

## Financial sustainability of MFI's - Key factor for the growth and development of SME's in Albania

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### **Abstract**

*The Albanian economy, as an economy of a developing country actually characterized by a positive trend upward. Macroeconomic indicators are demonstrating relatively stability, the financial system is healthy and progressing economic activity. SMEs contribute strongly to economic progress of the country. The importance of SMEs mainly valued as they contribute to the growth of employment in the country, producing for the domestic market mainly using national resources. Agribusiness is an integral part of the national economy and requires continued financial support. For several factors they are not supported financially from the commercial bank in Albania. Microfinance institutions has been a powerful tool for the development of SMEs, especially in rural areas, creating new jobs while contributing to economic development of the country. This research will study the impact and collaboration of MFIs in Albania, in promoting the creation, growth and development of SMEs, which is closely linked to an important aspect of the activities of MFIs, even with financial stability and increased performance. The financial sustainability of MFIs is a crucial factor in related to the ability to provide services in full compliance with the objectives, scope and mission. Achieving sustainability is a guarantee for MFIs to be safe in their activities in order to consolidate their future. The essence of this paper is to contribute to the theoretical and practical analysis about financial sustainability of MFIs in Albania with regard to strengthening relations MFIs and SMEs.*

**Keywords:** SME; MFI; Financial stability; funding sources

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### **1. Introduction**

Agriculture is considered as the backbone of developing countries and has great potential in supporting the development, growth and poverty reduction (Zeller, 2003). Despite the fundamental contribution in the development of agriculture for developing countries, remains an underdeveloped sector and people living in rural areas are generally poor. For this reason, agricultural development requires full attention to the support of micro-enterprises in Albania.

Agribusiness is an integral part of the national economy and requires continued financial support. On the other hand, micro-credit institutions through their branches as complementary parts of the system are the best choice, faster and long-term agribusiness. The rapid growth of this sector is expected to continue as a result of increased funding needs, especially in rural areas.

Microfinance has its origins in the early 1980s, where governments and international donors felt and believed that the poor, farmers, seeking low-interest loans as a way to increase production to meet the vital needs of the family, on the other governments saw as a catalyst and a factor for increasing productivity in the economy. Since 1980 microfinance as a field (science) has increased steadily and fast.

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Private donors, governments have supported and actively support and encourage the activities of microfinance as a foundation for a much broader scope, and financial sustainability. In general, microfinance services can help people with low incomes to reduce risk, improve management, increase productivity, have higher profitability of investments, increase income through self-employment and improve quality of their life and subordinates.

Financial services usually include savings, credit, and in some cases, payment services and insurance. In addition to financial intermediation, many microfinance institutions provide social services like formations intermediate groups, self-esteem development and training among members of a group management skills.

Farmers and rural entrepreneurs to develop their activities need financial support for the purchase of inputs, equipment and investment for their farms.

Increased mechanization of agriculture, demand for equipment, inputs and investments for agricultural and livestock farms, requires the provision of financial services in rural areas.

Farmers and rural enterprises often do not have sufficient access to long-term loans to finance their production activities due to the seasonal nature of agricultural production, ownership problems and difficulties in providing collateral, ownership of farms and small surface fragmented, are some of the reasons that have generated a tightening of banks and other financial institutions associated with agricultural lending. Development of agricultural sector in terms of market economy requires a financial support for the realization of investments.

## **2. Critical review of literature**

Despite the contribution of agriculture to the economic development of the country and creating potential opportunities of new job growth in exports, the sector remains limited and low access to financial markets. Empirical evidence shows that growing sector of SMEs and their development dynamism can strongly contribute to the achievement of a wide range of development goals, such as those of: achieving income distribution and poverty reduction (DFID, 2000); Employment creation (Daniels and Ngwira, 1993); Savings Mobilization (Beck, 2005); and production of goods and services that meet the basic needs of the individual (Cook and Nixon, 2000).

Regardless, the largest contribution to growth and economic development, growth and development of SMEs in developing countries is hampered by access to finance, poor managerial skills, and lack of training opportunities and high cost of inputs (Cook and Nixon, 2000). Further studies conducted in this field suggest that 'glitch' in liquidity and low access is finance for SMEs constitute the biggest obstacle for them (Green, 2002). SMEs have limited access to financial services offered by formal financial institutions to meet their needs for liquidity and investments (Kessy and Temu, 2009).

However, the generation of self-employment in SMEs, requires investment in working capital, and low levels of income such capital accumulation can be difficult. In such circumstances, the loan can help the poor to accumulate capital and investment in employment generating activities (Hossain, 1988). Microfinance enables customers to protect, diversify and increase their incomes by reducing their vulnerability to shocks to income and consumption (Robinson, 2002). According Grade (1984), loans enable individuals or enterprises enjoy the benefit of economies of scale and new technology. Availability of credit to small businesses and families with low incomes

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would could increase their economic power and eventually break the vicious circle "of low income - low savings - low investment - low income" (Yunus, 1984).

The banking system shows no interest in SME financing, as required amounts of them are very small and insignificant by commercial banks. Commercial banks are considered as catalysts for economic development of the country through mobilization and profitability by providing large amounts of loans that they offer. In this respect, they consider as dangerous and nonprofit funding to rural households and businesses, excluding from their target group. In a study done by Chijoriga and Cassimon (1999) revealed that, to borrow from MFIs involves high transaction costs due to procedures and long bureaucratic for loan review and decision. The study also noted that asymmetric information between borrower and lender is very high and this led to the establishment of rules to tighten the monitoring and supervision of borrowers from MFIs.

Despite higher transaction costs, SMEs are using funding sources MFIs to further promote and increase their activity in the country, so it is important to analyze the influence and impact of microfinance to SMEs with cost MFIs real. Therefore, this study aims to investigate the impact of microfinance services in the growth of SMEs in Albania, as well as to identify the benefits of microcredit, and to assess the share of costs arising from the obligation of the loan compared to the contribution of MFIs first in Albania in view of improving family welfare SMEs.

According Alemayehu (2010), considered microfinance institutions offering financial services to clients with low income or solidarity lending groups including consumers and the self-employed, who traditionally lack access to services offered by banking institutions.

Microfinance also known as microcredit, small loans are considered as provided for poor families to promote self-employment and income generation (Fazl, Hasan & Abed, 2006). Yacob (2007) believes that microfinance is the financing of loans, savings, and other basic financial services to the poor. According to the Grameen Foundation, microfinance is often called "bank for the poor".

#### *The history of the development of microfinance:*

Microcredit and microfinance are relatively new terms in the field of economic development, mentioned for the first time in 1970, according to Robinson (2001) and Otero (1999). From 1950 to 1970, providing financial services from donors or governments was mainly in the form of subsidies to rural credit programs. These often resulted in major failures of financial loss and an inability to come to rural poor households (Robinson, 2001).

Robinson says that 1980 represents a turning point in the history of microfinance, where MFIs such as Grameen Bank and BRI<sup>1</sup> began to show that they can provide small loans and savings offer premium services at a large scale by taking the ongoing subsidies, marking the first time ensuring profitability scale (Robinson, 2001). 1990 classified as years brought "accelerate the growth of the number of newly created microfinance institutions and a growing emphasis to increase the level of coverage" (Robinson, 2001, p.54). Dichter (1999, p.12) refers to 1990 as the "decade of microfinance". Microfinance now been transformed into an industry by Robinson (2001).

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<sup>1</sup> Raykat Bank Indonesia

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Along with increased microcredit institutions, was deemed necessary that in addition to providing credit delivery to the poor (micro) be offered and other financial services such as savings and pensions when it became clear that the poor had a request for providing these complementary services (MIX<sup>1</sup>, 2005).

The importance of microfinance in development is strengthened with the launch of the Microcredit Summit in 1997. The Summit aims to reach 175 million poorest families across the globe, especially the women of those families, with credit for financial and business services other self-employed until the end of 2015<sup>2</sup> (Microcredit Summit, 2005). Finally, the UN declared 2005 as the International Year of Microcredit.

Analysts have found that small firms contribute strongly to the strength and economic progress of the country, and have described it as the backbone of the national economy. The importance of small enterprises mainly valued as they contribute to the growth of employment in the country and especially in the long run, produce for the domestic market mainly using national resources and can facilitate technological innovation by providing opportunities for new ideas.

#### *The contribution of SMEs to the economy*

If we present concisely the role of SMEs in economic and social life of the country we will emphasize the following aspects:

1. SMEs to promote free and productive employment of able-bodied people.
2. SMEs through the creation of jobs generate legitimate income sources for people and society.
3. Sustainability and the development of SMEs guarantee sustainable economic growth, ability and flexibility to adapt to changing market demands.
4. The growth and development of SMEs and promotes increased domestic savings and investment.
5. Training and development of human resources, among others, achieved through the creation and promotion of SME development.
6. Creation and development of SMEs in various parts of the country, where are the sources of raw materials and human resources, balancing regional development of the country.
7. SMEs to provide goods and services that are appropriate to better meet the needs of local markets, tastes and preferences of particular individuals.
8. SMEs provide opportunities for improving the quality of work and working conditions that contribute to a better life and also allows a significant number of people able to benefit from social protection programs.
9. SMEs stimulate entrepreneurial skills, innovations, inventions, technological developments and research in various fields of production and services.

<sup>1</sup> Microfinance Information eXchange

<sup>2</sup> The original objective was to reach 100 million by 2005, but members of the Microcredit Summit Latin American / Caribbean in April 2005, these objectives are changed (Microcredit Summit, 2005).

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10. SMEs to enable participatory socially useful work even groups of individuals with limited physical abilities.

11. SMEs promote good social relationships between employers and employees.

The existence of difficulties and obstacles on various forms, makes it necessary to draw attention to assist venture (small business and middle) at all stages, before the creation, operation and growth through further development of his. In this regard, an important role can play MFIs which besides providing loans may also offer financial assistance; managerial assistance: before starting the business when the business started, and when the business grows and develops.

### **3. Microfinance industry in Albania**

The microfinance sector has experienced a steady growth trend in the recent years, despite quite unstable macroeconomic and politic climate in the region and Albania. Year 2014, initially estimated to be a positive year for the Albanian economy was associated with big challenges for the individual consumer, as well as for the private businesses.

Despite this, our microfinance market kept the same growth dynamic in 2014, as in the previous years consisting in an increase by 5.6% of the outstanding loan portfolio and number of customers served. The level of credited amount during the year from all MFI has been around 16 billion all, performed through 150 branches across the country. Today, our MFI provide their services to more than 65,000 customers, evenly distributed between rural and urban areas without income or gender discrimination.

MFI's key strategic focuses remain the activity in agriculture field offering personalized credit products adopted to any type of seasonality and business activity cycle. MFI's extend credit and savings services to every single small customer even in the most distant areas of the country that hardly can be reached by other financial institutions. MFIs focused on providing services to a specific target group, as are micro companies, family businesses and farmers, taking into consideration they are underserved from the financial market and are one of the main drivers for the economic growth of the country.

This research will provide an overview of all MFIs in Albania, as well as to disclose their performance and impact on economic growth of the country. The essence of this paper is to contribute to the theoretical and practical analysis to increase performance of MFIs in Albania and increasing their contribution to the country economy.

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Table 1. Consolidated table of key data (Albanian MFI's)

	2012	2013	2014
<b>CAPACITY</b>			
No of branches	142	147	150
No of total staff	872	955	1052
No of Loan Officers	498	523	555
<b>FINANCIAL (in LEKE at year end)</b>			
Total Assets	18,830,203,613	19,096,772,176	20,815,220,044
Total Savings	1,808,127,978	2,298,427,611	3,992,440,450
Total Debt	11,961,402,214	11,189,952,128	13,650,713,592
Total Equity	4,439,571,039	4,670,502,216	4,861,327,617
<b>LOANS (in Albanian Leke)</b>			
Loan Portofolio outstanding	14,798,889,307	15,336,341,435	16,188,388,401
No of active customers	59,008	61,654	65,104
Volume Disbursed	10,192,060,398	10,431,054,580	10,864,732,861
No of loans disbursed	32,906	34,919	36,160
Portofolio at Risk (PAR 30)in %	0	0	0
<b>SAVINGS</b>			
No of members of credit and sav-ings associations	44,870	48,163	53,415
No of members active with savings in the credit savings associations	9,907	6,650	7,106
<b>SOCIAL IMPACT</b>			
No of active women customers	19,065	20,624	21,905
No of active men customers	48,753	50,637	53,385
No of active customers in urban area	30,439	31,996	33,429
No of active customers in rural areas	28,569	29,658	31,675
No of active customers in agricul-ture	19,445	20,594	22,620
Total no of family members of ac-tive customers	272,368	286,353	301,138
Total no of employees of active cus-tomers (including borrowers)	94,524	96,180	100,318

Source: *The Albanian Microfinance Association (A.M.A)*

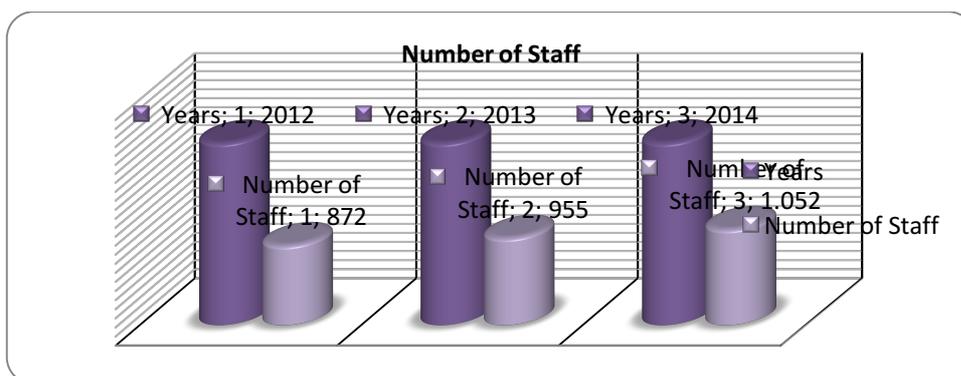
Microfinance Institutions in Albania:

- Continuing to grow with special focus in agriculture sector;
- Maintaining an impressive portofolio quality of PAR 30 at less 5% at the same time when banking sector has a ratio of over 22% of non-performing loans;

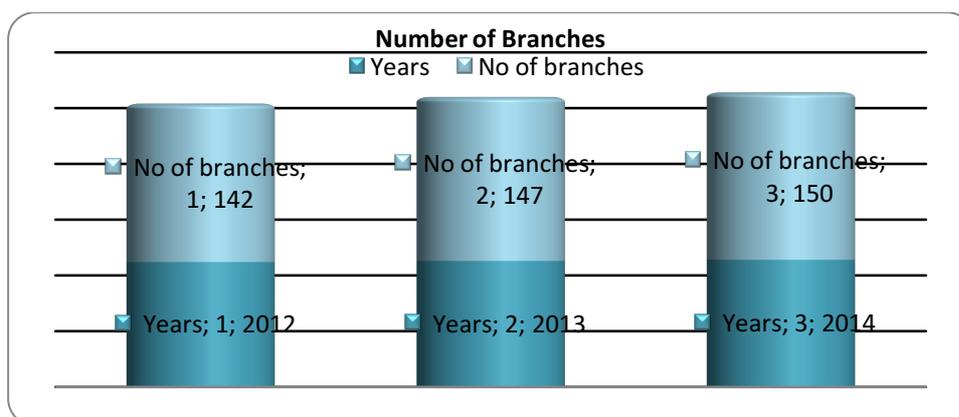
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- Directly impacting more than 10% of the jobs in Albania through lending activity of micro and small business activities;
- Reaching more than 10% of the rural population through lending to micro and small farms in Albania.

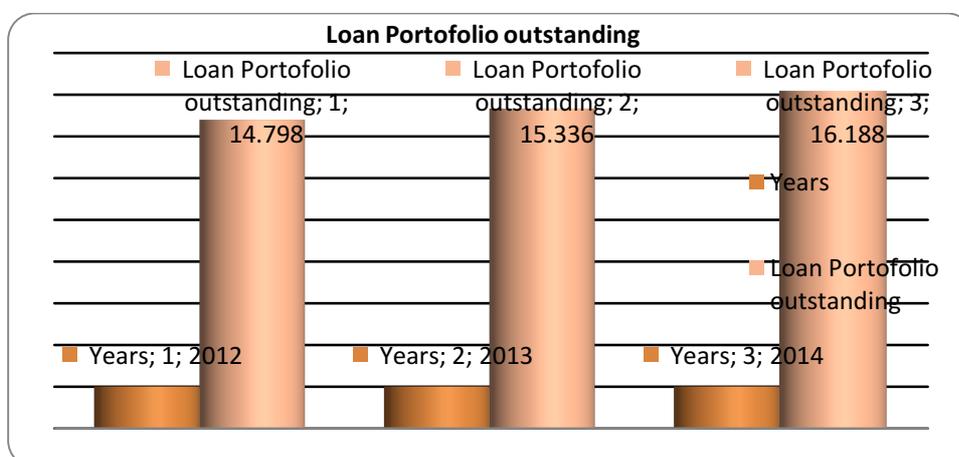
Continue playing an active role in promoting and educating customers with financial services to become bankable in a country where penetration of financial services is the lowest in the region.



Source: The Albanian Microfinance Association (A.M.A)

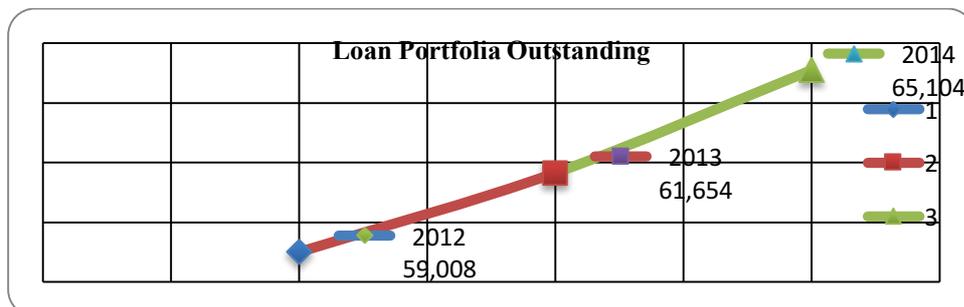


Source: The Albanian Microfinance Association (A.M.A)



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Source: The Albanian Microfinance Association (A.M.A)

#### 4. Microfinance organizations in Albania (From NGO-s to formal financial institutions)

During the 22 years of existence the microfinance organizations of AMA in Albania have developed into two business models, credit and savings associations and their unions, and non-bank financial institutions.

Legal framework and institutions development up to date for Credit and Savings Associations and Non-Bank Financial institutions:

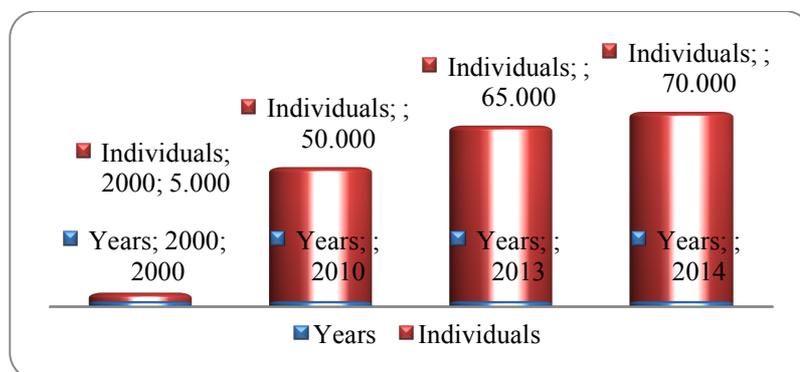
- 1992-World Bank Pilot Project approved by the Albanian Government on poverty alleviation, creating the first Village Credit Funds as predecessors to the local Savings and Credit Associations.
- 1993-Creation of the Albanian Development Fund (ADF) with two principal departments: Rural Credit (which objective was the creation and support to the village credit funds) and Rural Infrastructure.
- 1994-Creation of the Department of Urban Credit, in the framework of the Albanian Development Fund (ADF) which in 1999 became Besa Fund.
  - 1996, Vote of the first law on the Credit and Savings Associations.
  - 1999, First Regulation 'On granting of license for the conduct of financial activity by non-bank subjects in the Republic of Albania' approved by the Supervisory Council of the Bank of Albania, changed in 2009 and 2013.
- 1996-Foundation of Irish League of the Credit unions established which transformed into a union of credit and savings associations in 2002.
- 1999-NOA (originally Partneri Shqiptar ne Mikrokredi) established initially as a credit and savings association and in 2001 transformed as a non-bank financial institution.
  - 2001, New law on Savings and Credit Associations and their Unions voted by Albanian Parliament (last amendments in 2003 and 2006).
- 2000-Transfer of the financing activity in north-east Albania from the Rural Finance Fund to the newly created MIF, Mountain Areas Albanian Fund MAFF).
- 2001-Vision Fund Albania (VFA) established under the umbrella of the World Vision Albania as non-bank financial institution.
- 2002-The Albania Savings and Credit Union is created subsequent to the joining of 60 local Savings and Credit Associations.

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- 2005, First regulation 'For the supervision of the credit and savings association and their unions'.
- 2006-Creation of the Albanian Microfinance Association (AMA).
- 2008-Besa Fund transformed into a licensed Non-Banking Financial Institution.
- 2009-The First Albanian Financial Development Company (FAF-DC) established, as an implementation of the Strategy 'For the conversion of the Mountain Areas Finance Fund-MAFF' into 'Financial Development Company'.
- 2010-Regulation 'On risk management in the activity of non-bank financial institutions' approved by the Council of Supervisors of Bank of Albania, changed in 2013.
- 2012-New Law on the Albanian Deposits Insurance Scheme: SCAs deposits will be ensured for the first time likewise traditional Bank deposits (last amendments in 2014).

Milestones of outreach as active customers of microfinance organizations, unions of credit and savings associations and non-bank financial institutions:

- 2000 – over 5.000 individuals
- 2010 – over 50.000 individuals
- 2013 – over 65.000 individuals
- 2014 – over 70.000 individuals



Source: The Albanian Microfinance Association (A.M.A)

## 5. Financial sustainability of MFI'S

According to Pissarides (2004), MFIs can be considered as self-sustainable through the use of subsidies, grants or other sources, which can provide income to the poor to acceptable levels. Sustainable MFIs should ensure stable operations in order to be able to serve the poor both now and in the future. Of course, that one of the main sources of financial stability is insurance, financing and administration of funds from donors.

In any case, MFIs must be institutionally sustainable. Also, MFIs should generate real social impact on the poor. Thus, they should see an increase in the depth, impact on current customers and increasing the breadth of outreach to the poor, in order to gain stability and to achieve their social mission. A study in the Asian region, reveals that only six of 49 MFIs were ASA1 financial self sufficient. Six MFIs, including Grameen Bank, were over 80% self sufficient financial, while

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the remaining 37 MFIs were less than 80%. Another study by CGAP show that only 5% of MFIs, CGAP applied for funding were functional enough people (McGuire & Ors, 1998).

Many empirical studies have investigated the issue of financial sustainability in the microfinance sector. They used different approaches. Mark Schreiner (1997) established a framework to analyze the performance and sustainability of MFIs that are subsidized, including two international MFIs, Grameen Bank and BancoSol. He argues that this structure is a way of disciplining measure how well an MFI uses public funds to improve the welfare of the poor. He suggests one way to summarize the work of an MFI in terms of six stakeholders: society, the poor, poor consumers, donors, employees and investors "(Schreiner 1997).

An Indian study has made an attempt to examine the financial viability of the multiple dimensions such as demand, mission, legal and regulatory framework, ownership, governance and human resources and financial stability (Vijay & Nagasri, 1999).

Emilio Hernandez (2004) conducted a study to assess the financial sustainability of MFIs in Nicaragua, if they were able to achieve viability, but the evaluation is based only on their financial performance. Another study was done by Kereta in Ethiopia in 2007, based on triangular model of Mayer (2002), financial sustainability, impact on the welfare and well-being and extraction of poverty. Simultaneously, Ismail and Condron (2008) analyzed the sustainability of Islamic MFIs in Indonesia, through the use of two methods, that of technical efficiency (using analysis of data) and the level of information.

Most of these studies focus only on financial measures which tend to be restrictive indicator on the implementation of results based on historical data of past performance. Financial indicators alone are not enough to help the organization to move in the direction of the target, it needs to integrate all the key indicators for other prospects to support the management of future challenges (Kaplan and Norton, 1996). For this purpose, Kaplan and Norton in 1996 have developed balanced points (BSc) with four interrelated perspectives: financial, customer, internal business process, learning and growth perspective. BSc can be adapted to non-profit organizations (NGOs) as well as profitable, helping in the development and adoption of new perspectives on the nature of the organization (Kaplan and Norton, 2004 Marcus, 2009).

Another study has classified sustainability in four dimensions:

☞ First, the sustainability of the market through the design of effective products and services to suit the needs of customers.

☞ Secondly, the legal and political stability;

☞ Third, the impact of sustainability by providing a positive impact on poverty;

☞ Fourth, institutional stability, which is branched into four sub-dimensione- a. sustainability of the mission; b. program sustainability; c. sustainability of human resources; d. financial sustainability.

Sustainability generally means the ability of an ongoing program to perform activities and services in pursuit of the statutory institutional objectives. For an ideal IMF this means the ability to continue

It is acting as a financial development institution for the rural poor (Khandker and Khalily, 1995). There are two different approaches to dealing with the concept of sustainability, and access

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Welfarist institutional approach. Research shows that the microfinance industry significantly characterized by the institutional approach to sustainability.

As the concept of microfinance came into focus, the question of whether donor support is necessary in the long term and the issue of sustainability of such institutions came up as well. It could be argued that the long term sustainability of MFIs is not important as long as money was given to micro entrepreneurs and a start up help was given. This would imply that sustainability of the micro enterprises is more important than the long term existence of the financial institution that stood behind the start up.

As MFIs seek to reach as many poor people as possible in the long run to fulfill their goal to fight against the worldwide poverty, it became clear that this outreach is only possible on a sustainable and efficient basis. Some opponents of this argument state that sustainability is not possible by reaching the poorest people on the planet. They furthermore argue that there exists a tradeoff between outreach and sustainability. One might assume that sustainable MFIs are typically for-profit commercial companies, but this is not true.

Actually, almost two-thirds of the sustainable MFIs are NGOs, cooperatives, public banks, or other not-for-profit organizations (Rosenberg et al., 2009). Sustainability in general means the ability of a program to continuously carry out activities and services in pursuit of its statutory objectives. For an ideal MFI this would mean the ability to continue operating as a development financial institution for the rural poor (Khandker and Khalily, 1995, 36). Since MFIs are more and more viewing their financial services as profitable businesses, it is of importance to constantly look for possible cost reductions or reallocations in order to operate profitable and economically viable. For a better understanding of the profitability and sustainability, ratio analyses are often used. In the following part different forms of sustainability and ratio analyses are examined and the principle of "double bottom line" of MFIs is discussed.

#### *Operational sustainability*

Operational sustainability accompanies the concept of operational self-sufficiency (OSS) which measures operating revenue as a percentage of operating and financial expenses, including loan loss provision expense and the like. If this ratio is greater than 100 percent, the MFI is covering all of its costs through own operations and is not relying on contributions or subsidies from donors to survive (Churchill and Frankiewicz, 2006, 367).

OSS in general includes all the cash costs of running a MFI, depreciation and the loan loss reserve. Sometimes donors will exclude the cash costs of funds from their analysis because "those MFIs that begin to access the commercial financial markets and pay the cost of capital would look relatively worse than other institutions with the same costs and outreach, but who have remained reliant on donor capital to fund their portfolio" (UNCDF, 2002, 20). This applies due to the fact that some donor fund dependent institutions do not have the same financing cost as commercial MFIs. OSS is calculated as:

Financial Revenue (Total)

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(Financial Expense + Loan Loss Provision Expense + Operating Expense)

*(Microfinance Bulletin 2008a, 13)*

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The United Nations Capital Development Fund (UNCDF) in 2009 defines OSS simply as:

$$\frac{\text{Operating income}}{\text{Total operating expenses}}$$

(UNCDF, 2009)

Operational sustainability actually refers to the future maintainability of the MFI's OSS. For MFIs it is one of the major goals to achieve OSS in order to maintain viable and further grow in their operations.

### *Financial sustainability*

In general, financial sustainability describes the ability to cover all costs on adjusted basis and indicates the institution's ability to operate without ongoing subsidy (i.e. including soft loans and grants) or losses. Here UNCDF distinguishes financial self-sufficiency (FSS) from OSS only by the fact of an adjusted basis.

The FSS indicator measures the extent to which a MFI covers adjusted operating expenses with operational income. This ratio is calculated by using:

$$\frac{\text{Adjusted operating income}}{\text{Adjusted operating expense}}$$

(UNCDF, 2009)

Ledgerwood additionally states that the FSS indicator should show whether enough revenue has been earned to cover direct costs, (including financing costs, provision for loan losses and operating expenses) and indirect costs (including adjusted cost of capital) (Ledgerwood, 1999).

Due to the fact that donor support is not unlimited in reality, financial viability of microfinance services is crucial for expanding outreach to large numbers of the world's poor. Moreover the retention of profits of microfinance operations is important to capitalize growth (CGAP, 1998).

## **6. Conclusion**

In the end the concept of microfinance with its potential to generate profits surprised many. The huge number of poor people, completely forgotten by the formal financial market for such a long time, turned out to be viable customers of micro financial services and changed the paradigm of western countries. Microfinance will continue to provide attractive investment opportunities in the future if people from developed countries keep being on the lookout for new markets, products and investment opportunities in this field.

A final argument for the sustainability of MFIs and the profits on business with poor is clearly that microfinance investors would like to invest in projects that meet the commercial standards, too. Well performing MFIs are therefore able to attract even more investors which then promote growth and more outreach of these institutions. Commercial investment is an integral part for the long-term existence of microfinance. Nevertheless, many MFIs cannot cover their costs completely and people might still think this is suitable because of their social mission and the self-

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evident and constant support of donors. However, it must be considered for how long donor support can be ensured and whether continuing financial support from donors is realistic in the long run.

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