MICROFINANCE BUSINESS MODELS DURING COVID-19 AND BEYOND

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ABSTRACT

Over the past 18 months, the microfinance sector faced significant operational and market challenges due to the COVID-19 pandemic. At the beginning of COVID-19, prevailing wisdom held that microfinance business models would undergo lasting and irreversible changes due to the depth and severity of the crisis. While to a certain extent this occurred, most MFIs in Europe did not fundamentally change their business models, although many changes introduced through digital technologies have become a permanent feature of MFIs' operations. Only a few MFIs fully digitally transformed to become fintech-like institutions.

This paper identifies the key building blocks of a microfinance business model and reviews their relevance in view of the recent pandemic crisis. Business model changes are analysed from the point of view financial sustainability, operational efficiency, resiliency towards external shocks and institutional capacity to provide services.

Against this backdrop, this paper documents how MFIs refined their business models by modifying their purpose, changing operational models, finding new customer segments, modernising delivery channels, adjusting risk measures and revising the funding options. Furthermore, this paper traces the evolution over time of the changes MFIs made to adjust their business models to the emerging pandemic.

Finally, this paper reviews the challenges to implementing new business models, as well as opportunities to overcome them in view of the accelerated trend towards digital transformation and increased presence of fintechs on the market.

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SUMMARY

This paper explores microfinance business models and, as such, is a part of a wider global debate about the future of microfinance sector and its role in advancing financial inclusion.

Despite differences of views and ideas in relation to the depth and speed of business model innovation, the latest evidence shows that increasing financial inclusion through digital channels has never been more urgent. Microfinance institutions (MFIs) have a critical role to play in supporting the most vulnerable people and equipping them with the tools they need to enter the digital economy—however their own digital readiness lags the needs and requirements of their increasingly digital-savvy clients.

Many microfinance institutions still use their original "low-tech high-touch" models to reach unsophisticated low-income clients. These models are becoming increasingly obsolete and inefficient, and MFIs must find digital ways to reach and interact with their customers, use data for better credit management and product design, and build more flexible core systems that support adaptability. This requires MFIs to coordinate across every aspect of their business to achieve a fully digital-enabled business model.

As shown by global initiatives such as NYU's Sentinel project and Accion's Digital Transformation Initiative (supported by the MasterCard Center for Inclusive Growth), digital transformation is a continual process that is driven by many factors, not least of which is the digital literacy of clients and digital readiness of small businesses to transact using digital financial services and channels. In that sense, the digital transformation is a process of gradual adjustment—the speed of which is often defined by unpredictable circumstances such as the COVID-19 pandemic which, by all accounts,

has given a major boost to digitalisation of financial services and delivery channels. Yet much remains to be done, both by individual institutions and the industry at large.

This paper analyses the structure of business models of European MFIs to better understand how MFIs create value for customers, position themselves in the market and finance their operations. Specifically, this paper explores MFI business models in the context of the COVID-19 pandemic, which challenged the viability of MFIs and offered opportunities, at least for some, to adjust their operations in response. The COVID-19 pandemic offered MFIs the opportunity to accelerate their digital transformation efforts that, by and large, had been initiated prior to the onset of the crisis. The initial assumption was that the crisis would change the business models of MFIs in a fundamental way and move them towards applying new technologies and adopting fintech-like operations.

As our field assessment shows, many business model changes have been introduced as a reaction to the evolving pandemic situation, and some of them became new permanent features of the MFIs' operations. However, there was no fundamental change to how MFIs operate and their business model structure. Despite this, the recent crisis experience was an excellent launchpad for deeper changes that were superimposed on the various adjustments to the business models introduced during the COVID-19 pandemic.

This paper begins with a brief review of the debates at the beginning of 2020 that tried to predict possible changes to the microfinance business model in the following months, of which only some turned out to be realised. The section following defines a business model in the context of an MFI and analyses the key building blocks of an MFI's business model. Using these building blocks, this paper further categorises the prevailing six types of business models seen across Europe.

Subsequently, this paper reviews in detail how the various components of MFI business models evolved during the pandemic. In general, the changes were mostly of an adaptive rather than disruptive nature and allowed MFIs to quickly and effectively adopt to a rapidly changing landscape in 2020–21. This paper then examines the relationship between business models and technology (particularly digital innovations). This serves as a backdrop for a discussion of the opportunities and challenges for digital repositioning and transformation of MFIs that may lead to new forms of business models and operational arrangements.

The analysis of the changes that were recently undertaken by MFIs leads to the assessment of the digital maturity of MFIs in Europe, broadly categorised in three types: 1) traditional MFIs with some digital adjustment, 2) hybrid institutions that retain traditional relationship lending approach while digitalising internal operations, and 3) fintech-like MFIs that operate as digital-only lenders.

Finally, this paper reviews the opportunities for alternative MFI business models that can take advantage of digital technologies through outsourcing, partnerships, and collaboration with various digital platforms. To meet the digital challenge and keep pace with customer expectations, MFIs need to digitally reposition their operations and move towards more inclusive and collaborative business models enabled by ecosystems that address customer needs in a holistic and seamless manner.

Our analysis demonstrates how all MFIs made some incremental adjustments and vital operational changes, but none went so far as to

fundamentally rethink their business model and introduce new ways of doing business. Microfinance institutions survived the emergence of fintechs, which so far do not operate extensively on the traditional microcredit market in Europe. However, this situation may change as new social finance fintechs enter the market and new business models emerge that combine the microfinance methodologies with fintech solutions and offer opportunities for growth and scale that MFIs so far have not managed to grasp. These opportunities can emerge through the digital repositioning of current MFI business models and through an ecosystem-enabled digital transformation of MFIs. These two processes can occur sequentially or simultaneously, depending on emerging trends in the financial services market and other complementary services for micro- and small-business clients.

This paper concludes with a review of changes induced by COVID-19 to MFI business models and the challenges to introducing alternative business models in future. The latter relate to the scale and scope of operations, use of data, adapting technology, and developing a new interconnected ecosystem in which MFIs are just one part of a larger network of suppliers of services.

INTRODUCTION

Objectives of This Paper

This paper explores the structure of MFI business models to better understand how MFIs create value for customers, position themselves on the market and finance their operations. Specifically, this paper explores the business models in the context of the recent COVID-19 pandemic, which tested MFI viability and offered a potential opportunity, at least for some, to adjust their operations in response to the crisis. Understanding MFI business models helps institutions and investors have a clear and transparent picture of the organisation's ability to provide services and remain viable. As such, they provide a high-level view of the organisation's building blocks and their role in maintaining the institution's good financial and operational standing.

Business models are not set in stone; they evolve in response to new challenges and opportunities and provide guidance for organisations to redefine how they do business. Examining the constituent building blocks of business models offer important insights on how they can be adjusted to a changing market or funding environment. Often, changing one component of a business plan leads to adjustments in others, even if the overall change is not a radical one.

The goal of this paper is to explore the range of business models applied by European microfinance institutions and examine how these enable them to provide financial services to their target markets. The findings and questions raised in this paper will be useful to MFIs' leaders, investors and funders—as well as policymakers supporting the microfinance sector.

While the discussion about microfinance models is not new, this paper is different in that it is the first, to our knowledge, that explicitly analyses the building blocks of an MFI's business model and proposes a categorisation of business models of MFIs present across Europe. It also defines potential scenarios for MFIs to follow in future as the digitalisation and virtualisation of financial services continues to prevail in the sector.

Methodology

This paper draws on an extensive literature review[1] of market trends, interviews with 16 institutions[2] in early 2021 (at which point the impact of the pandemic on MFIs and their clients started to come into focus), and MFC's previous research on the effects of the pandemic on microfinance. The interviews were conducted using a semi-structured questionnaire with CEOs and senior managers of MFIs. These interviews were supplemented with short case study analyses to illustrate different aspects of the business models' building blocks.

Business Model Debate During COVID-19

The onset of the pandemic sent shockwaves through the business world, and MFIs were no exception. Recognising the implications of the lockdown and other limitations on doing business, many experts and practitioners in the sector started to speculate around the potential impact of the pandemic on microfinance business models, which were predicted to drastically change due to digitalisation, virtualisation of services and diminished lending activities. Three strands of debate related to microfinance business models emerged during COVID-19: a pundits' debate, a crisis watch initiative and an action-research approach, each providing insights into the evolution of microfinance operations and sustainability.

COVID-19 and the Microfinance Pundits

Some of the early predictions articulated by microfinance experts and pundits were quite radical, namely that MFI business models would need to change completely within a short period of time. However, it soon became clear that day-to-day management activities ensuring business continuity took priority over rethinking the business model. It is also important to note that, although early voices advocating the change in business models were quite prominent, they rarely offered specific guidance for MFIs to weather the difficulty of the global health crisis.

While MFIs were adjusting to the new circumstances, the debate over microfinance business models has become more specific and focused on the need to consolidate smaller MFIs and digitalise internal processes and customer interface. As noted by Greta Bull, a leading microfinance industry expert,[3] the pandemic revealed fundamental weaknesses in the business model itself, including weak governance, difficulty attracting technical expertise, inadequate resources, rigid business models, and a heavy reliance on manual processes, to name a few. Over the last ten years, many MFIs have experimented with digitalisation, in the main using donor funds and in ways that studiously avoided challenges to the core business model. Yet Bull remains optimistic about the role of MFIs in the new reality, assuming they will be able to catch up and transform their processes to match the new digital reality.

Other opinions[4] were less positive, and even suggested that the inherent weaknesses of MFIs exposed during the COVID-19 crisis justified suspending funding to weaker institutions to force

1. See Annex A for bibliography
2. See Annex B for the list of interviewees
3. www.cgap.org/blog/after-storm-how-microfinance-can-adapt-and-thrive
4. www.cgap.org/research/covid-19-briefing/microfinance-solvency-and-covid-19-call-coordination

consolidations or mergers with stronger MFIs. The authors noted "It can be difficult to distinguish microfinance providers that have inherently weak business models but strong capital support of shareholders from those that have fundamentally sound business models but lack such capital support. Furthermore, as regulatory-imposed repayment 'holidays' are lifted, previously undetected portfolio quality issues in those microfinance providers may surface." According to this line of thinking, microfinance needs some form of "clean up," and the crisis could serve as the ideal opportunity. However, the authors did not offer criteria how to assess the weaknesses that would disqualify the MFIs from further funding nor provided any practical ways how to proceed with such a consolidation. As the pandemic evolved, the discussion about MFI business models became more toned and focused on the actual feasibility of digital transformation and adaptation to the new reality.

Microfinance COVID-19 Crisis Watch

Another strand of the debate is a crisis watch approach as evidenced by the Sentinel Project (implemented by the NYU's Financial Access Initiative[5] in partnership with the Mastercard Center for Inclusive Growth) to observe how MFIs tackled the crisis and adjusted their business models in real time in response to the evolving pandemic events.

The project followed a dozen or so large and medium-sized MFIs, around the globe across a range of markets and contexts, that were willing to report on their situation monthly. The purpose of this case study action research initiative was to document and understand choices made by microfinance leaders as their institutions negotiated the pandemic. Of particular interest were any pressures and demands on institutional leaders, the decisions they had to take and what trade-offs they faced to balance external developments with the internal need to manage their organisations. The project is also trying to monitor how the organisations fared compared to their competitors, and what constraints and prospects they faced for rebuilding the scope and scale of their operations after the crisis.

The Sentinel's blogs reveal how MFIs fall in three groups in terms of their fate during the COVID-19 crisis: (1) Some organisations have been doing very well, almost thriving—using the pandemic to deepen their relationship with customers, build out new operations (especially in the digital area) and generally put themselves in a position of strength for the post-pandemic period; (2) Others struggled to survive through the end of the year; (3) Those in between were coping, but with a limited ability to leverage the crisis as a means of reinventing themselves into stronger and more resilient organisations.

While the existence of these three groups is not surprising, it is more interesting to understand what factors determine which category a particular MFI will belong to. There seem to be three key variables that differentiate these institutions, and interestingly, the distinguishing factor is not necessarily the quality of MFIs' response during the crisis.

The first factor is the underlying strength of the institution before the crisis, both financially and operationally—combined with the quality of relationships with investors and funders who can provide support during a crisis. The second factor is the "luck" the institution has had in terms of the pandemic, including the prevalence of the virus, degree and length of lockdowns, regulatory response, and level of financial support provided by the state to financial institutions and/or their clients. The third factor is the degree of an MFI's innovation and adaptability in response to the crisis.

5. www.financialaccess.org/sentinel

While none of the institutions under observation continued business exactly as before, some have made major investments and changes in their operations. Many have introduced new products or services in response to changing client needs as well as HR changes. However, the degree of these changes varied and several MFIs made only modest adjustments.

Microfinance Digital Transformation Action-Research Initiative

In 2018, Mastercard Center for Inclusive Growth launched a first-of-its-kind partnership with Accion to leverage global networks and resources of both organisations to develop new solutions for underserved micro and small businesses to help them to grasp the benefits of the digital economy. The partnership combined technological innovation, digital transformation, research and professional engagement to create tools for small businesses and the financial service providers who serve them.

The project proved to be very timely during the pandemic and offered interesting insights into MFI business models that experimented with new digital innovations and solutions that can serve as guidance for other MFIs to reform their business models. The 2021 report,[6] which was based on the experience of MFIs participating in the project, proposed six strategies to support digital transformation on multiple levels of the digital divide. The overall conclusion was that, irrespective of the current level of digital maturity of clients and institutions, there are viable strategies that can help MFIs advance in their digital transformation journey. The experience of the Accion Network points to several important paths to digital transformation. First, MFIs need to acknowledge the importance of the legacy high-touch approaches and find creative ways to modify the lending processes such that they retain key human contact elements while digitalising other parts that do not require a high-touch approach. At the same time, MFIs need to recognise that a new generation of customers demand modern, digitally enabled solutions—which may require MFIs to run two parallel systems, at least for the foreseeable future.

Another important lesson from the field is that there are many ways to approach digital transformation and that there is no single “gold standard” in terms of an MFI becoming a fully digitally transformed institution, apart from whether such a thing is desirable and practicable. Many MFIs take intermediate steps, such as creating digital centres of excellence, which serve as in-house incubators of solutions that can be evaluated within a controlled environment before applying them throughout the whole organisation. Less frequently, some MFIs have even launched a separate digital entity to complement their more traditional operational models. This variety of pathways demonstrates that MFIs can find a solution that meets its needs as an organisation at various levels of institutional digital maturity and clients’ digital readiness.

These findings point to the need to rethink the microfinance business models from the perspective of core competencies, specialisation, and operational efficiency, which call for a greater and wider partnership relations with other service providers and stakeholders. The emerging experience shows that MFIs, despite having already numerous partnership arrangements, still operate at a lower level of cooperation and maintaining fee-for-service relations, limited to a small group of vendors providing services to MFIs and/or their clients. Only a minority of MFIs are expanding their understanding of partnerships and move towards the ecosystem-enabled relations where synergies can be created beyond direct service agreements.

Business Models in Microfinance: An Evolving Concept

Despite differences of views and ideas, the debate around business models shows that financial

6. The Digital Transformation Guide: Six Strategies to Scale Financial Inclusion: www.accion.org/the-digital-transformation-guide-six-strategies-to-scale-financial-inclusion

inclusion through digital channels has never been more urgent. MFIs have a critical role to play in supporting the most vulnerable and equipping them with the tools they need to enter the digital economy, however their own digital readiness lags the needs and the requirements of the increasingly digitally savvy clients.

Many microfinance institutions are built on low-tech, high-touch models designed during the pre-digital era to reach unsophisticated low-income clients. Now these solutions have become obsolete and inefficient, and MFIs must find digital ways to reach and interact with customers in new ways, use data for better credit management and product design, and build more flexible core systems that support adaptability. This requires MFIs to coordinate across every aspect of their business to achieve a fully digitally enabled business model.

However, transformation is a continual process that is influenced by a number of factors, not least of which is the digital literacy of clients and the readiness of small businesses to transact using digital financial services and channels. In that sense, digital transformation is a gradual process of adjustment, the speed of which is often defined by unpredictable circumstances, such as the COVID-19 pandemic (which, by all accounts, has given a major boost to the digitalisation of financial services and delivery channels). Yet much remains to be done, both by individual institutions and the industry at large.

BUILDING BLOCKS OF A MICROFINANCE BUSINESS MODEL

What is a Business Model?

In its simplest form, a business model is a design for the successful operation of a business, identifying revenue sources, customer base, products and the details of financing.

A business model is neither a business plan nor a revenue generation strategy. Rather, business modelling is about experimentation. Designing and executing business models for a business is akin to designing and running experiments for scientists. However, while a scientist might look for “the truth”, an enterprise searches and tests business activities that can work in the marketplace at a particular point in time and in the specific conditions.

A business model requires strategic and deliberate thinking, experimentation, and tinkering of its various components to make it work in given economic and social conditions.

Six Building Blocks of a Microfinance Business Model

A business model can be described[7] as a set of components or building blocks that represent various business activities and processes that combine to determine how an enterprise creates value and positions itself in the market.

7. One of the recent most popular frameworks – a business model canvas – was proposed by Alexander Osterwalder (see www.strategyzer.com/canvas/business-model-canvas). The business model is a condensed version of the canvas model adapted to the reality of a microfinance institution.

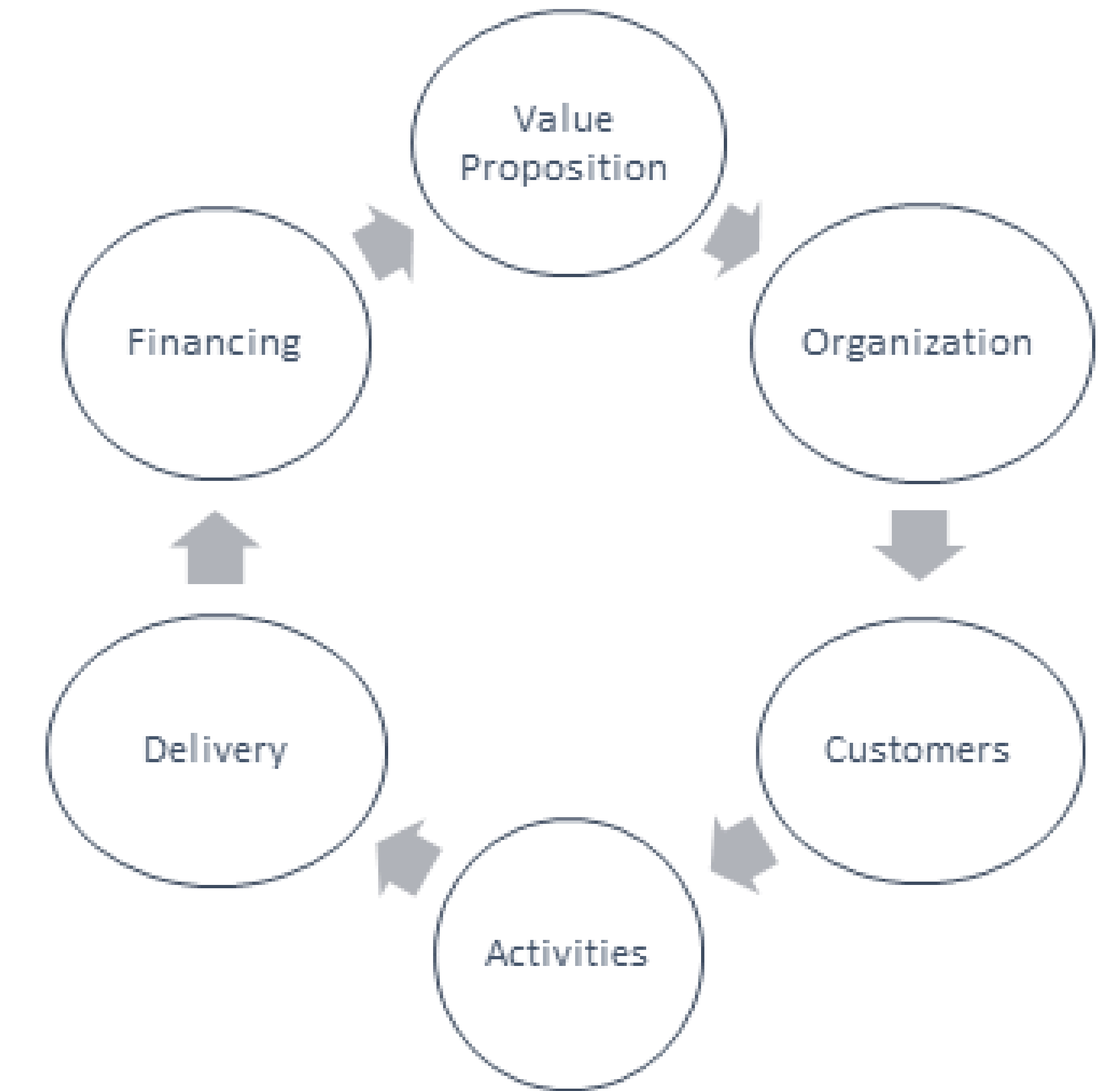
A microfinance business model can be described in six dimensions:

Value Proposition: What is the mission of the organisation and how it creates value for its customers?
The purpose of an organisation refers to its mission (the reason for its existence) and the way it creates value for customers. Broadly speaking, MFIs cater to two distinct segments: socially/economically excluded and economically active micro and small businesses for whom microfinance is an additional (or alternative) source of funding. In terms of value proposition, they provide access to loans that are otherwise unavailable on the market (e.g., personal loans for migrants or self-employed) or offer services that are available in the mainstream market but not for low-income individuals or microenterprises.

Organisation: What is the legal form and how does the organisation operate?
The organisational aspect of the business model refers to the legal form of an MFI (cooperative, private entity, public organisation) and the resulting legal and regulatory regime. It also includes the ownership structure and the level of institutional independence (independent entity, owned by a group of companies or holding, owned, or affiliated with a network).

Customers: Who are the customers and the main market segments served by the organisation?
The customer dimension relates to the types of customers that MFIs serve: businesses, individuals, or both. It also includes the specific segments of the business and consumer market served by the MFIs: specific social groups (e.g., women, migrants) or types of businesses (e.g., self-employed, family businesses).

Activities: What services does the organisation provide and what geographic areas does it serve?
The activities dimension of the business model relates to the main types of products and services provided by an MFI (financing, business development services) and its geographic outreach. As such, these products and services are the core of an MFI program.



Delivery: What lending technologies does the organisation apply and what operational systems does it use to deliver their services?
The delivery dimension of the business model refers to the lending technologies used by the MFI (traditional relationship lending, transactional lending[8]) and the operational processes (back-office loan processing) supporting the delivery system. These include internal loan management systems and cloud-based loan processing platforms. This aspect of the business model also includes the way an organisation communicates (personal communication, call centres, digital communication) with its customers and promotes its activities to target audiences.

8. By "relationship lending" we mean assessing the business viability by personal contact with clients on-site of their business and assessment of character through references, etc. "Transactional lending" refers to making loan application assessment and decision based on data without a need for a personal contact, for example by using credit scoring.

Financing: What is the revenue model and the level of sustainability, and how does the organisation finance its operations?
The financing component of the business model determines the ability of an organisation to make money, cover its costs and create a financial surplus. This includes the revenue model (interest rate, fee for service, grants) and the sources of funding (internal: retained earnings; external: loans, bonds, equity, grants, subsidies). This component of the business model also includes the role of shareholders, investors, and donors that play an important role in securing the financial resources for a successful operation of an organisation. In the EU, there are no deposit-taking MFIs; only banks and credit unions can take deposits. Thus, internal sources of funding are limited to retained earnings. The external sources are loans and grants for some MFIs, but virtually no equity options except for equity from European Investment Fund and private donors. IPOs and other market-based funding are not viable options as MFIs are small.

Typology of Microfinance Business Models in Europe

Using the building blocks framework, it is possible to identify six general business models of MFIs currently operating in the European market, ranging from heavily subsidised social projects to fully commercial microcredit operators:

1. **Social Purpose Project:** MFIs operating as a social purpose project work with the most vulnerable clients and typically provide subsidised loans and free business support services. As such, these MFIs are organised as non-profit organisations funded by government projects, charitable contributions and corporate sponsorship. Some may strive to be operationally sustainable but in general they operate at a financial loss (compensated by a high-valued social impact).

2. **Social Fringe Lender:** MFIs acting as a social fringe lender offer loans and potentially other support services to clients who are in transition from being funded by social purpose projects and more commercially oriented MFIs. Clients of these institutions are typically start-ups and early-stage enterprises, migrants and other marginalised individuals facing access to finance challenges. Like Social Purpose Projects, Social Fringe Lenders are typically non-profit organisations and offer soft funding supported by a portfolio of grants and donations, although the loan capital may be obtained on quasi-commercial terms.

3. **Social Enterprise Lenders:** These MFIs provide loans and other financial services (such as guarantees) to social enterprises such as: nonprofit organisations, arts and culture organisations, social purpose businesses and similar entities. Social Enterprise Lenders can have different legal forms (non-profit foundations, cooperatives, non-banking financial institutions, etc.) and typically operate as a social enterprise themselves. They balance their social purpose with financial sustainability and are often operationally self-sufficient.

4. **Collaborative Finance Organisation:** Collaborative MFIs include credit unions, savings and credit associations and financial cooperatives, as well as smaller cooperative banks. Due to their cooperative principles, they work with clients who are members and typically are limited to specific professional groups or members located in a given geographic area. Cooperative institutions are generally financially self-sufficient and funded by their members, although some may be able to accept external funding. Collaborative finance institutions also include various new forms of crowdfunding platforms that facilitate the sourcing of funds from a

larger pool of lenders and donors. However, unlike cooperatives, such platforms are not financially regulated.

5. **Market Gap Lenders:** MFIs acting as Market Gap Lenders address gaps in the lending and credit market for micro and small businesses. These institutions may offer loans of a type and size below the threshold for local commercial banks, or factoring and leasing services that are unprofitable for larger providers. Market Gap Lenders are, in general, non-banking institutions with a profit objective, and as such are regulated institutions.

6. **Commercial Microlenders:** Commercial microfinance institutions are typically non-banking financial institutions that have emerged at the beginning of the economic transition in Eastern Europe and over time have grown to become major players in the MSME finance market. They operate on purely commercial basis and, to some extent, compete with banks and other credit providers—but typically operate on the lower-end SME market.

A more detailed characterisation of each business model can be found in **Annex D**.

MFI BUSINESS MODELS AND COVID-19

The COVID-19 pandemic had impacted different MFI business models in different ways. Generally, MFIs did not fundamentally alter their business models; however, they introduced changes and improvements to some (but not all) building blocks of their business models. Some of these changes are of an adaptive and transient nature, while others are likely to become permanent features of in future. In some cases, the new approaches and features of the business model will function alongside older ones,[9] at least for the time being.

Value Proposition

COVID-19 Impact

Regardless of the purpose of an MFI (social, commercial, mixed) and its value proposition (financial inclusion, access to finance[10]), the COVID-19 pandemic had a profound impact on

9. For examples see: Korynski, P. The Tech-and-Touch Mix in Microfinance, Microfinance Centre, 2018. mfc.org.pl/the-tech-and-touch-mix-in-microfinance
10. "Access to finance" challenges appear when services do not exist on the market, for example lack of factoring products for micro and small businesses, or they exist but they are not accessible because of their features (too costly, not available in a particular location, etc.), for example high initial balance to open a savings account. "Financial inclusion" challenges appear when services exist on the market, but users are excluded for reasons other than the quality of their business proposition or loan application, such as their personal characteristics, social status, or ethnic background. In that sense, access challenges relate to the incomplete or fragmented financial market offer (supply-side issue) and inclusion challenges relate to potential market discrimination and unfair treatment by financial services providers (demand-side issue).

how MFIs operated and provided services during the crisis.

The socially oriented MFIs that work with more financially excluded customers experienced more negative impacts, inasmuch as their customers' businesses often deliver in-person services to their customers (e.g., restaurants, cleaning, etc.) that were limited during the pandemic because of lockdown.[11] Such clients (for example, migrants, who are generally in a more precarious economic situation) were less likely to receive government support, and some left for their countries of origin, which diminished their ability to meet their loan obligations. Finally, since socially oriented MFIs are considered "lenders of last resort" for financially weaker clients, during the pandemic these MFIs attracted the "wrong" unbankable clients who should not be funded under any circumstance, and not only in the pandemic. MFIs that offer personal loans for professional development and asset building observed an increased interest in this product, but for consumption purposes.

In comparison, MFIs working with better established businesses fared better, although not without challenges. Many business borrowers received government support in various forms, which allowed them to keep up with repayments, even if at a minimum level. This relatively satisfactory repayment of loans did not signal a need for revisiting the business model in any significant way.[12] From the MFIs' perspective, the loans were current and performing, and there was no need for concern for the performance of this segment.

MFI Actions to Mitigate COVID-19 Impact

While it may be too early to draw final conclusions, MFIs did not attempt to change the social purpose of their organisations as a result of the pandemic—by changing neither their mission (for example, to become more socially oriented) nor how they create value. Changing or adjusting the overall purpose was not a priority for MFIs during the pandemic.

Organisation

COVID-19 Impact

There were no systematic differences in terms of the impact of the pandemic resulting from different organisational forms, ownership structures and affiliations. In general, owners and shareholders, especially commercial banks that support the MFIs as part of their corporate social responsibility (CSR), were supportive throughout the pandemic and willing to accept potential operational losses, as was the case of MFIs that rely on subsidies and ongoing financial support. Their continued support was a sign of their commitment to the organisation and the cause that it is pursuing. There were no specific governmental programs for the microfinance sector in terms of operational support.

MFI Actions to Mitigate COVID-19 Impact

As was the case of the purpose component of the business model, MFIs did not change or adjust their legal status during the COVID-19 pandemic. However, this may change as the shareholders may be evaluating the MFI financial needs and their financial exposure in future.

One action that is related to the organisation is the implementation of a business continuity plan that describes policies and procedures for emergency and crisis situations. These often ignored and forgotten procedures, where they exist, came into their own during the crisis to adjust the organisation to the new conditions and

11. Dabrowska K., Korynski P., Pytkowska J. Impact of COVID-19 Pandemic on the Microfinance Sector in Europe: Field Analysis and Policy Recommendations. www.mfc.org.pl/impact-of-covid-19-pandemic-on-the-microfinance-sector-in-europe
12. Ibid.

FONDI BESA, ALBANIA: EMERGENCY READINESS AND BUSINESS CONTINUITY PLAN IN ACTION

Growing organizational complexity calls for a different system of management that includes preparation for unexpected crisis and natural disasters. The 2019 earthquake was a clear signal that Besa needed to be ready for the unexpected "black swan events" that are beyond the routine systems of control and management. This realization led to the development of the Business Continuity Plan (BCP).

The BCP is a comprehensive document that outlines the procedures and actions that an organization needs to implement at the time of a major incident, emergency, or crisis. Here, "crisis" is defined as an abnormal situation or event that is beyond the scope of normal business operations and that poses a significant threat to the organization as a whole or its specific territories, people, property, client relationships, operations and/or brand reputation.

The COVID-19 pandemic fully met this definition of "crisis", and as soon as it was clear that CIVOD-19 was not a typical transient event but an event with long-term and largely unpredictable consequences, Besa shifted its operations into crisis mode and activated the BCP. Based on this plan, the organization invoked the Crisis Management Team (CMT) led by the Executive Director with the involvement of other managers with clearly defined roles and responsibilities.

The Crisis Management Team, thanks to the existence of a clear BCP, was able to quickly reassign roles and responsibilities that were geared towards the appropriate response to the crisis both internally and externally in relation to clients, regulators and other stakeholders. The existence and the timely execution of the BCP helped Besa to ride out the crisis with few interruptions and relatively low losses and be able to return to normal operations much faster.

reassign responsibilities differently than during normal operations (see the case of Fondi BESA).

Customers

COVID-19 Impact

The COVID-19 pandemic had a strong and negative impact on MFI customers. One of the reasons for this was the relatively low digital maturity and digital transformation of micro and small businesses. According to the recent survey conducted by the EU,[13] half of respondents perceived that before the COVID-19 outbreak the two aspects related to a structural change of the existing business model (i.e. automation and/or digital transformation of the processes, and development of new products and/or services) had been implemented/adopted by only a few SMEs.

Some client businesses have slowed down or were temporarily suspended, however relatively few completely shuttered operations.[14] Most had to change their way of working in lockdown, even those that were declared "essential business activities" needed to adjust to new physical distancing procedures and increased sanitisation requirements. Many businesses suspended their activities during the pandemic, the service sector (street vendors, restaurants, hairdressing, beauty salons, tourism business) being the most affected. Shops, market trading activities, personal transport and construction were among the segments that were first to close or substantially reduce the

13. The state of digital transformation at regional level and COVID-19-induced changes to economy and business models, and their consequences for regions, European Commission for the Regions, July 2021. https://op.europa.eu/en/publication-detail/-/publication/3fb4164e-fodc-11eb-a71c-01aa75ed71a1/language-en
14. Ibid.

scope of their activities. Of those that did not have to close their activities, the majority were in agriculture (where the direct immediate impact was less pronounced), but this may be only a temporary phenomenon due to the nature of agriculture and the time lag between production and going to market. Businesses with multiple business lines fared generally better than single-activity enterprises, inasmuch as not all business lines had to discontinue or slow down at the same time or at the same rate.

Finally, there was a substantial percentage of entrepreneurs and business owners (for some MFIs up to 20% of clients), who voluntarily suspended activities for fear becoming infected or because of their personal situations.

It is also interesting to note that, although the situation may be difficult and, in some cases, the chance of restarting a business or returning to pre-COVID-19 sales levels may be small, the number of permanent closure among the microfinance clients was very small. Most businesses and entrepreneurs remain optimistic about their ability to rebound and continue, even if the way they operate will be different. Many also lack other options for earning an income, and so will make a strong effort to stay in business. For others, a microenterprise is more than a business or source of revenue, it is a part of their life, and they are unwilling to give it up.

One of the main reasons for better-than-expected performance of micro and small businesses is the direct governmental cash support for business owners. While the scope and scale of this support varied by country, the purpose was to prevent broad-scale employee lay-offs and sustain small businesses in the short term. These cash subsidies were instrumental in keeping MFI borrowers in good standing despite a fall in revenue from business activities. Finally, many governments introduced mandatory moratoria on loan repayments, which removed immediate pressure on businesses to meet their loan obligations.

MFI Actions to Mitigate COVID-19 Impact

Many MFIs, even those that did not provide business support and development services to clients, started to deliver webinars and trainings on business topics to help their clients manage their businesses during the pandemic. Some MFIs that offer mentoring and coaching services also provided training and support to their coaches to help them make the leap to delivering support services virtually. Some (but not all) MFIs provided clients information on funding opportunities and other support programs offered by the national and local governments to ensure that clients could take advantage of available assistance. However, beyond providing information, MFIs did not help their clients with applying for such programs.

Activities

COVID-19 Impact

Without exception, there was a significant decrease of the activities of MFIs during the pandemic, both in terms of the number of new loans disbursed[15] as well as the range of services provided. In general, MFIs did not alter their core activities, although the mix and type of loan products may have changed during the pandemic. Also, those MFIs that offer additional business development services (BDS) scaled back or suspended these services because of a lack of funding and the difficulty of providing them during the pandemic. Lending decreased sharply for several reasons: lower loan disbursement for business activities that could be funded (there was clearly an increased demand for cash from old and new clients but that posed higher risk of defaults), less liquidity to finance new loans, less reflows from

15. For instance, according to the Microfinance in Europe: Survey Report 2020 edition (EMN/MFC, 2020, www.mfc.org.pl/overview-survey-2020), as Bosnia and Herzegovina shows, the value of disbursements decreased by 6% in Q1 2020 compared to 2019 and further decreased by 19% in Q2 compared to 2019.

loan repayments due to mandatory moratoria—to mention a few. Also, MFIs that operated in a more traditional way needed time to adapt their internal processes and procedures to deliver loans using virtual communication and documentation processes. This included securing digital signatures on loan agreements, digital transfer of various documents, virtual due diligence visits and virtual reference checks of potential clients. In addition, staff working arrangements were changed due to lockdown restrictions, with loan officers and administration staff working from home. As mentioned, BDS suffered an even sharper decline than loans, as these services are of the auxiliary type that need to be funded by MFIs, which in a time of crisis was not the priority. Also, MFIs that provided these before the pandemic as in-person services were not ready to offer business training and mentoring services online or through mobile communication.

MFI Actions to Mitigate COVID-19 Impact

Debt rescheduling was the most common reaction by MFIs during the initial months of the COVID-19 crisis, followed by introducing new options for emergency loans. The following options were reported by most MFIs:

1. **Loan rescheduling and internal moratorium on loans:** While virtually all MFIs introduced some form of moratorium on loan repayment and loan rescheduling, there were differences as to how this was executed. In rare cases, MFIs offered loan rescheduling to all clients; the majority took a more limited approach offering loan moratoria on a case-by-case basis and only to those who requested rescheduling and made a case for it. Most rescheduling was on a month-to-month basis leaving the MFIs with an option to request loan repayments as soon as clients resumed business activities.

2. **New types of loans:** Some MFIs tapped into COVID-19 support funding provided by state agencies. This allowed them to offer new (subsidised) liquidity loans and significantly increase their client base during the crisis. Successful delivery of crisis lending strengthened the relationship with the funding agency, and highlighted new opportunities in distributing state funding to MSMEs. It also allowed MFIs to work with a new target groups or in new locations.

CRYSTAL, GEORGIA: EXPANDING THE CUSTOMER BASE

For Crystal, the pandemic was an opportunity to reflect on how it provides services. It identified the need for new products, especially for growth-oriented businesses that need a different type of financing. For this reason, Crystal started experimenting with micro-equity as a new form of financing for growth-orientated businesses.

In the long term, Crystal may hive its micro-equity product into a new subsidiary so as to better manage the risks of equity investments separately from its core lending business—in line with its commitment to provide long-term assistance to development-oriented MSMEs within the Crystal Group.
Crystal has launched fixed-asset financing (leasing) for MSMEs and farmers in 2020, thereby diversifying its offerings and expanding its customer base.

Crystal has also created "Akido", an e-commerce platform and B2C marketplace that businesses of any size can use to market products to customers using online payment methods or via online installment product offered by Crystal directly. This has simultaneously created an additional sales channel for the MFI. In 2020, Crystal founded Crystal Consulting, another fully owned subsidiary that delivers training, mentoring and digital applications to high-growth client MSMEs.

FINCA, ARMENIA: POST-COVID ORGANISATIONAL CHANGES

FINCA Armenia initiated its digital transformation with the aim to improve the availability and speed of its services. The process started in 2019, and the period of slowdown in the pandemic offered the opportunity to advance and further develop the new approach.

The basic feature of the new approach is fully digital delivery of microloans for farmers and clients who are formally employed (who constitute more than 70% of FINCA's client base). The loan processing time will be as short as 30 minutes, compared to up to 5 days previously.

The second important aspect of FINCA Armenia's development strategy is the transition from pure lender to business partner and strengthening its non-financial services delivery. As most clients will interact digitally in future, it envisions that its branches will be a space for physical delivery of non-financial services such as training for farmers. As farming practices in Armenia are very traditional, FINCA Armenia will organise meeting and workshops with agricultural specialists to present new cultivation techniques, new crop varieties—as well as "green" topics such as renewable energy, energy efficiency resources and green cultivation.

3. **Post crisis loan products:** While most MFIs curbed the numbers and amounts of new loans during the pandemic, some launched emergency loan products to support clients with liquidity during the crisis. The demand for such products turned out to be modest, as borrowers may have been unwilling to assume additional loan burdens during these uncertain times.

As MFIs accelerated their internal digitalisation process, the need for branches in the field decreased. Some decided to merge their field offices and transform the existing ones into training centres to provide value-add services for clients (see case of FINCA Armenia).

To a lesser or greater degree, MFIs with plans to digitalise before the pandemic often had a budget to do so. Some developed digital tools that were underutilised, and some solutions used were cost-free or free (WhatsApp or Zoom). Many MFIs were a few years into their digitalisation journey,[16] and the pandemic was an opportunity to accelerate the process given that staff were not too busy with lending activities.
At the same time, for the past few years the European Investment Bank (EIB) offered development loans to MFIs for the purpose of upgrading internal systems, which also helped with the digitalisation process. Still however, more resources are needed to revamp MFI operational systems to make them fully digital.

Delivery

COVID-19 Impact

Since most MFIs in Europe were still using the traditional relationship-lending technologies, and any digitalisation was typically focused on back-office processes, MFIs were caught unprepared for the inability to digitally approve and deliver the loans to customers at the beginning of the pandemic. Efforts were taken to quickly adjust internal processes to go virtual (for example, replacing site visits with virtual contacts through Zoom/WhatsApp/Skype, digital application, and submission of documents by email, digital signatures, etc.), and they were to some degree successful, but there was a lag time in implementation for the organisations, their staff and the customers who had to learn the new way of interacting with staff and applying for loans.

16. Earlier efforts to digitalise MFIs are described in: Korynski, P., Experimenting with Digital Solutions: Initial Lessons from European Microfinance, Microfinance Centre, 2018. www.mfc.org.pl/experimenting-with-digital-solutions-initial-lessons-from-european-microfinance

MICROSTART, BELGIUM: SEARCHING FOR EQUILIBRIUM IN THE POST-COVID-19 LANDSCAPE

microStart works through two legally separate but operationally integrated entities (a social cooperative and a non-profit organisation) offering financial and business development services for clients who need assistance with starting and operating a successful small enterprise.

The business model has so far relied on balancing the net positive revenue from the non-profit part (which is funded through grants and donations) and the financial operational and credit losses from the social cooperative providing loans to clients. microStart works with more risky clients, and its loan losses are higher than in typical small-business lending operations. These losses (write-off) got even a bit higher during the pandemic as vulnerable clients faced additional challenges during lockdown and with an overall decrease in business activity. As a relatively new institution, microStart was on its way to becoming operationally self-sufficient when the COVID-19 pandemic arrived, which pushed the goal of reaching breakeven into the future. If things go well, the target date for the breakeven is between 2025–27.

The pandemic exposed some improvement points in how microStart operates and serves clients and offered an opportunity to rethink the business model going forward if breakeven is to be achieved. One major change was to speed up the digitalization of internal and external processes by migrating to a new operational loan platform, Singlify. The platform created options for remote card readers, digital document management, digital signatures, and credit scoring.

In addition, microStart developed a new distribution model that combines five traditional physical agencies and one digital branch, with the locations for agencies provided free of charge by the business partners of microStart. During the pandemic, microStart instituted virtual monitoring of clients, demonstrating how remote monitoring can be performed in a cost-effective way in the future. Also, its business advisory services received a facelift.

MFI Actions to Mitigate COVID-19 Impact

MFIs almost uniformly accelerated their efforts to digitalise operations, introducing remote communication processes and adjusting lending processes to make them available through digital channels. Some strategies employed by MFIs include:

1. **Online loan applications and loan approvals:** Most MFIs used traditional application processes; although online options existed previously, they were used only by a small number of clients (usually younger ones). The crisis eliminated any possibility of submitting a loan application other than in electronic form, and this forced both institutions and clients to use online and mobile systems that were in place but not extensively used before.

2. **Digital disbursements and collections:** Those MFIs that still disbursed cash and accepted cash repayments had to quickly develop online options using banks, mobile phones or credit/debit cards.

3. **Distance monitoring:** Since face-to-face and onsite monitoring was not possible, MFIs turned to technology to monitor clients and their ability to repay loans. Various options were used: Skype, Zoom, WhatsApp, Viber, and other communication platforms—relying in the main on mobile apps as most clients have smartphones with video capabilities.

4. **Remote work arrangements:** All MFIs moved to remote work arrangements by mandating staff to work from home and use technology to communicate and collaborate. Even with the easing of restrictions on movement and social distancing, most MFIs continue to work in a virtual way although some aim to gradually return to face-to-face contact with clients.

Financing

COVID-19 Impact

Despite initial fears, only a few MFIs reported liquidity problems causing them to reduce, if not completely suspend, lending and reduce expenses in the short term. Some MFIs received emergency funding from their lenders and investors under existing contracts, others had to enter tough negotiations to receive emergency funding. Larger MFIs were able to obtain cash loans from local banks to cover liquidity shortages to pay salaries and other current expenses. Those MFIs who were unable to access cash had to introduce more drastic measures such as reducing salaries or even laying off staff. However, most MFIs entered the crisis in relatively strong liquidity positions, which helped them survive the crisis without major negative consequences.

MFI Actions to Mitigate COVID-19 Impact

The simplest and most obvious strategy was for MFIs to reduce lending and renegotiate the terms

NOVITI FINANCE, LITHUANIA: EFFICIENT LENDING ATTRACTS GOVERNMENT FUNDING DURING COVID-19

Noviti Finance is a new-generation institution that benefits from the well-developed digital environment in Lithuania. Its fully automated lending process allows micro and small business clients to obtain loans quickly; Noviti's automated client credit risk model allows it to select viable clients and keep risk under control.

Noviti always wanted to cooperate with the government agency, INVEGA, which until the COVID-19 pandemic preferred working with banks. However, the crisis prompted INVEGA's decision to open its doors to non-banks. COVID-19 support funds from government included funds for administration (on-lending) to banks and non-bank institutions. Noviti took the lion's share of the available financial resources (double the amount that the largest bank took).

The global crisis was an opportunity for Noviti to react quickly at a time when traditional lenders were passive, inflexible with loan restructuring and slow in disbursing loans because of complicated procedures and risk aversion to small businesses. Noviti used its competitive advantage to expand its lending business during the pandemic.

Being fully digitalised and equipped for virtual communication with clients was a great advantage that other financial services providers did not have. Additionally, Noviti's flexible loan terms and conditions were very helpful during the crisis. For example, unlike other financial institutions, it offered clients the opportunity to delay repayment twice during the quarantine and lockdown (25% of clients used this opportunity and paid only interest for two months) and provided loans to companies with low credit scores.

and conditions of external funding, both loan capital and grant funding. In addition, MFIs that continued lending reduced their loan amounts and applied stricter approval criteria to mitigate increased risk of lending during the pandemic. Those MFIs that had cash reserves used them during the crisis and others, if they could and qualified, took emergency operational loans from local banks to cover the temporary cash shortages. However, there were no major changes in the type of funding that was available to MFIs as investors and lenders limited their exposure to their current portfolios, and in general did not extend loans to new MFIs.

Some MFIs reverted to project-based funding whereby they apply for available donor-funded programs that are often based on a fee-for-service revenue model. Such programs, for example offering disbursing emergency loans to businesses during the pandemic, provide short-term stability and security for the MFI in the short run but do not allow for developing broader market-based lending programs and limit the organisation's ability to grow.

FWW POLAND: NEW TYPES OF LOANS DUE TO COVID-19

Before the pandemic, FWW, one of the oldest MFIs in Poland, offered zero percent loans to vulnerable clients using internal resources it accumulated from various donors and sponsors. It also managed small loans for vulnerable groups for Polish Development Bank (BGK) programs. FWW's revenue for this came from charitable donations, internal resources, and fees for administering the BGK programs. When the pandemic hit, its existing business model proved insufficient. Traditional clients were no longer seeking loans and the organisation faced a survival dilemma. Luckily for FWW, in 2020 the BGK launched emergency loans for small businesses. FWW successfully applied for the BGK emergency program. FWW offered internal resources as to co-fund the project, which diminished its ability to continue lending with its own resources. As a fee-for-service, the new BGK program brings modest revenue that allows the organization to continue operating—but at the cost of losing independence in terms of its lending activities (loans and loan recipients are narrowly defined and limited to selected geographical areas). It also entails a huge bureaucratic burden which is costly for FWW necessitated internal changes to comply. More people are now engaged in the program and operational costs have increased.

PERMICRO, ITALY: COVID RECOVERY WITH RESILIENT SHAREHOLDERS

PerMicro serves underserved segments of entrepreneurs in Italy that are typically unreached by traditional financial institutions. At the beginning of 2020 PerMicro was very optimistic: 2020 looked very promising. For the first time the organization had several months of sustained positive financial results and was hoping that the trend would continue. In February, Italy was badly hit by COVID-19 and by March, many of its clients stopped operating their businesses, repayments were suspended due to a national loan moratorium, and many migrant clients returned (at least temporarily) to their home countries. The organization had little money coming in, little income-generating activities and the only clients seeking loans were those who should not be funded under any reasonable circumstances. As a result, 2020 delivered a significant financial loss that could have put PerMicro out of business.

PerMicro's shareholders came to rescue at this very difficult moment. They clearly understood the situation and they offered to increase the share capital by providing equity. The shareholders showed not only the much-needed financial support to the organization but, more importantly, they demonstrated long-term commitment to PerMicro on the strength of their belief that the pandemic was one-of-the-kind extreme event. The shareholders recognised the social and economic value of the organisation in the longer perspective and its ability to rebound if shareholders show resilience.

MFI BUSINESS MODELS AND TECHNOLOGY

All businesses – including MFIs – rely on technology to deliver products and services to customers, and technology has become standard even though MFIs may not be fully digital or may have not transformed into a fintech. However, technology adds a digital layer onto existing business models and the key question is how a business model is built around technology.

Business models are fundamentally linked with technological innovation and digital innovation in particular, yet a business model as a construct is separate from technology.

Over the past few years, MFIs have engaged in digital transformation, initially slowly and reluctantly but increasingly in the recognition that the future of financial services is digital, and that the customer experience can be enhanced through digital technologies. COVID-19 accelerated that process and put many, although not all, MFIs on a path of technological innovation and experimentation that influences how their business models operate.

The old battle cry of "digitalise or die" has proved useful only to a certain degree. As is often the case in life and business, gradual adaptation to the new digital world dominates the rapid shock-therapy changes that some pundits predicted at the beginning of the pandemic. It is also true that, at this point, there is no doubt that business growth and customer satisfaction cannot be achieved without the use of digital tools. Therefore, the challenge is not whether to adopt digital tools, but which ones to select and how to use them to become the best company.

There are at least three different ways in which digitalisation influences and changes companies and their business models: (1) optimisation of the existing business model (e.g., cost optimisation through applying labour-reducing loan processing and redirecting staff effort to value-enhancing activities for clients, etc.); (2) transformation of the existing business model (e.g., reconfiguration or extension of the established business by acquiring new capabilities, for example, access to new payment systems for clients, etc.); and (3) development of a new business model (squeezing out established market participants, new products/services, for example, capturing new client segments through digital channels that were previously unavailable, etc.).

Typically, the business model is influenced by new technologies through as a series of steps that can also be observed in the digital evolution of MFIs. First comes the digitalisation of products and services (for example, offering online loans, etc.); second:, the digitalisation of processes and supporting decision-making with data and digital solutions such as artificial intelligence (in the case of microfinance, some processes are being digitalised and some technological tools are introduced, such as chatbots and to some degree AI solutions, cloud computing, etc.); and third, the transformation of the value proposition and operating model of the whole organisation, which involves a major overhaul how an MFI operates and is the highest level of the digital transformation.

The pandemic experience demonstrated that most changes introduced by MFIs occurred by integrating and adapting digital tools, except for fundraising—which still follows a traditional investment model. Better customer experience, communication, talent attraction, more loyal customers, brand awareness, internal collaboration—all these can be achieved with the use of technology (although not without challenges and limitations).

At the same time, it is important to understand that innovation is not limited to technological innovations and high-tech solutions, but also includes marketing innovation, management innovation, process innovation and product innovation. Trying out different ways of doing things in the business and rejecting conventional wisdom means innovating with the business model, even though these innovations may not be high-tech.

This confirms the view that business models, while closely related to technology and innovation, are more than digitalisation and digital transformation—even as MFIs become more technologically enabled and move towards fintechs. Both internal factors (such as the organisation's digital readiness) and the external environment determine the scope, scale and speed of digital transformation, and how the business models embrace the technological changes to create value for customers.
To take advantage of digital opportunities and innovate their business models, organisations must have the ability to sense business model opportunities, seize them through the development of valuable and unique business models, and reconfigure the organisation's resources and capabilities accordingly. These capabilities are not a subject of this review, however they are likely to add value in explaining why certain organisations operate more successfully than others, and why, for example, there were differences in performance of MFIs during the crisis, as observed by the Sentinel research.

DIGITAL MATURITY OF MFIS

Microfinance Digitalisation

The relation between MFIs and fintechs in Europe is complex. With fintechs having earned a bad name, MFIs avoid calling themselves "fintechs" for fear of being equated with predatory payday lending and strive to retain their image as responsible lenders. This negative reputation of fintechs has contributed to the slow adoption of fintech technologies by MFIs and has largely eliminated any potential partnerships with fintechs, as there are few good candidates for creating a partnership or a strategic alliance. Moreover, most fintechs operate in the consumer lending business, which is a marginal line of activity for MFIs.

However, this is changing as the fintech sector has grown and expanded, offering other services that can provide useful solutions for MFIs without being in direct competition for their lending business.

There are also many credit unions and cooperative finance institutions in Europe that provide microfinance services, but they still do so in a traditional way. They also have adapted to new financial market conditions, but continue to enjoy the loyalty of their members, especially in rural areas where they play an important role. Of all MFIs, credit unions are in the best position to digitally transform and digitalise through a shared loan processing platform. While technically feasible,[17] the main barrier is the organisational culture of the credit unions who want to maintain their independence, in addition to the high cost of implementation and servicing the common operational platform.

Many MFIs are still hesitant to "rip-and-replace" their legacy core systems—data storage on their own servers, loan transactions using "DIY" programs, customer management systems, etc. These systems seem to still work well and meet MFIs' needs. Any serious digital transformation would require substantial financial investment—and funds for this are lacking.

At the same time, the new fintech lenders have encroached on the traditional microfinance market, luring some MFI clients with a fast and easy loan approval process that comes at very high interest rates. Therefore, competition between MFIs and fintechs has created a challenge for MFIs, especially on the consumer segment of the market. So far, there are not many examples of fintechs that have succeeded in enterprise lending, especially on the lower-end microenterprise and self-employment segment where MFIs are still very strong. However, fintechs engaged in enterprise lending and other services (such as factoring or leasing) are emerging, offering direct competition to MFIs at the lower end of the market.

New entrants, such as Noviti Finance in Lithuania, operating as an MFI fintech have the advantage of entering the market at a point when technology has greatly advanced, such that they do not suffer from legacy problems. Noviti also fares better than other MFIs because overall levels of digital maturity of borrowers in Lithuania is higher than in other countries, especially in Southern Europe.

Three Levels of Digital Maturity of Microfinance Business Models

There is a great variety of operational business models of microfinance in use across Europe. In general, European MFI business models find themselves on three levels of digital advancement. Some remain mostly unchanged with only minor necessary adjustments, acting as if they remained in the analogue era ("Analogues"). Others – most MFIs at present – have digitalised some parts of their business (mostly internal operations) but retain the relationship with clients in the traditional way ("Ambidexters"). And lastly, there is a small but growing number of MFIs that are becoming full-fledged digital organisations ("Fintechs").

Analogues

The Analogues are the social finance and entrepreneurship projects and social fringe lenders that, due to their small scale and strong social inclusion mission, find it difficult to introduce digital solutions on a large scale. The services provided by these organisations rely on personal relations with clients who often have challenging backgrounds and difficulty connecting with social and financial infrastructure.
These organisations have limited options to expand their services or make them more efficient through company-wide digitalisation. However, they introduce various solutions, in particular communications tools and loan management tools that increase operational efficiency and lower costs.

17. Banking software groups such as Temenos offer credit union processing platforms which could digitalise the operations of credit unions on a country or regional levels: https://www.temenos.com/us/solutions/credit-unions/

Digital transformation strategies:

1. Use available digital solutions such as communication tools that are ubiquitous and used by the target audience.
2. Purchase a digital service on a subscription basis, i.e. existing platforms to manage loan portfolios if the volume of loans justifies the cost and effort.
3. Create partnerships with other organisations and platforms to outsource some digital services.

Opportunities for scaling:

1. Create a European-wide social finance organisation (as a collaborative network or through a merger of country-level programs) to create scale and explore synergies; such a network or enlarged organisation to deploy digital applications efficiently because of the expanded scale (and likely scope) of their operations.
2. Off-load select functions to a shared knowledge and resource platform to feed the social finance organisations with information and knowledge support without the need to develop these resources on their own on a limited basis and scale.

Digital transformation challenges:

1. Small scale of operations that are typically limited to regional if not national level and to specific target groups.
2. Lack of investment resources to finance digital transformation or create a common operational/support platform.
3. Perceived cultural and organisational differences between social finance providers maintaining a unique approach to working with vulnerable clients.

If they continue their operations as is, these organisations will have little to gain even if they digitalise internally or via outsourcing or partnerships. The limited scale will not allow them to reap the potential efficiency gains from the technology. Therefore, Analogues need to find ways to increase their scale and scope of operations to make digital transformation a viable investment.

Fintechs

Some MFIs are beginning to deepen their digital transformation towards becoming a fintech or digital-only MFI.[18] For example, FINCA Azerbaijan transformed into a fully digital organisation to provide services through digital channels only, virtually eliminating human contact with clients. Another small MFI in Bulgaria, Mikrofond, is also developing a digital only operation to reduce costs and better compete on a very competitive lending market in the country. These examples show that MFIs can digitalise to a high degree, but they will not be able to service certain segments of the markets in the same way as before, for example start-ups and vulnerable individuals who still need a personal touch service in addition to access to capital.

There are also new entrants in the enterprise lending market that do not yet serve the lower-end microenterprise market that MFIs occupy but will be able to downscale and threaten the position of MFIs in this segment. Fintech companies such as SMEFinance (Lithuania),[19] Kredyt Market (Poland)[20] and Brutto (Poland)[21] offer digital loans and other financial products for SMEs using a fast and easy onboarding process that is attractive to entrepreneurs. These services, however, are only available to existing small businesses, meaning that when it comes to early-stage enterprises—MFIs retain a competitive advantage.

18. This trend has been initiated a few years ago by ProCredit Bank, which decided to exit the microenterprise lending market and transformed itself into a digital-only bank whose customers have little in-person contact with the institution.
19. www.smefinance.eu/en
20. www.kredytmarket.com
21. www.brutto.pl

Ambidexters

Ambidexters represent the largest and growing number of MFIs in Europe. They have initiated digital transformation to various parts of their organisations but largely retain relationship lending and direct contact with clients. By doing this, they combine the best of two worlds (at least for now): the increased efficiency thanks to the digital technology of the back office and the time-proven personal relationship lending with clients. Decisions are still made based on the loan officer's assessment of the business' viability, while loan processing is automated (to varying degrees depending on the size and scope of the MFI). These organisations have a good opportunity to expand operations in both the traditional and digital market segments. By retaining the traditional approach, they continue to serve less digitally advanced borrowers. By developing digital capabilities, they can enter the new segments, and if opportune, they can pivot to a fully digital mode.

Digital transformation strategies:

1. Develop internal digital operational processes by building or acquiring more sophisticated digital operational systems.
2. Outsource the internal operations to specialised digital platforms.
3. Retrain staff to prepare them for potential pivot towards a fully digital organisation.

FINCA AZERBAIJAN

Once the largest institution in the Caucasus with over 165,000 borrowers, FINCA Azerbaijan and its clients were hit hard by the devaluation crisis in 2015. Due to economic challenges and uncertainty, many clients struggled to make repayments and loan demand plummeted. With rising client delinquencies the institution struggled to maintain its operations and had to pause loan disbursements for 2 years and drastically reduce cost by laying-off over 1,000 employees and significantly downscaling its national branch network. During this time, FINCA Azerbaijan concentrated on implementing radical organizational change and development of a new more efficient and centralized digital business model which then became the genesis of the institution's later rebirth.

Rising again after this challenging period, FINCA Azerbaijan continued building out and developing this new strategy for rebuilding its operation as an almost fully digital, centralized, and lean institution. Clients must apply for loans through the call center, only visiting branch offices to sign final loan contracts and for answers to basic questions. Digital acquisition strategies are used to reach new clients. Clients receive loans using FINCA-branded plastic cards issued in partnership with local banks and are encouraged to make cashless repayments via repayment kiosks, on-line, or through partner banks. The entire lending process is centralized and organized around a head office call center, including sales, recoveries, and collections. Digitalization of processes produces a lot of transactional data which are used by FINCA Azerbaijan for assessing credit risk of repeat clients.

Opportunities for scaling:

1. Increased capacity to process loans faster, offering a competitive advantage while retaining the quality of loan approvals thanks to the personal due diligence.
2. Ability to introduce new digital products alongside traditional enterprise loans to micro and small businesses.

Digital transformation challenges:

1. Necessity of maintaining two lending systems (traditional and digital operational platform) and potentially not utilising the capacity of the digital platform to its full potential.
2. The partial digital transformation may slow the digitalisation process as field staff may not be willing to engage in further changes in their roles and jobs.

The majority of MFIs in Europe are moving towards digitalising their internal processes and back-office operations while retaining the human touch and personal relationships with clients. This hybrid model has thus far proved resilient to external shocks and is still appreciated by clients who value personal contact with loan officers. When MFIs layer new technologies over existing personal relationship systems, customers get the best of both worlds: a person-centric model of service that they value and the digital infrastructure that allows MFIs to process transactions efficiently and compete in an evolving technological market.

MIKROFOND BULGARIA

Mikrofond is a small business lender that faced increased competition from consumer lending fintechs that, for the last 10 years, have dominated the credit market in Bulgaria. Entrepreneurs who previously were loyal customers switched to using online lenders for financing their businesses; the fast and simple loan process was far more appreciated by customers than the lower interest rates offered by MFIs.

Mikrofond decided to catch up with the competition and bought a new fully digital loan management software in 2015, but its suppliers were slow to deliver and given the pace of technological change, the software (with its poor flexibility) soon became obsolete. The hybrid model of partially digital and partially personal lending process was cumbersome for both the institution and its clients.

The COVID-19 pandemic accelerated the decision of Mikrofond management to embrace fully digital lending using open and flexible applications. Soon, all clients, including start-up and new enterprises will apply online, receive a loan, and repay through digital channels.

DIGITAL OPPORTUNITIES FOR MFIS

Digital Potential for Microfinance

The future of finance is digital, and increasingly MFIs are understanding that sooner rather than later they need to invest in new digital platforms. However, it is expensive and complicated to develop new solutions with sophisticated algorithms, origination capabilities and processing efficiency that third-party providers offer. Therefore, MFIs may need to leverage the capabilities of fintechs in this area. This is especially important when the consumers want to have a simple and seamless experience managing their financial needs across various providers through secure technology. MFIs that are isolated from the larger financial system are at a huge disadvantage and vulnerable to competition from fintechs.

Such investments and strategies make sense if MFIs have sufficient scale and scope to reap the benefits of technology. However, most MFIs in Europe are small, which limits the opportunity for organic growth or creating partnerships with fintechs. Going forward, as some MFIs already experiment with digital-only services, it is likely that the European MFIs may bifurcate into: a few larger organisations (likely through mergers among smaller MFIs[22] or through strategic alliances) that can deploy technology at scale—and a larger number of smaller social finance projects that cater to the vulnerable and unbanked individuals and enterprises.

22. This assumes that MFIs would be able to operate across the national boarders within the EU, which is not the case yet and may not be so for some time.

NOA AND EASYPAY, ALBANIA

When the lockdown began in March 2020, NOA's branch opening hours were cut back to only a few hours per day. Loan repayments and collection become a major challenge within the cash-centred Albanian economy. With close to 30% of its customers living in remote and rural areas and with little access to alternative bank branches, NOA identified a more convenient solution: a new partnership with EasyPay. Licensed by the Central Bank of Albania, EasyPay is a recognised payment institution working with many state and private institutions. Its activity is based on a dense network of 460 physical offices, covering almost every commune in the country based on a "franchise/partner agent" strategy, at an affordable price and with quality customer service. In less than two months, despite the full lockdown regime, the two institutions were able to align their information systems and launch this new repayment channel to all NOA customers. The solution would enable them to repay either at NOA's offices, partner bank branches, or the large EasyPay network through a real-time recognition of their payments.

Since its introduction, EasyPay has come to account for 30% of payments overall (approximately 1,300 per month), and the preferred method for payments during evenings, weekends or holidays.

Outsourcing Operational Functions

Not all functions and operations that are necessary to run an MFI must be procured internally. It is feasible, practical and economical to outsource certain parts of the value chain to third-party specialised services providers.

In rare instances, MFIs have begun to outsource functions that they performed internally. The initial outsourcing was limited to independent collection agencies that collected on bad debt on behalf of the MFI in line with a predefined revenue and cost-sharing agreement.

Recently, outsourcing trends have slowly expanded to include other services such as loan repayment. Instead of managing repayments on its own, an MFI enters into a partnership agreement with a payment company that handles all loan payments for clients. This removes one complex function from the MFI's responsibility while allowing the partner organisation to expand its client base. With the right pricing arrangement, this partnership may be a win-win option for both partners. The partnership between NOA and EasyPay in Albania is one such example.

MFI as an Operational Integrator

The outsourcing model, if taken to the extreme (wherein all functions are performed by a third-party provider) creates a lean MFI model whereby the institution performs the necessary operational and legal functions (as required by the law and regulation), but operationally is an integrator of various external solutions. Such a model has the advantage of being flexible, adjustable to the changing market situation and readily scalable—although technical integration may be a challenge and fees for using various services may not always create the desired cost structure for the MFI.

Strategic Partnerships

Most MFIs internally procure all the support functions they need to deliver their financial services, and only a few may subcontract or partner with other organisations such as fintechs or training companies. A lack of partnerships is a weak point in the development of European microfinance and an under-explored opportunity to make operations more efficient and customer experience better. The partnerships can provide numerous benefits such as lower cost, better service, new delivery options—and create win-win solutions for all participants.

Some MFIs that work with marginalised and vulnerable clients seek strategic partnerships with specialised organisations and institutions that provide support services for such clients. This includes employment agencies, non-profit organisations offering services to migrants and refugees and training organisations working with the MFI's target group.

Another example here are strategic partnerships that some MFIs, especially in Western Europe, create with commercial banks. The banks often provide corporate support and financing for MFIs as well as refer clients who fall below the threshold of the banks for finance.

An emerging trend is where MFIs create strategic partnerships with service providers in order to offer an entirely new service to clients, for example, payment or money transfers. While such services are provided under the brand of the partner organisation, they are available, physically or virtually, for clients of the MFI, thus enhancing the service menu and increasing convenience for customers.

MFI as a Platform-Based Business

As mentioned earlier, some MFIs are in the process of digitally transforming to become hybrid or fintech-like organisations. However, there are other options for digitalisation that the microfinance sector should explore, namely: platform business models.

Platform business models offer shared technology infrastructure for various users (for example, MFIs) and can help to facilitate interactions across many participants and offer shared services. These interactions could take the form of short-term transactions (such as connecting MFIs and their clients) or they could involve the formation of longer-term collaboration to achieve a shared outcome or sustained effort to accelerate performance improvement of participants by helping them to learn faster together.

Platform-based business models may offer an attractive alternative to the otherwise small and fragmented MFIs in Europe that operate independently and with little connection with other relevant business and social networks. This fragmentation became evident during the pandemic, when every MFI was left to solve their problems in isolation limiting their ability to transform their business models. Several options and modalities for a platform-based business model seem to be feasible and should be explored in the future.

Transactional Platforms

Using operational platforms to manage a portion or the entirety of back-office operations can offer many benefits to MFIs. Instead of developing internal systems or customising off-the-shelf solutions, an MFI may use an external operational platform that has the functionality needed by the MFI. Increasingly, there are operational platforms that offer services that are tailored for the microfinance industry or can be easily adjusted to be used by MFIs. While there is risk in placing internal operations on an external platform, developing and maintaining one's own operational system is both complex and costly. An external platform eliminates many internal constraints, such as the need to service the system and update it periodically. One recent example of this kind of arrangement is Singlify, whose platform is being adopted by some MFIs as their operational platform.

QREDITS (NETHERLANDS) AND SINGLIFY (UK)

The leading MFI in the Netherlands, Qredits, has used advanced IT systems since the beginning of its operations, and its hybrid model of tech and touch model has been supported by several in-house built solutions. Separate, although interlinked systems have been specifically designed to include features specific to the context of the Netherlands.

Qredits entered into partnership with Singlify, a provider of Salesforce, a cloud-based end-to-end system for microfinance providers. With Qredits inputs and know-how Singlify is expanding and improving their platform enabling smaller MFIs to manage their lending processes from applications, assessment, contracts, loan management and impact reporting. Additionally, there will be a module for coaching matching and relationship management - the BDS pillar of many MFIs. Qredits plans to transfer their operations to Singlify as well in the future once it can accommodate its many sophisticated options.

Network Collaborative Platforms

One example of a potentially disruptive business model is the new initiative of the European Ethical Bank, which gained significant impetus during the COVID-19 pandemic. It attempts to connect various social finance initiatives through a pan-European cooperative governance structure and use fintech solutions to achieve scale and efficiency. As this is still a work in progress, it is unclear whether this new initiative will be a bane or a boon for microfinance, but it clearly sends a signal that the current MFI business models need to change faster than they have so far if they do not want to be made obsolete by new business models such as the one of the European Ethical Bank.

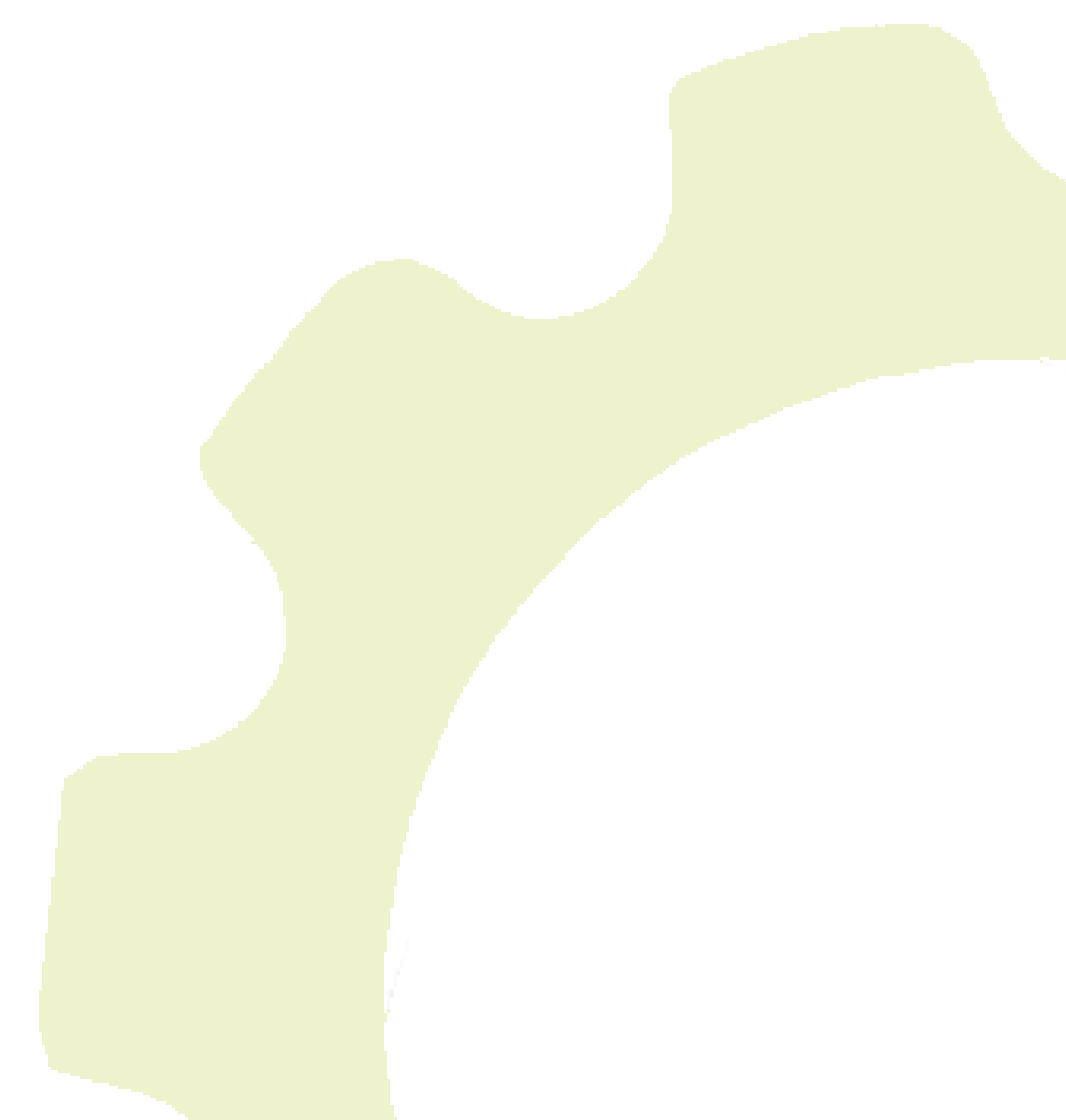
Aggregation Platforms

Many MFIs in Europe cater to socially disadvantaged and vulnerable individuals and microenterprises—and therefore need to help their clients resolve social and personal issues in addition to helping them start and operate a business for which they provide funding. One of the main challenges is to have access to appropriate information and social networks. Compiling this information on one's own is challenging and expensive. There are economies of scale to be had in a pan-European resource platform that can provide broad support for social lenders by off-loading some of the tasks and responsibilities from MFIs. Such a platform could serve a public utility funded by the EU and/or local governments.

Learning platforms

In addition to social inclusion services, many European MFIs offer entrepreneurship and business development support for their clients, especially those starting their business or are in the early stages of launching their small ventures. With very few exceptions, each MFI has developed its own system to support its clients through training, mentoring and other services. Since developing these in-house services is expensive, most are limited to very basic ones and inevitably there is a lot of overlap and duplication of effort between institutions that can be avoided. A broader entrepreneurship learning portal could assume some of these functions that MFIs now perform on their own and could even be larger in scope and scale and offer more learning and development opportunities.

Given the current trend, digital platforms will likely become the preferred business model for MFIs in future. For MFIs, this means a new higher level of operational efficiency and digital readiness, and will call for new strategic and operational partnerships and even collaboration with competitors. Currently, apart from the UK-based Singlify, there are no efforts to provide MFI platform financial and non-financial services to microbusinesses in Eastern Europe.



EUROPEAN ETHICAL BANK: A NEW BANK WITH A SOCIAL PURPOSE AND FINTECH BACKBONE

The key objective of the European Ethical Bank is to create a financial system for a sustainable future, namely the first pan-European ethical bank with an ability to scale up and replicate. The distinguishing feature of this new initiative is the focus on local communities with centralised shared services to minimise costs and efficiently expand to new geographies.

The new institution will work not only with individuals and firms, but also with various types of institutions to help them use their assets most efficiently to achieve their mission. Thus, non-bank financial institutions such as MFIs will be able to get access to banking as a service and digitalisation services.

Typical clients of the bank will be: (1) Individuals, aiming to have transparent control through mobile banking over their assets in a bank (with underlying objective that all their investments will be supporting projects with positive social and environmental impact); (2) SMEs and social enterprises looking for a bank to support their businesses, operations and investments by reasonably priced loans, with thorough understanding and support for their individual business models while facilitating their expansion and growth on local and international markets; (3) Ethical and impact-orientated financial institutions and intermediaries seeking a bank to help them access cheaper financing, lower transaction costs and modern state-of-the-art financial tools and services, and (4) Impact-orientated NGOs looking for a financial institution to provide leverage for their activities, (5) Fintech companies that aim to launch their services with a bank who understands technology and is able to support them with required regulatory services.

The bank's operations will be fully digitalised, offer mobile and web apps using the latest and most advanced technologies for digital onboarding, personal financial management, customised reporting. The core banking system design will easily integrate with a variety of other financial applications allowing users to create a highly personalized experience. In the background, smart database structures will use a unique combination of SQL relational databases for transactions, non-relational documents for maximum flexibility in data collection and processing. A legacy free software stack will allow for easy adaptability and new functionalities, AI engines to support quick and smart decision-making in all operational processes.

The bank will be registered and organised as a joint-stock company, with the majority shareholder to be held by a fair shares company (fairshares.coop) called ECHOS that will gather project partners and raise capital. Minority shares will potentially be offered to international and local development financial institutions. Owners' interests will be represented by the president of ECHOS through the joint-stock company's general assembly. As the model is compatible with the standards of the International Cooperative Alliance, the word "Co-op" will be used when referring to the institution. Thus, the European Ethical Bank will be a kind of a "cooperative fintech".

NEXT STEPS

General Observations

As mentioned, business models are not set in stone; rather they constantly evolve to deliver better operational efficiency for value creation in response to evolving external conditions. Changing a business model in any significant way is significant undertaking for any organisation and a risky endeavour under any circumstance, let alone during a global health crisis. Therefore, business model changes take place incrementally on a continuous basis addressing different aspects and dimensions of the business model as needs arise. This is one reason why we should not expect business models to change even during the pandemic. Specifically, the ability for MFIs to operate in a radically different way and change their business model is limited. With the increased financial inclusion and improved access to funding for micro- small and medium businesses (MSMEs) in Europe, MFIs mostly operate on the fringes, serving customers that fall outside of the target market of traditional lenders. Increasingly too, MFIs face a challenge from fintechs that have mushroomed in recent years—although primarily in the consumer lending market. Operating in this limited and difficult fringe market does not offer many opportunities for business model innovations, although there is space for improvement in some respects.

Also, it is interesting to note that some changes were of reactive and adaptive nature, for example changing the communication channels with clients and introducing a different way of loan monitoring using various technological tools that replaced the face-to-face and on-site meetings. Some of the changes are temporary and some MFIs indicate that they will be returning to the "old" ways of doing business. On the other hand, some changes to the business models introduced during COVID-19 may become a permanent feature of MFI operations. For example, the classic microfinance feature of frequent client monitoring is taking a new form and will likely rely more on technology.

Changes to Business Model Building Blocks: Work in Progress

Business models have been a preoccupation for many MFIs' boards and investors for a long time, although during the COVID-19 pandemic their focus was on successfully surviving the crisis. It is thus no surprise that the broader discussion about business models has taken a back seat and may resume when the pandemic is over. In general, MFIs were faced with three options in relation to their business model during the COVID-19 pandemic: (1) change the current business model to a new one, (2) adjust the business model to match the evolving external environment, or (3) do not change the business model at all. So far, there were no cases where MFIs either radically changed their business model in response to the COVID-19 crisis or have not changed anything in the way they operate and do business.

All MFIs, without exception, adjusted their business models to adapt to the new restrictive conditions caused by the pandemic. These adjustments related mostly to core activities (provision of financial services) and the delivery mechanism (client onboarding, loan assessment, disbursement) and communication (internal and external). MFIs also changed their work arrangements and office practices to accommodate the requirements of social distancing and the lockdown rules.

The changes to the business model can therefore be summarised as adjustments to certain components of the business model without changing the overall way that MFIs operate, make money, or realise their social mission. As discussed, the most common changes to the business model were seen in the Activities, Delivery and Financing parts of the business model. There were no changes with regards to the Purpose of the MFIs (their objective and value creation), Organisation (legal form and affiliation) and virtually no change in relation to Customers.

In that respect, the popular assumption that the COVID-19 crisis would lead to deep and permanent changes in the way MFIs operate proved unfounded, although it may be too early to make the final call on this, as the scope and scale of COVID-19 impact is still largely unknown. It may well be that MFIs are in "wait-and-see" mode wherein they have made the minimum necessary adjustments to the business model and are delaying major decisions until such time as all the outcomes of the COVID-19 pandemic manifest themselves in full.

Reasons for Limited Change in Business Models Thus Far

Potential reasons for a lack of change to MFI business models during the COVID-19 pandemic are the following:

1. The microfinance business model, as it is implemented in Europe, is still valid and resilient in its basic design, although gradually evolving and adapting to the new reality.
2. Government intervention meant that the financial stress was not as acute as it would have been in the absence of support for businesses and to some extent to MFIs.
3. Government funding for enterprises meant there were few defaults, only temporary delays in repayment; most of the restructured portfolio is back on track.
4. Older MFIs had experience in dealing with previous crises, notably the 2008 financial crisis, which was much deeper and had a stronger impact on the operations of MFIs.
5. Investors were accommodating and did not advocate major changes in the business model that could potentially create unwelcome disruption during the crisis and pose additional risks.
6. MFIs were busy with the current operational issues, there was no time available to plan and execute major strategic changes.
7. There are few alternatives to the current business model that can be easily applied to the microfinance sector.
8. The new reality after the pandemic is as yet unclear, and it is too early for making major deep changes to business models.
9. The crisis directly or indirectly affected all businesses and all parts of the society; therefore, all MFIs were in a similar situation, therefore there was no pressure from competitors to make any radical changes.

Opportunities for a Paradigm Shift

Every crisis, and in particular a global such as the COVID-19 pandemic, creates opportunities for radical changes and a shift away from the current paradigm. This may be the case for the current landscape of microfinance in Europe.

As the analysis of this paper shows, all MFIs made incremental adjustments and necessary operational changes, but none ventured to fundamentally rethink their business model and introduce new ways of doing business. MFIs also survived the emergence of fintechs, which to

date do not operate in the traditional microcredit market in Europe.

However, this situation may change as new social finance fintechs emerge and new business models are created that combine the microfinance market with fintech solutions and offer opportunities for growth and scale that have been unavailable to MFIs to date. These opportunities can emerge through the digital repositioning of current MFI business models and through an ecosystem-enabled digital transformation of MFIs. These two processes can occur sequentially or simultaneously, depending on emerging trends in the financial services market and other complementary services for micro- and small-business clients.

Digital Repositioning

At the same time, the relatively low levels of digital technology applied by the majority of MFIs in Europe, have not changed even during the global pandemic and offer an opportunity to radically rethink MFI business models and financial inclusion in the post-pandemic reality when MFIs could spend time on developing new strategies.

Excluding the credit unions and credit cooperatives that operate under different rules, in future three types of MFIs are likely to emerge in Europe replacing current business models:

1. Business development finance organisations

These include the Analogue organisations previously mentioned, which operate on a small scale as individual organisations under the guise (and often regulation) as MFIs. However, their scope and modus operandi do not fit into the typical framework of a financial institution, and they should be reframed as business development finance organisations with a different legal capacity. Making this change will clarify the role of those organisations involved in entrepreneurship-type activities that also involve financing and will allow them to streamline operations—for example by creating a common operational service platform or merging into a larger organisation with a presence across many markets in Europe. At the same time, this will clarify the definition of microfinance and microcredit in Europe and will help the 'true' microfinance institutions to clarify the status of an MFI as a financial institution. For these organisations, the social purpose and mission will remain the driving force for their activities.

2. Hybrid digital MFIs

These are the larger MFIs that have been operating for a longer period and have focused solely on financial services. They have operated using a "relationship lending" approach that they will retain, at least for some clients and types of products, while digitalising and automating most internal operations. This model is likely to be followed by the market gap lender and commercial lenders identified earlier. These MFIs span the social mission and the commercial objectives of the older MFIs.

3. Fintech MFIs

These are MFIs that are ready to fully digital transform, and the new generation of MFIs that launched operations recently when new technologies were already available to create a new type of institution. These also include new entrants into the microfinance space who may focus more on their commercial objectives while still adhering to the socially responsible lending principles.

Ecosystem-Enabled Digital Transformation

While digital repositioning will offer MFIs a clear picture of their digital needs and capabilities, it can only take them forward for a relatively short period of time. The technology dynamics in the financial services market and the emergent trend toward ecosystem-based financial services trace a development path that MFIs need to adopt to keep abreast of technological innovations and customer expectations. An ecosystem approach aims at offering customers a seamless and extended service offer by bundling services beyond the core lending products (such as microloans).

These service bundles could focus on different aspects of the target customers' needs, such as social inclusion, entrepreneurship, housing and financial health. An ecosystem approach is a radical departure from the current system of independent MFIs offering a limited range of services regardless of their level of digital maturity—although the more digitally advanced an organisation is, the easier it may be able to form or join an ecosystem that centres around specific aspects of customer needs or customer segments.

In an ecosystem offering, the customer is at the centre serviced by several vendors providing complementary products and services that are integrated on a single digital platform.[23] Taking an ecosystem approach would allow MFIs to continue providing their core financial services while creating new entry points of access to their financial products. They could also improve their strategic positioning by providing non-financial services (as some MFIs already do) but through digital partnerships with the collaborating specialised providers. This would allow MFIs to focus on their core business and still offer services to clients.

Different customer needs can be addressed through ecosystems. For example, a digital ecosystem can support new entrepreneurs and early-stage business customers who seek a multitude of support services in addition to loans. The platform could allow the customers to access various services for the development of their business and join a supportive network. One way of describing this type of platform would be the traditional "one-stop shop" for business start-ups, but taken to a new digital and connected level. Other types of ecosystems could focus on social inclusion, SMEs in the retail sector, green business and ecological investments, etc.

Services may be offered through a differentiated services model, reflecting different customer preferences and differing service provision costs. Some services might be provided free of charge, others through paid subscription packages and some made available on-demand on a pay-per-use basis. Another feature of an ecosystem approach is that it allows an MFI to participate in several platforms at the same time, which can greatly enhance their outreach and build scale—one of the limiting factors for European MFIs. For instance, an MFI can simultaneously be a part of a start-up ecosystem, green finance ecosystem, social inclusion ecosystem, etc.

There are at least three different ways how MFIs could launch or participate in an ecosystem platform. An MFI can be a "builder", whereby the MFI would develop and own the platform and provide all the products and services across an end-to-end customer journey for a specific need. MFI can also be an "integrator", owning the ecosystem platform but offering a mix of its own and third-party products from collaborating partners. Finally, an MFI can be a "service provider", offering its products and services to digital platforms owned by third parties. In all these cases, MFIs must offer digitalised financial products to be able to connect with clients through the digital platform.

23. Impulso.site is an example of a platform that provides a variety of solutions for entrepreneurs at different stages of development.

It will be a matter of time and effort to engage MFIs in the ecosystem-enabled approaches, and some initial smaller-scale experimentation is warranted before scaling up.

Moving away from the traditional solo operations business model, MFIs have at least three options leading to creation of an ecosystem-based approach to providing services:

- **Process-centred ecosystem:** This is the easiest and the most traditional approach, and is based on disaggregation of the MFI's lending value chain into distinct components that can be subcontracted to specialised service providers, for example, loan collection, payment processing and management, etc. This approach does not require major changes to the current business model, only some internal adjustments, wherein the core business model unchanged.
- **MFI-centred ecosystem:** In this instance, MFIs build their own ecosystem by creating their own platform that connects diverse services from the traditional ecosystem. This requires major adaptation and changes to an MFI's business model; however, it does not require major changes to its relations with its immediate environment. An MFI connects various relevant services and providers in one place for the benefit of their clients, for example, payment system, training, and entrepreneurship advisory services, etc.
- **Customer-centred ecosystem:** This is the most advanced ecosystem, one which radically changes the MFI business model and requires changes in the overall surrounding environment forging new types of relationships with the broader ecosystem participants. The customer is the focal point of this ecosystem, and the role of an MFI is reduced to its core function of providing microfinance services, while other services are provided by other participants of the ecosystem.

The various ecosystem options are summarised in Table 1.

Table 1: Microfinance Business Models and Ecosystems: A High-Level Framework

		Ecosystems	
		Traditional	New
Business models	No or some incremental adjustments	Solo MFI model	Process-centric ecosystem
	Major changes and model reformulation	MFI-centric ecosystem	Customer-centric ecosystem

A few projects underway in Europe and Central Asia may be a provide a useful example of what was described above. KICB, one of the biggest banks in Kyrgyzstan, has developed a digital wallet business in the country through their Elsom project (launched in 2014). Today, Elsom is not simply a digital wallet but a rich and complex ecosystem platform that required huge time and financial investment. Through more than 320 integrations (utilities, taxi, education institutions, travel agencies, remittances, etc.) Elsom provides a number of payment options and other financial services (loans, deposits, etc.) to customers. Additionally, Elsom was designed as a multi-tenant platform that can be used by other financial providers that cannot afford a similar investment and that would benefit from the KICB platform. That means that any MFI can become a tenant as a "service provider" and connect to the platform via ready-made APIs giving access to particular back-end functionalities.

Another example is a platform implemented by the Bulgarian Development Bank and its subsidiary MFI. The platform is focused on the MSMEs, and offers information about production inputs, tools and access to other vital information. The platform also gives MSMEs access to different options to finance their business by directly applying for loans through a self-service portal. In the next phase of the project, these functionalities will be extended to include other MFIs in the country that would like to benefit from a shared platform.

Future Challenges

Taking microfinance business models to another level in Europe in the context of rapid digitalisation of financial services and transactions requires several bold steps on the part of MFIs, industry stakeholders and policymakers. As has been noted in this analysis, MFIs are slow in digital transformation but need to adapt to the new conditions sooner rather than later. However, there are several barriers that they need to overcome to be successful in this process.

The following are the key challenges in future:

Scale

With only a few exceptions, MFIs in Europe are small (and many are very small). The size of an MFI's operations limits its ability to digitally transform and take advantage of what the new technology can offer. There is a need for increasing the scale of the organisations through mergers and other forms of partnerships, collaboration on operational platforms and developing other models such as franchises.

Scope

Scaling opportunities, for many MFIs, are limited by their scope, which sometimes includes non-financial services for the borrowers. Providing these services alongside financial services means MFIs need two different types of operational processes that are difficult to scale at the same time.

Data

The microfinance sector has traditionally struggled to use data to generate customer leads and improve the bottom line. Despite collecting a lot of data, most of it is used (and only to a small degree), to make loan decisions. Moreover, MFIs rarely, if ever, seek other customer data beyond checking the credit history of applicants.
New developments in cloud services and the open banking system in Europe open new opportunities for data-based loan decision-making. Furthermore, MFIs could and should use the large

amount of alternative data that can provide a better behavioural profile of a client, even if they lack a borrowing history or have a low credit score. Efforts to use more data, and use it more effectively, could allow MFIs to offer personalised products or services based on individual data; this could fundamentally change their relationships with customers. It would redefine the concept of "know your customer" from a passive compliance exercise required by regulators to an active opportunity identification.

Regulatory Environment

Microfinance is regulated in most jurisdictions in Europe, although there are differences in the extent of the regulatory and supervisory requirements. Two main regulatory challenges exist for MFIs in Europe that make their operations inefficient and limited in scale: (1) lack of a "European passport" for MFIs that would allow an MFI registered in one member state to offer its services in another without the onerous process of registering a new organisation, and (2) inability to connect to and fully participate in national payment systems, as most microfinance licenses are limited to lending operations.

Financing

For older and smaller organisations, one of the main constraints to engaging in systemic digitalisation is the lack of funding for new technology. MFIs do not have sufficient internally generated resources to finance major "rip-and-replace" investments that may be required for full digital transformation. There is a need for a specialised fund that can support the MFIs in these efforts.

Client Digital Maturity

Digital transformation will yield benefits if clients are digitally ready and mature enough to fully connect and use the digital services offered by MFIs and fintechs. Much more needs to be done on the microenterprise and SME level to bridge the digital divide in Europe.

Ecosystem Design Experiments

As mentioned, the financial sector is moving towards greater integration around specific customer needs, and MFIs would be wise to follow this trend. As a new approach, it requires experimentation and testing. A few small pilots could pave the way towards wider applications. Useful lessons can be drawn from value chain and cluster development projects, as they offer transferable and highly relevant practical experience.

CONCLUSIONS

Many MFIs are still in "wait-and-see" mode because they do not know the full real impact of the COVID-19 crisis on their operations—however it is likely that MFI business models may undergo deeper changes than those that occurred during the pandemic.

Even where it is possible and desirable to do so, there are few incentives for MFIs to radically change their business models. Microfinance continues to be a "protected" sector because of its social mission and purpose. The EU, national governments, development agencies and the private sector use microfinance as a tool to achieve their social goals, whether these be related to job creation or activities to increase corporate social responsibility. Therefore, in the absence of market pressure and unchanged expectations and priorities of funders and donors, MFIs are unlikely to change their business models any time soon.

Since the impacts of the pandemic are not yet fully understood, it is too early to assess the need for change in business models, and whether MFIs will go beyond the adjustments that they have made by either making them permanent or taking them to another higher level of change. Here we offer general observations on the state of business model evolution during the pandemic.

All MFIs were impacted by the pandemic; however, those MFIs that operate on a more commercial basis and depend less on external subsidies or narrowly defined projects fared better. They had more internal resources and more decision-making flexibility needed to make changes. On the other hand, MFIs that are more socially oriented, that operate on subsidies and depend on external grant support were in a weaker position in terms of manoeuvring through the crisis. Regardless of the type of business model that MFIs follow: shareholders, investors and sponsors were supportive of the organisations' needs and offered additional resources to weather the crisis.

In terms of resilience strategies deployed by MFIs during the pandemic, it appears that most organisations focused on preventive control to ensure they would soon "bounce back" to pre-pandemic levels, and on performance optimisation to adapt internal processes to cope with COVID-19 operational restrictions. Less effort, if any, has been put into developing strategies that would allow the MFIs to "bounce forward" and emerge in a better situation than they were in before the pandemic.

The overall conclusion is that MFI business models did not change in any radical way during the pandemic, although some necessary adaptive changes were introduced by most organisations. In addition to the natural tendency to resist major changes, there are several external reasons why deeper changes were not made, not least of which was the generous government support for business during the crisis that allowed borrowers to remain in good standing with loan repayments. Consequently, MFIs did not experience as profound a shock as during the 2008 financial

crisis when such support was unavailable. This external support served as a substitute any internal resources that would have had to been generated by the MFIs' business models.

Given that the full impact of the pandemic is still unknown, the topic of the MFI business models should be revisited within the next 18–24 months, by which time the economic situation is likely to normalise and when MFIs may need to review their business models in a more fundamental way.
At the same time, the acceleration of digitalisation and virtualisation of services during the pandemic hints at the new opportunities for MFIs to take advantage of soon as new technologies enter the microfinance space. MFIs need to review their digital maturity and readiness for transformation, and reposition themselves to better reflect their capabilities and the target market they serve. Moreover, they should take note of the emerging ecosystem-enabled approaches to provide financial services as bundles of complementary products and services beyond the traditional isolated MFIs offering a single type of product. The ecosystem paradigm is far-reaching and will require MFIs to radically change their business models towards shared collaborative systems involving multiple service providers.

ANNEX A: BIBLIOGRAPHY

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www.cgap.org/blog/after-storm-how-microfinance-can-adapt-and-thrive

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The Sentinel Project blog
www.financialaccess.org/sentinel

The Digital Transformation Guide: Six Strategies to Scale Financial Inclusion
www.accion.org/the-digital-transformation-guide-six-strategies-to-scale-financial-inclusion

ANNEX B: LIST OF MFIS INTERVIEWED

	MFI	Interviewee
1	Alter Modus	Ana Kentera
2	ACF	Zhanna Zhakupova
3	FWW	Mikołaj Steppa
4	Vitas Romania	Cristian Jurma
5	Microlux	Samuel Paulus
6	Hefboom	Piet Callens
7	MicroStart	Lens Lapauw
8	Helenos	Iza Norek
9	Crystal	Archil Bakhuradze
10	Fundacion Oportunitas	Francesca Malizia
11	Per Micro	Andrea Limone
12	Noviti	Linas Amarlys
13	FINCA Armenia	Vardan Haroyan
14	FINCA Azerbaijan	Tim Tarrant
15	ZEF	Goran Jeras
16	Mikra	Aida Ganic

ANNEX C: GUIDELINES FOR MFI INTERVIEWS

Microfinance Business Models During COVID-19: Questions for the interviews with the selected MFIs most affected by COVID-19

Part One: Current Business Model

1. How would you describe your business model?
2. How does your organisation make money?
3. Let's review the various components of your business model (use the framework template)
4. Has your organisation been sustainable / profitable before the pandemic?
5. Has your business model changed over time?

Part Two: COVID-19 Experience

What has COVID-19 changed in your operations? Review the following aspects:

- Demand for funding
- Credit analysis and risk management
- Service delivery
- Work organisation
- Market positioning and competitive position
- Funding availability

Which changes or impacts were most profound? Had the strongest or lasting impact on your organisation?

Which aspects of your operations will go back to the pre-COVID situation? Which changes will remain the permanent features going forward?

Part Three: Impact of the Pandemic on the Business Model

Let's translate these changes into their impact on the business model itself. How has the COVID pandemic impacted your business model? Which aspects of your business model have been most affected?

How would you say have changed the following features of your business model?

- Purpose
- Sustainability
- Efficiency
- Resilience
- Organisational capacity
- Risk management

Part Four: Adaptation of the Business Model to the Post-COVID Environment

Which parts of the business need to be changed or adapted in the post-COVID reality?

- Refining the purpose
- Changing the operations
- Finding new market segments
- Designing appropriate loan products

- Modernising delivery channels
- Adjusting risk measures
- Revising the funding options

Part Five: Outlook for the Future

How do you see the future of your organisation?

Are you optimistic or pessimistic?

Do you think that by adapting your business model you will be able to recover from the pandemic crisis and get back on the growth path?

How easy or difficult will it be for you to change / adapt your business model?

What are the main constraints for this change?

What actions of EU, investors and industry associations could help you in making the changes to adjust to the new post-COVID reality?

ANNEX D: TYPOLOGY OF MICROFINANCE MODELS IN EUROPE

	Purpose	Organisation	Customers	Activities	Delivery	Financing
Social Purpose Project	Charitable assistance in economic and social inclusion of vulnerable individuals	Non-profit / charitable organisation	Socially marginalised and excluded individuals and informal enterprises	Mixed activities, BDS and social services plus soft loans or grants	Traditional relationship, close and intensive contact with customers	Predominantly if not exclusively grant funded
Social Fringe Lender	Financial inclusion and financial services for the excluded and underserved individuals	Various types, typically non-profits, associations, NBFI with a strong social mission	Low-income individuals and microenterprises that do not have access to the mainstream financial system, often start-ups and self-employment	Loans and BDS	Typically, traditional relationship lending plus training and other BDS	Subsidised at various levels and from different sources
Social Enterprise Lenders	Financing for social enterprises and non-profit organisations that are not targeted by banks	Various types, typically non-profits, associations, NBFI with a strong social mission	Social enterprises, social projects	Loans, BDS, linkages to other social programs	Traditional relationship-based processes	Subsidised funding from various sources

	Purpose	Organisation	Customers	Activities	Delivery	Financing
Collaborative Finance Organisation	Access to finance for specific groups members of cooperative-type institutions	Financial cooperatives, credit unions	Members of a specific social group or location (e.g., rural area)	Loans and other support services	Traditional rule-based lending with some elements of credit scoring and risk pricing	Self-financed by members
Market Gap Lenders	Micro- and small businesses that experience challenges in receiving funding from the banking sector	Various (non-profit, NBFI, savings house, etc.)	Micro- and small businesses that do not have adequate access or want to broaden their access to finance	Loans and other financial services (e.g., guarantees, factoring, etc.), some may offer BDS through partnership with specialised organisations	A mix of traditional relationship lending and technological application, typically not a fintech	Equity from investors plus a mix of subsidised and commercial funding, often using retained earnings to expand lending
Commercial Microlenders	Individuals and microenterprises seeking additional "fast & easy" access to cash	NBFI, private commercial enterprise, fintech	Low-income individuals with weak access to banks, microenterprises seeking fast cash	Consumer and business loans	Digital data-based lending through mobile and online tools	Equity from investors plus commercial lenders

The project was implemented as part of the partnership between Mastercard Center for Inclusive Growth and Microfinance Centre for a new international support programme for small businesses and microfinance institutions in Europe and Central Asia. The partnership will enable micro-finance institutions to pivot, adapt and embrace digitization.

The Mastercard Center for Inclusive Growth advances equitable and sustainable economic growth and financial inclusion around the world. The Center leverages the company's core assets and competencies, including data insights, expertise and technology, while administering the philanthropic Mastercard Impact Fund, to produce independent research, scale global programs and empower a community of thinkers, leaders and doers on the front lines of inclusive growth. For more information and to receive its latest insights, follow the Center on Twitter, @CNTR4growth, LinkedIn and subscribe to its newsletter.