In this paper we will discuss the concept of Operating Self-Sufficiency and its place in Microfinance.

What is Operating Self-Sufficiency?
+/ Operating self-sufficiency is a percentage (%), which indicates whether or not enough revenue has been earned to cover the Microfinance Institution's (MFI's) total costs – operational expenses, loan loss provisions and financial costs.

What is the formula for Operating Self-Sufficiency?

\[
\frac{\text{Operating Income (Loans + Investments)}}{\text{Operating Costs + Loan Loss Provisions + Financing Costs}}
\]

What does it measure?
+/ It is an important measure of sustainability of the lending operations.
+/ Looking at the Ratio as a self-sufficiency figure allows determination of the extent to which operations are becoming (increasingly) self-sustaining.
+/ Operational self-sufficiency thus indicates whether or not enough revenue has been earned to cover the MFI's direct costs, excluding the (adjusted) cost of capital, but including any actual financing costs incurred.
+/ If an MFI does not reach operational self-sufficiency, eventually its equity (loan fund capital) will be reduced by losses (unless additional grants can be raised to cover operating shortfalls). This means that there will be a smaller amount of funds to loan to borrowers (which could lead to closing the MFI once the funds run out).

What minimum records are required for calculating the Ratio?
+/ Loan ledger with disbursement schedule and repayment data on each individual loan, backed-up by a comprehensive credit policy outlining various terms and conditions.
+/ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple ageing table or a comprehensive portfolio report.
+/ Key financial statements like the balance sheet and income statement, adjusted for loan losses, depreciation & accrued interest.
The definition of operational self-sufficiency varies among different MFIs and donors.

The difference centers on the inclusion of financing costs. While actual financing costs used to be included only in levels three and four (as mentioned earlier), some analysts include them in calculating both operational and financial self-sufficiency, and some only in calculating financial self-sufficiency.

Some MFIs argue that operational self-sufficiency should not include financing costs, because not all MFIs incur financing costs equally – this makes the comparison of self-sufficiency ratios between institutions less relevant.

While some MFIs fund all of their loans with grants or concessional loans, and do not need to borrow funds – or collect savings – and thus, either do not incur any financing costs or incur minimal costs.

Other MFIs, as they move progressively toward financial viability, are able to access concessional or commercial borrowings, and thus incur financing costs.

However, all MFIs incur operating expenses and the cost of making loan loss provisions, and they should be measured on the management of these costs alone.

Furthermore, these MFIs argue that they should not be penalised for accessing commercial funding sources (through the inclusion of financing costs in the formula), nor should MFIs that are able to finance all of their loans with donor funds, be rewarded.
The choice of which formula to use is personal, because both are correct. However, it is important that when comparing institutions, the analyst determines that the same formula has been used, because no standard definition has yet been established.

**How to calculate Operating Self-Sufficiency?**

**Step 1**
From the unadjusted income statement, sum up all operating income. This would include:

- Interest on Current and Past Due Loans +
- Interest on Restructured loans +
- Interest on Investment +
- Loan Fees and Service Charges +
- Late Fees on Loans =

**Total Operating Income**

**Note:**
GRANT INCOME SHOULD NOT BE INCLUDED

**Step 2**
From the unadjusted income statement, sum all expenses related to microfinancing. These typically would include:

1. Operating Expenses
2. Loan Loss Provisions
3. Financing Costs

**Total Direct Expenses**

**Step 3**
Divide Total Operating Income by Total Direct Expenses (Operating + Loan Loss Provision + Financing Costs) to get Operational Self Sufficiency.
What events/activities affect (distort) the Ratio?

- This Ratio is also affected by unaccounted, unreported and/or hidden subsidies with regard to operations.

- Organisations providing micro-credit, as well as other services, can allocate costs in such a way that their credit operations look more sustainable than they really are.

- When MFIs allocate costs to subsidiaries or do not carry them on the books at all, for instance, when donors meet certain costs, such as paying for consultants or health workers collect loans/savings – this Ratio is affected.

*This technical note has been compiled specially for Sa-Dhan by Ramesh S. Arunachalam, using Best Practices material available with Sa-Dhan and stakeholders like CGAP, SEEP and others. First published in August 2006. © Sa-Dhan. Website : www.sa-dhan.org