

FINANCIAL SUSTAINABILITY APPROACH – A REVIEW WITH SPECIAL REFERENCE TO NGOS AND MFIS

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Abstract

Financial Sustainability is important for any organisation. There are mainly four approaches of financial sustainability. The Accounting Approach that considers surplus and Dependency Approach that considers opportunity cost of concessional funds and donation. The Operating Approach emphasises on institutional internal capacity to cover all its cost including opportunity cost of dependancy approach. The profitability approach not only considers the revenue generated but also contemplates capital invested to generate the revenue. It also considers systematic risk associated to organisation. Operating Approach and Profitability Approach are the most appropriate to study the financial sustainability of an organisation.

Introduction

Any institute carrying economic activity with a financial or social objective can carry on its activity uninterrupted for longer period only if it is financially sustainable. As one cannot depend or sustain on one which itself is not sustainable. Looking at the role of Non-Government (Not for Profit) Organisation (NGOs) and

Microfinance Institutions (MFIs) in the economy and society it is very important that they should be financially sustainable so as to carry all microfinance activity continuously and to achieve desired commercial goal and social goal. Many authors have indicated various approaches of financial sustainability. Following are the major approaches of financial sustainability (FS),

Approaches to Financial Sustainability

Administrative or Accounting Approach

Leon in his book ‘Four Pillars of Financial Sustainability’ highlighted administrative approach of FS for non profit organisation. The study explains that “financially sustainability is an organization’s capacity to obtain revenues in order to sustain productive processes at a steady or growing rate in order to produce results and to obtain a surplus¹”. The study considers accounting principles of financial sustainability i.e. surplus.

$$\mathbf{FS = Total\ Income > Total\ Cost}$$

Financial sustainability may be achieved at the project, program or organizational level. It mainly focuses on continuity in organizational activity for longer period and requires the concerted efforts of the entire organization. Financial and Strategic Planning, Income Diversification, Sound Administration and Finance and Own Income Generation are the four fundamental pillars for the financial

¹ Total income - Total costs = Surplus

sustainability of an organization. For achieving financial sustainability long-term commitment, leadership, investment of time and money, business plan, effective management and team work are the essential requirements (Leon, 2001).

Dependency Approach

According to Paxton & Cuevas, Subsidy Dependence Index (SDI) is considered to be an important indicator of sustainability. The SDI measures the percentage by which interest rates are charged to clients in order to cover program costs and eliminate subsidies. It also indicates the cost to society for subsidizing micro credit activity of an organisation (Paxton & Cuevas, Outreach and Sustainability of Member-Based Rural Financial Intermediaries, 2002). The same is supported by the study of Marakkath.

According to (Khandker, 1995) and (Yaron, 1999) subsidy dependence index is computed as:

$$\mathbf{SDI = NS / LPxi}$$

Where NS = Net Subsidy,

LP = Average loan portfolio

i = Average annual on-lending interest rate paid on that portfolio.

This ratio helps measure the percentage increase in the average on-lending interest rate required to eliminate subsidy in a given year while keeping its return on



equity to the approximate non-concessionary borrowing cost. An SDI of zero implies full self-sustainability, meaning that profit is equal to the social cost of operation. A positive index would show that economic costs exceed profit; here the on-lending interest must be increased by the amount of SDI to eliminate the amount of net subsidy:

$$FS = SDI \leq 0$$

According to Marakkath, operational self-sustainability ratio (OSS), financial self-sustainability ratio (FSS) and subsidy dependence index (SDI) are the base for financial sustainability. Calculation of SDI considers the opportunity cost of concessional funds or subsidy. SDI close to zero, indicates self-sufficiency without a dependence on external subsidies. An SDI above zero means that the MFI still needs subsidy to operate i.e. it has not achieved financial sustainability. The Subsidy Dependence Index (SDI) is less used measure of sustainability, though it is one of the best indicators of adjusted profitability from a technical stand point (Marakkath, 2014).

Operational or Earning Approach

Most of the literature considers operational approach of financial sustainability. As stated by Thapa et al, 1992 in literature of Bayeh Asnakew Kinde, “Financial sustainability of microfinance institutions is probably the key dimension of microfinance sustainability. It refers to the ability of MFIs to cover all its costs from its own generated income from operations” (Kinde, Financial Sustainability of Microfinance Institutions in Ethiopia, 2012). It emphasises on institutional internal capacity to cover all its cost.



Shahidur Khandker explains the concept of financial and economic viability for financial sustainability. To meet the financial viability criterion, the program should charge an interest rate that generates revenue equal to or exceeding the cost per unit of principal lent. Economic viability refers to organizations' ability to meet opportunity cost of fund. These nullify the effect of donations and subsidized or soft loans and surviving ability of an organization without low cost subsidized funds (Shahidur Khandker, 1995).

According to Meyer Financial Sustainability of MFIs is important as the poor benefit most if they have access to financial services spread over a long period of time rather than providing them short term benefits. MFI must cover its operating and financial costs over long term for financial sustainability. For the purpose he has bifurcated cost into operating and financial cost and explains that financial sustainability has two dimensions, one operational self-sufficiency which refers to the ability of the MFI to cover its operational costs from its operating income. Whereas, a microfinance institution is said to be financially self-sufficient when it is able to cover not only operating cost but also financial costs i.e. cost of funding from its self-generated income. He has taken subsidy at market value so as to eliminate effect of donations, subsidies and soft loan and to arrive at true financial self-sufficiency. It is expected that microfinance institutions that have attained operating sustainability is organically in a position to achieve financial self-sufficiency to cover its cost of funding, operating costs and cost of provisions for losses, without relying on subsidies (Meyer, 2002). Bogan V. and many researchers have adopted the definition given by Mix Market which is based on the line of Mayer.

$$\text{OSS} = [\text{OI} - (\text{CF} + \text{OC} + \text{LS} + \text{OCS})] / (\text{CF} + \text{OC} + \text{LS} + \text{OCS})$$

Whereas, OSS= Operating Sustainability, OI= Operating Income

OC=Operating Cost

LS = Loss Provision

OCS= Opportunity Cost of Subsidy

Sa-Dhan define financial sustainability as, “the MFI is able to cover all its present costs and the costs incurred in growth, if it expands operations” (Sa-Dhan, 2005). All the costs included under this are operational costs, financial costs adjusted for inflation and growth required. According to Sa-Dhan, “financial sustainability is a tangible parameter and can be measured and monitored through eight ratios”². According to it long term sustainability, cost reduction and interest rate covering all cost is important for financial sustainability (Sa-Dhan, 2005).

According to Microfinance Information Exchange (MIX)³ self-sufficiency refers to the organizations ability to cover its cost fully. A firm is financially sustainable if it has operational sustainability level of 110% or more. Here operational sustainability shows the proportion of total financial revenue to its operating expense, financial expense and loan loss provision (mixmarket.org, 2012). The operational sustainability rate indicate only earning approach⁴ but does not consider profitability approach⁵ of financial sustainability. It doesn't consider the capital structure effect on financial sustainability of an organization.

² Eight Ratios include: Return on performing assets; financial cost ratio; Loan loss provision ratio; Operating costs ratio; Donations and Grants ratio; financial self-sufficiency and Imputed cost of capital. <http://www.sa-dhan.net/Adls/Microfinance/Miscellaneous/SustainabilityInMicrofinance.pdf>

³ MIX Market (www.mixmarket.org) is a public data hub where microfinance institutions (MFIs) and supporting organizations share institutional data to create transparency and market insight.

⁴ Earning approach is surplus i.e. excess of income over expenditure

⁵ Profitability approach is rate of return on equity, assets or capital employed.

According to Anand Rai in current scenario Financial Self Sufficiency is an approximate indicator and not relevant as grants represent less than 1% of the sources of funds of MFIs. Further very few MFIs are making losses as the rate of interest charged on loan portfolio is quite high so Operational Self Sufficiency too is not a very interesting indicator. As a result more comprehensive model for financial sustainability is needed. He developed a model to quantify financial sustainability through financial sustainability index model. Model uses four financial indicators by its beta⁶. These are Portfolio at Risk for more than 30 Days (PAR>30 days); Capital to Asset ratio; Operating Expense to Loan Portfolio and Operational Self Sufficiency. The weight given to the indicator is based on its usage by different rating agencies which lack theoretical and technical support. Further it does not consider profitability in terms of return on or capital for financial sustainability (Anand Rai, 2012).

Profitability Approach

As per the report of Rosenberg published by CGAP as technical guide, financial sustainability refers to profitability, MFIs can maintain and expand the financial services in the long run, if they can cover all of their costs and generate net income. Financial sustainability can be reflected as Return on Assets (ROA) or Return on equity (ROE). For the purpose it emphasises on three adjustment to accounting profit, these are; subsidise cost of fund, in-kind subsidy and inflation (Rosenberg, 2009).

⁶ Beta is a product of weight and range of the financial indicator.

$$\text{Return on Equity} = \frac{\text{Profit After Tax And Provisions} \times 100}{\text{Average Owners Capital Including All Reserves And Surplus}^7}$$

According to Marakkath, ROA is one of the base to assess financial sustainability. However, he found lack of literature support to demarcate the level of ROA, at which an MFI can be assumed to be sustainable. ROA is used less in relative sustainability assessments. The study considers operating sustainability as dependent factor to find out financial sustainability of an MFI operating in India (Marakkath, 2014).

Mistry and other researchers have considered return on equity as an indicator for performance evaluation. According to him return on equity reflects financial sustainability of an organization (Mistry, 2015).

According to Capital Assets Pricing Model; risk and return are directly correlated. Higher the risk, higher the return expectation (Avdhani, 2011). The model gives idea about risk free security and risky security. Expected return on risky security is more than the risk free security. The difference between expected return on risky security and risk free security is called risk premium. The expected return on owners equity is more than the debt equity; as the earlier one is risky then the later. The financial risks associated to business are broadly divided into two types: systematic risk and unsystematic risk. Risk associated with Market, Interest rate, Inflation and Trade Cycle are considered as systematic risk. The risk premium for the systematic risk of a company or a group of companies can be calculated by comparing it with

⁷ Donations and subsidies are included as a part of reserves and surplus.

market risk. Considering capital assets pricing model an organisation said to be financial sustainable if its Return on Equity (ROE) is greater than the sum of Return of Risk Free Security (Rf) and Risk Premium (Rp) associated to the industry (Mistry & Shah, 2016).

$$FS = ROE > Rf + Rp$$

Review of Financial Sustainability Approach

Most of the authors and researchers have linked financial sustainability with earning capacity or institutional capacity to cover all cost. Financial sustainability is position where an organisation is able to cover all its present costs, cost of inflation and required cost to attend future growth prospects. Such organisations cannot sustain without achieving financial sustainability. There four different approaches of financial sustainability, these are administrative and accounting approach (i.e. surplus); operating approach (operating sustainability i.e. earning point of view); profitability approach (i.e. rate of return on equity or assets) and dependency approach (i.e. subsidy dependency level). However, operating sustainability is a position where an organization is able to recover all cost from its operating income so accounting approach is included in operating approach. Subsidy dependency level (Dependency approach) is relevant for those organisations which are dependent on subsidized loan or donations and irrelevant for other organisations. Further operating sustainability (operating approach) and return on equity or assets (profitability approach) considers the adjusted cost of fund on subsidy or donation. Considering the issue mainly two approaches of financial sustainability one is from



earing point of view i.e. operating sustainability and the other is from profitability point of view i.e. return on assets or return on equity point of view, is more relevant. Most of the empirical research in the area of financial sustainability considered operating sustainability as a parameter for financial sustainability. However, operating sustainability does not consider the systematic risk of inflation and growth aspect. It is important to study both earning capacity and profitability that consider inflation and expected growth rate, to decide financial sustainability of any organization.

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