# BRAC DONOR CONSORTIUM REVIEW

# SAVINGS AND CREDIT ACTIVITY

# RCP AND RDP

# JANUARY 1990 TO SEPTEMBER 1991

REVIEW PERFORMED BY

DOUG SALLOUM, CALMEADOW FOUNDATION

LORNA GRACE, CALMEADOW FOUNDATION

NOVEMBER 1991

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SUMMARY OF CONTENTS:

## EXECUTIVE SUMMARY

### PART A: Financial analysis - performance versus forecast:

In operational terms BRAC has been very successful during the first 21 months of RDP II and RCP. BRAC has reached or exceeded all of its major savings and credit operational targets except for disbursements. The one concern with respect to these achievements is in the area of loans outstanding - the quality of these loans is not all that it should be.

In terms of financial forecasts, RDP II overall, as of September 30, 1991, was underspent relative to the budget approved last year by the donors but was overspent in its savings and credit activities. The overrun in the savings and credit activity relates almost entirely to an increase in Revolving Loan Fund requirements. Loan fund requirements were Tk 32 million (37%) over forecast due primarily to Deep Tube Well loans made during the last quarter of 1990 and in the first quarter of 1991.

Interest income on loans was under forecast by 9%. This variance can only be explained by inadequate loan repayment performance.

Other RDP budget deviations (operating expenses over by 5% , capital expenditures under by 6%) are not considered significant.

RCP has reported profit in excess of target (13% over forecast) due primarily to the fact that operating costs are still less than expected (16% under budget). Interest income in RCP as in RDP however, is not sufficient - only 14.6% on the average loans outstanding - not the 16% return of a well performing portfolio. This lower than expected return on the loans is the most serious threat to the viability of RCP in the long run.

The reviewers recommend that BRAC revise its RDP II Revolving Loan Fund forecast to provide for its plans to install Deep Tube Wells. In addition they strongly recommend that BRAC address the repayment performance of its loan portfolio in a systematic way.

Last year's review stated that BRAC's loan classification system seriously masks repayment problems. This is still true. There are clearly a significant number of loans which are classified as current which are not paying properly. Some of these are collective loans such as power tillers and Deep Tube Wells. With these collective loans there does not seem to be a strong sense of responsibility or ownership on the part of the members for the asset involved or for the debts associated with them.

Poorly performing current loans in general are not receiving proper attention from management or operating staff because these loans are still assumed to be the better quality loans in the portfolio.

PART B: Expectations for RDP II and RCP:

It appears that BRAC will have sufficient funds from the donors' original commitments to complete RDP II even with the increased requirement for funds for Deep Tube Well loans. This conclusion is based on what the reviewers consider reasonable exchange rate expectations.

Following is a summary of the revised requirements and the latest estimates of funds available from the donors:

| | 1990 | 1991 | 1992 | 1993 | Total |
|---|---|---|---|---|---|
| | | | (Tk million) | | |
| Donor funds available: | | | | | |
| **Base case forecast** | **438** | **670** | **538** | **263** | **1909** |
| +10% | 438 | 670 | 582 | 288 | 1976 |
| - 10% | 438 | 670 | 495 | 238 | 1841 |
| Estimated requirements: | | | (Tk million) | | |
| RDP | 319 | 310 | 286 | 000 | 915 |
| RCP | 169 | 318 | 287 | 202 | 976 |
| Total required | 488 | 628 | 573 | 202 | 1891 |

The funding requirements for RCP have not changed. The model for RCP has been revised, however based on actual information from the first 21 months of operation. BRAC and the reviewers believe that RCP will continue to be profitable and that it can absorb a number of downside scenarios because of the strong capitalization provided to RCP by the donors (the BRAC loan).

PART C: New credit policies:

BRAC initiated a number of new credit policies in June 1991. The most contentious of the policy changes is the one concerning new loan classifications.

> **All loans will be classified as of one of three types; general, collective or housing. General loans must be repaid within one year. The repayment term for the other categories of loans will remain as before, not exceeding 5 years.** Medium term individual loans - loans to purchase a cow or a rickshaw, for example - will now have to be repaid in one year - before they would have had a two or three year term.

BRAC has stopped making medium term loans available to individuals because they feel that the repayment terms were too easy - that as a consequence the borrowers did not take these obligations seriously. By increasing the instalment amounts for asset loans BRAC feels the borrowers will have to make a sacrifice in order to obtain the desired asset. This BRAC feels will improve discipline and repayment performance.

A concern with respect to this policy is the possibility that many of BRAC's members will no longer be able to borrow to purchase larger assets. If BRAC solves the problem of risky asset loans by eliminating them then the borrowers will be the losers.

It is also possible that the larger individual loans will be more risky with a one year term than they were with a two or three year repayment period.

The reviewers recommend that BRAC monitor these short term asset loans carefully. Until evidence proves the contrary these one year asset loans should be considered risky.

With respect to the other policy changes there appears to be some inconsistency in BRAC's approach. BRAC has at the same time made the credit process more flexible and more constrained. The overall vision of the process seems to be unclear with respect to how much discretion the members and staff should have and how much should be defined by Head Office. The new limits imposed with respect to household and member debt appear to be rather arbitrary. In addition they can't account for regional diversity and they will have to be regularly adjusted for inflation or else will restrict borrowing in the future.

The reviewers recommend that for the time being BRAC quit changing policies that directly affect the borrowers' behaviour. It is now time for BRAC to consolidate the changes made and more importantly to concentrate on its own behaviour and in particular its monitoring and follow up of delinquent borrowers. At this point in BRAC's development methodological changes are unlikely to have as much impact on loan quality as an improved monitoring system.

## PART D The Break even structure of BRAC:

On an operating basis BRAC's RCP is breaking even now. BRAC's operating costs in terms of loans outstanding is 14% p.a. An RCP office requires less than 5000 borrowers to break even on an operating basis - each borrower having an average loan of approximately Tk 2750. These break even conditions are now being met in the average RCP office.

On a more rigorous basis, call it a market basis, RCP is not breaking even now nor is it ever likely to. This is not an issue of having or not having the right number of borrowers. It is an issue of interest rates. BRAC would have to charge between 20% and 30%

p.a. in order to break even on a market basis. The fact that RCP's operating costs are 14% p.a. and that borrowers pay only 16% on their loans means that RCP's cost of funds must be no more than 2% in order to break even. Whereas 2% money does exist it can not be called market priced funding.

RCP will still be able to break even on a subsidized basis because it has received funds at 0% from the donors. These free funds accomplish two things for BRAC - first they lower RCP's financing costs to about 3% p.a., and secondly they allow RCP to earn extra income from investments.

PART E: Monitoring:

The reviewers' primary concern with respect to monitoring was the control and improvement of loan quality. BRAC is not yet to the point of having a monitoring system which can identify loans that are not performing before they reach term. Two positive initiatives of the last year make the attainment of such a system more feasible than it was at this time last year;

- a consultant with bank information system experience has been contracted to advise BRAC on the design of the necessary monitoring system from the bottom up.

- BRAC has begun to collect the basic borrower repayment data so that in the future staff will be able to analyze loan performance correctly.

The most significant feature of the new process of data collection is the fact that at base it deals with each individual borrower. This was a recommendation of the previous review team. BRAC will soon be able to produce a statement on each borrower. It will be some time however before any useful data comes out of the process because the computer systems still have to be designed to handle the data and the reports that the data base will provide are still to be determined.

It is in this last area, report design, with a particular emphasis on monitoring of the loan portfolio quality that the reviewers' recommendations are concentrated.

In addition the reviewers recommend that BRAC's RCP staff gain some analytical experience both in loan quality evaluation and in the interpretation of financial results.

PART F: Long term sustainability issues:

The reviewers feel that BRAC has demonstrated its operational and general management ability in the development of the Branch Office system of RCP. This is the first pre-requisite to long term viability. The reviewers also believe that the strong capitalization (once completed from donors' grants) will protect the operation from short term difficulties if they arise while BRAC readjusts its operation if necessary to avoid any major changes in the basic business of lending to the rural poor of Bangladesh. We believe that BRAC will address the issue of loan portfolio quality in its operation. There remain a number of long term issues still be dealt with however;

- The donors have a right and an obligation now to expect BRAC to have a definite policy for the structure of RCP after 1993, in particular with respect to the protection of the savers funds and the use of the BRAC Loan.

- RCP's profit margin is very slim if it only charges 16% on its loans. It would not take much in the way of cost increases to significantly narrow that margin further. BRAC's only defense in the long term would be to charge more for its loans or to secure more low cost funding.

- BRAC should diversify RCP's sources of funding from the two now available - donors and members.

The issues with respect to long term viability facing BRAC are basically issues of financial structure and philosophy.

There appears to be an opportunity in the current political and economic environment to create a private sector bank based on RCP. This is an opportunity which may not always be available. A regulated private sector commercial bank would go a long way towards answering the donor concerns and towards diversifying funding sources. The reviewers' recommendation is that BRAC proceed to create a private sector bank and investigate immediately the various issues outlined in Part F of this report with respect to incorporation, equity, other sources of debt, interest rates, etc.

In conclusion the reviewers feel that the concerns raised in this summary and in the complete report are ones which if responded to by BRAC will result in BRAC becoming one of the most professional and transparent rural micro-credit programs in the world. BRAC is already one of the most successful in operational and qualitative terms but with more attention to loan quality and a clear financial structure for RCP it can be the best in a rigorous financial sense as well. There are few other micro-credit programs that pass the tests that the reviewers are expecting BRAC to. It is only because it is so good that the reviewers want BRAC to aim to be even better.

## PART A: BRAC'S SAVINGS AND CREDIT PERFORMANCE AT 21 MONTHS

### A.1 General:

In the preparation of this portion of the report the reviewers compared the actual performance of BRAC's RDP and RCP savings and credit activity over the last 21 months with BRAC's targets and forecasts for the same activities.

In addition to a review of the operating performance of RDP and RCP the financial results of these two programs were also studied. BRAC's quarterly financial reports as of September 31, 1991 were compared with funding requirements budgeted for RDP II and with the forecast balance sheet and income statement of RCP.

BRAC was asked to produce the financial budgets to September 1991 by the reviewer. The fact that quarterly budgets are not prepared as a matter of course is disappointing. Comparing actual quarterly expenses to total annual budgets as BRAC does on its regular reports to the donors does not tell anyone, least of all BRAC, how the projects are progressing.

Recommendation:

> **BRAC should as a matter of course prepare quarterly budgets and present these as part of its quarterly activity reports to the donors.**

This first section of the reviewer's report is highly analytical. Some readers may wish to skim the analytical section. It is provided primarily for those interested in the quantitative rationale for the conclusions and recommendations and doesn't make for brilliant reading.

Following this section of analysis is one of comments based on the analysis (A.3) and then discussion of the two major findings of the analysis - the larger than expected requirement for loan funds within RDP (A.4) and the apparent deterioration in the quality of BRAC's loan portfolio (A.5).

### A.2 Analysis - Operational and financial performance:

Each of the tables and graphs referred to in this and following sections of the report are contained in Appendix 1. in the order discussed.

**Table 1:**

> Before reviewing the financial performance of the savings and credit activities within RDP II and RCP it is very important that the donors first stop to reflect on what BRAC has

accomplished in the first 21 months of these two projects. Table 1. is a summary of BRAC's achievements to date in RDP and RCP.

BRAC has managed to meet or exceed all of its 21 month operating objectives except disbursements. These are major accomplishments considering the scale and complexity of the work involved. Whatever else this report may conclude, no one can take from BRAC the fact that they have doubled membership from 270,000 to 540,000 in the period and that the number of villages where BRAC is now providing services to the poor has increased from 2667 to 4537. The positive impact that these two programs are now having on the lives of the approximately 2.5 million Bangladeshi rural poor directly affected is a testimony to BRAC's ability and motivation as well as to the donors' commitment and funding.

The financial aspects of what BRAC has accomplished in the savings and credit activities within RDP and RCP are summarized in Tables 2 - 6 in the attached Appendix 1. Table 2 deals with funding for RCP and RDP II - amounts originally expected from the donors, amounts received to date, budgeted amounts and amounts actually required by BRAC. Tables 3 and 4 deal with RDP and Tables 5 and 6 summarize the financial aspects of RCP.

**Table 2:**

The first part of Table 2 shows the original commitment made by the donors to fund RDP II and RCP (in Taka at the exchange rates applicable at the time). For example it was originally estimated that the donors would have provided BRAC with Tk 780 million by September 1991. In fact they have provided Tk 919 million, 18% more than initially forecast. The donors have not provided more than promised in terms of their own currencies nor have they funded more rapidly than forecast. Rather the increase in funds received by BRAC can be explained almost completely due to a general devaluation in the Taka relative to the donors' currencies.

It is helpful to use the US$ to illustrate how currencies have moved. The dollar has strengthened by almost 22% since the proposals were agreed to (from Tk 31.7 to Tk 38.5 per dollar). Similar devaluations of the Taka with respect to the other currencies have also occurred with some strengthening more or less than the dollar.

The Tk 919 million received is more than BRAC said it would need by September 1991 (BRAC budgeted to require Tk 880 million). On the other hand BRAC has used more than it said it would (Tk 901 million - an expense overrun of Tk 21 million or 2% to date).

Closer examination reveals that RDP II has underspent its budget and most of the excess funds received from the donors went to RCP as investments. Tk 18 million has been kept within RDP for use in the near future.

**Tables 3 and 4:**

Table 3 begins to provide more detail with respect to where BRAC was over or under on its funding requirements within RDP. The scope of this review only covers items A.3, A.4, A.5 and C (which between them represent 43% of RDP's expense budget and all of the income budget). Other reviewers will have to determine what is happening to the items which are significantly off forecast such as item A.6.2 - TARC's, A.6.3 - REP and B.2 - Development of Rural Managers. But it is significant to note that the major deviations from budget outside of savings and credit activities are ones of underspending. If these other activities are not actually under budget but rather behind schedule they will be needing the excess funds that have been transferred to RCP for investment. The Tk 18 million reported by BRAC as being held in cash by RDP will not be enough to fund the work which has not been completed - the TARC's, REP, etc.

The budget versus actual performance of the specific items within the RDP II budget relating to savings and credit are summarized following.

**A.3 Branch and Regional Office Operating Expenses - 5% over budget:** A review of these over-expenditures reveals no major issues of concern. The overruns relate to charges due to other RDP programs, an under budgeting of travel expenses and the costs resulting from the early high turnover of female PO's. Two of these causes are non-recurring and the third (travel budget overruns) will not be significant by the end of RDP II.

Most BRAC offices house staff in excess of those budgeted to savings and credit activities - NFPE and other sectoral PO's for example. The costs of housing and feeding these staff should be paid from their respective budgets not from the operating costs of the offices. Approximately TK 2.5 million of the Tk 4.5 million excess is this type of cost which will be recovered by the RDP office operating budget and re-allocated correctly to other budgets.

BRAC believes that the cost of hiring and losing a large portion of the female PO's is behind them now. This remains to be seen but at least BRAC is still trying to increase the number of female PO's despite the cost involved.

BRAC mis-budgeted its Area Office travel costs and will have to adjust its other operations to compensate. In any case this error will be corrected in the RDP III budget and in the meantime will probably not produce an over run on this item of much more than 2% - which is not material in terms of the whole budget of RDP II.

**A.4 Branch, Regional office and Head Office capital investment - 6% under budget:** The under-expenditure here relates to activity which is proceeding rather slower than hoped. Nevertheless BRAC has established, as shown on Table 1., all of the Area Offices that it had hoped to by now. Some are very recent - 10 since June, for example. This slower than hoped for start up of new offices has in the past been offset by a more rapid than expected growth in VO's and membership. It is expected that the new offices will continue to reach levels of operation at least as high as those forecast despite the somewhat slower start.

The Tk 18 million that BRAC is holding in cash in RDP which should be more than enough to fund the completion of the scheduled capital investment activities.

**A.5 Loan Revolving Fund - 20% over budget:** BRAC has required Tk 17.5 million more than it forecast to fund RDP's loans. This item would have been Tk 32 million (or 37%) over budget but for an extra Tk 15 million in funds received from the Ford Foundation. (By way of a check, Tk 32 million is the amount by which the loan portfolio in RDP exceeds target (see table 1.)).

The fact that funds required for loans in RDP were in excess of forecast is a more important issue than the other budget items previously discussed. This is because the explanations for this overrun have serious implications for the future performance of RCP and RDP.

There are only two basic reasons why BRAC would end up with a loan portfolio higher than forecast - either they disbursed more than anticipated or else they are receiving less back that planned. The first explanation is out since as mentioned already disbursements are below forecast. Therefore we can conclude that less principal is being repaid than expected.

There are also only two ways to explain the fact that principal is being repaid more slowly than forecast - either loans are being made for a longer term than targeted or else the borrowers are not repaying as they should. The first trend had been observed at the time of last year's review and has continued strongly since.

The following summarizes how the shift in term has developed.

| Term structure: | Short | Medium | Long |
|---|---|---|---|
| Budgeted | 59% | 37% | 3% |
| Total RDP to June/91 | 72% | 16% | 12% |
| Total RCP to June/91 | 63% | 26% | 11% |

This trend is even more striking if the 6 month period from January 1991 to June 1991 is summarized.

| Term structure: | Short | Medium | Long |
|---|---|---|---|
| RDP 6 month disbursements | 69% | 13% | 17% |
| RCP 6 month disbursements | 27% | 23% | 26% |

It is clear that long term loans have gained prominence at the expense of medium term ones. This is largely due to the number of deep tube well loans made in the last two years. This shift in term is sufficient to explain a major portion of the increase in the loans outstanding and the need for more funds for loans.

At this point in the analysis it was not clear whether an element of late or poor repayment was also to blame for a portion of the larger than forecast loans outstanding figure. An analysis of the interest earned by RDP provided a damning clue to this effect.

**C. Net Interest Income - 9% under budget:** In that the value of loans outstanding in RDP has held at or above forecast since January 1990 (see Table 4 - items showing outstanding loans at various times and Graph 1.) it would be logical to expect that income from these loans would also be above forecast. The fact that it is below forecast implies strongly that something is wrong with repayments.

The interest income for both RDP and RCP are less than forecast in absolute terms but more critically, also as a percent of average loans outstanding. This means that although BRAC is charging the borrowers 16% on its loans, due to poor repayment BRAC is receiving something less.

RDP's gross loan portfolio since January 1, 1990 has developed as shown in Graph 1, a relatively straight line progression. The average net loans outstanding for the 9 month period has been calculated at Tk 194 million. At the 16% p.a. interest charged the borrowers BRAC should have earned Tk 23.2 million from January to September but in fact earned Tk 21.6 million in interest income for the same period. This represents a rate of return on the loans of only 14.9% p.a., not the 16% p.a. forecast.

net loans in RDP:

| | |
|---|---|
| at January 1, 1991 | Tk 146 million |
| at September 30, 1991 | Tk 242 million |

Since the borrowers pay interest and principal together in their regular instalments, if interest received is low then it is reasonable to conclude that principal repayment is also less than expected. This was our suspicion earlier and at this point we began to become concerned.

**Tables 5 and 6:**

Table 5 shows the budget vs. actual balance sheet for RCP and Table 6 the comparative income statement.

The major balance sheet deviations are the following:

**Investments - 27% over budget:** Investments is higher than expected because sources of funds (deposits and the BRAC loan) are higher than forecast and the uses (loans and fixed assets) are lower.

**Net Loans - 3% under budget:** Although net loans are lower at September 30 than forecast last year's performance indicates that by the end of the year loans outstanding will be above budget. The growth in the loan portfolio at the end of last year was partly seasonal and partly due to the Deep Tube Well loans made between November and February. Graph 2 shows how the RCP loan portfolio has more or less matched forecast to date.

It is interesting to remember that at this time last year there was concern as to whether RCP would reach its forecast loan portfolio values. At that time there were only 10 Area Offices in RCP and these had started out with lower than optimal levels of loans outstanding. Graph 3. shows that by the end of the year 1990 these offices had in fact not only reached their own revised lower target for loan levels but had attained the general forecast as well. It is unlikely that the issue of adequate loan portfolio values will be a major concern either in RCP or RDP for the foreseeable future.

**Fixed assets - 15% under budget:** These assets are below forecast primarily because of the lower than forecast needs at Head Office level. Head Office will have to start spending for facilities shortly and this shortfall will be eliminated. There is more than enough funding for this capital expansion when it occurs within the investment account.

**Members savings and group tax - 13% over budget:** Members' savings exceed budget because BRAC includes the 5% forced savings component plus the required Tk 2/week in this category. Only Tk 2.4/week was budgeted. Group tax amounts are low because to this point disbursements are low and group savings are 4% of disbursements. Much of this shortfall in group savings will be picked up later in the year but in any case total deposits will still be over budget at year end.

**BRAC loan - 9% over budget:** The loan from BRAC is in fact the donors' funds passed through BRAC to RCP at no cost. The loan is Tk 36 million above forecast because BRAC has received Tk 55 million more than RDP could use. This excess except for Tk 18 million has been passed on to RCP. It could be that RDP will need some of the excess back when the programs in RDP that appear to be behind schedule catch up.

The major features of the income statement that bear mentioning are the following:

**Loan interest income - 9% under budget:** BRAC earned only 14.6% p.a. on its average net loans outstanding in RCP for the first 9 months of 1991. Last year the same calculation yielded slightly in excess of the 16% p.a. We can only conclude that there has been a worsening of interest payment performance since September of last year.

**Interest on deposits - 27% over budget:** This cost is higher than forecast because the level of deposits was higher, both at the beginning of the year and at September 30. As interest income declines from 16% p.a. to something lower due to quality problems and the cost of funds increases as a result of higher levels of deposits RCP's net interest income will be squeezed. The issue of interest rate policy is discussed in Part F. of this report.

**Operating expenses - 16% under budget:** As was the case last year at this time operating costs are still under budget. The Head Office operating costs are still lower than forecast and depreciation expenses are also low relating primarily to delayed staffing and capital expenditure at the Head Office level.

Of all of the RCP budget vs. actual comparisons the lower than forecast interest income issue, because of the quality implications, involved is the most serious.

A.3 General comments from the analysis:

BRAC has received Tk 55 million more from the donors than required to date for RDP II and RCP due to exchange rate gains. BRAC has passed Tk 37 million of this on to RCP for use as investment funds and kept Tk 18 million in RDP in cash.

RDP as a whole is under-spent relative to budget. Other reviewers will have to determine how well BRAC has been able to accomplish the objectives of the other activities within RDP II but the savings and credit activities have met all the targeted objectives except for disbursements. The savings and credit activities are over budget, however primarily because of a larger than anticipated requirement for funds for loans. In that some activities in RDP are behind schedule RCP may have to return a portion of the excess received from RDP.

There have been a number of deviations from forecast within the savings and credit activities of RDP but the over run on the Revolving Loan Fund and the below target interest income on the loans outstanding are the only issues of concern.

RCP is performing well. Profits are over forecast due to the fact that operating expenses continue under budget. RCP is not earning sufficient income on its loans however and net interest income is being squeezed as the cost of savings rises.

A.4 Loan fund requirements:

Based on the pattern of the past year and the results to date RDP II will need more funds for its loan portfolio than previously forecasted. RDP's loan portfolio is now Tk 32 million over forecast and BRAC estimates that Tk 60 million more than forecast will be required from now until the end of 1992. The total loan fund overrun by the end of RDP II is therefore likely to be in the range of Tk 90 million. Graph 4 illustrates this revised view of RDP's future loans outstanding situation. This revised forecast for the growth of RDP's loan portfolio has been included in the latest RDP II budget and compared to the current estimate of the funding available from the donors. This exercise is described in Part B of this report.

A.5 Loan portfolio quality in RDP and RCP:

The major problem in trying to describe what is going on in BRAC's lending is the fact that there is still not a useful way to directly measure repayment performance. BRAC continues to use current, late, overdue and not yet transferred as the categories for rating the portfolio quality. Our concern now, as in the past, is the fact that this grouping ignores the non-performing loans which are in the current category. The reviewers are aware, for example, that there are a number of loans for Deep Tube Wells which are classified as current which are not paying.

As stated earlier we have been lead by a series of deductions to conclude that BRAC's loan portfolio quality has, at best, deteriorated since the last review. The interest rate test described in the analysis section does not tell us where the problems exist - it merely says that the borrowers are not paying interest as they should.

It is not the interest rate test alone which lead us to conclude that repayments are not as good as expected. In addition to the recovery rate which is almost useless as a measure of quality BRAC has introduced another indicator of loan quality that seems to support our expression of concern. As of January 1990 BRAC began forecasting the monthly realizations (instalments due) for each office and collecting the actual results as a comparison. Graphs 5 and 6. show how these two numbers have varied since the beginning of the year.

Average Realization Rate vs Target
(9 months, 1991)

| | |
|---|---|
| RCP | 77% |
| RDP | 87% |
| Total | 82% |

Whereas there is still some debate possible concerning the definitions used by BRAC in the calculation of the realization targets there can be no argument with the statement that however realizations are defined the borrowers are behind in paying them.

The few observations that can be made at this time concerning the loan quality based on BRAC's reporting system are included in the Appendix 2. prior to Tables 8 to 11.

What else can be said at this time other than loan repayment is not as good as it should be? We lack the statistics to be more precise. The reasons for the poor repayment are undoubtedly varied but are more a matter of opinion than analysis.
The reviewers' opinions, to be added to BRAC's own views and the impressions of other informed commentators on these issues, are offered following:

- the schemes:

  There is a tremendous interest on the part of BRAC in making Deep Tube Well loans. At present BRAC believes that 2/3 of the wells in operation are profitable. (Profitable is still a rather subjective term). There are now 309 DTW's in operation and debt associated with them is in the range of Tk 50 million or approximately 10% of the loans outstanding.

  BRAC proposes to make another Tk 200 million in DTW loans (operating and capital) before the end of 1992 and an additional Tk 90 million worth in 1993. This is clearly BRAC's major strategic thrust for loan schemes over the next few years.

- the borrowers:

  There does not appear to a strong sense of responsibility on the part of the borrowers for the collective loans or the assets financed by them. It appears as if these loans were ones which BRAC wanted to make and which as a consequence the borrowers don't feel obligated to repay. Collective schemes which are not working do not inspire borrowers to repay.

  The small groups do not seem to be very important to the members. Some groups do not appear to be very strong. The small group leaders do not actively collect the instalments due and don't seem to take a real leadership role.

  Peer pressure can work against BRAC if the members see some people not paying and suffering no consequences as a result. Non-payment can snowball in such a situation.

- the lending staff:

  The PO's are aware of who is not paying, in particular on the collective loans, but do not seem to know what to do about it. They are waiting for Head Office instruction but Head Office may not realize how serious the situation is because of the loan classification system. Many of the non-performing loans are still classified as current.

  The PO's do not seem to enforce any consequences with delinquent borrowers. In theory BRAC should suspend all lending to the group members if one is in default. This doesn't seem to actually happen. BRAC doesn't ever take the borrowers' savings or the group funds to repay loans. It appears that a borrower loses nothing by not paying. This is hardly an incentive for the good borrowers.

It could be that there is too much emphasis on disbursements and not enough on recovery. BRAC may need a clear incentive and penalty policy to encourage Area Office and Branch Office staff to increase loans outstanding and decrease late and delinquent payments.

- BRAC management:

  BRAC's emphasis at the senior levels seems to be expansion and not quality of lending. BRAC senior staff should focus more attention on internal policies related to improving and controlling loan quality.

  With respect to the DTW loans there does not appear to be a clear connection between the profitability of the well and the repayment of the loans. BRAC monitors the first but not the second. Profits apparently earned by the good Tube Wells are not automatically applied to the debt outstanding. There should be an improved co-ordination between the monitoring of the economics of the schemes and the loan repayment performance associated with them.

Whereas it is not clear what the cause of the payment problems are what is clear is that BRAC must begin to get control of this issue. The situation is far from desparate and there is no need for the donors to panic but BRAC must show some serious progress in this area shortly.

The reviewers' recommendation with respect to how to go about getting on top of this issue are contained in Part E. the recommendations are in Part E because as we have said before we believe that the secret of a good repayment record is first good monitoring.

PART B THE PROSPECTS FOR RDP AND RCP

B.1 Donor funds available:

| | 1990 | 1991 | 1992 (Tk million) | 1993 | TOTAL |
|---|---|---|---|---|---|
| AKF/CIDA | 0 | 91.6 | 123 | 123 | 337.6 |
| DANIDA | 78.8 | 37.8 | 43 | 30 | 189.6 |
| EZE | 25.2 | 50.3 | 38 | 0 | 113.5 |
| FF | 3.6 | 3.6 | 4 | 4 | 14.8 |
| NORAD | 30.0 | 37.8 | 36 | 33 | 136.6 |
| NOVIB | 141.0 | 163.8 | 148 | 25 | 477.8 |
| ODA | 126.8 | 190.3 | 108 | 16 | 440.7 |
| SIDA | 32.5 | 94.3 | 39 | 33 | 198.3 |
| TOTALS | 437.9 | 669.5 | 539 | 263 | 1908.9 |
| +10% | " | " | 582 | 288 | 1976 |
| -10% | " | " | 495 | 238 | 1841 |

As the above table summarizes the base case forecast for donor funds is Tk 1909 million by the end of 1993. The base case used the exchange rates currently applicable to the various donor currencies. A 10% general strengthening or weakening of the donor currencies relative to the Taka would result in a variation of the funds available of + or - about Tk 70 million.

The same process of using the then current exchange rates applied last year underestimated the amount of Taka funding available to BRAC as the Taka fell generally relative to the donors' currencies after November 1990. There is no particular reason to expect the Taka to strengthen over the next year or two. The base forecast is considered a conservative one for the next two years.

B.2 BRAC's requirements for funds in RDP II:

BRAC's revised funding requirements including an anticipated increase in loan funds required due to Deep Tube Well loans and an observed trend to a larger number of borrowers in each Area Office are shown in the Appendix as Budget 1. The only change from the budget approved last year is the increase in item VIII - Loan Fund Requirement - by Tk 90 million, Tk 30 million in 1991 and Tk 60 million in 1992.

| Estimated requirements: | 1990 | 1991 | 1992 | 1993 | Total |
|---|---|---|---|---|---|
| RDP | 319 | 310 | 286 | - | 915 |
| RCP | 169 | 318 | 287 | 202 | 976 |
| total required | 488 | 628 | 573 | 202 | 1891 |

BRAC requested approval for an increase in the total budget for RDP II last year from Tk 578 to Tk 828 million. That increase was an opportunistic one which allowed BRAC to revert to its original plan with respect to the planned opening of new Area Offices. The request was prompted by the observed increase in Taka funding available.

This year BRAC is again requesting approval for a revision in its RDP II budget - and again believes that the increase can be funded from anticipated gains in the exchange rate.

There are two issues with respect to the forecasts prepared by BRAC for the last year of RDP II:

1. This review did not consider what has been happening in the areas of RDP II other than savings and credit. The mid term review mission will have to determine whether the other activities are on target or not and whether BRAC will be able to complete them with the now forecast funding available.

2. BRAC has not been very accurate so far at predicting the amount of funding required for loans. This is a very difficult exercise and whereas BRAC is becoming more experienced at the process we must consider what would happen of this most recent forecast is significantly off.

If the requirement for loan funds turns out to be less than forecast BRAC would have a surplus at the end of RDP II (assuming the other activities remain within budget). This is not considered too serious and the disposition of the funds if any could be discussed with the funders of RDP III.

If RDP II requires more funds in 1992 than forecast BRAC has a number of options:

- it could slow the lending activity down either before or after the end of RDP II,

- it could borrow funds from banks or from RCP to complete the disbursements in RDP II and then include the shortfall in its request for funds from the donors in RDP III, or

- it could temporarily use members' funds for loans within RDP.

The donors should be prepared to accept all of these options except the last one should BRAC have to come up with more funds for loans. The costs of any overrun should be born by BRAC and not the donors in this case.

stay within the forecast requirements for funds and that if BRAC can't it has the capability to manage its options. The loan fund requirements should be monitored carefully however, in particular prior to the end of 1992 as a new round of DTW loans are planned at that time.

BRAC's forecasts with respect to the remaining funding requirements for the savings and credit activities of RDP II and RCP are considered reasonable as is the assumption that the exchange rate will not strengthen generally relative to the donors currencies.

| | 1990 | 1991 | 1992 | 1993 | Total |
|---|---|---|---|---|---|
| Donor funds available: | | | | | |
| base case forecast | 438 | 670 | 538 | 263 | 1909 |
| Estimated requirements: | | | | | |
| RDP | 319 | 310 | 286 | 000 | 915 |
| RCP | 169 | 318 | 287 | 202 | 976 |
| total required | 488 | 628 | 573 | 202 | 1891 |

Recommendation:

**The donors should accept BRAC's revised RDP II budget indicating an increased requirement for funds of Tk 90 million over the budget approved in 1990.**

### B.3 The prospects for RCP:

A number of changes have been made in the model for RCP. In general the revisions were made to accommodate trends which after 21 months of experience have been seen to differ significantly from estimates previously made. Other changes were made to correct errors in the model only recently discovered.

- the purchase price of fixed assets has been increased for those branches to be purchased after 1992 from RDP - from Tk 0.95 million/branch to Tk 1.54 million/branch.

- the number of borrowers per branch (or Area Office) has been increased as follows:

year 1: from 600 to 700
year 2: from 1400 to 1800
year 3: from 2400 to 3000
year 4: from 3400 to 4000
year 5: from 4000 to 5000
year 6: from 4000 to 5500

- savings has been changed from Tk 2.4/person/week to Tk 2/person/week (from 80% of the members) plus a 5% forced savings component

- the schedule for the purchase of RDP's Area Offices has ben revised as follows:

1995: from 10 to 20
1996: from 10 to 20
1997: same
1998: from 25 to 30
1999: from 30 to 35
2000: from 30 to 40
2001: from 30 to 40
2002: from 50 to 0

The total purchased is still 300 Area Offices from 1990 to 2002.

- The requirement for Deep Tube Well loans in 1991 and 1992 has been incorporated into the revised model as well.

With the above changes incorporated BRAC has prepared what is now the new base case for RCP, attached as Budget 2. in Appendix 1.

A number of sensitivity cases were run on the new base case:

1. loan interest sensitivity:

The model was run using loan interest of 14%, 18% and 20%. The 14% case is relevant because this shows what will happen to RCP unless BRAC can improve its return on loans outstanding from what it now appears to be. At 14% RCP begins losing money in 1997 and never again becomes profitable. Obviously the 18% and 20% scenarios are more positive than the base case. The 20% scenario is useful because Grameen has just revised its loan rate to 20% and BRAC should seriously consider following this lead.

2. deposit volume sensitivity:

The impact of a 20% increase and a 20% decrease in total savings was tested. The model indicates that more savings are better than fewer. The less savings that RCP has the less investments there are. Since investments pay more than the cost of deposits this is not surprising.

3. loans outstanding sensitivity:

If loans outstanding for whatever reason decrease by 20% from forecast RCP will incur losses for the period 2000 to 2008 but then recover.

In all of the negative sensitivity cases except the 14% loan interest case RCP was able to continue to operate, in other words after a period of losses profitability was re-established. The conclusions from this exercise are the following:

- due to the strong capitalization and the underlying economics of RCP the program should be able to withstand a number of possible long term deviations from forecast performance,

- the most serious threat to the long term viability of RCP is a decline in interest rates on loans.

Recommendation:

**That the donors accept the revised base case for RCP and that this case be used, unless further revised, to measure the performance of RCP until the period of donor funding is completed.**

## PART C BRAC'S REVISED CREDIT POLICIES

### C.1 General:

A number of changes have been introduced in BRAC's credit policies since the review in November 1990. These new changes were officially in place by June of this year but many had begun to be instituted in an unofficial way starting in April of 1991.

Each of the credit policy changes implemented by BRAC was introduced to correct a problem in the credit operation - a problem identified either by BRAC or by outside reviewers. Before one is inclined to provide cautionary or negative comments with respect to these changes it is important to understand BRAC's reasoning in each case.

### C.2 The problems observed and BRAC's reaction:

1. **Classification of loans:**

**All loans will be classified as of one of three types; general, collective or housing. General loans must be repaid within one year. The repayment term for the other categories of loans will remain as before, not exceeding 5 years.** Medium term individual loans - loans to purchase a cow or a rickshaw, for example - will now have to be repaid in one year - before they would have had a two or three year term.

BRAC has determined that there is a problem with their medium term loans. Borrowers were found to be repaying according to schedule for the first year of the loan but thereafter their payments would become irregular. Since most of these loans initially demonstrated good repayment performance this problem was assessed to be a lack of willingness rather than a lack of ability to pay on the part of the borrower - in other words an attitude problem and not an economic one. The extended payment schedule previously available was considered too easy and as a result was not taken seriously by the borrowers.

The amount of follow-up required to collect payments on these medium term loans resulted in them being more expensive to provide than short term loans. Monitoring of medium term loans was not effective at catching poor repayment because these loans would only be re-classified from current to late or overdue once their original term had expired, often after one or two years of poor payment history.

To counter the perceived slack behaviour of the borrowers, to reduce the operating costs to BRAC of asset loans and to provide for a more timely monitoring of these loans, BRAC initiated the new classification policy. BRAC feels that if a borrower wants to obtain a major asset like a cow or a rickshaw then he or she must make a serious commitment and be willing to make sacrifices to repay the higher instalments resulting from a shorter loan term. By forcing them to repay in one year the borrower will have to more carefully assess his or her ability to repay the loan than before.

2. Loan ceilings:

Loan sizes are now controlled only by ceilings related to the number of loans previously received. The policy now is that a borrower's first loan can not exceed Tk 3500, the second Tk 5000 and the third Tk 7000. Previously each loan purpose had a limit (the maximum loan available to purchase a cow used to be Tk 5000, for example).

BRAC observed that many borrowers were obtaining loans with one stated purpose and using them for another. They were often forced into this dishonest behaviour because the limits set for each activity were too low. For example, if a borrower wanted to be involved in small trading but required a certain amount of money in excess of the limit available for trading, he or she might apply for a cow loan since this type of loan had a higher limit.

It was difficult for BRAC to constantly review and revise the loan limits for each type of activity that the borrowers were involved in. There were regional variations in the costs for the goods and services that members might want to borrow for as well and BRAC had to try to accommodate these differences in its loan limits.

The change is expected to simplify the loan approval process and to make the credit analysis at all levels more realistic. BRAC and the group members will know what the borrower intends to do with the funds because there is now no reason to misrepresent the purpose of the loan.

3. Borrowers per household:

The maximum number of members (and consequently, borrowers) per household has been limited to two. There was no limit before. In addition the maximum amount of loans that one household can receive from BRAC is set at Tk 10,000. Previously the limit was Tk 14,000.

BRAC had observed that often more than two members of one family would be VO members and would take out loans and would benefit from other BRAC services (NFPE in particular). As a result of this concentration some families benefitted at the expense of other needy persons. BRAC wishes to spread the benefits of its services more widely. By limiting the membership in one family to two persons it was felt that the services would be more widely distributed.

In Bangladeshi villages the basic economic unit is the household not a particular income eraning activity. Funds are moved freely from sources to uses within the household depending on the current opportunities and needs. Since it is the income of the household as a whole that determines debt capacity BRAC thought it prudent to reduce the amount of debt available to that household.

4. Number of loans per borrower:

The maximum number of loans that one borrower may have at any one time is two. In other words a member can participate in only two schemes at a time. This is a new restriction.

In order to keep borrowers from exceeding their debt capacity and also to simplify the record keeping involved in recording and reporting on the loans outstanding this measure was introduced.

5. Advance payment:

No advance payments will be allowed unless the whole loan is repaid at once. If a borrower repays all at once he or she will not be eligible for a new loan until the scheduled expiration of the completed loan.

BRAC was experiencing a problem managing its cash flow because of irregular loan repayments. Borrowers would often repay more than one instalment on a loan at a time. This would usually occur with a borrower who on other occasions would miss a payment or two. The Area Office would end up with either more cash than anticipated and have to make an extra trip to the nearest bank to deposit the excess, or else a cash shortage, and again have to travel to the bank in order to be able to fund disbursements.

In order to impose more discipline on the borrowers and to make cash management in each office more accurate BRAC is requiring borrowers to stick to the repayment schedule that they agreed to.

This policy will also reduce the possibility of a borrower too quickly obtaining a large loan. Before it was possible to take a loan for a short period, repay it and then get a larger one immediately.

C.3 Implications and impact of the changes:

Data is not yet available to assess how the changes previously described have impacted the borrowers. In fact it is not at all certain that BRAC currently has the information system necessary to be able to produce data which would allow them to analyze the impact of the changes. The following comments therefore are not quantitative but rather qualitative.

1. **Re: The term structure of the portfolio:**

There will be a shift to the shorter term loans as a result of the new classification. Medium term individual loans will be phased out over the next two to three years. The portion of the total portfolio in medium term loans will decline significantly.

The funding impact of this is that loans will turn over more quickly and loan portfolio outstanding will be lower than would otherwise have occurred. This trend will help to offset the previously discussed shift to longer term loans for Deep Tube Well purchases and will to some extent reduce the total forecast Revolving Loan Fund requirement of RDP II. BRAC will have to carefully review its whole loan portfolio term distribution while preparing RDP III's budget as a result of these two competing trends.

2. **Re: The borrowers' activities:**

Although BRAC might not intend to discourage borrowers from taking the larger loans, which are generally for assets, this is in fact what might happen. In the field staff were saying that more people are taking out small trading loans, for example and fewer for cows, rickshaws, etc. as a result of the policy change.

3. **Re: The risk structure of the loan portfolio:**

There are two competing factors involved here. If previously medium term individual loans were poor quality the loan portfolio will improve as these loans are phased out. If however, the same number of large loans are made but for shorter terms then there is a possibility that the quality will not improve at all but in fact deteriorate. If for example, a borrower could not repay a loan with instalments of Tk 10/week then he or she will have great difficulties repaying Tk 30/week.

C.3 <u>Comments and recommendations:</u>

The first general concern with respect to these changes relates to how BRAC was able to first identify the medium term loans as a problem and secondly to determine that the issue was one of attitude and not economics. Based on this reviewer's experience with BRAC's monitoring information it is not at all certain that management had adequate data with respect to the performance of the medium term individual loans in order to assess the problem. If as a result of a lack of good data BRAC has misunderstood the medium term loan situation it is very unlikely that the situation will be improved by the changes implemented.

The second general comment was raised earlier concerning the possibility that BRAC's members will not be able to borrow to purchase larger assets as a result of the changes. In this reviewer's opinion it may be rather like throwing the baby out with the bath water. If BRAC solves the problem of risky asset loans by eliminating them then the borrowers will be the losers.
This would be a shame as these types of loans are the ones which, if administered correctly, will actually increase the wealth of the borrowers most rapidly.

In addition to these two general concerns there are a number of specific ones which may be useful to BRAC and the donors.

1. Classification of loans:

It was important to the reviewers last year that BRAC address the unknown performance of some of its larger individual loans. BRAC has done this and determined that there is in fact a problem. They have further decided that the root cause is one of borrower attitude not economics.

The obvious concern here is that the new loan instalments required to repay a large loan over a term of only one year may be too high for the borrower to handle. By stressing the borrower's attitude toward these debts has the economics of the loan suffered? Only time will tell if the problem was one of attitude or economics and whether the action taken was the right one but good monitoring would help in answering this question.

Recommendation

**As stated elsewhere, BRAC should initiate a monitoring approach which concentrates on the higher risk loans. Until evidence proves the contrary these larger one year loans should be considered risky. The new reporting system should identify loans over a certain disbursement amount (perhaps Tk 5000) and track their repayment performance closely on a monthly basis.**

2, 3 and 4. Loan ceilings, borrowers per household and number of loans per borrower:

There appears to be some inconsistency on these issues. On the one hand BRAC has removed some standardization in its credit policies in favour of a more flexible approach with respect to loan amounts for different purposes but on the other hand it has imposed new limits and reduced others with respect to borrower debt. The new limits appear to be rather arbitrary, they don't account for regional diversity and they will have to be regularly adjusted for inflation or else will restrict borrowing in the future.

It seems as if BRAC's credit policies are becoming a bit of a patchwork affair. Any lender has to strike a balance between standardization and flexibility but it is not clear that BRAC has a consistent vision of where that balance should be. It is possible to standardize the process of loan evaluation without having a standard definition of what an individual's or household's debt capacity is.

Recommendation

**BRAC should consider carrying out a review of its credit policies and its methods of training credit officers with a view to determining the proper balance between standard criteria and standard methods of analyzing loan applications. The credit decision process should be clearly described for the lending officers in the form of a credit manual which states how the economics of the loan is to be assessed. How to assess debt service capacity is a skill that can be standardized and taught.**

5. Advance payment:

The requirement that borrowers stick to the repayment schedule as enforced by this new policy is consistent with decisions made last year. As intended this change may also assist the Area Office accountant to manage the cash position. There is no reason to argue with this change if borrower discipline is considered to be important. This reviewer thinks that borrower discipline is extremely important and that any action which enforces discipline is useful.

6. General comment with respect to changes:

Making changes at the operating level of an organization as large as BRAC is very difficult. A great deal of staff time and effort must be spent informing the members of the changes. Even more time is required to ensure that these new policies are understood and adhered to. Whereas BRAC is to be commended for its willingness to make the effort to revise its policies it has perhaps tinkered enough with how the borrowers are to behave.

BRAC has implemented a number of policy changes that directly affect the borrowers in the last 2 - 3 years. It may be that the number of changes implemented and rate at which BRAC has been imposing them has created confusion in the minds and attitudes of the borrowers. BRAC should probably leave those policies that directly affect the borrowers alone for a time in order to be able to assess the impact of the changes already made and also to concentrate on policies and procedures within the organization itself.

Borrowers are remarkably similar wherever they are. Many different methodologies have been tried in various parts of the world with varying degrees of success. One constant of good lending programs regardless of the methodology used, however, is the existence of a good monitoring program combined with a strict policy of follow up on the part of the lender in the case of delinquent payment. This is the area that this reviewer feels should now receive most of BRAC's management attention.

## PART D BREAK EVEN STRUCTURE OF BRAC

### D.1 General:

The concept of break even analysis is quite simple at first glance. Break even occurs when costs and income are equal. The conditions that exist at that time are break even conditions. The problem in BRAC's case, as in most break even analysis situations, is that not every one will agree as to which costs should be included and which income items should be set equal to them. Without wanting to over-complicate the exercise but wishing to deal adequately with the subject it probably necessary to look at least three different types of break even for BRAC;

1. Loan interest income only compared to operating expenses only:

    This could be called operating break even and is often what some commentators mean when discussing break even. In BRAC's case the conditions required for operating break even have already been reached by RCP.

2. Loan interest income only compared to operating plus financial costs:

    This is a more rigorous test of the viability of a lender and could be called real world or market break even. There are no operating conditions foreseeable under which BRAC will ever attain this level of break even - as long as it continues to charge 16% p.a. on its loans.

3. Loan interest income plus investment interest income compared to operating costs plus lower than market financial costs:

    This could be called a subsidized break even analysis since in it we do not expect income to cover all costs, and in addition, there is source of income other than loan interest income which is funded at less than market rates. BRAC's RCP has this kind of structure. The subsidized structure for RCP was designed because it has been assumed that lending to the landless poor of Bangladesh can not be done on a pure market basis.

### D.2 Operating break even analysis:

For the 6 months to June 30, 1991 RCP's operating costs for 30 Area Offices (including loan loss provision) totalled Tk 15.6 million which is equal to 14% p.a. of the average loan portfolio outstanding during that period.

Whereas the total operating costs for RCP will continue to climb in absolute terms they are unlikely to ever be higher than 14% of the loan portfolio. The logic here is that the overhead or fixed costs of running RCP (head office and regional office expenses) are highest at the beginning as a percentage of operating costs. In addition average loan portfolio per office within RCP is still growing in real terms while operating costs have more or less peaked.

Therefore as long as RCP earns at least 14% on its loans it will be able to break even on an operating basis. BRAC is charging 16% on loans and therefore should always be able to cover the operating costs of RCP with interest charged the borrowers.

To determine how many borrowers or loans are required to produce income equal to the operating costs of one Area Office we can again conservatively assume that RCP will never be any more efficient than it is now and further assume that one RCP office will have to produce one thirtieth of the total current required break even income. The income that one office will have to produce in one year is;

$$\frac{\text{Tk } 15{,}600{,}000 \times 2}{30} = \text{Tk } 1{,}040{,}000$$

In order to receive Tk 1,040,000 from a loan portfolio charging 16% p.a. requires that the office have an average value of loans outstanding over the year of Tk 6,500,000. This is the operating break even loan portfolio for one office.

There are an infinite number of combinations of average loan size and number of borrowers which would yield the break even loan portfolio - everything from one borrower with a one year loan for Tk 13 million to 13 million borrowers each with a one year Tk 1 loan. If we assume that either the loan amount is fixed at the current average value in RCP (Tk 2750) or that the number of borrowers is fixed at the current average for an RCP branch (5000 borrowers) the results are as follows:

Operating break even conditions for RCP per Area Office;

| | |
|---|---|
| borrowers required (loan of Tk 2750) | = 4725 |
| average loan required (5000 borrowers) | = Tk 2600 |

The fact that the break even conditions in both cases are equal to or less than the current averages found in RCP just confirms what we already concluded - that RCP is covering its operating costs.

D.3 Market break even analysis:

| | | |
|---|---|---|
| Operating costs | 10% - 14% | p.a. of average loans outstanding |
| Financial costs (incl. inflation) | 9% - 14% | " " " " |
| Profit | 1% - 2% | " " " " |
| Required income to cover costs | 20% - 30% | p.a. of average loans O/S |

The operating costs we have already said will not exceed 14% p.a. BRAC forecasts that at RCP's most efficient this cost will reduce to approximately 10% p.a.

BRAC is currently paying 9% p.a. for its deposits but deposits represent only 1/3 of the funding currently required for the loans. BRAC is not paying anything for the other 2/3 of the funds and so is now paying on average only 3% p.a. to fund RCP's loans. This is hardly a market situation. When BRAC borrows from banks in Bangladesh it pays 16% like everyone else. BRAC's real world cost of financing therefore would range from a minimum of 9% (if funded completely by deposits) to at least 14% (1/3 deposits and 2/3 bank debt).

The reviewers have assumed that 9% is the maximum rate of inflation in Bangladesh ie. that at a rate of 9% on deposits the savers are at least maintaining the value of their assets. The required charge to the borrowers to cover inflation costs therefore is included in the financing cost of the lender.

If RCP was a commercial private sector bank it would have to charge an additional 1% - 2% to provide a return to its shareholders. 1% - 2% on loans would provide something in the range of 15% return on equity which is not an unreasonable target return for this kind of enterprise in this economy.

If pressed to say what rate does RCP require now to break even the worst case would have to apply - 30% p.a. If all goes well - if deposits develop as forecast and operating costs decline RCP might in the future be able to break even charging 20%.

BRAC will never be able to truly break even on a market or real world basis charging 16% p.a.

D.4 Subsidized break even analysis:

RCP's actual income sheet is as follows:

| | 6 month operating results (Tk million) | per cent of loans O/S |
|---|---|---|
| Loan interest income: | 15.9 | 14 % p.a. |
| minus: cost of funds: | (3.2) | (3 %) |
| Net interest income: | 12.7 | 11 % |
| Other income (investments): | 7.2 | 6 % |
| minus: operating costs: | (15.6) | (14 %) |
| Net income: | 4.3 | 3 % |

RCP's interest income should be 16% of net loans outstanding. For quality related issues as already discussed this income is below forecast. However, even if interest income was at the required level the following is clear:

- RCP would not break even without a lower than market rate of interest on its funds and without the income from its investments.

This is not news to anyone familiar with this project but perhaps this analysis makes the issues clearer.

At different times in the forecast performance of RCP the components of income and expenses vary as a % of total costs. Based on the currently approved budget for RCP the following summarizes the most profitable and least profitable forecast years for RCP:

Most profitable forecast year - 1996

| | 12 month operating results (Tk million) | per cent of loans O/S |
|---|---|---|
| Loan interest income: | 210 | 16 % p.a. |
| minus: cost of funds: | (60) | (5 %) |
| Net interest income: | 150 | 11 % |
| Other income (investments): | 67 | 5 % |
| minus: operating costs: | (137) | (10 %) |
| Net income: | 80 | 6 % |

Least profitable forecast year - 2002

| | 12 month operating results (Tk million) | per cent of loans O/S |
|---|---|---|
| Loan interest income: | 561 | 16 % p.a. |
| minus: cost of funds: | (210) | (6 %) |
| Net interest income: | 351 | 10 % |
| Other income (investments): | 54 | 2% |
| minus: operating costs: | (366) | (10 %) |
| Net income: | 39 | 2 % |

The point in comparing RCP's best forecast year with its least profitable is to again emphasize the relative importance of the various components of income and cost. RCP does well in 1996 because investment income is high and operating costs are low. Conversely RCP earns its lowest profit (or comes closest to not breaking even) when that investment income falls. Investment income is forecast to fall in 2002 because 50 Area Offices will be purchased from RDP in that year and the funds to purchase them will come from the investment account.

## PART E MONITORING

### E.1 General:

The reviewers' primary concern with respect to BRAC's monitoring systems and procedures is the control and improvement of loan quality. There are other relevant and important features of a good monitoring system but based on previous conclusions the area of loan repayment performance is the one which for the time being requires the greatest attention.

### E.2 Progress made since last year's review:

Unfortunately BRAC still does not have a simple way of measuring and reporting the quality of the loan portfolio. As discussed in Part B the loan quality categories now used do not place proper emphasis on the current loans which are not performing adequately. Some of the recommendations made last year on this issue have been implemented but others have not. What has been accomplished leads us to believe that the remaining recommendations will follow.

- a consultant with bank information system experience has been contracted to advise BRAC on the design of the necessary monitoring system from the bottom up.

- BRAC has begun to collect the basic borrower repayment data required so that in the future staff will be able to analyze loan performance correctly. This data is contained on a new Collection Sheet prepared by the GS's and monitored by the PO's.

The most significant feature of the new process of data collection is the fact that at base it deals with each individual borrower. This was a basic recommendation of the previous review team. BRAC will soon be able to produce a statement on each borrower. This is the first step to getting control over the lending operation. It will be some time however before any useful data comes out of the process because the computer systems still have to be designed to handle the data and the reports that the data base will provide are still to be determined.

There is a concern with the new collection Sheets, however and that relates to the amount of responsibility placed on the GS's and the potential for error involved in the process as information is transferred for each borrower each month from one sheet to another. BRAC is aware of the potential problems but these two aspects of the new forms will have to be watched carefully.

E.3 What needs to be done:

BRAC needs to produce reports which will be useful to the PO's, the Branch Managers and the other management staff in a timely and accurate manner and even more importantly which identify areas of poor repayment before the term of the loan expires.

Recommendation:

**The reviewers recommend the creation of a process of loan quality monitoring based on the repayment performance of each loan regardless of the term of the loan. The process will build on the data contained in the new Collection Sheets as outlined following:**

1. Area Office or Branch Office loan quality reports:

Every borrower who is not up to date with repayments should be placed on a "Delinquent Borrower List" at the end of every month. This list should be organized by VO and should be prepared in the Area or Branch Office with a copy sent to the Regional Office. The loan scheme should be noted on this list as should the amount of principal (including interest capitalized) outstanding at the month end on each loan as well as the PO responsible. Each month the Branch or Area manager should organize the PO's to carry out a campaign targeted at these borrowers and should enforce the remedies available:

- no loans to the other members of that small group (or VO if possible) until the delinquents have repaid,

- taking of members' savings or group funds if the delinquent loans are not repaid or at least back on schedule within a pre-determined number of payment cycles,

- expulsion from membership of the delinquents. If access to credit is a valued service to the BRAC members then the threat of cutting off that access has to be a real threat that BRAC is prepared to implement.

This is a major task and may absorb a good deal of branch and area office staff time to the exclusion of new disbursements. This is an intentional consequence of having a poorly performing loan portfolio - lending should slow or even stop until the repayments are back on schedule or the poor payers are eliminated.

2. Regional and Head office reports:

The regional and head office management should track the loan repayment performance of the branches and area offices based on the "Delinquent borrower lists". These lists should be further organized (either at RO or HO depending on the availability of computers) such that the amount of principal outstanding at each month end can be summarized as follows:

Principal O/S showing on time repayment
Principal O/S showing 1-3 payments in arrears
Principal O/S showing 4-10 payments in arrears
Principal O/S showing 10+ payments in arrears

The second step at the RO or HO is to assign provisions against income and accumulate reserves against gross loan values for each office. The provisions will vary for each category of repayment performance, ie 0% for on time repayment up to 100% for acknowledged disasters. These categories and the levels of provisions are only suggestions at this time but the process must be initiated with the recommended logic and on some similar rational basis.

BRAC should write off the worst loans. Provisions are taken from income and used to reduce the value of the loan portfolio for the specific reason of being used to absorb write-offs. This has been recommended before and was going to be done but as yet has not been. The write-off experience will help BRAC determine what is a realistic way of estimating provisions. The 2% of disbursements may not be realistic - too much for the good offices and not enough for the poor ones.

Still using the data from the "delinquent borrower list" the RO and HO can begin to do more detailed analysis of the loan payment performance based on a range of classifications - type of scheme, or location or loan size or whatever - to begin to better understand where the problems are. Once management understands where the problems are then they can begin to formulate general strategies that will aim to reduce system wide risks. the specific monitoring of DTW loans or short term large asset loans becomes feasible with the proposed system and a true understanding of the magnitude of the problems can be finally arrived at.

In addition to the above recommended loan quality reporting system or one like it the reviewers believe that BRAC needs more financial analysis experience in house. BRAC should be able to say what its problems are with respect to loan repayment or financial structure. This is a new discipline for the monitoring and management staff of BRAC and is not a skill that can be learned without outside assistance.

Recommendation:

The reviewers recommend that BRAC's RCP staff gain some analytical experience both in loan quality evaluation and in the interpretation of financial results. This will likely require staff to take specialized training in financial analysis, perhaps outside of Bangladesh.

## PART F: LONG TERM SUSTAINABILTY ISSUES

The reviewers have concluded that BRAC is well on its way in RCP to becoming a sustainable entity. This conclusion is based on a number of observations;

- BRAC has demonstrated its operational and general management ability in the development of the Branch Office system of RCP. The ability to develop and operate a significant number of offices in different regions of the country is a necessary pre-requisite to attaining a size where economies of scale can reduce operating costs. As yet these reductions have not started but it is reasonable to conclude that the operating costs are at their highest now and will decline as the real value of the loan portfolio of the branches increases while staffing does not.

- the various scenarios that have been run on the model for RCP and the attainment by BRAC of the operational targets leads us to believe that future performance will be more or less on the forecast.

- as long as the donors continue to meet their commitments to RCP there will be a strong capitalization which will protect the operation from short term difficulties.

- BRAC has demonstrated its ability to adapt to situations and will undoubtedly have to do exactly that in the future. The problem with a model is that it tends to have assumptions built in that do not allow for the compensating capability of the institution. Within BRAC that capability is very significant and must not be forgotten in any attempt to forecast the viability of RCP.

Notwithstanding the above comments there remain a number of issues which still have to be dealt with, however;

- BRAC must seriously begin to address the issue of loan quality. The sensitivity analysis confirmed that an average return of only 14% on the loans outstanding is not sufficient to allow RCP to continue operating and to be self-sufficient.

- The role of the donors in the supervision of RCP will be less effective after the funding to RCP has been completed. The donors realize that they will not have direct influence over RCP after 1993. Consequently now, while they still can, they are pressuring BRAC to define the regulatory structure of RCP and to clarify the uses of the members' funds and the BRAC loan. The donors have a right and a responsibility to do exactly that at this time.

- BRAC is vulnerable due to its relatively high operating cost structure and the current practise of charging only 16% p.a. on its loans. BRAC's costs, particularly salaries, may rise due to pressure from competing institutions or as a result of general inflationary trends and the viability of RCP would be threatened as a result. BRAC's only defense in the long term would be to charge more for its loans or to secure more low cost funding.

- BRAC now has only two sources of funding available to it - donors and members. There is no legal basis for BRAC to use the members' funds and the supply of donor money in the long term is never secure. BRAC's future ability to grow can not be certain unless it either diversifies its sources of finance or becomes legally entitled to use the savings of the members.

If BRAC seriously begins to address and improve its loan repayment record the last operational issue which could impede the self-sufficiency of RCP will be behind them. The remaining issues with respect to long term viability facing BRAC are basically issues of financial structure and philosophy.

BRAC needs to develop a clear structure for RCP that will protect to the full extent possible the borrowers and savers and that will have a diversity of funding sources.

There appears to be an opportunity in the current political and economic environment to create a private sector bank based on RCP. This is an opportunity which may not always be available.

Recommendation:

The reviewers recommend that BRAC proceed to create a private sector bank and that the following issues be explored immediately:

- **incorporation and approval process:** The requirements with respect to minimum capitalization, maximum debt/equity ratios, provisions, reserves, etc. will have to be studied as will the process of obtaining governmental approval to start up and operate a bank. The reporting requirements of a private sector bank is an additional issue which will have to be studied.

- **equity:** In order to incorporate a bank BRAC will need equity. With respect to this issue BRAC has several options:

  - a portion of the borrowers' savings could be converted to equity. This may be politically an astute move but it will not add much financially or managerially,

  - all or a portion of the BRAC Loan could be converted with the approval of the donors into equity,

- BRAC could possibly obtain some capital from private investors within Bangladesh or from outside of the country. This option would depend on the investment climate in Bangladesh and the prospects for profitable operation but would bring with it valuable outside professional participation in the management of the proposed bank.

The source of future equity is also tied to the issue of ownership and control of the proposed bank. This is a critical issue that will require a great deal of discussion, internally and with the existing donor group as well as with future potential investors and representative groups of members.

- **savings:** BRAC should consider replacing savings as a major source of funds unless it can charge more for its loans. Paying 9% p.a. on deposits is very expensive. If BRAC decides not to use the members' funds in RCP these deposits could instead be managed by BRAC and invested to create a "future fund" for the members. This solution if applied within RDP and RCP would answer the donors' concerns with respect to the security of the members' funds.

- **debt:** If BRAC determines that savings should not form the major part of the loan funding then there is a need for more debt to fill that role. BRAC should investigate other sources of funding including the World Bank funds available through the recently created credit development foundation and the Bank of Bangladesh. These funds are potentially available at 2% and 6% p.a. Some of the BRAC loan could become a real debt also earning BRAC some interest income.

- **loans rates:** If BRAC becomes a private sector bank it should try to charge what it needs to earn a reasonable profit. This rate will be greater than 16% p.a.