive time. Once the loan has been made, relatively little time is dedicated to servicing loans (2-5%). This reflects the insistence among MFIs on servicing the loans through automated bank transfers.

Third, once a client falls in arrears with their payments, the MFIs display great willingness to invest considerable time in chasing arrears (8-13% for the personal lending MFIs). The emphasis on delinquency control appeared to be driven by a fear that inaction on part of the MFI could foment a non-payment culture among borrowers.

Finally, MFIs also appear to invest considerable time on promotional activities (external meetings, presentations, outreach activities, marketing, liaising with partners and networking). With the exception of MFI A, the MFIs spend between 10 and 17% of their time on promotional activities. MFI D spends the greatest proportion of its time on promotional activities largely because it has a dedicated outreach worker. Because the MFIs in the sample are still dependent on granted loan capital and other forms of subsidies, they must invest considerable time on maintaining contracts and relations with public and private sector organisations. This may explain the considerable time invested in external relationship management and promotional activities.

Table 4 shows how the administrators across the participating MFIs spend their time.

Table 4: Proportion of time spent by admin staff by category (% of productive time)

	MFI A	MFI B	MFI C	MFI D	Average score	MFI E
Loan enquiries	4.9	4.5	11.5	14.9	**9.0**	0.0
Money advice	0.0	1.6	3.4	0.0	**1.3**	0.0
No shows	0.0	0.0	0.0	0.0	**0.0**	0.0
Making loans	19.8	2.9	21.4	9.9	**13.5**	2.8
Month-end reports	1.5	3.2	3.7	3.3	**2.9**	9.5
Servicing loans	13.7	15.5	16.0	23.2	**17.1**	6.7
Delinquency control	10.7	0.0	15.7	11.9	**9.6**	0.0
Promotional activities	0.0	0.0	8.9	0.3	**2.3**	0.0
Office management	40.3	69.9	19.4	36.5	**41.5**	71.0
Other activities	9.1	2.4	0.0	0.0	**2.9**	10.0

Notes: Reported as percentages based on weighted data

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

Here there is considerably more variation than could be observed for the MFIs as a whole. This variance centres principally on the extent to which the administrators get involved in loan provision, dealing with loan enquiries and giving applicants money advice.

On the one hand there are MFIs whose administrative staff specialise almost purely on office management tasks, with very limited involvement in the MFI's core activities. This is very much the case of MFI B, where the administrator spends little time on lending activities (with the exception of servicing loans).

On the other, the administrators at some MFIs have an extensive involvement in the making, servicing and monitoring of loans, which is the case at MFI A. The rationale behind this division of labour seems to be to maximise the exposure of lending staff to clients. As we will see when looking at the timesheet data for the loans officers, the model seems to achieve that, as MFI A lending staff spend more time than the loans officer of any other MFI on dealing with potential customers.

The two above-mentioned divisions of labour may only work in larger organisations. The administrator in MFI C, the smallest MFI in the sample, has a non-specialised role getting involved in all aspects of the operation of the MFI.

Table 5 displays the use of time among managers across the MFIs.

Table 5: Proportion of time spent by management by category (% of productive time)

	MFI A	MFI B	MFI C	MFI D	Average score	MFI E
Loan enquiries	1.6	1.2	3.8	0.7	**1.8**	0.0
Money advice	0.0	0.0	0.0	0.0	**0.0**	0.0
No shows	0.0	0.0	0.0	0.0	**0.0**	0.0
Making loans	17.2	11.4	12.1	3.2	**11.0**	3.4
Month-end reports	12.4	4.0	7.7	6.1	**7.6**	1.3
Servicing loans	0.0	0.9	4.9	0.1	**1.5**	0.0
Delinquency control	7.4	1.7	7.6	0.9	**4.4**	0.3
Promotional activities	6.9	25.8	13.9	35.1	**20.4**	25.0
Office management	54.5	54.0	48.3	47.5	**51.1**	64.4
Other activities	0.0	1.0	1.7	6.4	**2.3**	5.6

Notes: Reported as percentages based on weighted data
Source: Timesheets submitted by MFI employees for the period 25.06.07-13.07.07

One of the factors distinguishing the MFIs is the degree of management involvement in making loans. On the one hand, the management of MFI D and MFI E only have very limited involvement in making loans. This appeared to be related to reliance on contractual income and the complexity of funding arrangements.

On the other, there are managers who are much more involved in the loan process, particularly MFI A and MFI C. In the case of the former, the managers spend more than 6% of their time on interviews alone, which is more than the managers in all the other MFIs combined. This is largely a reflection of the organisational culture of MFI A. All the organisation's activities are centred on increasing the loan book through seeing potential clients. To be able to do that, managers cover for loans officers on leave and generally offer extensive lending support.

Finally, we turn to the use of time among the loan officers across the participating MFIs (Table 6). The loans officers play a crucial role in a MFI as they have the most extensive contact with the client base and often build relations with customers, vital in informing lending decisions and in limiting defaults and loan losses.

Table 6: Proportion of time spent by lending staff by category (% of productive time)

	MFI A	MFI B	MFI C	MFI D	Average score	MFI E
Loan enquiries	11.8	2.6	13.4	1.7	**7.4**	0.6
Money advice	4.0	0.1	0.8	0.1	**1.3**	0.7
No shows	5.6	0.1	0.1	1.7	**1.9**	0.1
Making loans	46.5	54.4	38.5	48.9	**47.1**	58.4
Month-end reports	0.0	0.0	0.0	0.0	**0.0**	0.0
Servicing loans	0.0	0.0	0.0	0.0	**0.0**	0.0
Delinquency control	7.2	17.4	21.6	18.9	**16.3**	3.9
Promotional activities	2.8	2.9	8.7	6.9	**5.3**	12.5
Office management	21.8	18.8	16.9	19.7	**19.3**	21.5
Other activities	0.3	3.7	0.0	2.1	**1.5**	2.2

Notes: Reported as percentages based on weighted data
Source: Timesheets submitted by MFI employees for the period 25.06.07-13.07.07

Making loans constitutes the single most time-consuming activity for loans officers. Three out of the four personal lending MFIs spend around 20% on delinquency control. This activity generally involves monitoring daily, weekly or monthly bank reports of direct debits, and acting accordingly by calling, paying visits to or sending letters to the clients. The lending staff are to varying degrees supported by administrators and managers in monitoring and acting upon non-payment.

Lending staff at MFI A spend considerably less time on delinquency control than the other MFIs because of its automated arrears monitoring system. This system requires loan officers to make a call to delinquent clients, whilst all other aspects of the delinquency control (further follow-ups and debt collection) are dealt with by administrative and management staff.

This time-saving arrears reporting system combined with the way in which support and management staff are organised enables lending staff at MFI A to focus on seeing potential clients. 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.

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 7).

Table 7: 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**

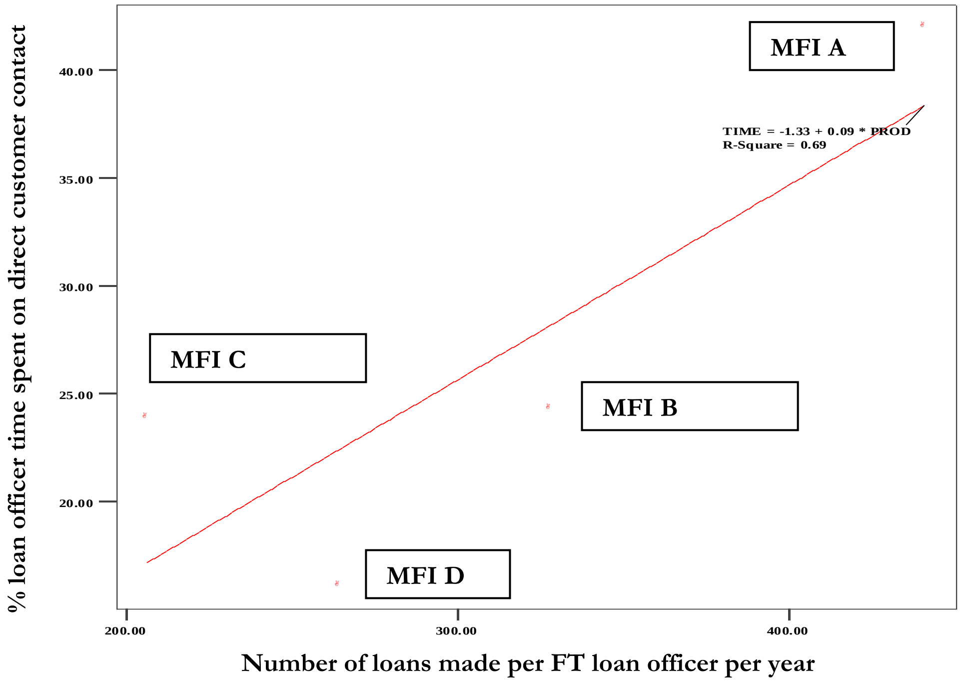
Notes: Estimated based on number of loan applicants seen during timesheet exercise
Assumes 60% success rate based on data from MFI B
Source: Timesheets submitted by MFI employees for the period 25.06.07-13.07.07

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.

Figure 1: Direct customer contact and loan officer productivity



In summation, MFI A which puts the greatest emphasis on maximising the time loans officers spend on interviewing, by involving administrators and managers in offering lending support, also processes the greatest number of loans per full-time loan officer position. Further, our findings suggest that part of maximising lending staff exposure to potential customers may also lie in outsourcing administrative aspects of arrears control and possibly other areas to external companies.

Partnership effectiveness

Like the productivity of staff, effective partnerships can improve the sustainability of a MFI, by increasing its client base through referrals and marketing. In addition, the willingness of a partner organisation to donate loan capital and buy other service from a MFI is determined by how effective they perceive the partnership to be.

In order to measure the effectiveness of these partnerships, 27 partner organisations filled in an online questionnaire (Table 8).

Table 8: Partner organisations by MFI

	MFI A	MFI B	MFI C	MFI D	MFI E	Total
Housing association	1	3	..	3	0	**7**
Debt advice agency	0	0	..	2	0	**2**
Bank, build society	1	2	..	1	0	**4**
Local government	0	0	..	3	6	**9**

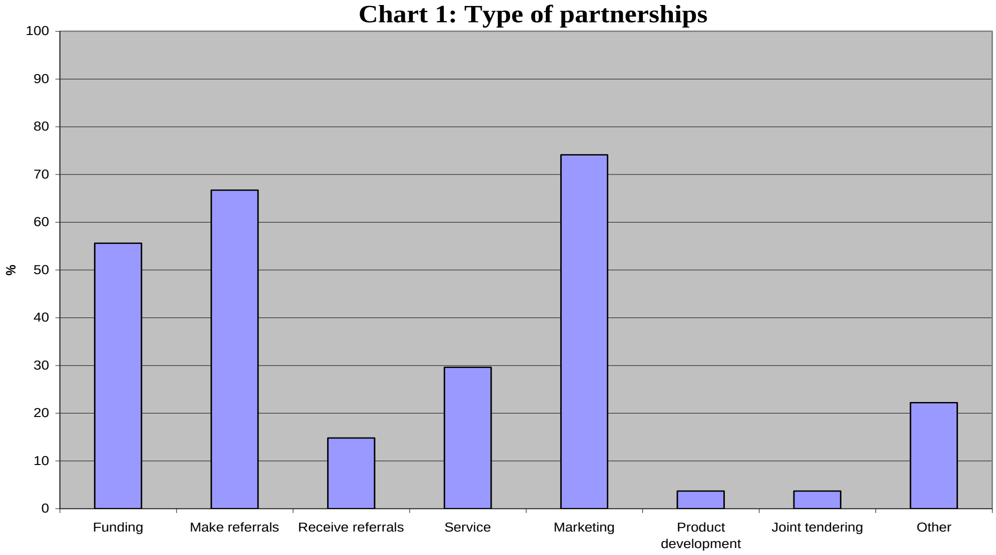
RDAs	0	1	..	0	0	**1**
Charity	0	0	..	1	0	**1**
Business advice	0	1	..	0	0	**1**
Other	0	2	..	0	0	**2**
Total	**2**	**9**	**..**	**10**	**6**	**27**

Source: Online questionnaire filled in by MFI partner organisations September and October 2007

Local government and housing associations constitute the majority of MFI partners. In this sample, the majority of local councils are cooperating with the MFIs in relation to the provision of home improvement loans. For housing associations, partnerships with the MFI sector is seen as a key strategy in reducing the risk of households falling behind on their rent by offering an alternative to their tenants to pawnbrokers and doorstep lender who often charge very high interest rates.

The MFIs and their partners cooperate in numerous ways (Chart 1, N = 27).

Chart 1: Type of partnerships



Source: Online questionnaire filled in by CDFI partner organisations September and October 2007

The majority of partner organisations refer clients to the MFI, market the MFI's product to its clients and provide the MFI with funding. About a third of the partner organisations fund the MFIs in exchange for a service, which in all cases refers to home improvement loans.

Broadly speaking we can draw a simple typology of the different types of partnerships. First, there are the partnerships which MFIs form with arms-length funders. Second, there are the organisations which fund a MFI in exchange for a service, typically local governments funding MFIs for the delivery of home improvement loans. Finally, there are the relationships between MFIs and so-called peer organisations, which provide non-financial services to low-income households, such as debt and money advice. These organisations include job centres, debt advisory agencies, business links and housing associations. These relationships are typically limited to referrals and basic marketing.

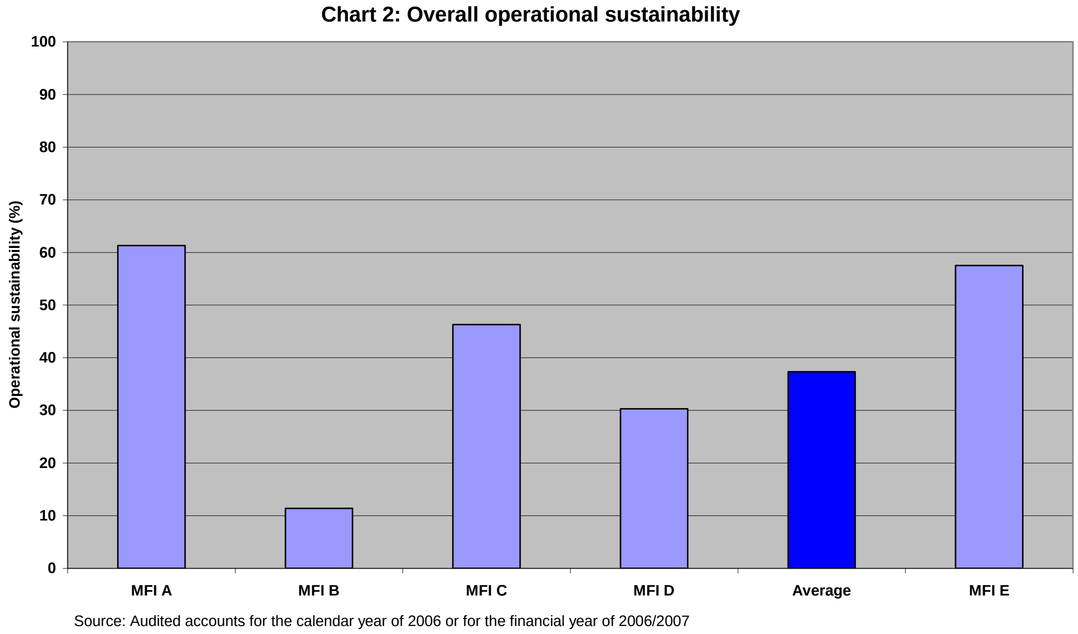
In total, 18 out of the 27 partnerships were referral-based, 15 of which were local government, housing associations and money advice agencies. Most partner organisations made less than one referral per week and most of the referrals from local government are made in relation to home improvement loans.

The way in which partner organisations perceive the MFI and the services it provides is likely to be important for their willingness to invest time and resources in a partnership, enhancing its effectiveness. Overall the survey data suggest that most partner organisations had very favourable views of the MFIs in terms of trustworthiness and reliability. However, the partner organisations expressed greater doubt about the effectiveness and meaningfulness of the partnerships themselves.

Loan portfolio analysis

So far we have looked at two key levers in enhancing operational sustainability – partnerships and staff productivity – and the extent to which the MFIs make use of them. But how sustainable are the MFIs?

Chart 2 shows the degree to which the MFIs are operationally sustainable. Specifically, using their most recent audited accounts, we calculate the total earnings (fees and interest income, and bank interest earned or paid) as a percentage of total overheads (staff, overhead and governance related costs). The average column refers to the average for the personal lending MFIs (i.e. it excludes MFI E).



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%. However, compared to other UK MFIs, the MFIs in the sample perform reasonably well.

The average operational sustainability for the personal lending MFIs surpass those of Aspire (32%) (Forster et al, 2006) and Street UK (7%) (New Economics Foundation, 2004). The average operational sustainability ratio is also on par with the average of UK MFIs (36%) (Brown and Nissan, 2007).

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.

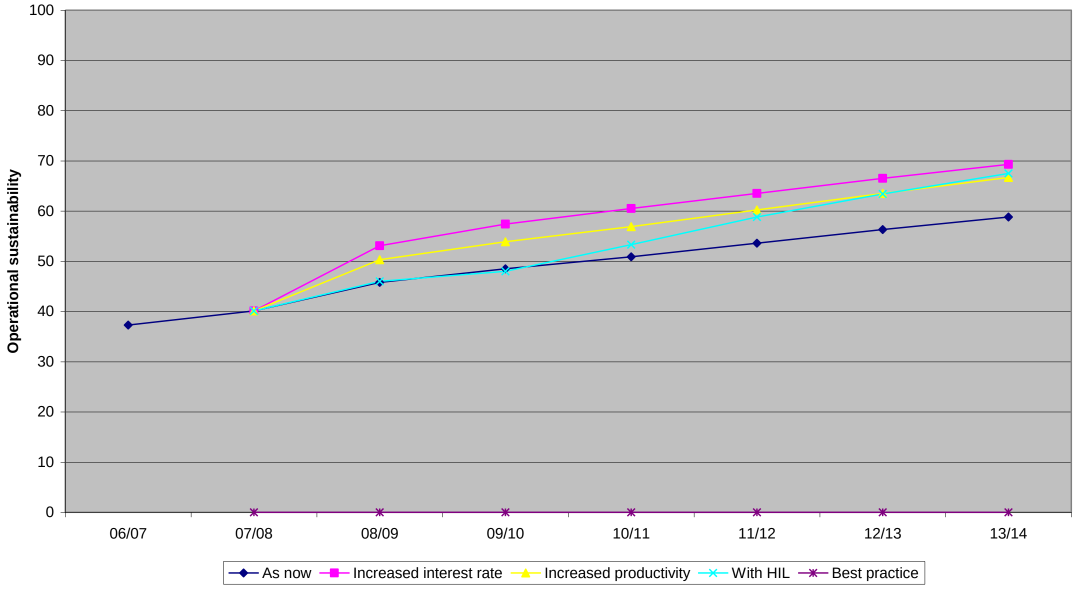
So far we have examined the current level of operational sustainability of the MFIs. However, given that the personal lending MFIs are relatively young organisations at an early stage in their development trajectory, a more interesting question may be how far along the sustainability continuum they can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

Drawing on the basic cost structure (staff, governance and office costs), loan and product portfolio mix (average amounts, number of loans, split repeat/new loans, interest rates, fees etc), and capital and funding streams (liabilities, financial expense, funding contracts) 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.

In addition, we also had to make some assumptions about the future behaviour of the organisations and the climate in which they operate. We assume an annual growth in loans issued of 10% for personal loans and a range of growth rates for business loans and home improvement loans, depending on funding arrangements (see Dayson et al, 2008 for further details). We also assume a 5% annual increase in the value of loans and an annual inflation rate of 4%. Furthermore, we have applied a standard bad debt ratio of 15% (10% for repeat clients) for both business and personal loans, and a ratio of 0.5% for home improvement loans.

In addition to these base budget projections (as now), 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 HIL). Chart 3 shows the average operational sustainability ratio for the MFIs under each of these scenarios.

Chart 3: Enhancing sustainability



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. The advantage with such a fee is that it is not affected by arrears and as such 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. The home improvement loan is offered to low-income home owners as a means of improving the standard of their housing. Many local authorities fund such schemes through paying subscription fees and subsidising interest rates, making them an attractive option for customers and MFIs alike.

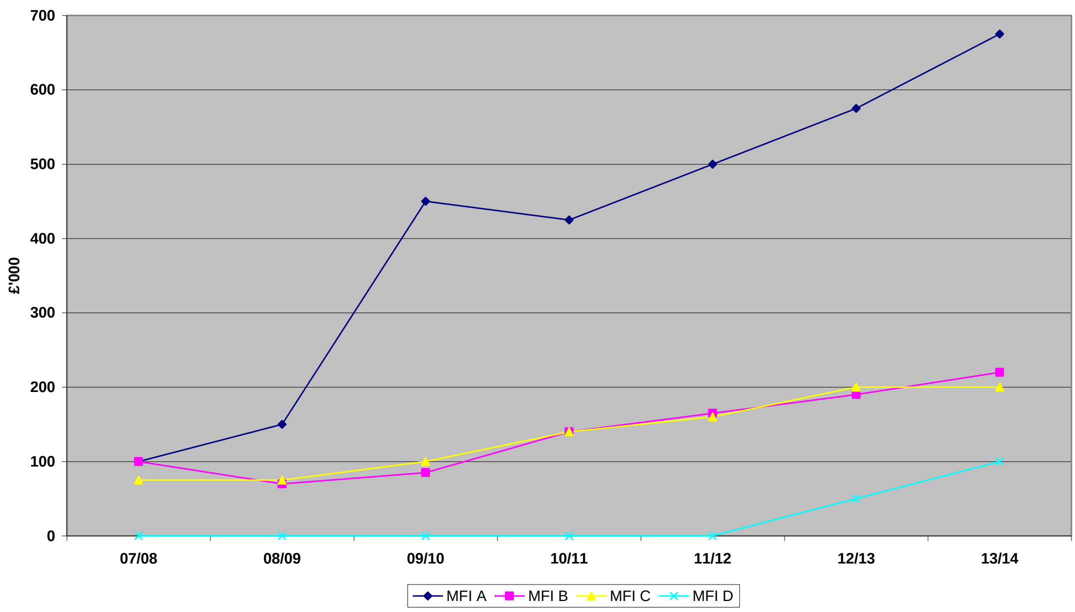
We assume that the MFIs make 41 home improvement loans at an interest rate of 8% and at an average value of £5,500 in their first year of operation (2009/2010). As suggested by Chart 2 even a modest higher-ticket loan portfolio can make a considerable contribution to raising sustainability, assuming 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).

So far we have assumed that the MFIs have access to interest free capital for on-lending. However, a potentially very important barrier for the expansion and future sustainability of the sector may be the availability of lending capital. Currently the MFI sector is not able to offer deposit services, except on an agency basis, and even if they were, it is questionable the extent to which the funds raised through medium and long-term savings products would be able to significantly contribute towards loan capital.

Chart 4 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). Here we exclude the capital requirements for the home improvement loan given that there are particular funding arrangement in which it is given that the MFI borrows to on-lend part of the home improvement loans.

Chart 4: Future capital requirements



The chart reveals that even if the MFIs were to implement best practice there would still be a considerable funding gap. Already in Year 1 (2007/2008), MFI A experiences a six-digit funding gap, whilst MFI C has a shortfall of £75,000. The figures for MFI B are similar to MFI C, whilst MFI D first experiences funding shortages in year 2011/2012 because of its slower projected volume growth in personal loans and considerable reserves.

The future capital requirements for MFI A are considerably greater than those of the other MFIs, because of the much greater scale of its operation. For example, according to our projections, MFI A will lend out more than £1 million in personal loans alone in year 1 (2007/2008) and over £3.5 million in year 7 (2013/2014). In comparison, MFI C will make loans (business and personal loans) for less than £350,000 in year 1 and less than £900,000 in year 7.

This would suggest that a recapitalisation strategy based exclusively on recycling existing loan capital is not a viable means of supporting the expansion of the sector. The sector is dependent on raising funds through grants, contract income and through borrowing loan capital.

Conclusions

Over three decades since Adams, Von Pischke and their colleagues at Ohio State University highlighted serious problems with the theoretical and institutional underpinnings of the subsidised and concessionary agricultural lending programmes in Latin America, the notion that MFIs should strive towards full sustainability is today part of the development orthodoxy.

Situated between the Western European model of state-subsidised enterprise support and the Eastern European sector focusing on scale and efficiency, the UK microfinance sector may offer important lessons in balancing efficiency and social impact. In this study, we have drawn on the findings of an in-depth benchmarking analysis of five UK MFIs to highlight lessons for the European microfinance market on reaching sustainability whilst targeting the lower end of the market.

Our findings suggest that the MFIs are still some way away from covering all their costs exclusively through customer fees. The most sustainable MFIs in the sample are able to cover just over 60% of their costs through interest rates, fees and bank interest earned. 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. However, the MFIs can, depending on their starting point and mix of products, make considerable improvements by adjusting interest rates and fees, and by increasing productivity. However, we also found that high overhead costs relative to activity earnings (interest income from bank deposits, income from interest and fees earned) can act as a break on sustainability.

The financial sensitivity analysis of future capital requirements and different models of recapitalisation suggest that raising loan capital purely through recycling existing funds is an unviable strategy to fund future expansion of the MFIs in the sample. Already in the first year of operation without granted or borrowed loan capital, the most sustainable MFIs experience considerable funding shortages.

There also appears to be a set of norms for maximising staff efficiency and productivity. We found a strong relationship between the time the lending staff spent on direct customer contact and loan officer productivity. Provided there is sufficient demand for the products of the MFI, by organising the non-lending in such a way to maximise the exposure of the lending staff and by allowing non-lending staff to step in for interviews when necessary, the MFI can raise the loan officer productivity considerably.

Further, our findings further suggest that part of maximising lending staff exposure to potential customers also lies in outsourcing administrative aspects of arrears control and possibly other areas to external companies. In terms of outsourcing administrative parts of arrears control, it does not appear to affect arrears levels.

Finally, we also found that the loan officer productivity is crucially linked to the proportion of repeat clients. The MFI which displayed the greatest loan officer productivity also had the greatest proportion of repeat clients. Repeat business involves lower transactions costs and generally constitutes a smaller risk for the MFI. It is considered crucial therefore to design your products and procedures in a way which entices customers to come back.

Based on the above findings, we suggest that there are certain structural and process-related changes which are likely to have a particularly positive impact on the sustainability of the sector. First, the MFIs can charge interest rates which more closely reflect the costs involved in providing loans. Second, the sector can take steps to maximise the lending staff's exposure to potential customers, namely reorganise staff to increase time frontline staff spend on seeing potential customers and implement time-saving outsourcing mechanisms. Finally, the MFIs can capitalise on links with other MFIs to enhance innovation and costs, through sharing best-practice and start-up costs and franchising certain products.

For their part, and in light of the likely shortages of loan capital of the sector in the future, the funders and policy-makers can aid the sector move towards greater sustainability through ensuring that loan capital is available to underpin portfolio growth and through providing development grants to stage-manage productivity increases.

However, the potential for becoming more sustainable is not uniform across the sector, but is likely to depend on the starting point of the MFI (i.e. interest rates charged, initial loan officer productivity), its product mix and its cost structure. Moreover, given the heterogeneity of the expanded EU microfinance sector and of the context in which they operate, the effectiveness and feasibility of these levers may not be uniform. There are in particular two contextual factors which condition MFIs' ability to make use of these levers.

First, the regulatory framework, especially caps on interest rates, may limit the possibility of closing the gap between delivery costs and customer fees. German law, for example, prohibits charging very high or usurious interest rates (Mark and Tilleßen, 2007).

Second, the depth of the market and the level of cost-sensitivity of the customers will determine the MFIs ability to reach scale and set customer fees resembling costs. The Microfinance Information Exchange (2006) notes that, in Central and Eastern Europe a highly cost-sensitive customer base prevents the microfinance sector from increasing interest rates.

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[1] MFI D's outreach worker is here included as a manager. The timesheet data of this staff group is only included in the analysis of the use of time of the organisation as a whole.