



# ESAF BRIEF: Innovation, Best Practices & Knowledge Generation

## An MFI Takes a Commercial Loan

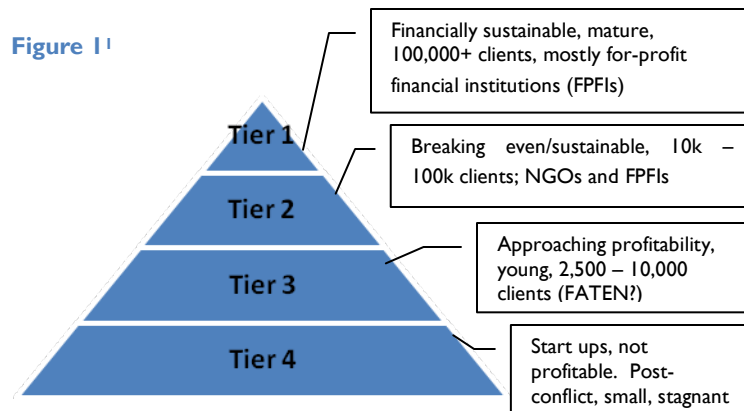
### Background/Context

For many microfinance institutions (MFIs), the first step towards commercialization consists of taking out a loan. Ironically, though MFIs are in the business of disbursing and collecting loans, for the non-profit MFI manager, taking out a loan can be fraught with challenges:

- Most commercial banks are unfamiliar with microfinance, and find it difficult to adequately assess the risk of lending to MFIs, creating a barrier to lending.
- MFIs must, therefore, have financial statements that not only show a profit and adequate equity, but must also move their financial statements and reports into formats that commercial bankers expect. This may require additional reporting and controls.
- The culture shift of moving from a purely donor or grant-driven operation to one with a commercial cost of funds can also be a significant hurdle for MFI boards and management.

In spite of these road blocks, taking this first step towards more commercially-driven operations can be worth it for many MFIs. Few MFIs are able to achieve Tier I status (see Figure I, below) on the basis of donor funding alone. These MFIs need other sources of finance to maintain or to expand their market share and while it's unlikely a commercial loan on its own will enable an MFI to leap to Tier I, it is a logical first step, and one which can force a level of financial discipline and transparency upon an MFI.

Figure I<sup>1</sup>



Type of financing available	Tier 4	Tier 3	Tier 2		Tier 1	
	NGO	NGO	NGO	FPFI	NGO	FPFI
<b>Public</b>						
Grants	X	X	X	X	X	X
Subsidized loans	X	X	X	X	X	X
Guarantees		X	X	X	X	X
<b>Private debt</b>						
Commercial loans			X	X	X	X
Guarantee funds			X	X	X	X
Bonds				X		X
Securitization				X		X
Commercial linkages			X	X	X	X
Private equity				X		X

However, it can be easier for the more sustainable Tier I or Tier 2 MFI to access commercial finance (see Figure I, above). As so many borrowers have bemoaned, when you need a loan, you can't get

<sup>1</sup> Foote, Sean. SVMN Microfinance 101 Class One. PowerPoint presentation. 2009.

one. When you don't need a loan, everyone wants to lend to you.

FATEN began operating as a financial service institution in the West Bank and Gaza in 1999. By year-end 2008, FATEN was one of the top three MFIs in Palestine. When the ShoreBank/ESAF team began working with FATEN in 2008, the MFI was projected to end the calendar year with a \$12 million portfolio and nearly 5,000 clients. However, it was not consistently operationally or financially sustainable, relegating it to the Tier 3 class (Figure 1).

According to FATEN management, the MFI had enough funds (both on-hand and through a "soft" loan from UNDP) to achieve a \$16M portfolio by fiscal year end 2009. However, after 2009 the funding picture grew murky. In a gap analysis facilitated by ESAF and SBI consultants in December, 2008, FATEN's managers expressed targets of reaching a \$20M portfolio by year-end 2010. Could FATEN make the leap to Tier 2 status, improve its profitability, and access commercial finance?

## Methodology

The SBI/ESAF consultants considered FATEN one of Palestine's most promising MFIs for commercialization, and began high-level conversations with FATEN's board and managers regarding accessing commercial finance. As a non-profit institution, seeking equity investors was not an option for FATEN. That left either hoping for additional donor funding, or commercial debt – i.e. a bank loan.

## A Culture Shift

The FATEN board worried that "going commercial" might cause mission drift. This was a valid concern. Pressures to grow and to increase profits can move MFIs away from serving more economically disadvantaged or geographically remote markets, because serving these markets may be less cost-effective. Market-driven growth can also cause cultural shifts within the organization. In order to give the board a better understanding of how accessing commercial finance might help or hurt FATEN, in 2009, SBI/ESAF team arranged for a study visit to the National Microfinance Bank of Jordan (NMFB). Commercial finance was a cornerstone of NMFB's strategy, which was based upon commercial borrowing rather than donor funding, and long discus-

sions about commercial finance ensued between FATEN board members and NMFB managers at this crucial field visit. FATEN's board came away from the meeting convinced commercial funding was a viable strategy that would enhance their mission.

## Making Sense of Financials

The need for additional funding was clear, and FATEN's management was willing to try for a commercial loan. But FATEN's lack of financial sustainability was troubling, and the SBI/ESAF team's first step was to analyze just what was going on. FATEN had been orienting its financial statements toward perceived donor needs, and as a result had inordinately aggressive loan loss reserves, which resulted in understated profits. By the end of 2009, FATEN adjusted the financials to reflect the true loan risk, showing a more realistic loan loss provision. FATEN's 2010 financials showed positive operating and financial sustainability.

## Preparing a Business Plan

In addition to being useful planning tools, bankers also like to see business plans. Near the end of 2009, SBI consultants facilitated a business planning exercise. The resultant three-year plan's financial projections<sup>2</sup> incorporated raising \$7 million from a variety of sources including debt and microfinance investment vehicles.

## Knocking on Doors

The final, and perhaps most frustrating, step was going to the banks to seek debt capital. According to FATEN's CFO, the banks asked for more documentation and had more stringent requirements than the donors ever had. This was particularly irksome since FATEN had secured a loan guarantee for the proposed loan from CHF.

FATEN ultimately narrowed the prospects down to the two most likely banks: the Bank of Jordan and Bank of Palestine. "We approached Bank of Jordan first because they had an ongoing agreement with USAID Washington Loan Guarantee Association," said Fares Abdelnour, FATEN's Finance and Administration Manager. The MFI used their new business

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<sup>2</sup> FATEN's CFO developed the projections for the plan using Microfin.

plan as part of their loan application to the Bank of Jordan. However, negotiations fell through when the term sheet presented by the bank for a \$2 million had unacceptable conditions attached.

Bank of Palestine proved to be a bit more open to the concept of lending to an MFI, largely because the bank had had experience as a microlender itself in the past, and was contemplating restarting its microcredit program. Even so, there remained hurdles to overcome. With the high levels of collateral in the bank's normal lending practices, the bank managers claimed they never had to write-off their commercial loans, and were unsettled by FATEN's write-offs (which were at quite normal levels in the microfinance industry). SBI consultants engaged in one-on-one sessions with the bank managers on microfinance industry standards, attempting to answer their questions about industry practices and to set their minds at ease. In the end, the bank obtained enough information about FATEN and the industry to offer a \$1 million commercial loan to FATEN.

In March, the SBI/ESAF team met with FATEN's board to approve the business plan and discuss the Bank of Palestine offer. The consultants encouraged the board to give the loan serious consideration. Without the additional funds, the MFI's growth would soon come to a halt, and the consultants were concerned that an offer from a third bank was unlikely. The process of negotiating with each of the banks had taken several months; turning down the Bank of Palestine loan would result in an interruption of the MFI's growth. FATEN's board decided to give one member the authority to negotiate. They then identified a few terms and conditions they would like revisited, but allowed that if the bank held firm, they would accept the terms as presented.

FATEN secured the loan.

## Elements of Evidence-Based Program Design

SBI began working with FATEN on commercialization in late 2008 – it took over a year to prepare FATEN for a commercial loan and then to acquire one from a local bank. FATEN struggled with all the typical challenges MFIs face when seeking a

commercial loan: the demands of additional reporting, changes to their financial statements, the hurdle of lenders unfamiliar with the microfinance industry, and fears of mission drift. Once FATEN was ready to apply for a loan, it still took months to negotiate an acceptable offer – in spite of having an external guarantee fund to rely upon. The assistance provided by the ESAF team went beyond business plans – board education was a critical component, as was education for the commercial bank managers considering FATEN's loan. Finding a local bank with a willingness to take the time to learn about the microfinance industry was crucial.

### The Banker's Point of View

The ESAF team worked not only with FATEN, but also with its lender, the Bank of Palestine. Bank management expressed two main concerns regarding lending to an MFI: the lack of a business plan and the absence of tangible securities which could be taken as collateral. The SBI team worked with FATEN to develop a comprehensive business plan, and FATEN was able to take advantage of a guarantee fund to allay concerns regarding collateral.

In the end, bank managers cited this guarantee as a key point in FATEN's favor, along with the volume and quality of the MFI's loan portfolio.

There was also an element of socially responsible investing. According to Hashim Naser, the bank's manager, "the Bank of Palestine has a social responsibility to help FATEN in continuing its role in community development and reducing poverty, given that we are the first national bank in Palestine."

## Conclusion

In the end, FATEN found in the Bank of Palestine a commercial bank which had a commitment to inclusive finance and was willing to try to make things work. "The Bank of Palestine showed readiness and willingness to work with MFIs," said Fares Abdel Nour, FATEN's Finance and Administration

Manager. “The bank has a good relation with FATEN, it offered a competitive rate, and was using the loan guarantee fund program that CHF offers.” Was the loan worth the work? FATEN has broken through the barrier and moved into Tier 2 MFI rankings as a fully sustainable MFI. It has also gained loan capital for growth, and is now on track to achieve its goal of a \$20 million portfolio by year end (see Table I) – all without sacrificing its mission.

**Table I: FATEN Results to Date**

	<b>FY 2007</b>	<b>FY 2008</b>	<b>FY 2009</b>	<b>May 2010</b>
<b>Number of Active Clients</b>	3,771	4,954	7,008	8,191
<b>Outstanding Portfolio (Millions of USD)</b>				
<b>Operational Sustainability</b>	92%	82%	125%	193%
<b>Financial Sustainability</b>	77%	72%	102%	145%