THE NGO, KAUNLARAN:
Rush to Commercialize, Sustainability, and Mission Drift

You worked for a donor agency and a microfinance non-government organization (NGO). Your organization received funding proposals and would evaluate such based on your agency's vision and policy. Definitely, one of the main concerns that you looked at was the financial sustainability of the organization. Your supervisor would review the proposals you had reviewed and, in turn, would submit it to senior management for formal approval.

In all this, you should be prepared to respond to questions about the proposals and explain your reasons for selection or non-selection. The major criteria that you must consider would include the key performance targets listed below:

- Increasing active borrowers
- Continuously improved loan product with portfolio yield not lower than 50%
- Maximum PAR (Portfolio at Risk) of 5%
- ROA (Return on Assets) of not less than 5% and ROE (Return on Equity) of not less than 25%

THE NGO KAUNLARAN

History

After 10 years of operation as a specialized microfinance NGO, *Kaunlaran*[1] planned to transform itself into a formal licensed financial institution. *Kaunlaran* was supported by several donors and received specialized technical assistance.

Management and Strategy

The transformation strategy of *Kaunlaran* was formulated during a series of meetings of the Board of Trustees. The Trustees agreed that *Kaunlaran* be transformed into a formal financial institution to attract resources from socially

[1] *Kaunlaran* – a Filipino term that literally means "progress"

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responsible investors and mobilize savings from the public. The Trustees agreed on the following:

- *Kaunlaran* created a company called the *Kaunlaran* Bank.
- *Kaunlaran* Bank became a formal financial institution that specialized in microfinance, regulated by the Central Bank.
- Additional investors welcomed shareholders and lenders to *Kaunlaran* Bank.

To prepare for the transformation, the *Kaunlaran* Board agreed on the following goals:

- To increase productivity ;
- To expand to other provinces;
- To decentralize branches and transform these into profit centers; and
- To upgrade the Management Information System to comply with the International Accounting Standards and reporting requirements of the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines).

Systems and Procedures

Kaunlaran had procedural manuals for credit products, administration, internal audit, and detailed personnel policies. *Kaunlaran* was in the process of developing a software package that produced key management reports in an accurate and timely fashion in both the Head Office and Branch level. The current system was inadequate for a regulated financial institution.

Product Methodology

Kaunlaran offered multiple loan products that were categorized into group and individual loans. The methodology and terms of the loan products were:

1) **Solidarity group credit.** Borrowers formed groups with five members each. The loan size ranged from Php 3,000 to Php 25,000. No collateral was required. Group members guaranteed each other's loans. The loan period was four to 12 months and installment payments were due weekly. In case the borrowers were not familiar with group formation or the products, they must attend two meetings. Loan applicants must also prepare basic business plans. On the latter, *Kaunlaran* offered a basic business planning course.

2) **Individual loans.** The loan period ranged from 12 months to two years. The loan size ranged from Php 25,000 to Php 100,000. Only mature clients were entitled to avail of this loan product; new clients

started as group solidarity credit. The borrower needed a guarantor and collateral to be eligible for the loan. The value of the collateral must be equal to the loan size. The interest was fixed at 24% per year. Loan applicants had to submit a business plan together with the loan application.

Outreach

Last year, *Kaunlaran* had 2,593 active clients and a total portfolio outstanding of Php 10.3 million. The average loan outstanding was Php 3,900. More than 95% of the clients were women. The number of branches did not expand significantly, as *Kaunlaran* focused on improving structures, systems, and methodologies to prepare for its transformation.

Market

As surveys also indicated, microfinance institutions (MFIs) experienced that a lack of access to credit was the most important constraint to starting or expanding a business. The rates that informal lenders charged varied from 10% to 15% per month. It was estimated to reach 3,400 clients after one year with a loan outstanding of Php 25 million. *Kaunlaran* estimated that its market share was around 50% of the total credit delivered by MFIs in the province.

Profitability and Portfolio Quality

Last year, PAR was more than 30 days and hovered around 5%. Management would feel comfortable with a conservative loan loss provision of 2% only. Most branches experienced low default. The Head Office appointed new Branch Managers for the two branches with high default. The management projected a stable 7% to 8% ROA with a slight dip in the year of transformation due to high transformation expenses.

Future Strategy and Funding Request

Kaunlaran requested funds and technical assistance for support during the transformation and start-up of the banking phase. *Kaunlaran* invited investors to provide equity in the *Kaunlaran* Bank and loan capital to fund *Kaunlaran*'s planned expansion in scale and scope.

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Evaluate *Kaunlaran's* strategy. What other strategies would you recommend given the performance measures they set?

ANNEX 1. *KAUNLARAN's* Key Indicators

Key Ratios	Current Period	12 month period
Outreach		
Number of branches	5	7
Number of professional staff	22	40
No active borrowers	2,593	3,900
Average loan	P5,200	P4,900
Portfolio in US$		
Gross portfolio	P10.3 M	P25 M
Portfolio yield	49.80%	49.42%
Loan loss provision.	6.00%	1.80%
Portfolio at risk > 30 days	12.27%	4.07%
Productivity		
Av portfolio per staff	P0.47 M	P0.625 M
Av. no clients per staff	118	98
Administrative costs/ avg. portfolio	32.08%	34.58%
Net loan portfolio/total assets	74.51%	80.90%
Financial ratios		
Equity/ (debt + equity)	65.14%	72.21%
Interest exp./liabilities	14.29%	19.43%
Operational self-sufficiency	124.36%	146.53%
Financial self-sufficiency	79.30%	118.29%
Adjusted ROAA	-9.20%	3.3%
Adjusted ROAE	-16.69%	4.6%