

Lessons from a Micro-Finance Re-Capitalization Program

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Abstract: Following a major disaster, micro-finance institutions (MFIs) often face high levels of bad-debt, which may require the institutions to be re-capitalised. This paper describes a re-capitalisation program implemented by the SANASA movement of Sri Lanka in 390 micro-finance societies following the Tsunami and highlights lessons for other similar programs. MFI re-capitalisation is a good use of funds in post-disaster situations. To create successful programs, donors should expect to relax some of their usual project requirements and MFIs should focus on maintaining credit discipline.

Microfinance can support economic and social rejuvenation after natural disasters such as floods, volcanic eruption or conflicts, by providing finance for rebuilding livelihoods, by strengthening community bonds and by protecting the poorest from income shortfalls. However, MFIs may face severe problems following a disaster, such as a loss of buildings and records, disruption to meeting habits, dislocation of membership, low levels of liquidity and high levels of bad debt. These can lead the MFIs to collapse, at a time when their services are most required. A number of studies have identified the type of support micro-finance institutions (MFIs) need to survive disasters (e.g. Arnold et al, 2005, or the MBP Rapid-Onset Natural Disaster Briefs published by Development Alternatives Inc.).

It is commonly accepted that MFIs will need to reschedule client's loans following a disaster, since borrowers will not have sufficient funds to maintain their payment schedule. It is also commonly accepted that rescheduled payments and increased calls for deposit withdrawals can lead to low levels of liquidity, which may require a liquidity loan. It is less accepted, however, that an MFI will need to write off a portion of its loans following a disaster and will need financial assistance (in the form of a re-capitalisation grant) to cover the resulting losses. Re-capitalisation is not mentioned in the World Bank's guidebook on surviving natural disasters for microfinance institutions. Development Alternatives Inc.'s Rapid-Onset Natural Disaster Brief states that support to MFI institutions should be limited to "debt rescheduling or emergency low-interest loans".

This paper shows that in some cases MFIs are right to write-off loans in post-disaster situations, since borrowers are unable to repay their loans. It also shows how donor support, in the form of a grant to the MFI, may be required to cover financial losses to ensure the MFI does not collapse, and how the support program can be designed to ensure credit discipline is not undermined. It draws lessons from a re-capitalisation program implemented by SANASA, the thrift and credit cooperative movement of Sri Lanka, following the Tsunami of December 26th 2004. The first two sections of this paper describe the background to the program and the program design. The experience of SANASA carries lessons for other MFIs, which can be applied in the design and implementation of re-capitalisation programs in other post-disaster situations. Section 3 of the paper describes these broader lessons.

Overall, SANASA's program of re-capitalisation has been a success. It led to 380 MFIs being re-capitalised, ensuring the long-term delivery of micro-finance services to a population of 70,000. It delivered \$1.5m of 'post-disaster' assistance to

the people most affected by the Tsunami in a way that ensures this money will be used for long-term livelihood development. It delivered this aid with minimal overhead – 10 local staff worked on the program for a period of 4 months.

Section 1: Background to SANASA's Post-Tsunami Re-capitalisation program

The SANASA movement of Sri Lanka is a network of approximately 8,400 village level cooperatives (Primary Societies), which offer savings and loan products to approximately 800,000 members. The movement was initially established in 1907, but has seen most growth in the past 30 years. In this time, membership grew, management in the Primary Societies became more professional and a national support structure developed, including a bank, a training centre and an insurance company. Membership is open to all, but a majority of members are women and from poorer sections of their communities.

380 of the villages impacted by the Tsunami of December 26th 2004 had active SANASA societies and approximately 70,000 SANASA members were affected. Following the Tsunami, the national support structure of SANASA implemented a recovery program for these societies. By May 2005, the national movement was mobilising membership to re-start regular cooperative meetings, re-creating society records which had been washed away and re-building society buildings. 6 'development centres' had been built along the coast to support the societies. These development centres helped the Primary Societies identify lenders who could resume repayment and re-started loan repayments where possible. Additionally, Primary Societies were providing emergency support in their local areas – supplying food, basic shelter and rations, looking after orphans, etc. Many of these programs were supported by international donor organizations who wanted to use a local community based organization to channel humanitarian assistance.

However, most of the Primary Societies were technically bankrupt. Even following the grace period, many of the Primary Societies loans were not performing. For example, people who had taken out loans to buy fishing equipment were now not able to re-pay their loans as the equipment was destroyed. Businesses were failing as local markets no longer needed their products. Housing loans were not being paid back as the owners had lost their jobs and the house was destroyed. In some cases members had been killed. Since these loans were non-performing and there was little chance of these loans being recovered, Primary Societies should have written off these loans.

In addition, most Primary Societies had re-scheduled their loans and given a one-year grace period on all loans. This further increased the losses of the society.

Bad-debt and grace periods result in a loss to the Primary Society as an institution. These losses need to be re-paid through the retained earnings and equity of the shareholders, reducing the capital in the Primary Society. As levels of capital fall, so the capital adequacy ratio falls, implying that the society should not be lending any more, or that the deposits of its members are no longer secure since there is a risk that the capital of the bank will not cover any further loan losses.

The situation was particularly acute in SANASA Primary Societies, since they cover a limited geographic area. Many societies had all their members impacted by the Tsunami. In many cases, the volume of bad-debt in the Primary Society was higher than the society's total capital, resulting in the society having negative equity. If the members of the society had asked for their deposits back, the Primary Society would not have been able to pay them. In some cases, up to 80% of loans in the Primary Society were worthless – most of the savings of the members had been wiped out. This could lead to a collapse of confidence in all community based organisations

and a ‘run on the banks’. Table 1 gives the results of a sample survey of 34 Primary Societies (with 5,000 members) completed in December 2005.

Table 1: Bad-debt levels as a result of the Tsunami

Area	% of December 2004 loan balance non-performing in December 2005
Ampara	74%
Hambanthota	14%
Mathara	84%
Trinco	24%
Average	32%

Mathara and Ampara, located on the South East corner of the country, were worst impacted by the Tsunami and so experienced the highest levels of bad-debt.

In order to re-build the capital structure of the Primary Societies, they needed a capital injection. This cannot be as a loan, since a loan needs to be paid back and is not capital. A grant is needed.

Re-capitalisation of MFIs has three benefits. Firstly it ensures that the Primary Societies can continue their operations and so provide micro-finance services to their members. Secondly it reduces the community pressure on members who were unable to repay their loans. Prior to the re-structuring, there were some cases where people who had already lost their possessions or livelihood in the Tsunami were being put under considerable pressure to sell their last possessions to re-pay outstanding debts. Finally, it removes doubts about the financial security of the micro-finance movement

that might otherwise undermine confidence in micro-finance institutions throughout the whole country.

SANASA reached an agreement with the Canadian International Development Agency (CIDA) in August 2006 to fund the Primary Societies' re-capitalisation. The objective of this program was to re-capitalise SANASA Primary Societies to cover the losses incurred from bad-debts and grace periods caused by the Tsunami.

The work to evaluate the needs of the Primary Societies in the South of the country was completed from September to November 2006. Payments were made to the Primary Societies in January 2007, two years after the Tsunami. Work to evaluate the needs of the Primary Societies in the East of the country, where conflict makes work considerably more difficult, is due to take place from March to May 2007.

Section 2: Design of SANASA's Post-Tsunami Re-capitalisation program ¹

The process to re-capitalise the Primary Societies followed a multi-step process:

Step 1: Gather information from Primary Societies

SANASA employed up to 10 staff to conduct society by society surveys of the impact of the Tsunami upon the society's finances. These surveys evaluated all the loans in the current loan book to understand which loans were performing, the reason for non-performance and the probability of a loan being re-paid. They also determined the cost of any grace period. Officers were given templates to collect the data and guidelines to determine the current value of loans. These guidelines did not cover all circumstances, however, so they also took full details of loans which needed closer examination.

Step 2: Estimate the re-capitalisation needs of the Primary Societies

¹ Further details on program design can be obtained from the author at gus.poston@gmail.com

The results of the officers' investigations were reviewed by the project manager, who also reviewed loans that fell outside of the guidelines. The project manager then presented the results to a 'Re-capitalisation Committee' which adjudicated on difficult cases and approved the level of re-capitalisation due to a particular Primary Society. The committee comprised senior managers from the SANASA Bank. Their decision was final.

It is important to note that the program funded Primary Societies, not individual loans. The program estimated the losses incurred by Primary Societies through analysis of individual loans, but did not make payments to individuals. It was up to the Primary Societies to write-off individual loans, following program guidelines. Writing off particular loans would have undermined the authority of the Primary Society and reduced credit discipline (see below).

Step 3: Transfer funds to the Primary Societies

Once the size of the re-capitalisation was decided, funds need to be transferred to the Primary Society. The communication at this stage is critical, to maintain credit discipline and ensure the funds were used well (see below for more details).

Section 3.1: Lessons from SANASA's Re-capitalisation program – for donors

The lessons learnt from SANASA's program should be applicable to other micro-finance re-capitalisation programs.

The first lesson is that the program was needed and has been very successful. Re-capitalisation of MFIs is a good use of donor funds in post-disaster situations. Re-capitalisation grants support enterprise, stabilise existing community structures and ensure the people most impacted do not suffer the additional burden of loans they cannot now service. Additionally, it ensures existing micro-finance institutions do not collapse – a lower cost solution than starting new micro-finance services. Finally,

implementation is simple and low-cost. The SANASA program was implemented in 380 Primary Societies in 5 months, using 10 staff.

The process to gain agreement from donors for the program was not simple, however. It took more than one year of negotiation and education of donors before SANASA found a donor who both understood the nature of the program and was willing to provide this type of grant funding. Re-capitalisation is taking place more than two years after the Tsunami. Donors should include micro-finance institution re-capitalisation programs in their 'expected package' of post-disaster assistance and be prepared to act fast to implement these programs.

This raises the question of when should a re-capitalisation program be implemented. Investigation of loans can only be done once, to maintain credit discipline and MFIs should first focus on making sure that everyone who can re-pay is repaying on previous loans. Although some will not be able to resume repayments immediately after a disaster, they may be able to after one year – the purpose of the one year grace period.

Experience from Sri Lanka indicates that detailed investigation should be undertaken immediately after the end of a grace period, since by then it will be clear who is able to repay, but also the situation of loans will still be clear.

The time taken to mobilise funds created considerable problems for SANASA, leading to many exception cases and unreasonable pressure being placed upon already badly impacted families. For example, some Primary Societies had put severe pressure on the children of dead members to re-pay their parent's debts. Some of these children sold their land or entered into agreements with money-lenders. In theory, these losses were not included in the program since they had not led to a loss for the

Primary Society, but in some cases the program helped the society give soft loans to the children so that they could extract themselves from money-lenders.

Re-capitalisation programs do not fulfil many of the normal ‘requirements’ of donor programs – donors have to be willing to loosen their normal rules. For example, some donors wanted to have an exact estimate of the funds that were required. Calculation of the required funds is only possible when detailed loan by loan analysis has been completed. Other donors wanted SANASA to include other components to the re-capitalisation program, for example entrepreneurship training or psycho-social support, since they did not believe that debt re-capitalisation alone would be sufficient to solve all the problems of the impacted communities. While this is certainly true, including other components would have complicated and delayed the program considerably – it is better to keep the program focused. Thirdly, many donors wanted a more accurate description of recipients, including gender break-down, etc. As explained above, the program funded Primary Societies, not individuals. While those borrowers who suffered the most from the Tsunami benefited most from the program, but it was not possible to identify which particular members of the community benefited. The nature of the intervention targeted the poorest, rather than an explicit selection process.

Section 2.2: Lessons from SANASA’s Re-capitalisation program – for MFIs

MFIs are vulnerable to disasters. Formal banks are large enough to withstand local disasters and may be supported by central banks. MFIs are smaller and more locally concentrated. They rarely get support from the central bank. Given this vulnerability, MFIs should prepare before a disaster strikes. They can open discussions with trusted partners on risk sharing in the case of natural disasters, or educate potential funding agencies to the nature of re-capitalisation programs.

The main risk in implementing a re-capitalisation program is that it will reduce the credit discipline of borrowers. There are many examples, including in Sri Lanka, where external assistance in a micro-finance program has made borrowers believe they do not need to re-pay their loans. This danger is increased when the external assistance is a foreign donor and the intervention is directly funding bad-debts. Credit discipline is a MFI's greatest asset – once it is undermined the institution will face major losses. The SANASA program focused on communication and the attitude of the members to ensure credit-discipline was not undermined.

Societies were clearly told that this was a one-off payment, never to be repeated. Field officers who gathered data in Primary Societies told the Primary Society managers that they were conducting research, not determining how much money to pay the Primary Society. No negotiation or appeals were allowed once the payment amounts were decided. Field officers did not mention the funding was coming from a foreign partner. These messages were repeated when funds were transferred to the Primary Society.

The program had no contact with individual members, only with the managers of the Primary Society. It was up to the Primary Society to explain that the society had received funds from the national movement of SANASA to cover their losses and up to the society to determine which members had their loans written off, using guidelines provided by the program.

Primary Societies had to submit a program of 'public work' that the society promised to undertake in order for funds to be disbursed, for example build a local road, re-paint the village school, repair irrigation works etc. This work ensured the community did not feel they were getting 'something for nothing'.

SANASA used a disciplined and structured process to gather data and decide levels of payment to Primary Societies. This structure is needed to ensure field officers gather the relevant information, but do not collect large amounts of unnecessary information. Field officers were given sample questionnaires, templates to fill in and guidelines for how to communicate with Primary Society managers.

However, there were a large number of exceptions and questions that were raised by the field officers, which should be expected. For example, if a loan was non-performing prior to the Tsunami, but had started to be repaid just before the Tsunami, should it be included? If a person had income now but was not willing to pay the loan, should it be included as a loss?

SANASA defined 'principles', approved by the Re-capitalisation Committee, for deciding on these cases which were. In some cases, part of the value of the loan was included in the losses, implying that there was a chance that the loan would be repaid, but generally loans were either included or not included.

During the program, SANASA realised that Primary Society managers needed guidance on how to use the re-capitalisation funds. For example, some Primary Societies wanted to use the funds to invest in large (and unnecessary) assets for the Primary Society, or into new (non-banking) ventures owned by the Primary Society. Others wanted to use the funds to support humanitarian programs. Additionally, especially in the East of the country, there was a danger that a large injection of funds would be appropriated by forces outside the cooperative. To protect against this, Primary Society managers were given training on how to use the mobilised funds and funds were deposited into an account of the SANASA Development Bank which could only be drawn-down slowly.

Finally, SANASA needed to provide guidance to Primary Societies on the tax and accounting implications of the re-capitalisation. Legislation had recently changed in Sri Lanka, allowing Primary Societies to write-off bad debts. This allowed Primary Societies to re-state their balance sheets to more accurately reflect their real value, but managers needed assistance with the new law.

In summary, a re-capitalisation program of micro-finance institutions is an effective way to provide support to community based organisations in post-disaster situations. Implementation requires considerable flexibility from donor organisations and considerable structure from the MFI. Re-capitalisation programs are not sufficient to solve all of the problems of a MFI, or of a community, in post-disaster situations, but they are useful and should be prepared for.

Arnold, M., K Burritt, M Jacquand, and E Miamidian (2005) *Surviving Disasters and Supporting Recovery: A Guidebook for Microfinance Institutions*, World Bank, Disaster Risk Management Working paper series no. 10

Development Alternatives International: *Microenterprise Best Practices Rapid-Onset Natural Disaster Briefs*