International Restructuring Experience in Commercial Banking and Microfinance

Two Case Studies:

Centenary Bank, Uganda

Bank Rakyat Indonesia

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2010

Overview

(1) Centenary Bank, Uganda:
Transforming a credit trust:
first into a microfinance commercial bank,
then into an MSME bank with a microfin. focus

(2) Bank Rakyat Indonesia I: Transforming microcredit village units (*unit desa*) into microbanking units (MBUs)

(3) Bank Rakyat Indonesia II: Restructuring the bank

(4) Lessons learned

Centenary Bank, Uganda:
An African Flagship of Restructuring

I.
Transformation of a credit trust into a microfinance commercial bank

1983: Established as:
Centenary Rural Development Trust

- Successful savings mobilization,
- serious loan delinquency problems.

1990:
Board decides to transform the trust

- Technical assistance (TA) by German Savings Banks Association
- **Management contract** with IPC Frankfurt

1993: Transformation into a commercial bank:

Centenary Rural Development Bank

- **Mission:** serving the economically disadvantaged people, esp. in rural areas

Introducing a highly effective individual lending technology:

- Analysis of total household activities, sources of income & repayment capacity
- cashflow-based lending
- an incentives-driven repeat loan system at 48% interest, “automatic third loans” at 32% interest
- flexible loan security requirements
- stringent enforcement of timely repayment
- backed by a system of computerized daily loan tracking
- instant recovery action in case of delinquency
- staff performance incentives focused on loan repayment

Results of transformation, 2002

- Depositors: 316,650
- Borrowers: 31,500
- Total assets: $61.3m,
- Total deposits: $48.7m
- Loans outstanding: $23.05m
- ROA: 4%
- ROE: 27%

II. Transformation into an MSME bank, 2002

(1) *Solving the quality vs productivity dilemma:*
shifting incentives from repayment towards a balance of loan repayment and disbursement

(2) *Solving the outreach vs. sustainability dilemma:*
adding finance for small & medium entrepreneurs

(3) *No mission drift:*
microentrepreneurs constitute 99% of borrowers

Results of transformation, 2008

- 730,000 depositors
- 93,000 borrowers
- Employees: 1,250
- Total assets: $228m
- Total deposits: $180m
- Loan portfolio: $151m
- PAR >30 days: 4.6%
- Loan loss rate: 0.73%
- ROA: 5.5%
- ROE: 35.4%

Lessons learned

Centenary Bank has demonstrated the feasibility of:

- Self-reliance through savings mobilization
- Maintaining a focus on microfinance
- Combining ME with SME & corporate lending incl. graduation from ME to SME loans
- Consistently low default and high profit rates
- **Combining outreach with sustainability**

Bank Rakyat Indonesia (BRI): An Asian Flagship of Restructuring

I .

Transforming microcredit units into microbanking units (MBUs)

The units before restructuring:

1968 government-owned BRI re-established as a commercial ***and*** policy bank:

- Commercial lending acc. to banking criteria
- Concessionary programs for small farmers and MSEs

1969 BRI sole lender of a mass credit program for rice self-sufficiency

- Establishment of „village units“ as loan channels
- Heavily subsidized targeted credit
- Onerous procedures, delays, illegal charges
- Lending restrictions undermine productivity
- 3,617 units in 1983, staff of 14,300
- Mounting arrears, >50% in 1982, heavy losses

Policy background of BRI unit restructuring, 1983

1982 Decline in oil revenues
1983 Interest rate liberalization
Withdrawal of central bank credit supply to BRI units
Options: closing or restructuring the units

BRI, 1983:

- Placed under new management with more autonomy
- TA by Havard Institute for International Development
- Redesigning the village units as Microbanking Units

Feb 1984: Restructuring effective

Transforming credit channels into profitable self-financed microbanking units (MBUs)

- Placed under own administrative structure, supervised by BRI branches, audited by BRI regional offices
- Moved from rice planting areas to business centers
- No government programs handled at units
- MBUs as self-sustaining profit centers
- Substantial profit-sharing incentives for staff

New savings product „Simpedes“

- Attractive interest rates with positive real returns
- unlimited withdrawals at any time
- Semi-annual prizes at public draws
- Immensely successful
- Generating increasing amounts of surplus liquidity

Single general purpose credit product „Kupedes“ (1984)

- For everyone who is able to save and repay
- Loans from $2.50 to $5,000 (now $10,000)
- Flat monthly interest rate of 2% = 44% eff. p.a.
- 25% interest rate rebate for prompt repayment
- resulting in a 95% on-time repayment rate
- Small loans collateral-free
- Monthly instalments (now variable)

2008: Interest rates eff.p.a. after rebate 17%-25% nominal, 7-15% in real terms

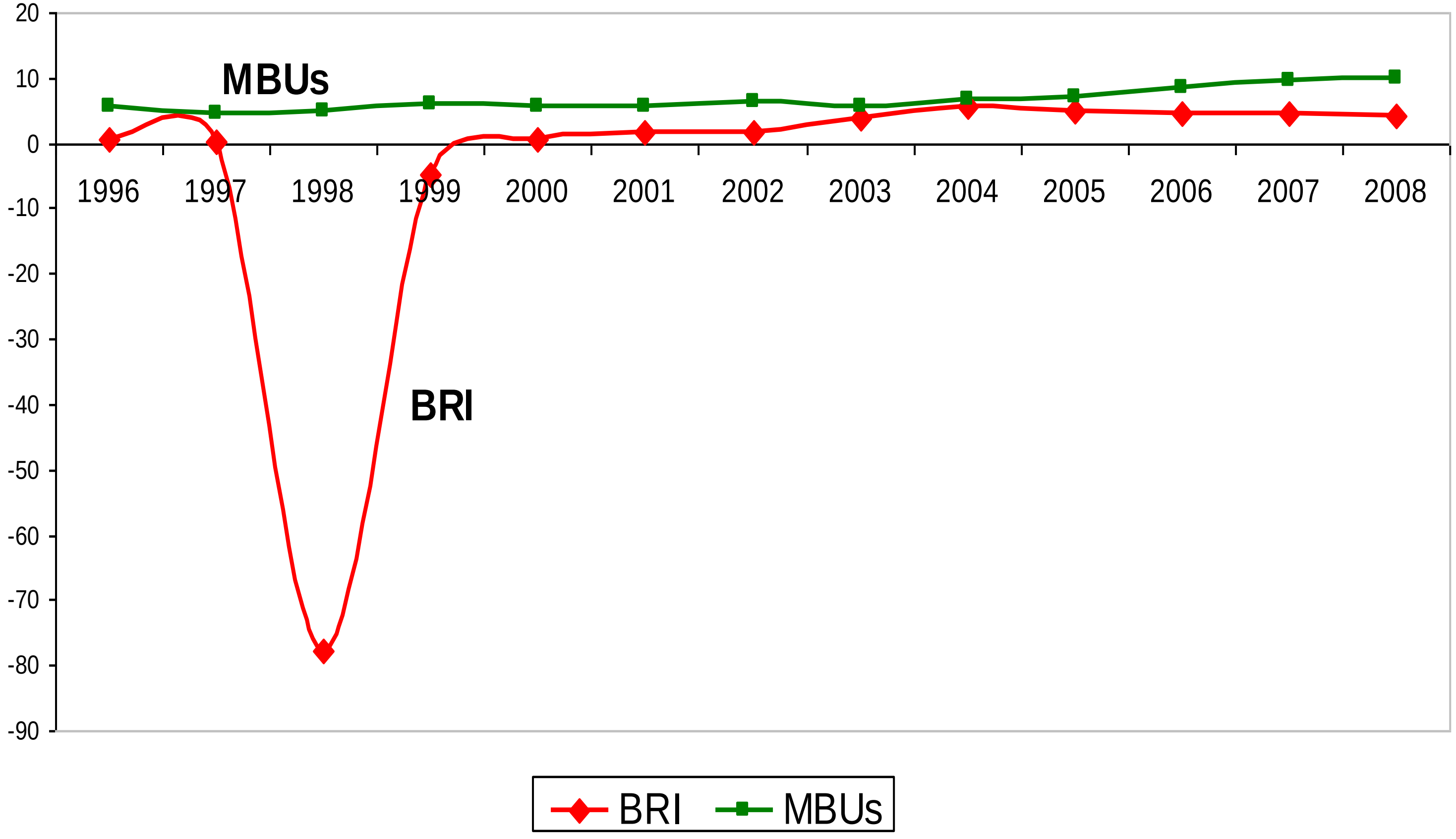
MBUs 2008: Outreach & performance

➢ Number of MBUs:	4,300
➢ Savings accounts	19.6 million
➢ Loan accounts	4.5 million
➢ Savings balance	$5.9 billion
➢ Loans outstanding	$3.9 billion
➢ NPL	1.65%
➢ ROA	9.8%

MBUs during the Asian financial crisis 1997/98
(collapse of the corporate economy & banking sector)

- Client confidence, growth of **savings accounts:**
  1996 16.1 million
  1997 18.1 million
  1998 21.7 million
  1999 24.2 million
- Stagnating credit demand, decline of **loan accounts:** from 2.6 million in 1997 to 2.5 million in 1998 and 1999
- Robust loan recovery – 12-month **loss ratio:**
  1996: 1.6% 1997: 2.2%; 2001: 0.5%
- **Continual profitability** – Return on average assets:
  1996: 5.7% 1997: 4.7% **1998: 4.9**% 1999: 6.1%

ROA of BRI and MBUs, 1996-2008



How the MBUs saved BRI during the Asian financial crisis

The MBUs cross-subsidized the Bank through:

- a continual transfer of profits
- a transfer of surplus savings mobilized at village level to the branches
- An international reputation as the developing world‘s most successful microbanking network

Lessons from BRI‘s microbanking units

1) With attractive savings and credit products, appropriate staff incentives and effective internal regulation and supervision, rural and peri-urban **microfinance can be highly profitable**
2) Low-income people can save, and rural financial institutions can **mobilize savings cost-effectively**
3) The **demand for deposit services** exceeds the demand for credit by a wide margin
4) Effective loan monitoring and **incentives for timely repayment are key success factors**

Lessons

5) **Outreach to vast numbers of low-income people** is the way to self-reliance and viability
6) **Catering to the poor, near-poor and non-poor** enables FIs to increase transactions, to lower transaction costs and lending interest rates, and to increase profits
7) Financial sector policies that are **free of distortive interference** are conducive to financial innovations (like the BRI MBUs)
8) **Savings-based self-reliance & profitability make MFIs crisis-resilient**

Bank Rakyat Indonesia II: Restructuring the bank

Policy environment

- Since 1983 increasing **financial sector deregulation**
- 1988 law eases establishment of banks and branches
- Rapid expansion of private banking sector
- Many new private banks owned by conglomerates: borrowing cheaply on international markets to finance business expansion
- State bank lending under political influence: in 1989 BRI still handled >300 government programs
- Central bank unable to enforce prudential norms
- **Banking sector out of control**

Effect of Asian financial crisis on BRI: comparing 1998 with 1996

- Devaluation: loss of value of total assets in US$ by 71%
- Surge of nonperforming loans ratio to 53%:
  - Corporate sector most affected
  - Microbanking sector barely affected
- **From net profit of $101 million to loss of $3.3 billion**
- **ROA fell from 0.7% to –78%**
- BRI technically **bankrupt in 1998**

The restructuring of BRI

- 1998: GOI decides to restructure BRI
- Restructuring in three phases:

1999: implementation of restructuring plan

2000: recapitalization ($3.0 billion, to be repaid)

2003: partial privatization (40.5%)

(1) Implementation of operational restructuring plan

1) **Resolution of NPLs and portfolio restructuring:**

- $2.2 billion of corporate bad loans transferred to Indonesia Banking Restructuring Agency (IBRA)
- Corporate lending limited to 20% of portfolio

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2) Enhancing risk management:

- Risk rating system for small businesses
- Risk ratio standardization for medium businesses
- 2002 Risk management committee at highest level, subsequently consolidated in a Division for Compliance and Risk Management, covering

  8 risks: operational, market, credit, liquidity, compliance, legal, strategy and reputational
- 2001: Work ethics program for 35,000 employees, appointing 1,000 as role models, change agents and motivators

Implementation cont‘d

3) **Business strategy redefined:**
   - **Focus on MSME** (target: 80% of portfolio), particularly micro and consumer lending (lowest NPL ratios)
   - Product innovation (eg, online savings, ATM, investment banking)
4) **Operational efficiency improvement:** office automation

Implementation cont‘d

5) **Organizational efficiency improvement:** mergers of regional and audit offices,
   voluntary resignations
5) **Accounting and management information system (MIS) enhancement**

(2) Recapitalization (2000)

July 2000:

- New boards of directors and commissioners
- Management performance agreement with GOI up to Dec 2003
- July/Oct 2000: Injection of $3.0 billion recap bonds (to be repaid)

Results of restructuring as of Dec 2000:

- NPL ratio at a historic low
- Profits resumed
- All financial indicators meet regulatory requirements

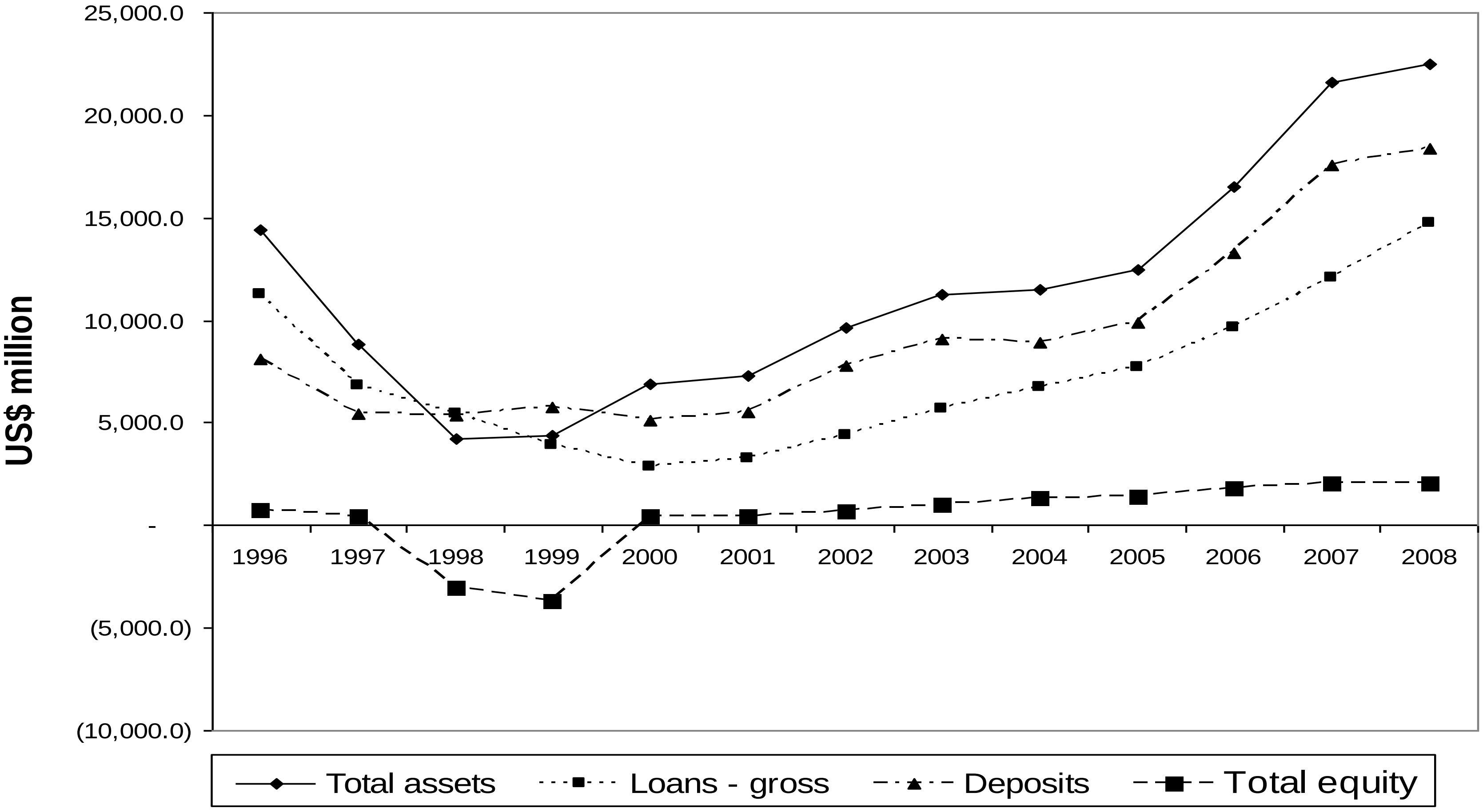
(3) Partial privatization (Nov 2003)

- Nov 2003, Initial Public Offering, listing on the Indonesian Stock Exchanges
- Share offerings oversubscribed 15 times
- Ownership, Nov 2003:
  - Government: 59.5%
  - Public: 40.5% (44.7% domestic, 55.3% foreign)
- Ownership, Dec 2008:
  - Government: 56.8%
  - Public: 43.2% (18.3 domestic, 81.7% foreign)

Restructuring in figures (in billion US$)

	1996	1998	2003	2008
Assets	14.4	4.3	11.2	22.5
Loans	11.2	5.4	5.6	14.7
GOI recap. bonds	-	-	**3.3**	**1.5**
Deposits	8.1	5.3	9.1	18.4
Equity	0.76	(3.1)	0.95	2.04
Net profit	0.10	(3.3)	0.31	0.54

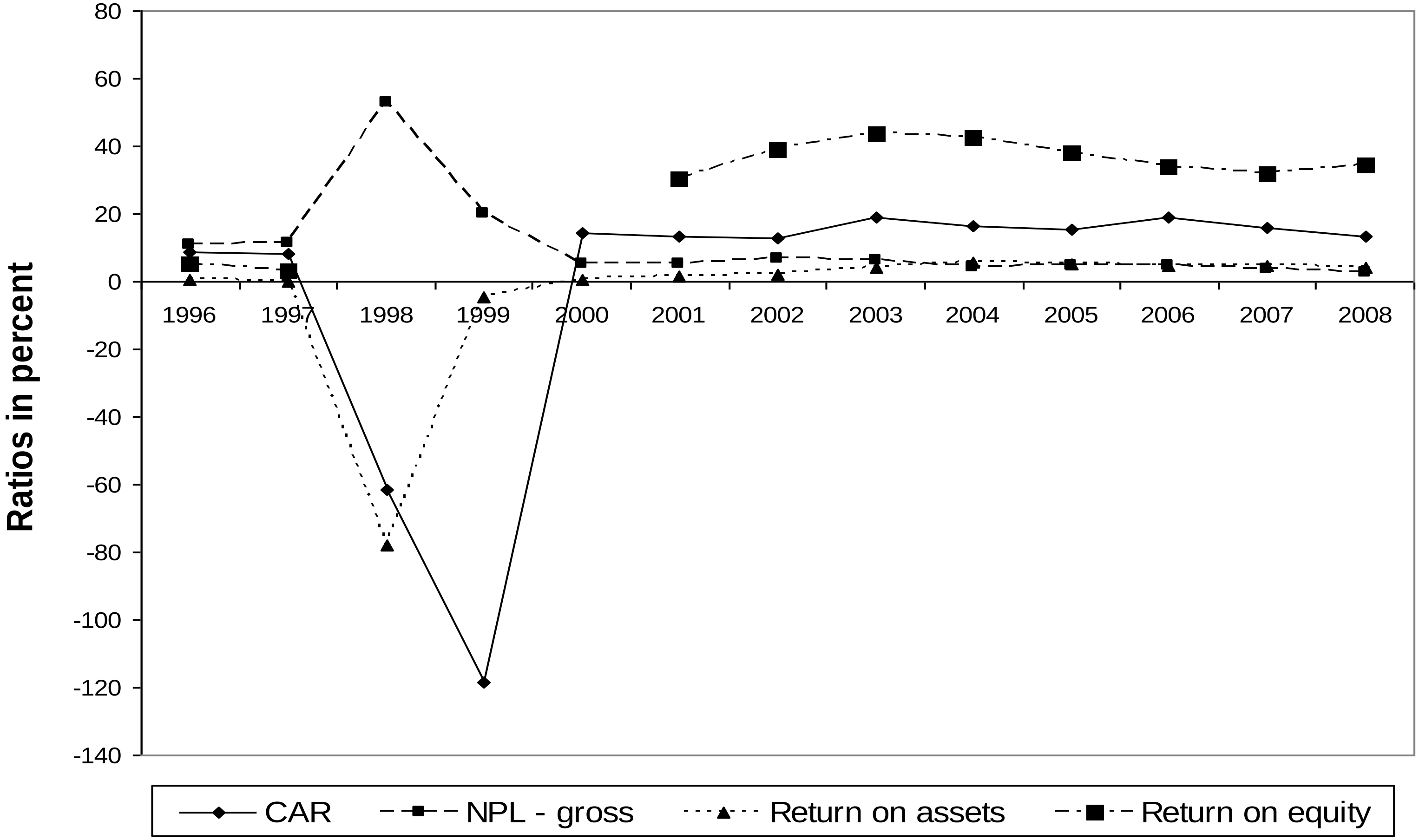
BRI: assets, loans, deposits, equity, 1996-2008 (in million US$)



Restructuring (performance ratios, in %)

	1996	1998	2003	2008
CAR	8.7	(61.5)	18.9	13.2
NPL	**10.6**	**53.0**	**6.0**	**2.8**
ROA	**0.7**	**(77.8)**	**4.0**	**4.2**
ROE	5.3	n.a.	43.4	34.5
NIM	n.a.	(3.2)	9.5	10.2

BRI: CAR, NPL, ROA and ROE, 1996-2008



BRI portfolio composition & NPL ratio, 2008

Segment	Loan size up to US$	Portfolio in %	NPL in %
Microbanking	**5,000***	**26.6**	**1.02**
Consumer	20,000	19.0	1.08
Small commercial	500,000	27.6	3.52
Medium commercial	5 million	7.7	6.33
Corporate	>5 million	19.1	4.53
Total		100.0	2.80
Total in billion US$		14.71	

Decisive factors in restructuring BRI

- Prudential regulation and effective supervision
- Commercial and social mandate:
  - Focus on MSMEs, commercial centers, remote areas
- New management team:
  - Fit and proper tests
  - Performance contract
- Commitment to good corporate governance:
  - Effective risk and compliance management
- Corporate culture:
  - Commitment to performance excellence
  - Open communication
  - Incentives for management, staff, owners, customers
- Partial privatization =>> market discipline

Lessons from BRI

External environment:

- Unprecedented systemic crisis
- Recognizing the options:
  closing, merging or reforming banks

Conducive policy and regulatory framework:

- Prior deregulation
- followed after the crisis by prudential re-regulation
- and effective supervision by an autonomous central bank, enforcing prudential standards
- **Political will:** Comprehensive transformation of BRI

Governance and ownership:

- Independent boards of directors and commissioners
  - Guarantee of no interference by government
  - Code of conduct
  - Feasibility of successful transformation by domestic management with commitment to excellence
- Partial privatization:
  - Effective market discipline
  - Commitment to profitability and accountability
  - Majority government ownership compatible with excellence

Strategy:

- Commercial and social mandate:
  - Profit optimization and social service
  - Focus on MSME (80% of portfolio)
- Inclusive outreach:
  - Rural and (peri-) urban sectors
  - Comprehensive area coverage
  - Micro-, consumer, small commercial, medium commercial, corporate
  - Cross-subsidization within the micro portfolio =>> lowering of average transaction costs, securing future markets

- Profit orientation:
  - Main focus on micro, small commercial and consumer lending as the most profitable market segments
  - Stringent risk management, esp. of the corporate agricultural portfolio (=>> value chain financing)
- Self-reliance:
  - Savings-based
- Full range of financial products and services

Institutional change:

Compatibility of

inclusive outreach, self-reliance and profitability

under domestic leadership,

given the political commitment to institutional autonomy and performance excellence

The political will is crucial!

www.adb.org/Documents/Books/Restructuring-Financial-Institutions/default.asp

جزاكم الله خيراً