

HIVOS SEED CAPITAL PACKAGE FOR FINANCIAL INSTITUTIONS

POLICY PAPER

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1 OBJECTIVE

A gap was identified in the instruments that Hivos and the Hivos-Triodos Fund (HTF) had at their disposal to support the growth of small/young Retail Financial Institutions (RFIs). Many small RFIs need loan capital for on-lending, in order to build up a track record and increase outreach. This will then in turn enable them to reach break-even and attract loans. However, for HTF in general the amounts required are yet too small (< \$100,000), the investments too risky and monitoring too costly. At the same time, within Hivos' economic policy, grants could only be provided for capacity building, training, technical assistance (TA), institutional development - and in exceptional cases for covering part of the start-up losses or for basic investments, but not for loan capital.

Therefore Hivos developed a new instrument to fill (part of) the gap: the seed capital package, which includes a component for expansion of the loan portfolio. This instrument is an elaboration on our existing policy as laid down in the economic policy document (1996, par. 3.3 on subsidies).

The objective of the seed capital package is to effectively and efficiently assist financial institutions to reach a level of operations, within the time frame of the contract, which allows them to qualify for HTF or local credit funding. It is targeted at RFIs with potential for growth and potential to qualify for HTF or local credit funding.

In developing this instrument, Hivos takes into account the (positive) experience and lessons learnt by CGAP, WWB and UNDP/Microstart in providing seed capital through grant contracts with conditional tranches.

2 WHAT IS A 'SEED CAPITAL PACKAGE'?

The seed capital package, in Hivos' definition, is a grant with conditional tranches. Disbursement of tranches is linked to reaching pre-agreed, contractual minimum performance targets. This grant package can consist of four components, managed in one contract. The amount of each component has to be calculated or estimated beforehand:

1. Grant to fund (expansion of) the loan portfolio. Two points are important:
 - a. In Hivos' philosophy it is important to encourage and support the development of a local sustainable financial sector (as opposed to creating new financial institutions where all capital and TA comes from abroad). Local confidence in the institution is crucial. This can be expressed through local ownership (equity), but also through local savings. This implies that the organisation should develop a strategy to increase local ownership of the institution (aiming at a minimum of 50% equity from national sources), and to be able to attract local savings in the longer term. In most cases, this requires changes in the legal status of the organisation (e.g. changing into a company or co-operative). It also requires the organisation to operate within the Financial Institutions or Banking Act within their respective countries. This will greatly vary between countries depending on the legal possibilities; e.g. sometimes it is not allowed to take on savings unless being a bank, such as in South Africa.
 - b. In principle, Hivos will ask for an option to be included in the contract, to convert (at least half of) this part of the grant into shares at an appropriate moment. If the option is indeed exerted, the Hivos-grant will be converted into a HTF-participation according to normal HTF procedures. Again, this can only be done if the legal status of the organisation allows for it. Taking this approach in discussions with (potential) partners shows that we believe in the potential of the organisation, and in addition it encourages the development of a transparent ownership structure and creates the possibility to transfer our shares to a local investor in the longer term.
2. Grant to cover (part of) the investment costs, for developing the Management Information System, transport means and other capital expenditure. Both the grant for expansion of the loan book and the grant to cover (part of) the investment costs have a positive impact on the equity position of the RFI. However, for reasons of transparency and practicality, in the contract the two items will be separated.

3. Grant to compensate for (part of) the initial losses, as projected in the business plan. An estimation of this component is included in the contract as a separate item for reasons of transparency. It is important to create an impulse towards break-even, and making the loss per year explicit is part of this impulse. End-of-year figures are checked against the estimates in the contract (contract figures are maximum amounts).
4. Grant for capacity building, training, technical assistance (TA) etc. International 'best practices' teach us that it is important to develop a strategic approach to technical assistance to RFIs (to increase the impact of Hivos' funding). In principle a TA/training-component will be included in every seed capital contract (or should be covered by other donors). The RFI should identify its needs for training and TA on a regular basis (at least annually). Ideally, an (inter-)national TA provider should be identified who can provide TA on a regular basis for the total contract period (e.g. a number of days per week, month or quarter, depending on the needs). Regionally, Hivos will take an active role to explore possibilities for developing a strategic networking relationship with one or more TA-providers. Although Hivos should approve the Terms of Reference between the TA-provider and the RFI, the RFI should contract the TA-provider directly (in order to have more control).

3 THE PROCESS

In order to provide a seed capital package to an RFI, a number of conditions has to be fulfilled. Below is a short description of the various steps in the process and what is required.

3.1 General remarks

- a. Providing a seed capital package to an RFI is a relatively large investment for Hivos, both in terms of time (appraisal and monitoring) and financial resources. This means that: i) The instrument will be applied very selectively and should be well co-ordinated between Hivos and HTF. To facilitate this, in the course of 2001 Hivos and HTF will together define brief 'country strategies' for Hivos (gants) en HTF (credit) support to RFIs. This will be based on a combined analysis of the financial sector in the respective countries. This is in line with international 'best donor practices', which show that for an effective and efficient investment in microfinance, it is important to select a small number of partners and work with them intensively (concentrate time, energy and funding spent); ii) Given the relatively large amounts of funding required, co-financing from other donors/social investors should be secured, in order to share the risk. This also requires co-ordination, so as to avoid duplication of funding.
- b. The appraisal process is the most crucial part in developing an appropriate seed capital package. It can take quite some time (6 to 12 months) from receiving the first proposal to signing the contract. It is important to allow for sufficient time at this stage: for the RFI to develop a realistic, good quality business plan and for an extensive appraisal visit to the organisation to discuss (and where necessary adjust) the final business plan, assess ratio's, agree on minimum performance targets and determine the amount of funding required for the four different components. This final appraisal will preferably be outsourced to an experienced consultant in microfinance (for capacity as well as time reasons - it will take approximately five days). Such an intensive appraisal process will also serve as a selection tool.
- c. In various ways external input is required in the seed capital structure, for capacity as well as time reasons. It is important to make sure arrangements for this are explored in the early stages of the appraisal process. The following input may be required: i) a consultant who can assist the RFI in developing the business plan (but important point of attention is that ownership of the plan should remain with the RFI); ii) a consultant who can carry out the appraisal; iii) a TA-provider that can assist the RFI on a regular basis throughout the contract period; iv) a local consultancy firm that can be contracted by Hivos to assist in the monitoring.

3.2 Appraisal

- a. *Financial projections:* The most important requirement is a realistic business plan and projections. Seed capital should contribute/push towards break-even of the RFI. This implies that: i) the organisation should have the commitment and vision to become financially and institutionally sustainable; ii) the business plan shows projections towards break-even within in a three to five year period. The three-year projection exercise should be repeated annually in a cyclic way (i.e. every year new/adapted three-year projections should be produced). If the business plan is not of sufficient quality, Hivos can provide funding for a consultant to assist in the preparation of the business plan.
- b. *Management:* equally (or even more) important is the appraisal of the capacity, initiative, entrepreneurship and vision of the management, board and staff of the organisation: will they be able to realise the growth as projected.
- c. *Other crucial areas* where the appraisal will look at are, amongst others: the ownership structure, the products, processes and procedures, the quality of the Management Information System, the market potential and the economic environment and availability of funding.

If the assessment leads to a positive conclusion on the potential of the RFI, the following step is to define measurable performance indicators based on the (if necessary, refined) projections, which will be included in the contract. A maximum of five indicators will be selected, taking into account the developmental phase of the organisation, its methodology and other specifics. The annex provides more details on the main indicators to select from (but others might be added). The indicators selected as well as their minimum value will be agreed upon between Hivos and the RFI (a proposal should be put forward by the consultant carrying out the appraisal). What is included in the contract are minimum performance targets: the value projected in the business plan minus (or plus) a 'safety margin'. This value indicates the bottom line for Hivos: below this we do no longer believe in the survival of the RFI. If these bottom lines are not achieved, it will mean the end of Hivos' relationship with the institution. The minimum performance targets will be set for six-monthly periods.

3.3 The contract

- a. *Contract period:* the contract covers a three, four or five year period, depending on the projections towards break-even. The objective is that after the seed capital contract has come to an end, the organisation has reached a level of operations where it is eligible for finance from HTF (or from a local wholesaler).
- b. *Conditional tranches:* The budget will specify the amounts required for the different components of the seed capital package per six-monthly period. Transfer of funds will be planned in six-monthly tranches, related to reporting on achievement of the six-monthly minimum performance targets as defined in the contract. The targets are specified for the whole contract period. Actual disbursement is subject to possible revisions for cash-flow reasons (based on the annual update of the RFI's three-year financial projections) and on the attainment of the agreed minimum performance targets. Where appropriate, a clause might be included in the contract to allow for one or two extra performance indicators to be added during the contract period (if found relevant given the RFI's organisational development).
- c. *Suspension:* if the RFI fails to comply with the conditions of the contract (e.g. the bottom lines are not achieved) the contract will be terminated by Hivos. A clause is included that stipulates the RFI to return any amount of the grant that has not been utilised by the time of the notice of breach or notice of suspension from Hivos, as well as the money that Hivos has contributed to the loan fund.
- d. *Option:* an option clause is included in the contract, which allows Hivos to convert maximally half of Hivos' contribution to the RFI's loan portfolio into a subordinated loan or share capital (if and when deemed appropriate, to be assessed by HTF in the final year of the contract period). The remaining part of Hivos' contribution to the loan portfolio could then be converted into shares for staff and/or clients of the RFI.

- e. *Monthly reports:* besides annual progress reports, audited accounts and annually updated three-year financial projections, the RFI needs to submit monthly financial reports. This includes a profit and loss account, a balance sheet, a loan quality report and an overview comparing the actual value of the performance indicators with the value as projected in the business plan, and the minimum value as agreed in the contract.

3.4 Monitoring

- a. *Contracting a local consultant:* It is important for the RFI to develop experience and discipline in preparing regular, monthly progress reports. Therefore, especially the first year of the contract, the RFI should submit reports on a monthly basis (later on it could be quarterly). In addition, monitoring visits will be needed on a quarterly basis. This means very intensive monitoring in terms of Hivos Programme Officer-time/capacity. Therefore Hivos will contract a local consultant capable to assist in this. This person should be well experienced in microfinance and financial analysis/accountancy, and able to check (and where necessary assist in the completion of) monthly reports. Ideally, it will be a consultancy firm and not a person, in order to ensure continuity. The same consultancy firm can be used for various seed capital contracts in the country or region. A terms of reference accompanies the contract with the consultancy firm. Every six months the consultant reports to Hivos with regard to the achievement of the minimum performance targets, progress made on institutional issues and advises on whether the next tranche should be disbursed.
- b. *Advice:* During the monitoring visits (as well as during the initial appraisal visits) by the consultant, advice and recommendations for improvement of operations and performance can be provided to the RFI in the form of a 'management letter' (similar to what accountants do). However, where technical assistance and/or training is required for the implementation of these recommendations, this needs to be done by a different consultant, to avoid potential conflicts of interest (the fourth component of the seed capital package).
- c. *Institutional issues:* Annually, Hivos will indicate to the RFI a number of (institutional) issues, which according to Hivos' (and/or HTF's) assessment should be priority issues for management to address. For the first year, these priority points of attention will be included in the accompanying letter to the contract.

ANNEX 1 EXAMPLES OF PERFORMANCE INDICATORS

The number of performance indicators included in the contract should not exceed five. By only selecting a few very important ones, there is more chance that they will be reached. The indicators chosen are the ones that are essential for Hivos to continue co-operation with the institution. Our decision-making concerning disbursement of tranches will be based upon them. If the agreed upon minimum values of these indicators are not reached, we will have to suspend the contract. Therefore it is important to set realistic, bottom line values, in which a safety margin has been included: if they are not reached this has huge consequences!

Of course Hivos will also have a keen interest in other (financial and non-financial) information concerning the development of the programme. This information should be included in financial and narrative reports by the institution.

Performance indicators for the contract should be selected on the basis of the priorities for the RFI in the coming years, and on the (related) objective of the Hivos-intervention. A number of key ratio's which are important for the management of an RFI to monitor over time (it is the trend which is crucial, not so much the absolute value!) have been summarised below. Performance indicators can be selected from amongst those, but others can be added.

1. Performance Ratio's

Portfolio at Risk (> 1 day, > 30 days)	=	$\frac{\text{Balance of Loans with Payments Past Due}}{\text{Total Portfolio Outstanding}}$
Arrears Rate (Amount Past Due)	=	$\frac{\text{Amount of Principal Due but not Received}}{\text{Total Portfolio Outstanding}}$
Loan Loss Ratio	=	$\frac{\text{Amount Written Off in the Period}}{\text{Average Portfolio Outstanding for the Period}}$

2. Efficiency Ratio's

Operating Cost Ratio	=	$\frac{\text{Operating Expenses}}{\text{Average Portfolio Outstanding}}$
Cost per Unit of Currency Lent	=	$\frac{\text{Operating Expenses}}{\text{Total Amount Disbursed in the Period}}$
Cost per Loan Made	=	$\frac{\text{Operating Expenses}}{\text{Total Number of Loans Made in the Period}}$

3. Productivity Ratio's

Average Number of Active Loans per Credit Officer	=	$\frac{\text{Average Number of Active Loans}}{\text{Average Number of Credit Officers}}$
Average Portfolio per Credit Officer	=	$\frac{\text{Average Value of Loans Outstanding}}{\text{Average Number of Credit Officers}}$
Total Amount Disbursed per Period per Credit Officer	=	$\frac{\text{Total Amount Disbursed}}{\text{Average Number of Credit Officers}}$

4. Viability Ratio's

Operational Self-Sufficiency	=	$\frac{\text{Operating Income}}{\text{Operating Expenses} + \text{Loan Loss Provision}}$
Financial Self-Sufficiency	=	$\frac{\text{Operating Income}}{\text{Operating and Financial Expenses} + \text{Loan Loss Provision}}$

5. Profitability Ratio's

(Adjusted) Return on Assets	=	$\frac{\text{Net (Adjusted) Income from Operations}}{\text{Average Total Assets}}$
Return on Equity	=	$\frac{\text{Net Income from Operations}}{\text{Average Total Equity}}$

6. Outreach Indicators

Number of Active Clients
Number of Women as Percentage of Total Number of Active Clients
Average Outstanding Portfolio
Average Loan Size Disbursed, Average Loan Size Outstanding
Client Retention Rate
Total Number of Staff, Number of Credit Officers
Effective Annual Interest Rate
Number of Active Savers
Amount of Total Savings