

Transformation of Micro-finance Operations from NGO to Regulated MFI

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Abstract

The transformation of micro-finance (MFI) non-governmental organizations (NGOs) into regulated financial institutions is a model that has been evolving since the late 1980s. It has become appealing to an increasing number of MFIs due to its anticipated benefits, such as an ability to mobilize public deposits, access to private sources of capital, improvement in governance and transparency, with an ultimate goal to reach significant scale and financial sustainability.

An overview of the transformation experience in micro-finance is summarized in this paper. This paper sets the agenda for the workshop "Transformation of Micro-finance Operations from NGO to a Regulated MFI" at Microcredit Summit in 2006. It presents key issues and challenges before, during and after transformation. The paper proposes a tool that will help managers of micro-finance NGOs as they assess their situation and make a decision on whether or not to transform, and if so, how. At the end, the paper summarizes the key findings and sets the agenda for moving forward.

The paper has primarily utilized secondary sources of data. The main studies used in this paper are: (1) a study commissioned by the Asian Development Bank on the achievements of expectations of institutional transformation as of February 2003, and (2) Case studies of three institutions representing Latin America, Africa and Asia, commissioned by Micro-finance Network in 1999. In addition, the author acquired additional information on the latest progress in institutional transformation through inquiries on major micro-finance list-serves, search on internet-based clearinghouses, and email and phone correspondences with key informants.

Transformation of Microfinance Operations from NGO to Regulated Financial Institution

Introduction

If a significant scale of outreach is an ultimate goal for microfinance operations, there are at least three main ways to achieve that. First, outreach can be extended through the expansion of the geographical coverage and range of services and/or products offered. Either way, the expansion could lead to an increasing number of clients and/or members served. It will require an increase in human, physical and financial resources. Secondly, a greater scale can be achieved through advocacy and partnership with other organizations working for the same cause. This strategy does not require an organization to increase its human, financial and physical resources, as it will be leveraging the resources already available in other organizations. Thirdly, microfinance operations may be restructured, such as through merger & acquisition, franchising, linkage with or downscaling of mainstream financial institutions or transformation from NGO to regulated financial institution. The latter has been one of the most appealing strategies to reach a scale, and is the focus of this paper.

An institutional transformation of micro-finance NGOs into a regulated financial institutions (RFI) is embraced as one of the most effective strategies for achieving a significant scale by offering a wider range of services, accessing commercial sources of capital and improving operational efficiency through enhanced systems, controls and transparency in reporting that would result from links to regulators and other banking expertise (Campion and White 1999), and financial sustainability of MFIs.¹

¹ It must be noted that the transformation of NGOs into RFIs should not be viewed as the only approach to sustainable micro-finance.

Definitions

Institutional transformation in this paper is defined as an establishment of a regulated financial institution (RFI) by a non-government organization (NGO) or a group of NGOs by transferring its loan portfolio to the RFI completely or partially (Fernando 2004).

Institutions are systems such as schools, churches and alike, which have an explicit goal of generating meaning in the society where they exist (Gutmann 2003).

Organizations mean systems whose only goal is to accomplish a defined task: a stereotype is the corporation (Gutmann 2003).

Micro-finance refers to a provision of financial services (credit, savings, insurance, leasing, remittances and alike) to lower income individuals who do not have access to mainstream financial services.

Overview of Transformation

While transformation first occurred less than a decade ago with BancoSol transforming into a commercial bank in 1992, it is rapidly spreading out. Worldwide, transformation is taking the following forms:

- a. Microfinance NGO transformation to a regulated commercial entity (non-bank financial intermediaries or commercial banks) – For example, BancoSol in Bolivia, K-Rep in Kenya, CARD Bank in the Philippines, BRAC in Bangladesh, Mibanco in Peru, Finsol in Honduras and Compartamos in Mexico.
- b. Traditional, regulated financial institutions penetrating the microfinance market (such as large retail banks, including state-owned

- institutions, small commercial banks, finance companies and credit unions) – For example, Sogebank in Haiti, BRI in Indonesia and Banco Pichincha in Ecuador created subsidiaries providing microfinance services.
- c. Creation of commercial microfinance institutions – For example, Bangente in Venezuela was created as a commercial financial institution from the start, while IPC is setting up “microbanks” in Eastern Europe.²
 - d. Merger between a commercial bank and a microfinance institution, or merger between two or more microfinance institutions – For example, CONFIE in Nicaragua and Genesis in Guatemala have incorporated into the commercial operations of an existing small commercial bank or finance company, while XAC and Gobi Ehlel, both of which were independent microfinance NGOs in Mongolia, have merged into one regulated microfinance institution.

While microfinance institutions are experiencing these different forms of transformation, this paper focuses on the transformation of NGOs into commercial, regulated financial institutions.

Current Landscape of NGO Transformation

As was defined in the ADB paper (Fernando 2004), **institutional transformation** in this paper is defined as an establishment of a regulated financial institution (RFI) by a non-government organization (NGO) or a group of NGOs by transferring its loan portfolio completely or partially to the RFI. Among the varying factors that motivated the microfinance NGOs to transform into a regulated institution, the following appear to be common:

- *Access to additional/commercial sources of funds:* NGOs feel unable to meet the large and growing demand for micro-credit because their

² Otero, 2001.

sources of funds are limited to donations, income from lending and subsidized loans. Even though microfinance has become a “sexy” strategy for poverty alleviation and donor support has “poured” into the field, earlier microfinance practitioners have realized that the donor grants and soft loans are limited (both in terms of amount and terms attached) and do not support the portfolio growth needed to ensure long-term sustainability for the institution. As NGOs, they do not have access to commercial sources of funds. Transformation is sought to access other sources of capital more rapidly and to increase leverage. For example, Mibanco reported that after transformation they have access to additional sources of funds, such as central bank discount window, voluntary savings and funds channeled to only regulated financial institutions.³ This is expected to enable them to expand outreach by financing a larger portfolio.

- *Wider range of financial services:* As NGOs, most microfinance institutions are not allowed to provide clients with financial services other than credit. In most countries, regulation prevents unregulated, non-profit microfinance institutions to mobilize savings. By transforming into a regulated financial institution, they can provide a wider range of financial services, including savings. This will allow them not only to access this relatively stable source of local resources⁴, but also to expand their outreach by attracting a larger pool of clients. Also, it is expected that by offering savings products MFIs would improve governance, since having such products heightens the board and management’s orientation to meet clients’ needs and requires a higher level of supervision and oversight. Unfortunately, the initial findings indicate that few transformed MFIs have

³ Campion, Dunn and Arbuckle, 2001.

⁴ While a number of unregulated microfinance programs require compulsory savings from their clients, these savings are used by the program as a loan guarantee. Clients typically can not access these savings until they leave the program. As such, compulsory savings represent a component of loan collateral and are distinct from voluntary savings (Campion and White, 2001).

taken full advantage of their ability to mobilize savings.⁵ And it has not been verified with confidence extent to which saving services would improve governance.

- *Self-sustainability and profitability*: For some NGOs, transformation into a commercial entity is seen as the only means to attain self-sustainability and profitability. The combination of access to a larger pool of funds and the ability to provide savings services among other financial services should enable them to expand their outreach and support the growth of the institution.

From an industry perspective, transformation is encouraged for the following main reasons:

- *Private sector ownership*: The involvement of private investors, with their own capital at risk, is expected to enhance the internal control and governance of MFIs. Currently, the lack of a defined ownership structure leaves NGOs susceptible to instability in their governance.⁶ However, transformation has only attracted a small amount of private sector ownership to date.⁷ Moreover, it has not been verified with confidence extent to which private sector ownership will lead to significantly improved internal control and governance. In some cases the same people that run the NGO also run the new institution. While this ensures continuity it little change in personnel may mean little change in terms of the above issues.
- *Higher efficiency and financial performance*: To survive in an increasing competitive marketplace, microfinance institutions need to cut down on costly transactions and increase their efficiency. This is expected to

⁵ Campion and White, 2001.

⁶ Poyo and Young, 1999.

⁷ Campion and White, 2001.

improve their overall financial performance which may significantly affect their ability to meet some of the social goals stated earlier on.

- *Improved customer service:* Having the status of regulated financial institutions, microfinance institutions will be able to offer a range of services and products to meet the various need of their clients. Also, as markets become more competitive, microfinance institutions must pay more attention to their customers' needs and desires to retain their market. Otherwise, they will risk losing customers to the competition. Furthermore, to encourage customer loyalty, MFIs need to offer competitive interest rates and provide quality products and services.
- *Improved financial transparency and accountability:* Regulation of financial institutions typically involves higher reporting requirements. This is expected to improve the financial transparency and accountability of the institution. This depends on effectiveness of other regulations in that country. In cases where corruption is rampant there have been cases of formal private banks collapsing. Also, what works in one country may not work in another.

According to the ADB study (Fernando 2004), most transformed MFIs have achieved encouraging results. (see Appendix 1 for details.) They have:

- Found new shareholders
- Increased equity capital
- Improved governance
- Achieved institutional sustainability
- Improved outreach to the poor

However, there is limited, if any evidence that demonstrates the above benefits with confidence. Some of the recently transformed NGOs are still transitioning between NGO and formal financial institution at an operational level, and in some cases, at organizational and financial levels as well.

As of March 2006, about 43 NGO microfinance institutions (MFIs) were transformed (see Appendix 2).⁸ As illustrated in the table in Appendix 2, the cases occurred in countries, with the largest concentration in Latin America, particularly in Peru. This raises the question why institutional transformation has occurred more in Latin America and why there is much less progress in Africa, Asia, the Pacific and East Europe.

There are several possible reasons:

- Regulatory environment
- Buy-in among board members
- Level of micro-finance industry development or the number of micro-finance institutions
- Institutional capacity
- Wider political environment

Also, as mentioned above, according to some studies on the sustainability of MFIs in Africa, over two thirds of the institutions are far from achieving sustainability. Their revenues on average are as low as 30-40 per cent of the actual operating expenses, with transaction costs inflated by high administrative costs and expatriate expenses draining program funds.

While not limited to Africa and Asia, the following are the common challenges experienced during transformation that discourage overall uptake on this restructuring strategy.

- Communicating the changes to staff and clients to avoid over-expectation and confusion (Mibanco). Most staff members were unable to move from NGO/charity-mode, which can generate a lot of friction. Also many do not think about profit and see that as a domain of private institutions. It may

⁸ This latest data updates the number of transformed micro-finance NGOs as reported in a study commissioned by Asian Development Bank Fernando, N. (2004). *Micro Success Story? Transformation of non-governmental organizations into regulated financial institutions*. Manila, Asian Development Bank: Regional and Sustainable Development Department..

be difficult to balance service to the poor and balance the books at the same time.

- Transforming MFIs are entering a more competitive environment. (Mibanco)
- The initial cost in the headquarters is high. (Mibanco, K-Rep)
- There are problems adjusting to the payment system. (K-Rep)
- Higher reporting requirements are difficult to meet. (K-Rep)
- Entering an unfamiliar area of new product development and management, e.g. development of savings products, is expensive and complex, requiring high levels of liquidity and risk management skills as well as a thorough understanding of the local economy. (K-Rep)
- Transformation requires developing or modifying management information systems. (K-Rep)
- Balancing the composition of “old - NGO” and “new – commercial” staff and board members is difficult. (K-Rep) This is a big issue for most. The private sector has specific characteristics including higher pay, which could create problems for staff. It is not always clear how one can merge these values with poverty reduction.

Cross Cutting Issues

Licensing and ownership models

The licenses are typically processed in one of two ways:

- MFIs select an institutional structure based on current banking legislation.
- MFIs work with a supervisory agency to enact special regulatory legislation for institutions providing micro-finance services.

For most institutions the licensing process was the most difficult aspect of being regulated, and several MFIs commented on the long time frame required to complete the process, which can take two years or more.

Nevertheless, it was acknowledge that most of the internal improvements

MFIs were required to make during this process were beneficial, in areas such as internal control, reporting capabilities, branch physical security and the like. On the other hand, the main difficulties posed by the licensing process involved finding an ownership and management structure that was acceptable to both the institution and the licensing authorities. Among the kinds of participants banking authorities were reluctant to approve were the following:

- The original NGO. In many cases banking authorities did not consider it appropriate for an NGO to own a major portion of a licensed institution. This issue has been resolved in nearly every case in a way that works for the MFI.
- Foreign institutions such as donor-related institutions and international microfinance organizations (Honduras).
- Individuals in senior management with microfinance experience but lacking conventional banking backgrounds. In several instances, key personnel had to be changed.

The bottom line is that microfinance institutions are likely to continue to have owners and managers who do not fit standard expectations. They do not, however, automatically fail the “fit and proper” test, as many bring compensating factors to the table, in terms of specialized knowledge, deep long-term commitment, reputation risk, etc. This is an area where flexibility is appropriate, and as regulators become more familiar with the microfinance sector, they are likely to become more comfortable making judgments about the suitability of individual players. (Rhyne, *The Experience of Microfinance Institutions with Regulation and Supervision*)

Experience with Licensing

K-Rep: Originally their license was supposed to be issued within three months, but before three months ended, five small banks were placed under the Central Bank's management due to a lack of liquidity. This was followed by the National Bank of Kenya experiencing a run on the bank, which almost caused its collapse. Because of these factors the Central Bank had other priorities and K-Rep's application was put on hold.

PRODEM/BancoSol: As the first MFI to pursue a banking license in its country, PRODEM had to invest significant time and effort in educating bank regulators about micro-finance and in preparing the necessary documentation, including feasibility studies.

Raising equity capital

Transformed institutions must maintain a gearing ratio between their capital base and deposit liabilities. The capital cannot fall below certain level of risk-adjusted assets, and institutions must increase their equity over time. FFP CLA, Compartamos, Mibanco, and ACLEDA Bank all managed to do this. The initial increase in equity, the greater opportunities created by the transformation, and rapid growth in operations have resulted in continued growth in the total equity of these institutions.

K-Rep began seeking investors in Kenya but banks were not interested due to lack of understanding of micro-finance, thinking it would not be profitable. After the issue received media attention, banks expressed an interest, but by then foreign investors had already been identified. K-Rep also focused on institutional rather than individual investors as it believed those to be more

transparent with a longer-term commitment. Donors assisted in identifying equity investors.

PRODEM/BancoSol: Raising equity was the most challenging aspect of BancoSol's creation, since commercial micro-finance was a new concept. In pursuing investors PRODEM sought a mix of international and local investors and ca. \$2,5 million of PRODEM 's loan book was sold to BancoSol in exchange for shares, resulting in an initial 18.1% ownership stake in the new bank. International institutions and private Bolivian investors funded the remainder.

CARD's transformation process did not involve raising equity from outside commercial or institutional interests. Because of the low capital requirements of Philippine rural banks, CARD did not need to attract outside investment to fulfill minimum capital requirements. CARD thereby did not invest any time in negotiation with investors. Instead CARD produced only one feasibility study and had the freedom to structure a members' ownership policy according to its own eligibility criteria. The drawback to this is an equity base limited to members' shares, staff, shares, donated equity and retained earnings, which raises questions about its ultimate influence on management.

Mibanco: In April 1997, an agreement was reached between ACP, ACCION and ProFund to transform ACP into a micro-finance bank. The government agreed to help facilitate the process but to hold no direct equity in the new institution. By July 1997, private-sector investors had been identified, which included two Peruvian banks, Banco Wiese and Banco de Crédito, and the partnership was announced publicly. The board members representing ACP on the Mibanco board hold no personal equity in either institution, thereby possibly reducing the intended benefits from private ownership of increased accountability, profitability, and access to additional sources of capital. In 1999, the Corporación Andina de Fomento (CAF) became an additional Mibanco shareholder, owning 3.8 percent of Mibanco's total equity, which exceeded \$13 million at the end of 1999. Other institutions, including banks

and insurance companies, wanted to invest in Mibanco as well, but the new bank was already overcapitalized. As of June 2000, Mibanco still had a low debt-to-equity ratio of 1.25:1, an extremely conservative gearing ratio that will permit additional leverage in the future.

Institutional models

MFIs have experimented with three main institutional models in the transformation from NGO to RFI.

- **NGO to RFI:** in this case, transformation results in a single institution and the initial NGO ceases to exist.
- **NGO to a RFI and a NGO:** this more typical, where the original NGO retains its legal status and spins off a regulated financial institution. In this case, the two resulting institutions have specific roles and responsibilities to complement each other. In some cases the NGO remains as a “laboratory” experimenting with new products, exploring new frontiers and/or providing consulting services. In some, the RFI takes over the responsibility for the main banking or financial services, such as credit, savings, insurance and any other financial services they are allowed to offer under their current legislation.
- **NGO to a group of companies:** This model results in a group of companies, including the regulated financial institution and the NGO. It allows the institutions to provide specialized services, such as insurance, leasing, business development services and the like, which may not be possible for either the NGO or the RFI alone. Institutions that choose this model tend to have a long term vision to expand the market and provide services that are responsive to their clients’ demand. They also tend to have more financial, human and physical resources at the time of the transformation.

Table 1 below presents a list of institutions that have employed a particular model. The results of each model are yet to be measured and verified. The decision to take on a particular institutional model depends on a number of

factors, including the regulatory environment, the long term vision of the institution, the leadership and human resource capacity, etc.

Table 1
Institutional Models of Transformation

Institutional models of transformation	Examples
NGO to a RFI	<ul style="list-style-type: none"> ○ ACP transformed into Mibanco ○ Compartamos transformed to Financiera Compartamos ○ FFP FIE
NGO to a RFI and a NGO	<ul style="list-style-type: none"> ○ PRODEM in Bolivia transformed into BancoSol and PRODEM ○ Nirdhan NGO transformed into Nirdhan NGO and Nirdhan Utthan Bank ○ Caja los Andes transformed into FFP ○ Calpia transformed into Financiera ○ Compartamos transformed into SOFOL and ○ FINSOL transformed into Financiera
NGO to a group of companies, including a RFI and other sister companies	<ul style="list-style-type: none"> ○ CARD NGO in the Philippines transformed into CARD Mutually Reinforcing Institutions (4 institutions, including a bank, NGO, training institute and a micro-insurance company) ○ <u>K-Rep</u> in Kenya created new legal entities – a holding company – an NGO, a consulting firm an a bank ○ XAC in Mongolia transformed into Xac Bank and other companies

Operational transformation

Obtaining a license, raising equity capital and identifying owners are all important issues. Significant attention and investment is required in successfully managing operational transformation issues. It requires adjustments of management information system, staff changes, training, development of new products and processes, marketing and client transitioning. K-REP in Kenya spent a great amount of money on MIS. K-Rep also had to change its reporting format to respond to requirements of the Central Bank and also had to make some staff changes. The transformed institutions had to change their operational policies and standardize their manuals before obtaining the license. Yet another challenge was to build client trust. Operating in an environment where banks may not have a good reputation requires good results and progress. K-Rep also needs to develop new policies and procedures for savings collection, teller functions, investment etc.

Experience in Operational Transformation

Mibanco: In the past, because of a lack of competition and the ability to charge high interest rates, ACP was able to delay addressing its operational inefficiencies, such as its high administrative costs and low client–loan officer ratio. It was hoped that the transformation would automatically rectify some of the problems; however, given the rushed time frame, cost-effective decisions were not always made. A large challenge remains for Mibanco to implement cost controls and improve its operational efficiency. Headquarters costs currently represent a significant portion of Mibanco’s total operating costs.

PRODEM/BancoSol: Transformation required investing in staff training and systems development. New accounting and passbook saving software programs were installed. PRODEM/BancoSol tried to hire as many as possible of PRODEM’s former staff as possible, with the remainder coming from the banking sector. The process of merging the commercial culture with that of the former NGO proved a challenging task.

What helped BancoSol down the road to profitability was that the bank had received a head start by acquiring a ready-made, established operation from PRODEM. Not only did the bank inherit a sizable loan portfolio, but it was also able to benefit from five years of know-how, experience, and technical assistance. PRODEM had already developed a lending methodology and target group, had already installed systems for repayment, financial accounting, reporting, and information management, and had already suffered through the initial financial growing pains associated with expansion.

Organizational culture

Organizational culture is a system of shared beliefs and values that develops within an organization and guides the behavior of its shareholders,

management, staff and clients. The degree to which transformation affects the organizational culture of an institution is largely influenced by changes in management and communication style (Campion and White 1999).

In the case of FINCA Uganda, the culture of the organization has moved away from its close-knit family structure as it grew bigger and more formal. There were new internal and external pressures to perform and be accountable to new authorities. The numbers of staff and their location grew significantly so that, for example, it is no longer feasible to have all the staff in one place. Coming together is by regions, and therefore weekly electronic updates have taken on a new importance.

Some of the staff members were newly hired from the banking sector while others were old staff retrained for the transformation posts. Tension did arise between the two, as expected, but it was not insurmountable. The joint training and sensitization helped to level the playing field. For a time there was so much emphasis on the change from village banking that staff began to shun village banking as a product, thinking it was no longer required or necessary. The competence profiling exercise played a big role in the harmonization of the new and old staff.

In the case of Mibanco, the strategic plan called for a blend of NGO and bank managers in the management hierarchy. The addition of traditional banking professionals with strong personalities in key management positions led to changes in communication patterns among staff, which became more hierarchical and formal. The methodology also changed to one based more on traditional banking methods. These changes lowered employee morale and customer satisfaction (Campion and White 1999).

Human Resources

The set of skills required of staff will change as NGOs transform into regulated financial institutions. Whether the organization chooses to hire additional bankers, re-train its existing staff, or to apply a combination of the two, MFIs need to be aware of the significant amount of time and money required (Campion and White 1999)

In the case of FINCA Uganda, the hiring process was done in three stages. The first was to assess the in-house staff and utilize their skills for the change in management based on the needs assessment. The second was to identify the remaining gaps and fill them with staff from the formal banking sector. These included such areas as branch managers, treasury managers, tellers, back office staff, savings managers and customer care officers. The third stage was to employ a competence profiling exercise to harmonize the two sets of people, including field staff and head office personnel, new hires and staff from the old institution. The exercise was also used to streamline all the job descriptions, remunerations and grading for mentoring and hand-over. Jobs were analyzed in relation to staff in order to correct anomalies in staff development and remuneration in the process of transformation.

The main challenges were a fear of dismissal, suspicion of the old, an informality in dealing with new types of clients and a lack of understanding of the micro finance industry by the new-comers, many of whom were used to the higher salaries and perks of the banking sector. With a professional HR Department these challenges were handled competently, with input from the protagonists themselves in terms of job analysis and their relationship to each other. For example, areas where some staff were overburdened or doing work not appropriate to their role were highlighted. As a result, people's emotions were not involved and they could identify where they were going and how they could be better evaluated and mentored.

A series of trainings and orientations took place. In the beginning all the staff had to be sensitized about the transformation, and communication

needs were constant. These were met by workshops, field visits and monthly bulletins.

Secondly, all managers were trained on the new products and in the IT system and had study tours of other transformed institutions. There were short and long term specialists attached to FINCA Uganda including, specialists in treasury management, IT, HR, marketing and sales, internal audit, savings, product development and law. These passed on their skills to their FINCA Uganda staff counterparts. Manuals were developed for all procedures and products. There was training of field staff, who now had to learn to market both village group loans and working capital loans along with a variety of savings products. The HR Department has a five year staff development plan, submitted to and approved by the Bank of Uganda.

Client Transitioning

While the benefits of transformation to clients may be obvious to managers, it requires an effective communication strategy to market the transformation to clients. The word "bank" often has negative connotations for people who have been excluded from the formal financial system due to a lack of the collateral traditionally required or an insufficient minimum balance (Campion and White 2001).

In the case of FINCA Uganda, when all the clients left their former banks, they moved to FINCA Uganda either as individuals or in groups. They needed to be clearly identified by FINCA International for transaction purposes. FINCA Uganda had to educate them and encourage them to open accounts. There was an influx, even though it was done in phases, branch by branch. In addition, there was tension with the bank branches clients had to shift from. Some clients were unable to fill in the vouchers because the vouchers were no longer in the local language.

At first, the transitioning village bank group clients were fearful of the formalities, of meeting in a banking hall, of not having the liberty to sit in the

compound chatting and discussing finance and non-finance issues. Later, those that had earlier intimidated by the formal banks appreciated the combination of teller operations staffed by people who understood them as low income clients.

Clients had several ways to express their feelings about the changes. These include frequent focus groups, suggestion boxes in every branch and standardized customer feedback forms on products and procedures. These were evaluated on a regular basis, and a hot line linked clients to the office of the Managing Director. The most frequent responses to feedback are changes in the products or the development of new products. Changes can include interest rates, a grace period and the need for additional loans. On the savings product, clients wanted increased hours of service, a lower cost of photos for opening clients, and relaxation of overly stringent requirements for opening accounts such as requiring utilities bills for their informal enterprises.

Competition

Until the late 1990s, MFI did not have to worry about competition. They enjoyed near monopolies as mostly small service providers sought to reach a huge untapped market. MFI operations in the same cities would even share learning with each other and divided the market based on pleasant agreements. However this is now changing to some extent due to:

- Expansion of the self-identified MFIs
- Entry of new commercial players into micro-finance
- Emergence of related business, primarily consumer lending, that overlap with the client base of traditional micro-finance

In addition, by transforming into regulated financial institutions, microfinance NGOs enter into direct competition with mainstream financial institutions. Unless, the MFIs decide to partner with those mainstream financial institutions and leverage their existing resources, competition will be

tough, considering that these institutions already have established infrastructure, market niche, human resources and financial resources.

In some cases, the competitive environment was less of a concern. For example, K-Rep was not concerned about competition in the short run. Its target market was only 4.5% of the population, and money lenders and ROSCAs did not present real competition. In general, traditional banks in Kenya did not understand micro-lending and only made a few attempts to reach this market. But this may be changing now.

In the case of FINCA Uganda, competition was fierce not only from similar microfinance institutions, but also from formal financial institutions that were starting to reach out to the traditional client base of MFIs.

In addition to partnering with existing formal financial institutions, MFIs may need to keep up with the competition by investing in technological advances like smart cards, debit cards, ATMs and personal digital assistants to automate credit decisions. The increasing competition for clients has translated into more credit alternatives for entrepreneurs. In the case of Mibanco, a high-end client was considering borrowing from other lenders because Mibanco had imposed a loan ceiling that she thought was too low, illustrating that an inflexible policy may drive a desirable customer to a competitor.

Implications of Transformation

Implications of transformation for Governance

As Campion and White state, the key difference in the governance structure of NGOs and those of privately owned financial institutions lies with

the selection of board members. Board members of NGOs are usually selected for their commitment to addressing social problems in their communities and their experience in this area. On the other hand, board members for regulated financial institutions are usually representatives of the institution's significant investors – that is, individuals who have a financial stake in the institution. Furthermore, a certain number of board members are required to have formal financial management expertise. Transforming NGOs often attempt to strike a balance between commercial and social objectives.

At least during the initial stage of their transformation, microfinance institutions seem to retain significant representation of their former NGO board. For example, in case of CARD Bank in the Philippines, three of its seven board members are from the former NGO board. This can be helpful in ensuring that the transformation institution maintains its social mission. It could also pose problems for the new institution, which needs to operate on different values that may at times contradict social goals. The older members can also delay the process of change. As in the regulated financial institution, the governance structure seems to be closely linked with the ownership structure of the transformed NGOs, as described below.

Implications of transformation on Ownership

There are seven different types of ownership identified from the analysis of seven transformed NGOs. These are founding NGO, other NGOs, public development agency/donor, specialized equity fund, foreign private investor, local private investor and employee stock ownership plan (ESOP). None of the institutions had any direct government ownership.⁹

All in all, the transformed institutions in Latin America seem to have benefited from specialized equity funds (Bancosol in Bolivia – 34%, Mibanco in Peru – 26%), while those in Africa and Asia have retained a significant

⁹ For more details on the percentage distribution of ownership in each of the seven institutions, see Campion and White, 2001.

ownership by their founding NGOs. The latter may be due to the availability of other sources of capital and the degree of capital market development. Interestingly enough, CARD Bank in the Philippines had 33.1% client ownership in 1999. CARD now offers preferred stock to individual members who meet certain eligibility criteria (such as having completed a fourth loan cycle and having maintained a repayment rate of 100% for all loans).¹⁰ This not only encourages poor clients to build an asset base and potentially increase their income, but also contributes to the positive financial performance of the institution. Having a financial stake in the organization may cause them to be more motivated in looking for higher repayment and financial return. It may also exclude those who need help the most because they may not be able to deal with above conditions. The issue of using this strategy to deal with poverty needs to be clarified and not used as loosely as it is by the proponents of micro enterprise.

Implications of transformation on Organizational Development

Once a microfinance NGO decides to transform into a regulated financial institution, it needs to address a whole range of organizational changes. For example, the most challenging issues that have been identified in earlier sections included transformation of the organizational culture, training and hiring of new staff, developing a new management information system and communicating the changes to clients and the staff. If these are not addressed carefully, they can create significant obstacles to the successful transition from NGO to commercial institution. The experience of handling organizational changes during transformation has varied from organization to organization. In case of Mibanco, the addition of traditional banking professionals with strong personalities in key management positions led to lowered employee morale and customer satisfaction. In contrast, CARD bank has not experienced a significant change in organizational culture.¹¹ In

¹⁰ Ibid.

¹¹ Campion and White, 2001.

this process, the roles of leadership and early planning have been the major factors leading to success.

These organizational changes are also important factors for further ensuring the social mission of the transformed institution. For example, the traditional banking culture has not been friendly or helpful to the poor, and the addition of traditional banking professionals may potentially convert the microfinance culture, which has been characterized by more personalized services with a friendly attitude towards the poor, avoiding humiliating them because of their income status. The same caution applies to staff training. While it is important to provide more technical expertise to the staff, it is equally important to make sure that staff will not get a misperception that they have to become like “traditional banking staff”.

Another important aspect has to do transition for the client. In transitioning the existing loan portfolio from the former NGO, Mibanco renewed only 80% of the loans. The remaining 20% were dropped because the new, more restrictive loan evaluation process identified them as not credit worthy because of bad credit histories or over indebtedness.¹² Unless communicated effectively, this could push away many poor clients who may now see the transformed institution as one of those “traditional banks” that have historically excluded them. This clearly demonstrates the tension between these two kinds of institution. I continue to wonder what the success rate of MFI in retaining poor clients is going to be. The 20% dropped in the example above may have had to be dropped to maintain these institutions. What difference would they make to poverty reduction? Is this not the same percentile that is left out normally? And remember there are still some people who were already excluded. So the transformation may push more former clients outside. These are hard questions, but I think they deserve to be highlighted.

¹² Campion, Dunn and Arbuckle, 2001.

Implications of transformation on loan methodology

There has been a marked shift over the past decade from group lending to individual lending, especially in Latin America. Major commercial providers entering the market have consistently chosen individual lending methodologies over group methodology.

Christen (2000) found that:

“In 1990, Banco de Desarrollo in Chile had a portfolio that was evenly split between group and individual loans, and NGOs had 80% of their portfolios in group loans. By the end of 1999, Banco de Desarrollo had gotten out of group lending all together, the NGOs had reduced their portfolios in absolute terms and new bank entrants all used individual lending techniques. Individual lending now accounts for more than 90% of the market. And there goes the poor who can only do this through groups. In Paraguay, in 1990 Fundacion Paraguaya operated a group program. By 1999, all lending through both the finance companies and Fundacion Paraguaya was individual. As in other countries, this shift is mostly seen in the fact that all later entrants offered only individual loans.”

This shift implies that group activities and dynamics will be reduced or totally removed, which will have implications for the so-called social mission of transformed institutions. Furthermore, it poses a danger to the portfolio quality. Much of microfinance success can be contributed to peer-group lending. For example, K-Rep’s group lending methodology reduces credit risk through loan pooling, portfolio diversification and mutual liability. It also saves on operational expenses for field activities that are delegated to the group, such as verification of business status and the value of pledged collateral.

Examples of how the shift to individual methodology could affect portfolio quality can be found in Bolivia. In Bolivia by 1999, the most

dynamic new entrants - FASSIL, Banco Economico and Acceso - had come into the market offering individual loans. However, these entrants have faced serious portfolio quality problems and have failed to dominate the market as they have in Paraguay and Chile.¹³

Therefore, it is important to systemically examine transformed institutions and determine what percentage has shifted to individual methodology and how the shift has affected their portfolio quality.

Poverty outreach

Based on his analysis of microfinance transformation in Latin America, Christen reports that regulated microfinance institutions in Latin America provide larger loans to their clients than do unregulated NGOs. Indeed, the average for unregulated NGOs (\$322) is roughly a third that for regulated microfinance institutions (\$803). He determined that this relationship also holds for a more appropriate comparative measure, the average outstanding loan balance as a percentage of GNP per capita, with unregulated NGOs having half that of regulated microfinance institutions. Such an increasing average loan size may have implications not only for the social mission, but also for the portfolio quality of the transformed NGOs. For example, in the case of K-Rep Bank, its default rates were higher for the larger loans. As a lesson, K-Rep returned "back to basics" policy of focusing attention on smaller loans to lower-income borrowers, both to better achieve K-Rep's mission and to improve credit risk management.¹⁴

However, a larger average loan or average outstanding loan balance may not necessarily mean that the transformed institutions are picking out less poor clients. While it is possible that transformed institutions are forced to increase their loan size in order to minimize cost per dollar lent (or the unit of local currency), the increase in average loan size may well be because

¹³ Christen, 2000.

¹⁴ Rosengard, et.al.2000.

their clients have matured and are taking larger loans. That is, a real growth in borrower business activity may have contributed to the rise in the average loan size. It may be due to inflation.¹⁵ A more appropriate measure may be the average size of first loans and the percentage of first loans relative to the total number of loans. Again these measures need to be looked at carefully in order to identify the factors that may be causing a change.¹⁶

Implications of transformation on social intermediation

As explained above, there are two main approaches to microfinance service delivery. The “Minimalist” approach focuses only on financial services, while “holistic” approach takes on providing services beyond credit and savings, such as training, business development services, issue-based campaigns, literacy, health, political literacy training, etc. Most transformed institutions have taken “minimalist” approach and shifted their focus to financial services. However, a few innovative institutions have retained their former NGO to focus on non-financial services. For example, K-Rep is now split into two institutions. K-Rep Holdings Limited has a dual registration as both a not-for-profit company without a share capital and limited by guarantee under the Company’s Act, and as an NGO under the NGO Coordination Act. K-Rep Bank Limited is licensed by the Central Bank of Kenya as a commercial bank. K-Rep Holding’s main goal is to help K-Rep fulfill its mission by complementing K-Rep Bank’s primarily urban, commercial financial activities with the deeper penetration of rural, poor communities with innovative products and delivery systems.¹⁷

How effective are those NGOs in continuously delivering social intermediation services? This question deserves further research into the transformed NGOs that have kept the NGO and created a regulated financial institution alongside. Moreover, there is a point of view that true

¹⁵ Ibid.

¹⁶ There has been no evidence so far that the increasing loan size is due to conditions attached to the source of fund.

¹⁷ Rosengard, et.al. 2000.

commercialization of the sector will occur when financial institution becomes independent not only of donor funding, but also of donor-dependent NGOs for key development functions.¹⁸ What this means is that the founding NGOs should not be retained to complement “true” commercial microfinance institutions with non-financial services, which, in turn, implies the elimination of non-financial services to the poor from the microfinance industry.

While there have been a number of case studies on transformed NGOs, only a few have examined whether or not the transformed institutions have moved from their social mission. Their findings have been mixed. Christen (2000) argues that there seems to be no compelling evidence that the push toward commercialization leads to mission drift among microfinance institutions resulting in the exclusion of poorer clients. In his study on the transformation of microfinance institutions in Latin America, he concluded that microfinance institutions seem generally committed to their initial mission and target group. However, he also stated that microfinance institutions could be cutting off the lower part of their target group as part of a strategy to enhance their financial performance.¹⁹ In line with this statement, Campion and White (2001) found increases in the average outstanding loan balances of three transformed NGOs in Latin America (BancoSol, Caja Los Andes and Financiera Calpia) since their transformation.

Not only are these findings mixed, but they have focused on only one region, Latin America. While it is true that commercialization is most advanced in this region, the transformed institutions in other regions need to be studied in order to reach a reliable and accurate conclusion that can be generalized for the whole industry.

Studies conducted so far have largely relied on “average loan balance” to evaluate whether or not the transformed microfinance institution has shifted their social mission. While the “average loan balance” may give an

¹⁸ Campion and White, 2001.

¹⁹ Christen, 2000.

indication of the level of economic need of a client that a microfinance institution is serving, it does not tell us whether or not the institution is still focusing on providing the social intermediation that has been found to be important for lifting people out of poverty. There is a debate over whether the larger average loan balance of transformed institutions represents the natural evolution of a maturing target group, or indicates mission drift. It is true that larger loans do not necessarily point to mission drift. If the institution continues to provide social services in addition to financial services, then they are assumed to have maintained their social mission.

Key Lessons Learned

While the experience of transformed institutions has not been researched enough to generate substantial evidence of the benefits, important lessons can be learned from earlier experiences. These lessons apply to the three phases of transformation: before, during and after transformation.

Before transformation:

- Study the political environment. Political climates may change, affecting rules and regulations for MFIs and RFIs. Unstable political environments may cause delays in license processing. In such a climate a transforming MFI's fate may become inextricably linked to the future of one particular political party.
- Engage the central bank and government policy makers and ensure that the central bank and other financial institutions have an understanding of micro-finance and its purpose. If not, training and education will be needed.
- Review the economical environment, taking into consideration financial policies, hyperinflation and macro economic trends.
- Ensure that the emerging institution has the ability to handle the unexpected, such as natural catastrophes.

- Be realistic in calculating the time and cost needed internally as well as externally. Changing regulations, procedures and policies and hiring and training new staff require substantial amounts of time. It takes time to apply for and receive a license. For most institutions the licensing process was the most difficult aspect of being regulated, and several MFIs commented on the long time frame required to complete the process -- two years or more.
- Consider re-composing the Board of Directors. Defining and promulgating institutional culture are two of the more significant challenges involved in the transformation process. The external aspect of the institutional culture must be considered. The corporate image as perceived from the outside is as important as how the institution perceives itself. In creating a formal financial institution, MFIs must protect against formalizing to the extent that they will alienate their client base.
- Consider transforming into new legal entities as in the case of K-Rep, where the former NGO became a commercial bank as well as a consulting firm.
- Be prepared to develop new products and services in order to be able to compete.
- Ensure that the mission is clear, that there will exist a balance between social and commercial objectives, and that policies are in place to prevent mission drift after transformation.
- Be prepared to start paying taxes and to adhere to liquid and reserve requirements and external and internal audits.

During transformation:

- Develop creative ways of attracting and retaining strong staff members, since MFIs usually do not have resources to pay their employees top dollar.
- Monitor the need to hire more staff. Growing companies face the perpetual dilemma of when to hire new staff. Should they add new staff to generate new business, or should they cultivate the demand

before creating the capacity to fulfill it? Neither of these choices is ideal, and the answer will depend on the financial situation of the institution and its projected growth pattern.

- Make sure employees retain their commitment to the development mission and adopt values that are appropriate to the private sector. For employees that joined the organization because of its social agenda, they need to be convinced that the private sector orientation is not in conflict with the social mission.
- When employing traditional banking professionals, they may bring a change in communications, management style and methodology, which may lead to lower morale among employees and lower customer satisfaction. At times, newly employed bankers have had a formalized communication style – communicating via letters and memos rather than in meetings, which has caused employees to feel they did not have a voice or influence in decision making. Therefore, be prepared to invest in staff training, human resources and systems development.
- Be prepared to handle pressure due to expectations, and market the new institution to clients to ensure that the purpose of the transformation is understood. Solicit customer feedback.
- Provide a number of savings products which meet the needs of the informal clientele, while simultaneously attracting additional larger deposits through the issuance of certificate of deposits.
- Compensate for rising costs by increasing the revenue-generating capacity of each loan. Increase the loan sizes and terms to maturity, rather than raising interest rates.
- Be prepared to rethink the organizational chart to effectively manage growth. The organizational design should ensure that the right information gets to the right place at the right time.
- Ensure that there is a tight fit between the employees' values and the corporate ideology.
- Consider the use of teams, as an alternative approach that may help improve competitiveness and customer service. As the building blocks of the organization, teams can do much of the planning, decision

making, and implementing. The primary reasons growing companies organize around teams are to empower employees and to increase productivity.

- Break down communication barriers between different functional units in the business, such as between marketing and product development, or between the finance and operations departments. This is necessary to build teamwork and cooperation within the organization and to increase productivity and responsiveness to the market. Working together builds a shared sense of the business as a whole, rather than as one of individual fiefdoms, and will enable the company to provide better customer assistance.
- Consider creating small business units within a large company. This produces an organization with the clout of a giant and the nimbleness of an elf. The business unit performs only the activities most vital to its competitiveness. It is organized around market segments, and kept small so that minute divisions of labor are unnecessary.
- Utilize the work force well. With too much work to do, people are more willing to share work and responsibility. In general, people would rather be over-utilized than under-worked. One is a challenge, and the other is boring.
- Do not staff new branches with new personnel.
- Strive to create an atmosphere that makes the firm the best possible employer to the people it wants to attract and keep.
- Organize around customers and markets instead of functions or products.
- Ensure there is a real client demand for services. By offering financial products that are attractive to lower income clientele, for instance BancoSol has been able to grow rapidly, dwarfing other microfinance efforts in the country.
- Be prepared to focus on public relations instead of fund raising; attracting investors instead of donors.
- Emphasize market research.

- Consider that arrears and losses can become more prevalent as the risk composition of the portfolio changes. In addition, monitoring and evaluation costs may rise as a relatively unknown clientele comprises most of the portfolio. The primary means of reducing risk in a portfolio is through the use of collateral - as loans that are secured by home mortgages tend to have lower loss records. BancoSol, however, does not require traditional forms of collateral. Recognizing the composition of its client base, the institution does not ask its clients to offer traditional guarantees. Instead BancoSol uses the solidarity group guarantee and sequential lending mechanisms to ensure low default rates. While repayment rates are impressive on the institution level, the Superintendent of Banks still considers such loans to be secured only by personal guarantees. Since regulations limit the amount of personal guaranteed loans to twice the value of the institution's equity capital, leverage is difficult to obtain.
- Be prepared to implement more efficient operational policies in order to compete with other commercial banks and to be more cost - efficient.
- Ensure the successful integration of micro-lending into the portfolio, with commitment at all levels of management, particularly at the top and middle levels.

After:

- Reward employees. Employees who enhance their company's competitiveness and make a direct contribution to profit should be rewarded by profit-sharing or employee stock options. This gives employees an interest in the success of the company, reduces turnover and increases staff productivity.
- Be efficient at the loan officer level in terms of both recruiting new clients and following up with clients who are having repayment problems. Enable loan officers to be pro-active in tracking possible delinquent loans. Maintain a high standard of professionalism from the managerial level down to the clerks. It is vitally important that the

- staff be highly motivated, visionary, idealistic and deeply committed to serving the poor through access to commercial financial services.
- Pay for knowledge, giving employees the opportunity to increase their base pay by learning to perform a variety of jobs. This directly encourages employees to be more flexible.
 - Ensure quality marketing. As the organization grows and enters new markets, each marketing strategy needs to be customized from the bottom up.
 - Manage growth at the branches by using incentives to limit the number of new applications the loan officer submits each month. This encourages field staff to select only the best applicants (assuming there is high demand) and to spend more time building relationships. By building this foundation, loan officers in the long run will have more time to dedicate to managing delinquency and reducing client desertion and, ultimately, to maintaining a larger portfolio. Because loan officers invest in client relationships at the expense of fast growth, they will ultimately reap the rewards of higher productivity.
 - Use information, strategy and methodology from the MFI. BancoSol got a head start toward profitability by acquiring a ready-made, established operation from PRODEM. Not only did the bank inherit a sizable loan portfolio, but it was able to benefit from five years of know-how, experience and technical assistance. PRODEM had already developed a lending methodology and target group, had already installed systems for repayment, financial accounting, reporting, and information management, and had already suffered through the initial financial growing pains associated with expansion. BancoSol would not have been able to achieve the same level of financial sustainability had it not inherited its nucleus from PRODEM, and its investors would have had to wait a great deal longer for any returns to materialize.
 - Keep an uncompromising commercial approach. For example, BancoSol does not provide the poorest of the poor with short-term relief aid, but rather provides working capital to those micro-entrepreneurs who demonstrate a capacity to absorb debt and an

ability to expand their businesses. It packages its loans within proper repayment incentives (i.e. the hope of a larger subsequent loan) and externalizes the costs of monitoring the loans by using solidarity groups to apply social pressure on the individual borrowers. Finally, the large spread between interest paid to depositors and interest earned from borrowers does not finance costly technical assistance or training of its borrowers, but instead goes right back into covering the operational and financial costs of micro-finance.

- Have a sound and professional approach to micro-credit delivery

Management Tool for Assessing Readiness for Transformation

Based on the experience of MFIs that have transformed, the paper proposes a guide/tool that will assist managers of MFIs in assessing their internal and external situations and making decisions on whether or not to transform and what needs to be done to prepare for transformation.

The guide consists of key internal and external factors to consider followed with questions that will guide managers in assessing their situations. A score will be given for each response that will help managers decide what needs to be done. The guide also provides examples of actions that need to be taken.

Microfinance NGOs that are contemplating to transform will benefit most from this tool by using it during their strategic planning process. It helps institutions to understand how prepared they are and what they need to do before launching into this significant venture.

Some examples of the questions provided in the tool are demonstrated in Appendix 4. Institutional readiness for transformation is assessed in the following three areas:

1. Legal environment
2. Institutional capacity
3. Costs and benefits

It is critical that all levels of stakeholders, including board members, management, field staff and clients, are involved in the strategic planning process and in this exercise to assess the institutional readiness for transformation.

Conclusion

Of the 7,000 NGOs providing microfinance services to poor entrepreneurs throughout the world, only a minute percentage has initiated transformation into privately owned, regulated MFIs. However, there is some evidence that most transformed MFIs have achieved encouraging results. They have found new shareholders, increased their equity capital and improved governance, institutional sustainability and outreach to the poor.

Transformed institutions have been able to grow because they have access to commercial and semi-commercial resources as well as increasing amounts of public deposits. Because they have access to public deposits they are no longer relying to the same extent on grants and subsidies and now contribute to government revenue through tax payments.

The concern that transformed MFIs may lead to mission drift has not become a reality in most cases. Instead most transformed MFIs have been able to further their outreach – their scale and scope of operations – mainly because of greater access to resources. Most transformed institutions do not have a predominantly private ownership structure. More time is needed to further see the implications of transformed MFIs. According to White and Campion (2002) “transformation into an RFI is a natural progression,” but not every MFI should be transformed into an RFI.

It has been acknowledged that not every micro-finance NGO needs to transform. There are large, efficiently run NGOs, such as ASA and BRAC in Bangladesh, that do not intend to become RFIs. However, important lessons can be learned from the experience of transformed institutions, which can assist microfinance NGOs to assess their situation and make a decision on whether and how they choose to transform.

There are large, efficiently run NGOs such as BRAC and ASA that do not intend to become RFIs, at least at this point of time. The situation is similar with institutions in Bolivia. However, NGOs still need to focus on

better governance, more efficient polices and transparency and need to adopt a more business-like approach.

The fact that only 43 MFIs have transformed raises the question why more MFIs are not transforming. The experience of earlier MFIs which transformed suggests that institutional transformation is not an easy task. There are both internal and external factors that influence MFIs' decisions to transform. Only if the internal and external environments are favorable, will the MFI decide to transform. To make transformation successful, MFIs need to assess their situation and plan carefully. This paper has proposed a guide/tool that will assist managers in their planning process for transformation.

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Appendix 1 Summary of achievements:

Potential Achievement	Indicators	Why these measurements?	Of the 39 MFIs transformed between 1992-2003 studied, how many achieved this
Greater access to commercial sources of funding	Improved access to commercial and semi-commercial sources of funds	Typically one of the main reasons MFIs chose to transform is because it gives them access to market capital, which will allow them larger outreach and growth	<ul style="list-style-type: none"> • <u>CARD</u> has the legal authority to mobilize savings • <u>Mibanco</u> has access to a range of sources of loan capital. It also started offering passbook savings a little more than two years after its transformation • <u>K-Rep</u> expects in its five-year-plan to increase its market share from 2.5% to 12.5%
Wider range of services, such as public deposit	Increasing amount of public deposits, money transfers, saving passbooks	In some countries transformation has been essential because laws do not permit NGOs to borrow from commercial banks (Mexico). Additionally, NGOs in most countries do not have a legal charter to mobilize voluntary deposits. As a result NGOs have not provided voluntary deposit	<ul style="list-style-type: none"> • <u>ACLEDA Bank</u> is the most active bank regarding money transfers in Asia and has had significant increase in public deposits • <u>BancoSol</u> offers money transfer service and was able to draw deposits from a wide variety of sources to fund loan books • <u>BRI</u> has six times as many deposit accounts as loans. As a result, deposit mobilizations have become a major activity within BRI, providing the bank with viable sources of funds from the private sector. BRI offers the much-in-demand combination of security, convenience, confidentiality, liquidity, and returns

		<p>services. Only in cases where bank regulators and governments have chosen to look the other way to the illegal activity of providing voluntary deposits mobilization activities. It has, however, made those NGOs vulnerable to political interventions</p> <p>According to White and Campion (2002, p27) some transformed MFIs that are legally able to capture savings do not take advantage of their ability to mobilize savings. This is attributed partly to dominating influence of the NGO's original lending culture</p>	<ul style="list-style-type: none"> • <u>Caja Los Andes</u> has expanded its capital through deposit mobilization, second-tier and interbank funds • <u>CARD</u> has introduced a voluntary savings product for members and non-members and current accounts • <u>CONFIA</u> increased its deposits • <u>FFP CLA</u> has recently begun providing money transfer service • <u>FINAMERICA</u> expanded its deposit mobilization • <u>Financiera Calpia</u> plays an important role in money transfers, which is an extremely useful service for many Salvadorian low-income households • <u>Financiera Compartamos</u> is not permitted to capture deposits • <u>K-Rep</u> will introduce individual loans, saving accounts, current account, issues counter checks and ATMs and plans to go public in five years after transformation • <u>Mibanco</u> has the right to mobilize savings deposits and. It collects time deposits and offer foreign exchange services. Mibanco has diversified interest rates and introduced two new loan types: fixed asset loans to purchase industrial machines and a loan to build or repair infrastructure. Mibanco also plans to begin offering passbook and term savings accounts in the next few years. However, Mibanco is waiting to add savings to its product line until it has successfully transformed its existing product operations. • <u>Nirdhan Bank</u> offers voluntary deposit services • <u>OMB</u> offers voluntary deposit services savings deposits • <u>SML</u> does not offer savings products • <u>XAC Bank</u> had dramatic result by increased voluntary deposits
Better governance and	1. Found new shareholders 2. Most	One of the key roles of the shareholders of	<ul style="list-style-type: none"> • <u>ACLEDA</u> have an ownership share of 44-51%_Banco ADEMI founder NGO holds 24% of bank's equity

<p>transparency as a result of private ownership</p>	<p>transformed institutions do not have predominantly private ownership structure</p>	<p>MFIs is in the area of governance, which itself varies with the state of ownership structure in the institution. Different types of ownership bring different attributes into the organization. The ownership structure in non-profit MFIs is entirely different from commercial banks and therefore the transformation of an NGO into a commercial bank has a strong influence on the governance of the new institution. Micro-lending NGOs do not have any structure of ownership as the capital of the organization is derived from external donors.</p>	<ul style="list-style-type: none"> • <u>BancoSol</u> the share of the founder NGO has declined • <u>CARD Rural Bank</u>, have an ownership share of 44-51% • <u>Corporacion Nicarguense Financiera – CONFIA</u> the founder NGO’s initial share ownership in the transformed institution was completely sole to a specialized fund • <u>Corposol/Finansol</u> (Colombia) transformation did not produce a positive result in governance, operations and financial sustainability due to service relationship with its founder providing incentives for Corposol to push loans to maximize its own income lending to imprudent lending on the part of Finansol. This brought Finansol to bankruptcy levels and what essentially saved it was the reputation of its key strategic partner ACCION. • <u>Crear Arequipa</u> founder NGOs share is 24% • <u>EMT</u> in Cambodia had an ownership share of 81% and later on 60% • <u>FFP CLA</u> the founder NGOs increased their ownership shares from initial levels • <u>FFP FIE</u> the founder NGOs increased their ownership shares from initial levels • <u>Financiera Calpia</u> the share of the founder NGO has declined • <u>Hattha Kaksekar</u> have an ownership share of 44-51% • <u>Mibanco</u> has increased branch efficiency and reduced time loan officers spent on paperwork. Its’ (prior ACP) board of directors identified and negotiated with potential investors in Mibanco. The resulting mix of investors comprised representatives from both the private and nonprofit sectors. There is also a government-promoted plan that has been written into the bylaws to offer Mibanco shares to interested clients. Mibanco’s
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			<p>shares are designed so that each initial owner has at least one seat on the board. To improve efficiency, Mibanco is looking at ways to diversify its portfolio to reach more businesses, speed up the loan approval process, and reduce costs.</p> <ul style="list-style-type: none"> • Nirdhan NGO owns only 12% of the equity in <u>Nirdhan Utthan Bank</u> • <u>OMB, First Micro-finance Bank</u> in the Philippines have an ownership share of 44-51% • Founder NGOs of EDPYMEs in Peru hold over 90% ownerships in their respective EDPYMEs • Founder NGOs in Asia have retained a significant share ownership in transformed institutions
Larger outreach	Larger number of clients served	<p>Outreach may be the most fundamental reason for transforming and a sample of transformed institutions in Latin America shows the number of borrowers increased in 10 of 12 institutions. According to Dunford (CGAP 2002, p2) three out of four NGOs that have transformed into banks in Bolivia have increased the value of their loan portfolio while decreasing the number of clients served. However this does not seem to be a trend, including in Bolivia.</p>	<ul style="list-style-type: none"> • <u>ACLEDA Bank</u> the number of business loans increased • <u>Banco ADEMI</u> experienced a decline in number of active borrowers following transformation and seems to be moving towards upper segment of the lending market • <u>BancoSol</u> has increased its number of loan takers dramatically after transforming • <u>CARD</u> holds raffles to attract new customers and has since an increase in its' saving since it begun the raffles. It expects to reach 100,000 landless rural women • <u>CONFIA</u> experienced strong growth in number of borrowers after transformation • <u>EMT</u> has increased its clientel during the post-transformation period • <u>FINAMERICA</u> experienced a decline in number of active borrowers following transformation. It was a result of bankruptcy of Finansol and problems associated with its restructuring and revival • <u>Financiera Calpia</u> significantly increase its client base in three years • <u>Financiera Compartamos</u> experienced

			<p>strong growth in number of borrowers after transformation</p> <ul style="list-style-type: none"> • <u>FFP CLA</u> experienced strong growth in number of borrowers after transformation • <u>Hattha Kaksekar</u> has increased its clientele during the post-transformation period • <u>K-Rep</u> expects to increase its group loan customer base with 45000 and has already significantly increased its services to poor people – both in deposit services and lending • <u>Mibanco</u>: New entrants had a significantly higher average poverty rate than the ACP new entrants. More than half (57 percent) of the Mibanco new entrants were poor, whereas only 26 percent of the ACP new clients (who took their first loans prior to the transformation) had household expenditures that fell below the national poverty line. • <u>Nirdhhan Utthan Bank</u> has strong representation of the poorest groups among its clients • <u>SML</u> in India has had a dramatic increase • <u>XAC Bank</u> in Mongolia has increased its clientele during the post-transformation period • In Asia most transformed institutions have experienced rapid growths in loan takers
Financial sustainability		Removes donor dependency	<ul style="list-style-type: none"> • <u>CARD</u>'s consolidated operational self sufficiency is projected to increase from 102% to 263%, and financial self-sufficiency from 81% to 213%
Cost of transformation	The process of transforming an institution is costly and time consuming, usually requiring between		<ul style="list-style-type: none"> • <u>Mibanco</u>: implemented a new computer system at a cost of \$1.5 million. As in most cases, Mibanco's institutional transformation has been a costly endeavor in the short term. However, Mibanco is already realizing many benefits as a result of the change. It achieved its main objective for the transformation—to have access to additional sources of capital to fuel

	\$300.000- \$400.000		<p>future growth. In fact, the shareholders' investment, combined with access to three new loan sources, greatly exceeds Mibanco's short-term projected capital needs. Mibanco originally anticipated a net loss for its first year, but, because of higher than expected returns on investments, the bank yielded a gain. In the future, Mibanco expects to yield a return on equity of 35 percent, with a minimum of 12 percent in difficult years.</p> <ul style="list-style-type: none"> • According to some studies on the sustainability of MFIs in Africa, over two thirds of the institutions are far from achieving sustainability. Their revenues on average are as low as 30-40 per cent of the actual operating expenses, with transaction costs inflated by high administrative costs and expatriate expenses draining program funds. Among the leading MFIs worldwide only less than a handful are financially sustainable and most of them are former NGOs that reached such a status after their transformation into a commercial bank. The institutions unable to ensure commercial returns are destined to live always off the uncertain charity of development aid and other external funding. (Formalizing Micro-credit
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Appendix 2
Microfinance NGOs transformed into regulated financial institutions

Latin America		8 countries and 24 MFIs
Bolivia	5	PRODEM – BancoSol ProCredito – Caja Los Andes FIE – FFP FIE PRODEM – FFP PRODEM IDEPRO, CIDRE, FADES, and ANED – FFP ECO FUTURO
Colombia	1	CorpoSol – FinanceSol
Dominican Republic	1	ADEMI – BancoAdemi
El Salvador	1	AMPES – Financiera Calpia
Honduras	1	FUNADEH – FINSOL
Mexico	1	Compartamos – Financiera Compartamos
Nicaragua	2	Chispa – CONFIA FINDE – FINDESA
Peru	12	ACP – Mibanco SEPAR – EDPYME CONFIANZA CARE Peru -EDPYME Edyficar IDESI – EDPYME Proempresa Habitat Arequipa Siglo XXI – EDPYME Crear Arequipa Habitat Tacna Siglo XXI – EDPYME Crear Tacna Habitat Crear Cusco Siglo XXI – EDPYME Crear Cusco Habitat Crear Trujillo Siglo XXI – EDPYME Crear Trujillo World Vision – EDPYME Credivision Fundacion Intervida – EDPYME Raiz Centro de Estudios Sociales Solidaridad – EDPYME Solidaridad
Asia		6 countries and 12 MFIs
Bangladesh		BRAC – BRAC Bank
Cambodia	4	Hattha – Hattha Kaksekar ACLEDA – ACLEDA Bank EMT – EMT TPC – TPC
India	1	SHARE – SHARE Microfin ltd
Indonesia		Bank Raykat Indonesia (BRI) LPD
Mongolia	1	XAC – Xac Bank
Nepal	2	Nirdhan – Nirdhan Utthan Bank DEPROSC – DEPROSC Bikas Bank Chhimek Bikas Kendra – Chhimek Bikas Bank CSD – SBB
Pakistan	1	AKRSP – First Micro-finance Bank
Philippines	3	OMB CARD – CARD MRI (incl. Rural bank, NGO, micro-insurance company and training center) ARDCI – Vision Bank , rural bank E-Zobel Foundation – Banco Ng Masa ASKI, DSPI, RSPI, TSKI and APPEND – Opportunity Micro-finance Bank
Africa		4 countries and 7 MFIs
Kenya	1	<u>K-REP</u> – <u>K-REP</u> bank
Senegal	1	<u>ACEP</u>
Uganda	3	FINCA Uganda – FINCA Uganda UMU Pride
Tanzania	1	PRIDE Tanzania FINCA Tanzania

Appendix 3
Institutional readiness for transformation

Legal environment	Response
How would you describe your relationship with banking regulators in your country? <div style="text-align: right; padding-right: 20px;"> Excellent 3 Average 2 Poor 1 </div>	
How would you describe the understanding of banking regulators and policy makers in your country about microfinance? <div style="text-align: right; padding-right: 20px;"> Excellent 3 Average 2 Poor 1 </div>	
How would you describe the appropriateness of existing regulatory status for your operations? <div style="text-align: right; padding-right: 20px;"> Excellent 3 Average 2 Poor 1 </div>	
How would you describe the ability of your institution to meet the requirements of the existing regulatory status for your institution to apply (e.g. min. capital requirements)? <div style="text-align: right; padding-right: 20px;"> Excellent 3 Average 2 Poor 1 </div>	
Institutional capacity	
Does your institution have an action plan for the transformation? <div style="text-align: right; padding-right: 20px;"> Yes 1 No 0 </div>	
Does your institution have the following systems in place? <div style="text-align: right; padding-right: 20px;"> Computerized MIS Yes 1 No 0 Standardized loans policies and procedures Yes 1 No 0 Standardized human resource management policies and training manuals Yes 1 No 0 Clear and transparent communication channels Yes 1 No 0 </div>	
Does your institution have reserve human resources to recruit for selling savings and other financial services? <div style="text-align: right; padding-right: 20px;"> Yes 1 No 0 </div>	
Does your institution have a team of skilled middle managers to take responsibility for the various departments? <div style="text-align: right; padding-right: 20px;"> Yes 1 No 0 </div>	
Costs and benefits	
Have you estimated how much the transformation process will cost? <div style="text-align: right; padding-right: 20px;"> Yes 1 </div>	

No	0	
Have you estimated how much the benefits of the transformation process will be?		
Yes	1	
No	0	
Have you done cost benefit analysis of the transformation process?		
Yes	1	
No	0	
Will the estimated benefits outweigh the estimated costs of the transformation?		
Yes	1	
No	0	
Is your institution willing and able to start meeting the following requirements? Paying tax, meeting reporting requirements, raising necessary minimum capital, competing with formal financial institutions		
Yes	1	
No	0	