THE CHALLENGES OF MANAGING THE DEPOSIT BUSINESS IN MICROFINANCE

Bachelor Thesis

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Executive Summary
Many people that live in rural areas of developing countries still do not have access to a bank account for transactions and savings despite the growing numbers of microfinance institutions. Research has proven that the demand for banking services exists and persists in those regions. What therefore appears to be the problem is the inability of formal financial institutions in microfinance to supply basic financial services that are attractive enough for the rural and/or poorer population to choose over informal services. Based on this still largely underbanked population in emerging market regions, microfinance institutions seem to face certain challenges in managing the deposit business.

This thesis therefore firstly aims to provide a description of the deposit business and its management challenges and risks with a special focus on the microfinance perspective. Moreover, because there is still only little research on financial risks in microfinance institutions, the second target is to contribute in narrowing the financial risk exposure research gap with a qualitative analysis of liquidity risk exposure and its implications on managing deposit business in microfinance.

For the first target, a literature review of deposit business with examples in microfinance serves to point out crucial challenges and risks. Due to the various deposit-taking microfinance institutions (credit unions, nonbanking financial institutions and banks) the focus is narrowed down on licensed and regulated banking institutions (microfinance banks and rural banks).
For the second target, a selected sample of regulated banks and rural banks over the period 2003-2013 from the MIX data is used to assess the average liquidity risk exposure in different regions. Because liquidity risk exposure can next to the balance sheet emanate from the financial stability of banks and the existence of an explicit deposit insurance, a financial system concept with a three-level approach (micro = service providers, meso = financial markets, macro = regulatory environment) is used as a method for the analysis. This method allows to consider the diverse situations for microfinance banks in each emerging market region. The following factors and methods are assessed to descriptively analyse the liquidity risk exposure in a financial system:

- Micro level: The balance sheet exposure of financial service providers is analysed with an assessment of the average *asset and liability structure* including a *key ratio group comparison* (deposit to total assets, deposits to loans and borrowings to total assets) and

the *financing gap* (= average loans – average deposits) by using the data in the selected sample.

- Meso level: For the financial stability of banks, the *bank z-score* is calculated in the selected sample and compared with the data from the Global Financial Development database.
- Macro level: Data from a deposit insurance database is combined with the selected sample to assess the existence of an *explicit deposit insurance* in the examined countries of each region.

The results show that the deposit business management in microfinance faces on one side the operational challenge of high costs on deposits from enhancing proximity and affordability through service deliveries in regions with a mostly dilapidated infrastructure and on the other side financial risks, of which liquidity risk exposure is the main challenge for microfinance and rural banks. The analysis in emerging market regions reveals for each region its diverse situation but shows that commonalities exist. Especially large banks in Africa and South Asia tend to have on average very low risk exposures with on average more deposits than loans on the balance sheets, which especially in Africa may be partly explained with a very low financial stability of microfinance banks and a lack of explicit deposit insurances in most of the countries. Such constantly low exposure suggests that a significantly large part of the funds is presumably kept in less productive liquid assets. The low return on liquid assets and the high costs of deposits negatively impact the financial performance of banks, why a decreasing willingness of raising additional deposits may prevail in the region.

However, to better understand the impact of the found challenges on deposit business management requires further research on the deposit costs and the influence of liquidity risk exposures as well as the impact of large liquid assets shares on deposits. Further studies on deposits in microfinance require also additional data as the current datasets provide insufficient information on deposit related expenses, maturities and interest rates, as well as on liquid asset structures and returns.