

# **Innovations in Reducing Costs and Enhancing Productivity: Field Treasury Systems**

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## **Innovations in Reducing Costs and Enhancing Productivity**

Microfinance has proven to be one of the most effective tools to help alleviate poverty. While microfinance is relatively young when compared with the formal financial sector, the formalization of micro-finance is younger still, and the vision of halving poverty by 2010 has pushed key players to design, test, and replicate successful models all over the world. Today, the microfinance sector spans various age bands, from more formalized and saturated markets in Latin America to rather nascent markets in other parts of the world.

Experience has shown that sustainability is critical to the longevity and further growth of any microfinance institution (MFI). Sustainability, or financial health, becomes more critical as the sector continues growing; unfortunately the potential market continues to grow as well. Growth, among its other ramifications and side effects, both positive and negative, has the ability to drag the focus away from sustainability.

### **Factors of sustainability**

Sustainability is the ability to generate sufficient funds to sustain the costs of the program. Various factors determine the sustainability of the program. These include pricing of the product, costs of funds, administrative overheads, loan losses or portfolio quality, and inflation. Each determinant has its own significance and can be controlled in different ways.

Pricing of the services primarily reflects the long-term vision of the program and is set at a level by the management. Cost of funds is usually driven by the sources of funds an MFI has, along with the internal fund management

procedures. Administrative costs are driven by the operational structure and productivity of the program. Needless to mention, credit risk determines the level of portfolio quality, which the program carries in its balance sheet. The right balance between all the above factors is critical to make an MFI sustainable.

This paper will emphasize the internal factors and/or reasons that contribute to increased cost of funds and the innovations the Kashf Foundation employed to lower these costs.

### **Cost of funds**

Factors driving the cost of funds can be separated into two main categories: **external and internal**. The external drivers include the sources of funds an MFI can access. Typically, in the case of subsidized lending, the cost is usually fixed and is lower than the market, thus allowing the MFI to enjoy higher margins provided the price is set at a market level. In the case of commercial loans however, the MFI has to face the market trends and the interest rates fluctuate with the market. The choice or provision for hard or local currency loans affect sustainability where the foreign exchange risk is carried by the MFI itself or even hedged, in which case the cost of hedging adds to the overall costs. In most of the cases, these costs are beyond the control of management.

The internal factor that drives the cost of funds is the process through which an MFI oversees the fund management within the organization. An effective system of internal fund management ensures the lowest levels of idle funds at any given point in time, thus lowering the costs of overall funds employed in the system. The funds can be accumulated as *idle funds* in the system for various reasons, ranging from operational inefficiencies, like lags in disbursements, to inadequate procedures deployed by the MFI.

## **History of fund management in Kashf- Description, outcomes and lessons learned**

The experience of the Kashf Foundation (KF) in managing funds in the field can be divided into three periods over the previous 6 years. We shall discuss the practices adopted in each period, their outcomes, and the key lessons learned that improved the systems.

### **Up till year 2002**

#### ***Description of the system***

KF started a recoveries and disbursement process through its own field staff in all of its 20<sup>1</sup> branches. The practice was adopted from Grameen's model where the loan officers carry the cash resulting from disbursement and recoveries to and from the field. The franchise model of KF suggested that each branch should have a bank account operated by the staff assigned to it. Each transaction occurring at the branch would be supported by the bank and recorded in a cashbook maintained in the branch. At the close of each business day, these records would be reported from each branch, enabling us to track our funds on a daily basis.

In the event of a projected shortage of funds in the field, the branch could have the funds transferred once a week from the head office through a written request. The head office carried out bank reconciliation at regular intervals.

#### ***Outcomes***

- a) Cash handling by field staff exposed us to **security risks**. One of our loan officers was shot on the street for an insignificant amount.

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<sup>1</sup> As of December 2002, KF had 20 branches in 2 districts

- b) An inefficient fund transfer practice, coupled with lagged information from the branches to the head office, caused significant amounts to remain idle in field bank accounts. As of December 2002, these amounts represented approximately **19%** of the total funds obtained from lenders and the cost of funds as a percentage of closing outstanding portfolios stood at around **10%**. The total funds in the field not utilized were approximately half a million dollars. In effect, on an annualized basis, we were paying around USD 30,000<sup>2</sup> extra to keep this afloat.
- c) There was a clear **information lag** between the field *bank* balances and the head office.

***Lesson:***

- a) In order to manage the security risk, our environment does not allow us to have our staff carry cash and thus we have to introduce a system whereby we can eliminate cash handling by our staff.

**From 2002 to 2003**

***Description***

As KF expanded to 30<sup>3</sup> branches in 4 districts, the interface for disbursements and recoveries was changed. In order to manage security risk and eliminate cash handling, KF asked its clients to interact with the bank branch for respective KF branches. The choice of the bank was made considering the distance from the closest bank to the corresponding KF branch. Consequently, KF had accounts in different banks throughout its network. Checks were issued in individual clients' names, which they could

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<sup>2</sup> KF borrowed from Pakistan Poverty Alleviation Fund at a fix rate of 6% per annum

<sup>3</sup> As of December 31, 2004

cash at the bank. Center<sup>4</sup> representatives were asked to deposit their installment amount in the bank one day prior to the meeting<sup>5</sup> date. A minimum balance was maintained in the bank accounts to encourage the bank staff to give operational support to our clients.

## **Outcomes**

- a) The practice resulted in heavy traffic of KF clients in the bank branch. The banks started complaining and indicated that the branch infrastructure was not designed to cater to this kind of clientele. KF experienced operational issues in the form of customer service from the bank. The problem was handled by maintaining relationship with the banks at the field and head office levels. These problems typically included rudeness toward our clients, making them wait for a substantially long period of time before they could get checks cashed, and refusal to accept small denomination notes.
- b) With the privatization and changing economic scenarios, the deposit balance maintained with the banks was no longer an incentive for them.
- c) The informational lag and heavy bank balances continued to be a problem. The total float now represented around **11%** of the total funds borrowed. The cost of funds as a percentage of closing outstanding portfolios stood at around **8 %**. The decrease primarily resulted from an increase in branch networks. The total funds in the field accounts amounted to approximately USD 750,000 (per branch USD 25,000), which resulted in an annualized incremental borrowing cost of around USD 45,000.

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<sup>4</sup> Centers are comprised of 25 women

<sup>5</sup> Meetings occur and installments are due every other week

- d) There were also instances where bank staff, KF staff, KF clients, or others colluding with them tampered with deposit slips or embezzled funds.

***Lessons:***

- a) KF realized that a more sustainable structure should be in place in order to address these problems. The system of managing funds should address security risks, operational risks (for example, better client service), and fund management.
- b) KF also learnt that it would be worthwhile to exploit a strategic partnership with one of the leading commercial banks in order to get a long-term solution.

**From 2004 to 2005**

***Description***

KF managed to enter into a strategic partnership with a commercial bank. We signed an agreement for cash management services with one of the bigger commercial banks in the country (CB) with a reasonable branch network. Over 95% of KF branches could be linked to the bank branches. Under the agreement it was agreed that:

- a) KF clients would interact with the bank in order to get disbursements and deposit their recoveries. The recoveries would be deposited through a specially designed, sequentially pre-numbered, carbonized deposit slip, which helped in eliminating the problems of forged documents through over-writing and collusion, etc.

- b) CB would ensure transfer of all recoveries to a main account on the same day thus maintaining a zero balance account in the field.
- c) CB supported fund transfers from the main account to field accounts upon receiving a request from KF with a time lag of 2-3 days, thus eliminating the KF head office intervention from the process
- d) CB also provided the detailed report of total recoveries received and disbursements made at each KF branch. This information was received one day in arrears.

### **Outcomes**

- a) It took 4 months to deploy the system in 95% of the branches as of December 2005<sup>6</sup>.
- b) The total float of funds in the field was reduced to USD 140,000 (per branch USD 4,100). This helped reduce the excess annualized borrowing cost to USD 8,500.
- c) The cost of funds as a percentage of closing outstanding portfolios stood at around **4 %**.
- d) The field bank balances represented approximately 1% of the total amount borrowed as of December 2005.
- e) After having worked under the agreement, the bank slowly yet strongly showed its concerns about the operational burden.

### **Lessons:**

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<sup>6</sup> The total branches stood at 34 as of December 2005.

- a) Efficient fund management has a direct impact on the overall costs of funds which in turn gives larger leverage to the organization to make its services more effective at lower costs.
- b) Frequent MIS can help streamline the reconciliation procedures thus helping in identifying any potentially problematic areas in time.
- c) The commercial banks cannot handle the traffic of microfinance clientele in the long run. This may increase the dependency risk of the MFI, especially in a growth scenario.

### **Future Strategy**

KF conducted a detailed exercise, evaluating all available options to handle fund management. The objective was to explore and evaluate a long term sustainable/cost effective solution for managing fund flows and cash handling within the organization with better service to our clients, mitigating external and internal risks associated with managing cash.

The areas or the models included:

- a) Working with more commercial banks under cash management arrangements.
- b) Collaborating with the Pakistan Post (post offices).
- c) Internalization of cash management system: This entails changing the interface of KF clients from commercial bank branch to KF branch. It also translates into the evolution of a separate teller and fund management function both at the field and head office levels. This can be achieved through two possible models. The first model suggests handling cash in all KF branches; clients can deposit their recoveries

and get the disbursements of loans directly from KF branches. The other model would be a Hub-Spoke branch structure in which case one hub branch would cater to clients at 4-6 spoke branches for handling all of the cash transactions. In both events, the KF branch will remain connected with the commercial bank branch in order to maintain fewer accounts with low balances.

Analysis has shown that internalizing the cash management system will reduce dependency risks on banks, enable KF to have a distribution network without the presence of commercial banks and reduce the overall costs of managing funds. The comparison showed that handling cash internally costs three times less than outsourcing to a commercial bank.

KF has started working towards internalized cash management for both the aforementioned structures. It has also been decided that KF will continue to explore new options (for example G-cash) as they become available.

