Microfinance Banks – Weathering the Digital Revolution

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This blog draws[i] on the experience of Kenyan microfinance banks. Microfinance banks are regulated deposit taking microfinance institutions. Nevertheless, most trends are believed representative of existing or future trends in other markets as they digitise.

Over the last 18 months no fewer than six microfinance banks in Kenya out of 14 have been sold[ii]. Prices have been relatively low reflecting several years of losses in the sector. It is particularly interesting to note who have been purchasing Kenyan microfinance banks, and to think through what this portends.

Purchases of Kenyan Microfinance Banks

- 2023: Maisha Microfinance Bank purchased by Cactus Cantina Investments Limited, a company owned in part by Peter Njonjo, who owns Twiga Foods, a leading Kenyan ag-tech company.
- 2023: SMEP Microfinance Bank purchased by a US Christian faith-based non-profit engaged in financial services internationally. Hope Advancement Inc.
- 2023: Daraja Microfinance Bank purchased by Umba a Nigerian/Irish fintech.
- 2022: Key Microfinance Bank purchased by LOLC: Sri Lankan international finance group with operations in 18 countries and a history of successful operations.
- 2022: Century Microfinance Bank purchased by Branch International Limited, a California headquartered fintech.
- 2022: Choice Microfinance Bank purchased by Wakanda Networks Limited, which is 100% owned by a successful Chinese entrepreneur.

Of interest are that purchasers typically have access to significant reserves of foreign capital. One purchase was by a finance group (LOLC) and another by a non-profit organisation owning multiple microfinance institutions (Hope Advancement Inc.), but multiple purchases are associated with fintech/ag-tech.

So, what are these new owners purchasing?

i. The microfinance bank licence is easier and cheaper to purchase than a commercial bank licence but enables the institution to conduct most financial transactions. Is this a step towards digital banks?
ii. The ability to operate in (arguably) the most dynamic financial technology market in Africa and to test different business models, technologies, and digital products in a receptive market.

These trends suggest, firstly, that the Central Bank of Kenya has become more flexible in who is a suitable owner of a financial institution in Kenya, though perhaps not at the level of a commercial bank license yet; and secondly, that there is an implicit recognition, that new thinking and new ideas are required in the microfinance bank sector for it to thrive.

What has been happening to Kenyan Microfinance Banks?

Kenyan microfinance banks, and many other financial institutions, have been affected by a confluence of factors, which include:

A difficult economic environment. Covid-19 contributed to loss of income through loan rescheduling, and much higher levels of loan default, combined with operational challenges at branch and field level. The Ukraine war has contributed to high levels of inflation, made worse by currency depreciation following the need for the Government of Kenya to fund dollar and euro bonds due in 2023 and 2024.

A highly competitive environment. Over 400 institutions have applied for a digital credit licence, with over 400 completed applications, and others in the process awaiting submission of requisite information. At the time of writing the Central Bank of Kenya had issued 32 licences. Competition extends to commercial banks that have been able to use digital credit, and digital channels, including apps, agents, internet banking and payment services, to provide services to a much wider range of Kenyan citizens.

High costs of deposits: Deposits are expensive microfinance banks who rely heavily on fixed deposits to fund their operations. Due to government financing and national debt issues, competition for funds is already leading to increases in treasury bill/bond rates. To the extent that government demand for funds crowds out lending from commercial banks, this simply puts even greater focus on the provision of digital credit.

Legacy cost infrastructure: Whilst smaller microfinance banks have a limited number of branches, branch infrastructure and staffing are increasingly becoming a legacy cost infrastructure. Financial institutions such as Equity Bank report that 98% or more of their transactions by number are occurring outside their branch network. Whilst the trend may not be as advanced in microfinance banks, the trend towards digital transactions is irreversible. This implies that in many cases branch staff are under-engaged, and that the microfinance banks are sitting on under-utilised, but expensive, human resources.

Changing consumer behaviour: Consumers in Kenya can more easily sign up to a bank account or access financial services through a mobile phone. Repayment discipline has likely been reduced through ease of access to credit facilitated by digital finance. Customer loyalty has decreased as interpersonal relations between financial institutions and their customers are increasingly digital.

Digitisation is a new hygiene factor: Digitisation has significantly increased efficiencies within the financial sector, including within microfinance banks. Back-office processes have been digitised, documentation management systems have been introduced, field-based applications assist loan officers, decisions are assisted through automated scoring, apps enable customers to access services remotely, technology assisted channels offer new forms of outreach through agents and merchants. The point is that basic digitisation is no longer a strategic advantage when most competing institutions have also digitised.

Branding in crisis[iii]: It has become increasingly difficult for financial institutions to stand out, because traditional brand differentiators, speed, quality of service, have become common. Furthermore, communicating differentiators has become especially challenging due to the multiplication of media channels. This contributes to greater costs and challenges in generating new business, and in keeping customers.

Who is succeeding currently?

Whilst microfinance banks are recording losses, leading commercial banks are reporting record profits. Profits are driven by multiple factors, related to the ability to leverage scale, including group operations outside Kenya, automation of transactions, and capture of payment streams. Microfinance banks faring better are those able to source low-cost deposits, such as Caritas Microfinance Bank, which can leverage deposits from the Catholic church, or SMEP which can leverage deposits from the Church of Kenya.

So, there are returns to scale, technology, channels, and low-cost deposits, which microfinance banks need to consider.

Reimagining microfinance

So, what can microfinance banks do? Reimagining microfinance has never been more important. Microfinance banks need to go back to first principles. The first step is to think differently, the second to build new capability.

a) Microfinance banks must focus on redefining who they are.
b) *Strategy*: Rethinking who they are, what they do, and what leverage do they have with prospective customers.
c) *Focus*: Putting customers first, learn about your customers, their needs and their lifestyles.
d) *Operations*: Reducing costs, through rethinking how infrastructure is used, and how branch staff can be optimally used.
e) *Future vision*: Increased focus on evolving trends, such as ESG, rural finance[iv], and digital agriculture[v].
f) *Promoting values*: Values put into practice will help to differentiate any institution this includes, understanding, purpose, transparency, visibility, relevance, relationships, partnerships and innovation.
g) *Data*: The ability to use data, including third party, alternative data
h) *Investing in human capital*: Staff who can help to achieve the capabilities we need for the future.
i) *Investing in partnerships*: Partnerships which can facilitate the new vision.

So, if we reimagine microfinance, then what opportunities are there:

Rethinking the branch as a profit centre: Understanding the business opportunities particularly based around rural branches utilising underemployed branch staff.

Driving efficiency: Making difficult choices to reduce costs. This requires thinking carefully through how outreach will be maintained, potentially through selected closure of branches, using agents for cash transactions and maintaining a service centre for enquiries, sales and loan servicing[vi].

Understanding customers: Spending time with customers, to understand their problems, issues, and pain points. Using this knowledge to drive innovation.

Leveraging technology: Technology is becoming more accessible for smaller financial institutions, through banking as a service platforms. These cloud-based platforms offer services on a pay-as-you-go basis and offer perpetual upgrades. The core banking platform and connected services are available for all institutions on the platform[vii].

Channels: Microfinance banks in Kenya can leverage apps, internet banking, but can also leverage agents. However, any agent banking needs to be thought through carefully and strategically[viii], FINCA

Uganda, a Ugandan microfinance bank clients can use Centenary Bank agents, which are used to accept cash transactions in place of some branches.

Lower cost deposits: The search for lower cost deposits is a difficult one for microfinance banks, this may best come through a focus on innovation, and thinking differently about financial services.

Innovation: This means rethinking how the institution provides financial services. These ideas are explored in more detail in the First Principles blog: Seven Principles for Reimagining Financial Services[ix]. Thinking 'use cases', and data. It means rebuilding financial services around how Africans manage their lifestyles. It means thinking through the 'capture' of value chains, through embedded financial services.

Driving efficiency: In the short term, this means in part, engaging branch staff who are now underemployed, in sales, research and business development activities.

Brand building: Attracting customers through brand building, this was an essential aspect of the market-led revolution of Equity Bank, more information on how this is done is provided in the study, "The Market-led revolution of Equity Bank"[x]

In Conclusion: Microfinance banks in Kenya and beyond must rethink their strategies, and review and replan on a regular basis, they must put in place the capacities required to navigate an uncertain future, and when upgrading banking platforms, put in place flexible technology solutions. But more importantly, boards and executives must learn to think differently about financial services, and ensure they engage in understanding their customers and their needs and how these needs can be addressed.

This blog is one of a series of blogs, please comment, should you wish to sign up to receive additional blogs, please write to David Cracknell at david@firstprinciples.consulting or register on www.firstprinciplesinfinance.com. David Cracknell is the Director of First Principles Consulting Limited, based in Nairobi, Kenya. He advises financial institutions, governments, policy makers and donors on financial services, including digital finance, policy and regulation, and inclusive finance. He is a frequent keynote speaker, and advisor to boards.

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ii BitKE (19th July) "50% of Kenya's Deposit-Taking Microfinance Banks Acquired by International Investors Following Significant Losses", https://bitcoinke.io/2023/05/microfinance-banks-acquired-by-international-investors/
[iii] Cracknell, David, (2022), "The Existential Branding Crisis Facing African Banks" (blog), First Principles Consulting
[iv] Cracknell, David, (2020) "Reimagining Rural Finance" (blog), First Principles Consulting
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