TECHNICAL ASSISTANCE SUMMARY

SEPTEMBER 2019

Technical assistance on cost–benefit analysis enabling MFIs to allocate resources efficiently

Introduction

LIFT is working to enhance access by rural households to various credit and non-credit financial products as this catalyses farmers' efforts to secure a decent income and improves agricultural productivity. With the increased security of tenure provided by the SLLCs, farmers are more willing to invest in their land in sustainable and productive ways. Yet they have been constrained from accessing higher value loans that would facilitate productive investment as they have been unable to provide collateral acceptable to the microfinance institutions (MFIs).

The group loans that have dominated the rural formal credit market for the past two decades tried to overcome the challenge of collateral through group guarantees; however, the amounts lent proved to be too small in value to be transformational and insufficient to meet the financing needs of the farmers, and with restrictive joint liability they excluded those who wanted to access credit individually. In contrast, the SLLC-linked individual loans have overcome the limitation of the group guarantee, which prohibited many clients from accessing loans and undertaking larger investments, by providing rural residents with more freedom and an alternative.

- 7 MFIs offering individual SLLC loans.
- 13131 loans.
- ETB 398.3 million (£11.4 million) total loan disbursement.
- ETB 35.1 million (£1 million) savings mobilised.

Data as of August 2019

Land Investment for Transformation (LIFT) – DFID funded GoE 6.5 year programme
(March 2014 to August 2020)

Working in four regional states of Ethiopia – Amhara, Tigray, Oromia and Southern Nations, Nationalities and Peoples' Region (SNNP) – LIFT aims to improve the incomes of poor people in rural areas and enhance economic growth, through:

- **Second level land certification (SLLC):** Registration and issuance of 14 million land certificates, recognising the rights of all rightful landholders including men and women in married and unmarried households.

- **Improved rural land administration systems (RLAS):** Implementation and operationalisation of an RLAS in 140+ woredas.

- **Increasing land productivity through the market systems development (M4P) approach under the Economic Empowerment Unit (EEU):** Undertaking interventions that focus on access to finance, rural land rental and environment and conservation agriculture.

The individual loan product that LIFT pilots and has rolled out with seven MFIs provides farmers holding an SLLC with the option of using their 'land use right' as collateral for a defined period and accessing loan amounts of up to ETB 100,000 (£2,857), with 1–5 year loan terms. Through this product clients are accessing loan sizes up to 2.6 times higher than with group loans, and clients are using these to finance diversified income generating activities both on-farm and off-farm (LIFT EEU Impact Survey, 2019).

During an assessment conducted by LIFT, MFIs indicated that they believed the product developed under the project enabled them to better achieve their social and financial mission. This was possible as they were offering an innovative product that catered to the needs of their clients while also making a better contribution to their financial sustainability. However, the MFIs could not substantiate these statements with data because they had not conducted a detailed cost–benefit analysis of the SLLC loan to advise on further scale-up and inform their conclusion about the product.

As a consequence, the partner MFIs requested assistance from LIFT in conducting a detailed cost–benefit analysis of their credit and savings portfolio. LIFT contracted MicroSave Consulting Limited (MSC) to provide technical assistance on a pilot basis to four of the partner MFIs: ACSI (Amhara Credit and Saving Institution), OCSSCO (Oromia Credit and Saving Share Company), OMFI (Omo Microfinance Institution) and Aggar MFI. The technical assistance targeted capacity development within the institutions, enabling them to conduct a cost–benefit analysis (CBA) of their loan and deposit product portfolios, including the SLLC-linked individual loan. The assignment was carried out between September 2018 and March 2019.

The CBA technical assistance aimed to:

- Support the MFIs in implementing a detailed CBA of the SLLC loan product.
- Strengthen the internal capacity of MFIs to carry out CBA of other loan products, which in turn should make the MFIs' operations more efficient and profitable.
- Instil the CBA exercise as best practice within the MFIs so they institutionalise it and will conduct it regularly, generating results that can be used to inform decision-making.

Why CBA for MFIs?

CBA is a tool used to support investment decision-making. In this case, it was initially used to decide whether to expand the SLLC loan product, and if so, how the product could be improved. CBA can provide a foundation for making alterations to the product, e.g. its staff complement (does the human resource available match what is required to deliver the product effectively and efficiently?); processing (can the process be streamlined?); funding (is the funding source too expensive and/or is the product costed appropriately?); loan monitoring; and pricing (are the interest rate and fees sufficient/appropriate?). Again, the overall purpose is to determine whether and how the product can be rationalised and enhanced.

The CBA exercise allows for comparison of the profitability and impact of the SLLC loan product with other loan products. It enables MFIs to design a better product mix (with a focus on products that have more benefits/are more profitable). The CBA also allows the MFIs to focus on where and how processes can be altered to make them more efficient.

Another rationale is that a **CBA can be utilised to evaluate opportunity cost** (the value of foregone benefits from alternative actions) and it should make MFIs' operations more efficient and therefore improve their bottom lines. This is partly because **interest rates for loans and deposits will lead to a rationalisation based on the CBA**.

Methodologies used in carrying out the CBA

CBA can be carried out using activity-based (ABC) or allocation-based costing. ABC provides relatively precise information, as it traces cost by assessing and estimating the costs of specific, significant processes associated with products such as loan applications, loan disbursements, loan accounting, loan monitoring and loan collections.

Mining the data for ABC requires relatively sophisticated accounting and management information systems such as a core banking system (CBS). However, partner MFIs have a largely centralised CBS that is not connected across their branches. For this reason, during the CBA exercise MSC used allocation-based costing, where they allocated costs by using 'logical criteria'. This method

MFI staff processing transactions at Omo MFI branch

also traces costs by assessing and estimating how much significant processes cost; but in the absence of a CBS the analysts manually gathered data, e.g. from the general ledger and financial statements and by interviewing staff. Considerably more subjectivity must be employed in using this method.

The delivery of the CBA technical assistance was carried out in two phases. The first phase included an inception meeting with the MFI's management, a mini training session with the MFI's costing champions (introducing the staff to CBA) and data collection.

The second phase was conducted after the CBA analysis was completed based on the data gathered. This phase was more targeted, hands-on, computer-based training of trainers and was provided for staff coming from operations, finance, marketing and product development, risk management and planning departments. Each partner MFI received customised training at their respective head office premises.

Staff on CBA training, Aggar MFI head office, Addis Ababa

The limitations of CBA

When the ABC methodology cannot be used, several inaccuracies in determining costs and benefits cannot be avoided, e.g. possibly underestimating the former and overestimating the latter. Similarly, as mentioned above, the subjectivity involved in determining costs, particularly indirect costs and how they should be allocated, can result in a less than accurate CBA.

Other CBA limitations include the following:

- A CBA does not consider extraneous factors such as the state of the economy, e.g. the impact of recessions, political instability, inflation and foreign exchange fluctuations.
- The challenge of determining the cost of capital, given the varied sources of funding for MFIs.
- A CBA does not evaluate the social benefits that most MFIs aim to provide, e.g. economic empowerment, gender equality and social inclusion.

Key findings

The CBA exercise was a revelation for the participants. For many of them it was the first time they had ever conducted a CBA and it enabled them to appreciate the costs and the benefits associated with their products. The following are some of the interesting facts that were revealed during the exercise.

- Firstly, regarding loans, the SLLC-linked loan has proved to be profit-making and has a low cost outlay across all the MFIs that participated in the CBA exercise. This result supports the MFIs' belief that the SLLC-linked loan product is profitable. It was also appreciated that carrying out additional rounds of CBA will be necessary to track the SLLC-linked loan performance, as the product has only been introduced recently compared to the MFIs' other credit products. For example, comparing the profitability of the SLLC-linked loan with the group loan was not possible as the former is a very new product compared to the latter. In addition, the traction of SLLC loans, though growing, is still very small compared to the group loans that in some MFIs make up more than 50% of their loan portfolio.
- Secondly, not all products assumed to be profit-making are generating income. Participating MFIs learned that some of their saving and loan products are loss-making. For example, in one MFI all savings

products except for the SLLC-linked savings product are loss-making before and after transfer price adjustment. This is because the cost of funds for savings is very high for that specific MFI, as it only mobilises limited savings and lacks economies of scale. On the other hand, another participating MFI's fixed-term deposit has relatively high expenses in terms of interest paid, which has led to a loss on that specific savings product compared to the other saving products the MFI offers.

- Thirdly, it appears that some partner MFIs have too many products. For example, OMFI has 46 different loan products, ACSI has 30 and OCSSCO 23 loan and savings products. Some of these loan products are bundled with savings products, which makes it challenging to allocate costs among various loans and more difficult to conduct an accurate CBA. Another drawback of having so many loan products is that MFI staff find it challenging to prioritise sales efforts among a plethora of products.
- Lastly, all four MFIs are in the process of digitising their operations. ACSI, OMO and OCSSCO have at least a quarter of their branches linked to head office through their CBS. However, since not all branches are networked and digitised, it was hard to get consolidated institution data such as number of transactions per product and staff time on specific products.

Lessons learned

There were key learning points identified during the facilitation of CBA by the four partner MFIs. Firstly, ABC is the preferred method of allocating costs in the CBA exercise. However, employing ABC will not be possible until the MFI partners digitise their management information systems, i.e. install and fully implement CBSs. Such improvements in the partner MFIs' ICT capabilities will enable better CBA to be carried out. CBSs will enable the MFIs to collect data more easily on daily transactions (deposits, withdrawals, loan disbursements and repayments), which will aid in future costing. Next, in order to more accurately allocate revenues and costs, the MFIs need to define staff roles more precisely. Doing so will also help them transition to ABC, the preferred methodology.

Another key lesson for all the participating MFIs is the need to conduct CBA more regularly to inform pricing of the products and collate the required data for the process. All involved in the exercise agreed that a simple, user-friendly step-by-step process for CBA was a useful tool for staff conducting this exercise, especially considering their inexperience in the methodologies. This led to the development of a simple step-by-step guide that was shared with the MFIs after the training to address this concern.

Additionally, the process mapping (including a time element) to identify and eliminate non-value adding, low-risk and redundant steps, i.e. 'streamlining', will aid in the effort to determine which products are worth continuing and which should be terminated. In addition, price reviews of MFIs savings and loan products should be undertaken considering market realities such as competition and cost of funds.

Another issue that MSC encountered was the uncertainty regarding the estimated SLLC loan loss provision, one of the cost drivers that must be considered for CBA. Given the very limited repayment history for SLLC loans, this amount was difficult to set. The delinquencies for other types of loan are very high for some of the MFI partners. Therefore, further capacity building for their staff in loan appraisal, loan monitoring, problem loan handling and loan collecting would be helpful.

Based on the lessons learned, the partner MFIs developed action plans to address the shortcomings that were exposed in their operations. This shows that the CBA exercise helped the MFIs draw some valuable lessons, which in turn can improve industry practice, if these and other MFIs continue to use CBA. LIFT has already shared an action plan summary with the partner MFIs, which they can build on and use for this purpose.

Discussion with prospective loan clients, Silte Woreda, SNNPR

Conclusion and way forward

- Overall, the exercise has proven to be worthwhile for the MFI partners, despite its limitations, particularly given that they lacked hard data and are only now installing and implementing CBS.
- CBA is helping MFIs:
  - Allocate costs more accurately.
  - Identify key information that should be collected for relevant analysis.
  - Rationalise their product mix.
  - Adjust staff complement appropriately for various tasks/activities.
  - Streamline various processes such as the steps involved in processing loan applications.
- The exercise has also identified key datarequired in order to move towards activity based costing.
- The CBA exercise was the first of its kind for most of the MFIs and was highly instructive in many aspects.
- The MFIs appreciate the benefits and the need to carry out CBA regularly in the future. Overall, the CBA exercise has been somewhat of an eye-opener for the partner MFIs, in terms of unlocking the potential to make their operations more efficient.

Key future areas of intervention include:

1. Building robust CBS capability, which is critical for the partners.
2. Building technical capacity of the staff so they become proficient in conducting regular CBAs that inform decision-making.
3. Work on enhancing strong credit appraisal and delinquency management.
4. Review of products and pricing/costing to decide which products to carry through and/or discontinue.

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About the Technical Assistance Summary series
This series summarises technical assistance carried out by the UK Department for International Development-funded Land Investment for Transformation (LIFT) programme. LIFT aims to improve the incomes of the rural poor in Ethiopia by securing the land rights of households through Second Level Land Certification (SLLC); improving Rural Land Administration Systems (RLAS); and increasing productivity by leveraging SLLC through a 'making markets work for the poor' (M4P) approach, in Oromia, Amhara, the Southern Nations, Nationalities, and Peoples' Region (SNNPR) and Tigray regions.

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