BUILDING VIABLE MICROFINANCE INSTITUTIONS: LESSONS FROM OTHER DEVELOPING COUNTRIES

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ABSTRACT

The realization that the problem of poverty cannot be effectively tackled without addressing the inadequacies of the provision of financial services to the poor has once more beamed the searchlight on microfinance. And as the focus is now on the viability of microfinance institutions, it becomes imperative to search for global best practices. Accordingly, this paper has undertaken country and institution case studies, covering six countries and three continents, to identify suitable environments and business/public policies that best support and promote sustainable microfinance. It is indicated that commercial microfinance thrives best when there are no competing public programmes that extend subsidized credit; there are no interest rate caps; there is a sound regulatory regime that recognizes the peculiarity of the microfinance portfolio and exposes microfinance institutions to international best practices, standards and ratings; and there is an abundance of technical assistance funded by the government and the international aid agencies.
1. INTRODUCTION

Micro finance is the supply of loans, savings, and other basic financial services to the poor. Like any one else, poor people use financial services to seize business opportunities, improve their incomes, deal with other large expenses, and cope with emergencies (Littlefield & Rosenberg, 2004). The poor rarely access financial services through the formal financial sector. They address their need for financial services through a variety of financial relationships. Providers of financial services to the poor include donor supported, non-profit NGOs, cooperatives, community-based development institutions like self-help groups and credit unions, commercial and state banks, insurance and credit card companies, wire services, post office and other points of sale. The clients of microfinance include female heads of households, pensioners, displaced persons, retrenched workers, small farmers, micro-entrepreneurs and all these fall into four poverty levels: destitute, extreme poor, moderate poor, and vulnerable non-poor.

A micro finance institution (MFI) is an organization that provides financial services to the poor. It can broadly be defined as any organization, credit union, downscaled commercial bank, financial NGO, or credit cooperative that provides financial services to the poor. MFIs include formal providers: those that are subject not only to general laws but also to specific banking regulation and supervision (development banks, savings and postal banks, and non-bank financial intermediaries). Semiformal providers are registered entities subject to general and commercial laws but are not usually under bank regulation and supervision (financial NGOs, credit unions and cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations (ROSCAs) and self-help groups. They can be government owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa, socially minded shareholders, like many transformed NGOs in Latin America; and profit- maximizing shareholders, like the micro finance banks in Eastern Europe.

Many NGOs that are now MFIs are still donor dependent. They use donor money to subsidize interest rate on loans and other costs of operation. With dwindling donor resources, such MFIs may not provide financial services to the poor on a sustainable
basis. MFIs therefore have to struggle to become efficient, and show evidence of prudent financial management in order to attract commercial capital, so that they can expand their portfolio and remain in business on a sustainable basis. This has necessitated the transformation of microfinance NGOs into regulated financial institutions in various parts of the world. This transformation of micro finance NGOs into privately owned, regulated financial institutions is a concept that has been evolving since the late 1980’s. This was born out of a desire to increase significantly the number of clients that have access to micro finance services in the world, increase institutional efficiencies and reduce donor dependency. Transformation here implies the institutional process of change that occurs when a micro finance NGO creates or spins off regulated commercial MFI, the most prevalent form of microfinance today. The motivation behind transformation derives from the fact that most microfinance NGOs have worked to reach the scale necessary to achieve operational self-sufficiency and to overcome donor dependency. While the donor agencies’ budgets are shrinking, and MFIs’ funding needs are growing, the success of the latter will increasingly depend on access to commercial capital, ability to mobilize local savings, improved customer service and expanded outreach.

An MFI that succeeds in recovering all of its operating expenses is said to have reached operational self-sufficiency (OSS). Where the institution is able to recover all of its operating costs, and make profit it is said to have reached financial self-sufficiency (FSS). The OSS and FSS are the necessary and sufficient conditions for institutional viability. Organizations that have attained institutional viability see interest and fees as the main source of operating income. Interest rates are key to sustainability, and their rates compete with those from informal finance. So when we talk of viable MFIs (VMFIs), we are referring to the MFIs that have attained OSS and FSS. A VMFI can access commercial funding that could enable it expand its portfolio and reach more poor people. The goal of microfinance today is to provide financial services to the poor on a sustainable basis, which could only be possible through the existence of VMFIs.

The purpose of this paper is to identify the factors that contribute to the viability of MFIs by drawing on the experience of countries and MFIs that have been successful. The paper
is divided into five sections, including this introduction. Section 2 reviews the literature on microfinance and MFIs. Section 3 is a case study of countries/MFIs. In section 4, the lessons from the case studies and the literature review are summarized. The paper is concluded in section 5.

2. LITERATURE REVIEW ON MICROFINANCE & MFIs

The poor are bankable, as they can save, invest, repay loans, and have need for insurance services (Seibeil, 2000). According to Von Stauffenberg (2002) the challenge of microfinance is not to get lots of money into the hands of the poor but to build up the institutions to identify which of those poor can work with credit. Lopez (2002) agrees with this philosophy of microfinance when he observed that:

Microfinance is about getting the money back, so it means that the target population we are reaching are the people who can get enough money. First, they have to be micro-entrepreneurs. Second, they have to get enough income to repay us and get their own money. This means that the poorest people are not the target population.

According to Easton (2005), massive market and regulatory failure prevented existing financial arrangements in developing countries from serving the poor in the following ways:

- Interest rate caps on lending to the poor undermine the profitability of lending and thus reduce supply of loans.
- Incomplete and erratic regulation of financial institutions mean that most financial institutions dealing with the poor do not have deposit protection so that when they fail the poor savers do not get their money. This undermines their confidence in the financial services available.
- State control of the financial sector that breeds corruption reduces the access of the poor to financial services by raising the cost of every financial transaction and
allowing undesirable transactions to take place thereby undermining consumer confidence in the financial system.

- Inadequate basic public services add to the burden on financial firms, increasing the cost of their services.
- Many financial firms are not interested in serving the poor and have not explored ways of reaping economies of scale.
- High and volatile inflation and absence of necessary legal framework for financial services.

Commercial banks have the greatest growth potential for microfinance, according to Navajas and Schreiner (1998), due to their widespread branch network, profit motive, private governance, competent organization structure, licenses and the need to take deposits. However, a number of obstacles prevent them from providing microfinance. These, according to Navajas and Schreiner (1998) include:

- The high risk and the high cost of taking small deposits, especially in rural areas.
- The inability to brand the products so as to price microfinance services higher than traditional services in order to cover higher cost.
- The fear of competition from subsidized lenders.
- High start-up costs due to the need for research and development when discoveries cannot be hidden from rivals.

The establishment of agricultural banks was part of the early attempts by governments to extend financial services, mainly credit, at subsidized interest rates to customers not considered credit worthy by commercial banks (Seibeil, 2000). This intervention, however, failed for the following reasons:

- The banks generally focused on providing credit rather than accepting deposits with adverse consequences on their self-reliance and viability.
- The banks were also unable to serve small farmers and other customers in the rural areas because they restricted their loans to agricultural activities instead of covering other kinds of rural-income generating activities.
• Interest rate regulation prevented agricultural banks from covering their costs and restricted the access of the poor to financial services.
• The banks have been largely unsupervised and exempted from prudential banking regulations and effective monitoring and supervision of their activities, a regulatory lapse that hastened their insolvency.
• Many of the banks lack the managerial wherewithal to diversify and enhance customer services.

The next major attempt to redress lack of access of the poor to credit was the extension of uncollateralized loans to the poor by NGOs (Easton, 2005). Thus, in 1971, Opportunity International, a not-for-profit organization with Christian roots, began lending in Columbia and ACCION International, also a not-for-profit organization, made its first micro loan in 1973. The Grameen Bank started to make micro loans in Bangladesh in 1976. These organizations began by providing credit because they assumed that poor people were unable to save and that their sole need was for capital (Easton, 2005). Microfinance appears to thrive in crisis-ridden countries, and the crisis may be financial, economic or political (Wenner, 2002). Hyperinflation in the 1980s encouraged the growth of microfinance in Latin America (for example, Peru and Bolivia). In Asia, microfinance flourishes in Bangladesh, which is one of the poorest countries in South East Asia. The establishment of ProCredit in Bosnia Herzegovina in 1996 and in the Democratic Republic of Congo in 2005 in the heat of the wars in both areas lend further credence to this (Easton, 2005). In contrast, microfinance is not well developed in Malaysia or Thailand, which are more high-income and stable countries.

The pioneers of microfinance developed new credit techniques that did not require collaterals but reduced risk through group guarantees, appraisal of household cash flow, and small initial loans to test clients (Littlefield & Rosenberg, 2004). Repayment of loans by group members depends on the stability of the group and this may be enhanced or threatened by two conflicting features of this methodology (Navajas and Schreiner, 1998). First, non-defaulting members undertake repayment for defaulting members or harass defaulters to avoid loss of their own relation with the institution. Secondly, default by
some members may prompt default by others if the cost of repayment of the defaulters’ loan are higher than the relationship to the group. The virtues of group (solidarity) loans, according to the United Nations Capital Development Fund (UNCDF) (2004), include:

- The self-selecting methodology is an effective means of character screening and verification, and this is a fundamental part of credit analysis and risk in any type of financing program;
- Before a group agrees to guarantee a loan, they discuss the business idea with the individual members applying for the loan. This discussion tests the soundness of the idea and serves as a substitute for a costly feasibility study;
- Groups serve as an outstanding method of 'guaranteeing' a loan when no collateral is available. Because a group's credit is 'frozen' until all members are current, groups exert pressure on their members to repay loans on time;
- Many cultures have a tradition of lending money to members of savers' groups. Thus, principles of group lending are often familiar to target clients;
- Groups perform many of the administrative duties in managing loans. This reduces an institution's cost of delivering credit;
- Group members tend to become interested and involved in each other's businesses over time and offer much guidance and support to fellow members.

The limitations of the group-lending model, according to Navajas and Schreiner (1998), are as follows:

- As individual members’ businesses grow at different rates, they would require different amounts of capital, making some members feel some constraints on what they could borrow while others would find themselves guaranteeing big debts for other people.
- As group members develop personal credit histories through their loan payments, the need for collective guarantees would disappear.
- Time for meetings may begin to compete with time devoted to personal business.
The demonstrated willingness of the poor to repay these uncollateralized loans and pay the full costs of providing the loans suggests that access is more important to them than cost (Littlefield and Rosenberg, 2004; Easton, 2005).

Wenner (2002) noted three stages in the MFI development: subsidy dependent, operationally efficient and profitability. Even though prior operation as a financial NGO before transforming into a regulated MFI is advantageous, Silva (2002) observed that most NGOs that were considering transforming into MFIs were always very reluctant to become fully commercial. MFIs that fully commercialise their operations are expected to grow and become viable. Growth is the main mechanism for an MFI to achieve improvement in outreach and sustainability and attain the minimum size to take advantage of economies of scale and scope to reduce average operating costs. Growth may, however, result in deterioration in asset quality and overstretching available resources leading to higher costs through less effective oversight of borrower behaviour and overburdening of the control systems.

The critical success factors for the sustainability of MFIs, according to Castello (2002), include:

- Outreach: Reaching as many people as possible permits an MFI to reach a certain minimum level of scale necessary for sustainability.
- Appropriate lending methodology: Group lending and village banking are better suited for scattered populations while individual lending works better in urban settings.
- Supportive regulatory and supervisory environment. Regulations that apply to mainstream financial institutions need to be modified to take cognizance of the special nature of microfinance portfolio and the transaction cost MFIs incur.
- Productivity: The cost of carrying a portfolio should be kept as low as possible and should decline over time.
- Governance and the investor profiles: There must be a clear mandate for profitability.
• Use of appropriate management information system (MIS).
• Appropriate segmentation of market/clients and deploying the right product/service to each market segment. In each market segment, the interest rate that covers all costs of providing the service should be charged while aiming at minimizing the transaction and opportunity costs for clients.
• The right human resources. The capacity to absorb and train good staff is the biggest constraint to growth in outreach.
• Absence of managed interest rates regime and interest rates ceilings.

As promotional and developmental support services are the key to success of the small and micro-enterprise sector, Brijmohan (2002) advises that MFIs should go beyond providing money to providing promotional and developmental assistance to micro-entrepreneurs. The focus of such assistance, according to Brijmohan (2002), would be to ensure that enterprise promotion, human resource development, technology introduction and upgrades, environment and quality control management and marketing are kept in mind when lending money. He sees the primary objective of such assistance as creating employment and income and generating an entrepreneurial spirit, arguing that once clients become truly entrepreneurial, the lender need not do more than keep supporting the enterprises to grow.

MFIs form one part of a much broader spectrum of socially oriented financial institutions (SOFIs), which include state-owned development, postal, agricultural, and savings banks as well as savings and loans cooperatives. There were about 600 million accounts in these institutions worldwide as at 2003 (Littlefield and Rosenberg, 2004).

On what should be the appropriate interest rate to charge on micro loans, the consensus is that rates must be high enough to ensure the lenders’ sustainability but low enough to be acceptable to borrowers (Hung, 2004; Easton, 2005). For instance, both Compartamos (Mexico) and Mibanco (Peru) started with annual interest rates of 100% and 80% respectively. Interest rates in the informal credit market could be as high as 1000% per annum as in the Philippines (Easton, 2005). Generally, however, rates should be higher
than commercial rates to cover the higher costs of operation in microfinance (UNCDF, 2004).

Since microfinance does not insist on traditional collaterals, credit bureaus are of critical importance to its efficient functioning so that they would facilitate the assessment of repayment patterns and other related issues (Butler, 2002).

According to Easton (2005), big banks have entered into microfinance through various routes, including:

- Creating an entirely separate subsidiary, as Bank Pichincha, the leading bank in Ecuador, did with CREDIFE, to serve the poorest customers and this turned out a remarkable business decision. Small loans now constitute 55% of its assets but 8% profits. Unibanco in Brazil and Banco Santander Chile have followed this model.
- Extending loans through a network of microfinance banks as ICICI, India’s second-largest private bank has done through a network of 53 microfinance banks, which market the loans. ICICI lends to the MFIs at 9.5-11%, slightly higher than it charges its corporate clients, and the MFIs re-lend the funds at 16-30%. ICICI now has an outstanding micro loans portfolio of US$265 million to 1.5 million customers.
- Establishment of investment funds, like Profund, a Latin American Investment pool. Profund was set up in 1995 when ACCION International, Calmeadows of Canada, Triodos of Netherlands and Fundes of Switzerland raised $23 million to invest in MFIs for ten years. Some of the MFIs that Profund invested in later evolved from not-for-profit NGOs into regulated banks, including Compartamos of Mexico, Mibanco of Peru and BancoSol of Bolivia.

An apex organization in microfinance, according to Navajas and Schreiner (1998), links retailing MFIs with donors and governments and performs two functions, namely, financial intermediary between government, donors, and MFIs and facilitating the creation and development of a microfinance sector through the provision of technical assistance. Technical assistance involves a long-term, one-on-one presence within an
MFI by a team of technicians from the provider (Navajas and Schreiner, 1998). They further assert that technical assistance may involve the inculcation of the principles of the fundamental problems that a financial methodology must resolve and the implementation of specific improvements in areas common to all organizations that may be stretched and strained as an MFI grows fast. In the framework of Navajas and Schreiner (1998), technical assistance would encompass the following issues:

- Design of a governance structure.
- Guidance and urging to do strategic planning.
- Design of systems for internal control.
- Installation and customization of hardware and software to track transactions and to manage accounts.
- Design of systems of incentive for personnel.
- Representation and handling of donors and their representatives.

It is preferable that apex organizations that lend funds should not at the same time provide technical assistance. Provision of funds may justify the submission of the MFI to outside influence through technical assistance. On the other hand, the implicit partnership created by technical assistance may destroy the credibility of the threat by the apex organization to make the MFI repay its loans (Navajas and Schreiner, 1998). According to Navajas and Schreiner (1998), technical assistance may help to mitigate three types of constraint in the development of microfinance, namely:

- Downscaling banks require help in the development of the loan and deposit services geared to poor households.
- Upgrading rural financial NGOs requires big technical changes, in products, sustainable organization, technology and psychology. Technical assistance is needed for financial NGOs to revamp their internal accounting, incentive systems, price structures, and overall philosophy.
- Improving the supervision of MFIs by providing the supervisory authority with knowledge, based on experience worldwide, on the risk in a portfolio of microfinance.
International apex organizations include ACCION International, USAID, Canadian International Development Agency (CIDA), FINCA, etc. ACCION International, for instance, has its mission as “to give people the tools to work their way out of poverty”. Through its partner programmes with MFIs, ACCION International increased the number of people served from 13,000 in 1998 to 1.26 million in 2004. During 2004, the big development aid agencies committed about $1billion to micro finance (Easton, 2005). The United Nations Development Programme (UNDP) is yet another source of technical assistance to MFIs and works through the United Nations Capital Development Fund (UNCDF) and the MicroStart programmes. The MicroStart programme is designed to help improve the access of the working poor to appropriate financial services offered by local organizations to enhance their economic activities, increase their revenues, and create employment. In a typical MicroStart programme, an International Technical Service Provider (ITSP) is hired to assist the participating MFIs with capacity building. Examples of such ITSPs include the Association for Social Advancement (ASA) in Bangladesh and ACDI/VOCA in Egypt. The trainings provided by the ITSPs involve strategic planning, microfinance financial analysis, bookkeeping and financial management, governance issues and microfinance “best practices”; business skills, loan appraisal, communication, and project loan policies and procedures; and client selection and follow-up (UNCDF, 2004). The programme also includes provision of grant to the participating MFIs so that they could expand their portfolio and open new branches. The entire support is governed by a performance agreement, which helps UNCDF to monitor performance closely through the ITSP and the MicroStart Advisory Board.

3 COUNTRY/INSTITUTION CASE STUDIES

3.1. Country/Regional Case Studies

3.1.1. Microfinance In Bolivia

Bolivia is one of the poorest countries in South America, with a GDP per capita of US$800 and 70% of its population living below the poverty line. The failure of the attempt by the Bolivian government to correct for market failure in the provision of microfinance through the establishment of development finance institutions coupled with
the growth of distrust in direct government intervention paved the way for NGOs to begin providing financial services to the poor. MFIs in Bolivia have been extremely successful compared to experience elsewhere. Bolivia produced the first financial NGO (PRODEM) to become a licensed and regulated bank taking many small deposits (BancoSol). According to Gonzalez-Vega et al (1996), financial organizations in Bolivia fall into two groups, supervised and unsupervised. The Superintendency of Banks and Financial Institutions (SBIF) is the public agency in charge of prudential supervision and shares regulatory authority with the Central Bank of Bolivia (BCB). The SBIF supervises commercial banks, private financial funds (FFPs, an example of which is FIE), savings and loans associations, and some credit unions and open co-operatives. There is a good network of apex organizations providing funding and technical assistance to MFIs, including NABIFO, which is a public agency. The law permits NAFIBO to work with only supervised intermediaries. Thus, NAFIBO lends only to supervised MFIs and this provides incentives for them to work hard to qualify for a license. In practice, however, the SBIF through a good understanding of the characteristics of BancoSol’s market, has been lenient to it. For instance, SBIF exempts loans less than US$2000 or less than 0.001 of net worth of BancoSol from the sum total of loans without real assets as guarantee that must be less than the net worth of the bank. Secondly, SBIF does not require BancoSol to provide detailed information on each individual borrower.

Other milestones in microfinance recorded in Bolivia include:

- Having some of the few MFIs that use individual loans to reach people almost as poor as those reached by group loans (Caja Los Andes and FIE).
- Venue of important experiments in small loans with terms adjusted to match the cash flows of farms and rural households (PRODEM and Caja Los Andes).
- All MFIs have benefited from support from donors and government.
- The Government’s decision in the late 1980s not to provide financial services or own institutions that provide them which has served as an enabling factor in the rapid growth and development of MFIs and the industry in general.
3.1.2. Microfinance in the Caribbean

Microcredit in Jamaica started mainly in the 1970s when the government launched the Community Enterprise Facility with seed money from the government of Netherlands. Repayment record under the programme was poor. In the 1980s the government sponsored two programmes, the Solidarity Programme (which was a micro credit facility for petty trading and small manufacturing) and the Micro Enterprise Development Agency (MIDA) in which credit was extended to credit unions, NGOs and Community Development Foundations. Poor repayment record again marred the Solidarity Programme while the capping of interest rates below market rates led to the failure of MIDA (Butler, 2002). In 1993, the Micro Enterprise Project that provided J$160m to the micro enterprise sector through credit unions, NGOs and commercial banks was launched. This project was jointly sponsored by the Government of Jamaica and the Government of the Netherlands. At the expiration of the programme in 1999, the funds were transferred to the Microfin Programme, which is managed by a private firm, Development Options. Other microfinance initiatives in Jamaica include:

- The Jamaica National Micro Credit Company, established in 2000 as a private initiative. The interest rate on loans from this source is 1% per week.
- Group loans targeted at inner-city communities sponsored by Bank of Nova Scotia/CIDA.

Generally, the problems, militating against the development of microfinance in the Caribbean include:

- A regime of high salaries (which implies high operating costs).
- The existence of a bigger commercial banking sector unlike in Africa or Latin America, which reduces the fringe of the “unbanked” population (Von Stauffenberg, 2002).
The existence of numerous state-sponsored micro finance programmes which were cheap and subsidized, thus undermining attempts at doing commercial, sustainable microfinance lending (Wenner, 2002).

• The high dependency of Caribbean countries on remittances from abroad, which weakens the demand for micro finance loans.

• The inadequate regulatory framework, which is not suitable for sustainable microfinance development (Von Stauffenberg, 2002).

• Substantial size of the informal sector with high unemployment and migration.

• The shortage of entrepreneurs (Wenner, 2002).

There is a regional orientation in the organization of the microfinance industry in the Caribbean due to the small, fragmented and diverse nature of the markets. Thus, the Caribbean Microfinance (Trinidad and Tobago) Ltd (MICROFIN), which is a subsidiary of Development Finance Ltd, adopted a regional outlook by operating in four countries, using subsidiaries. The mission of the MICROFIN is:

To generate a high level of economic value added (EVA) on its own in order to maintain financial soundness and portfolio growth, thus ensuring that MICROFIN remains a sustainable and suitable source of financing for the largest possible number of micro enterprises in the Caribbean.

According to Dhanrajh (2002) the strategy of MICROFIN includes regional operation, projection of a private sector image, use of technology to drive operations and remain competitive, and outsourcing non-lending functions. He noted that in presentations to its potential clients, MICROFIN lets them know that “This is a private sector company for profit. We want to make return just as you want to make a return”.

3.1.3. Microfinance in Nigeria

Nigeria has over 70% of its 140 million population living below the poverty line of $1 per day. Majority of these poor depend on micro, small-scale, farm and off-farm enterprises for their livelihood. However, majority of these poor but economically active segment of the population lack access to financial services from the formal sector. Policy
makers in Nigeria had long recognized the inability of the existing formal sector financial institutions to cater for the financial needs of the poor, and had sought to tackle this evident failure of the market. Public efforts at redressing the inadequate supply of financial services to the poor include government support to cooperatives, the establishment of public agencies to provide financial services to the poor, such as the Nigerian Agricultural, Cooperative, and Rural Development Bank (NACRDB), the Agricultural Credit Guarantee Scheme Fund (ACGSF), the Fund for Small-scale Industries (FUSSI), the Supervised Credit Schemes of various state governments, the Peoples’ Bank, the licensing of Community Banks in the 1990s and directives to commercial banks on lending to the poor. Commercial banks’ mandated participation in provision of micro finance has been through government’s directed credit programmes at subsidized interest rates, the establishment of rural branches under the Rural Banking Programme (RBP) which required banks to lend a specified proportion of their rural deposits to rural enterprises, and through the various initiatives on the funding of small and medium-scale enterprises (SMEs). However, it is pertinent to note that only with RBP, the Peoples’ Bank, the cooperatives, and the community banks did the policy makers take the poor’s need for financial services beyond the demand for credit to include deposit mobilization.

For a variety of reasons, these pro-poor financial schemes failed to meet their expectations. The credits-only institutions failed under the weight of uncollected loans, the savings and loans cooperatives could not mobilize adequate deposits due to restrictive interest rate policies while borrowers default grounded operations. Commercial banks that have the most potential to provide sustainable micro finance have continued to shy away from it while many community banks have failed even as the demand for financial services by the poor continues to grow. However, in order to create an integrated financial system that would cater for the financial needs of all segments of the economy, the Central Bank of Nigeria (CBN) in December 2005 published a micro finance policy for the country, stating the conditions for the establishment of micro finance banks (MFBs) and NGO MFIs, and the conditions for the NGO-MFIs to convert to MFBs. The micro finance policy for Nigeria promoted by the CBN established the minimum capital
of unit branch MFBs as N20 million and that of state MFBs as N1 billion while the minimum capital of community banks was raised to N20 million, effective December 31, 2007. The policy expects all community banks to convert to MFBs.

3.2. Institution Case Studies

3.2.1. BancoSol

PRODEM (Promotion and Development of Microfinance), the pre-cursor of BancoSol, began operations in 1987. It operated as a financial NGO, extending microloans to the poor. Many international donor agencies contributed to the funds of PRODEM, including USAID, the United Nations Capital Development Fund (UNCDF), and ACCION International. By 1990, however, the promoters of PRODEM found that its sustained growth was constrained by its NGO status and lack of access to sources of loanable funds more flexible than donor funds. Consequently, in 1992, PRODEM established BancoSol as a regulated bank supervised by the BCB and the SBIF. PRODEM owns one third of the equity of BancoSol and, together with other NGOs and donor organizations, account for 75% of BancoSol’s equity while prominent, successful, and politically influential Bolivian businessmen hold the remaining 25% of equity. Meanwhile, PRODEM continues to operate as an MFI with specialization in rural microfinance.

At the inception of BancoSol, PRODEM transferred to it tangible and intangible assets that enabled it to take off smoothly and become successful. On the tangible side, a total outstanding loan portfolio of US$6.5 million, some real estate from its network of urban branches, and 14,300 active clients were transferred. The intangible assets transferred by PRODEM to BancoSol, according to Gonzales-Vega et al (1996), included the following:

- Time-tested lending technology.
- A stock of information capital on clients.
- The actual client relationships embodied in a large portfolio of active, well-performing clients.
- An experienced staff.
- A reputation as a serious financial organization.
- Well-established connections with international networks.
BancoSol has the largest number of clients among MFIs in Latin America and is the only commercial bank in Bolivia that is also an MFI. BancoSol is different from other banks by having a portfolio built entirely on well-performing micro loans. The success of BancoSol is due to its management’s strong concern with financial viability, development of a lending technology appropriate for its market niche, a long learning period, and upgrading into a formal financial intermediary and massive technical assistance from USAID provided through ACCION International (Gonzalez-Vega et al, 1996). The features of BancoSol’s loans include:

- An applicant for loan must have operated an established business for at least one year.
- Clients operate in the informal economy and generally do not keep written accounts of their revenues and expenses.
- Lending methodology does not rely on standard financial information and on collateralisable assets.
- Loans are denominated either in the local currency or in US dollars. Terms to maturity of loans extend to a maximum of three years.
- All loans are amortized in equal-size installments, charge interest on the outstanding balance only, and do not require compensating balances.
- First time borrowers typically get small, local-currency denominated loans with weekly repayments and average terms to maturity of four months.
- The nominal interest charged is 4% per month plus a flat of up-front fee of 2.5% of the loan amount.
- Lending methodology emphasizes contract design and contract enforcement rather than intensive screening and monitoring.
- Sequential and substantial improvements in the terms and conditions of loan contracts (including larger loans denominated in US dollars) for well-performing clients.
- Timely disbursement of loans, thus increasing the value of the client-organization relationship by reducing borrower transaction costs.
• Loan security is the joint liability among group members for loans.
• Highly personalized service offered to the clients as loan officers develop a long-term personal connection with borrowers, which engender powerful informal incentives to fulfill contract commitments.

BancoSol’s organizational features that account for its success, according to Gonzales-Vega et al (1996), include:

- Strong leadership, deeply concerned with the bank’s financial viability from the very beginning as reflected in the adoption of interest-rate policies that cover lending costs and a resolute attitude towards loan collection.
- Operation of a fairly simple and flat organizational structure coupled with conscious investment in the development of highly personalized relationship. The resulting organizational structure and culture produced a strong set of personal motivations, clear commitment to the bank’s mission, and a style of self-management that emphasized recognition of individual contributions to the team’s effort.

- Fruitful investment in experimentation and learning during the PRODEM period to accumulate knowledge and experience about the environment, features of the clientele, the individual credit worthiness of heterogeneous clients and the comparative advantages of its own technology.
- Use of experienced businessmen in the Board who introduced effective internal control mechanisms and better managerial skills to face the challenges of operating as a regulated bank, by recruiting experienced bankers and professionals.

3.2.2. K-Rep Bank (Kenya)

K-Rep Bank is the first micro finance commercial bank in Kenya. Its mission is: to provide banking and microfinance services to low-income people on a commercially viable basis. K.Rep Bank is owned by Kenya Rural Enterprise Programme (K-Rep) Group which is a private development organization whose mission is to stimulate the
participation of low-income and poor people in the economic development process. At inception in 1984, K-Rep Group began providing loans to NGOs for on lending to micro enterprises. It stopped lending to NGOs at some point and focused on retail and direct lending. The experience it gathered in this business emboldened it to establish the K-Rep Bank Limited as a subsidiary. K-Rep Bank obtained its banking license in March 1999 and began operations later in December of the same year. It is under the regulatory and supervisory authority of the Central Bank of Kenya and it is the first African microfinance NGO to transform into a regulated financial institution. The main shareholder of K-Rep Bank is the K-Rep Group, with the other shareholders as African Development Bank (ADB), International Finance Corporation (IFC), the Netherlands Development Finance Company, Shore Bank of U.S.A, Triodos Bank of Netherlands, and a staff association KWA Cooperative Society.

The K-Rep Group consists of three subsidiaries: the K-Rep Bank, K-Rep Advisory Services (engaged in consulting and capacity-building business) and K-Rep Development Agency (involved in research and product development). The products of K-Rep Bank include group loans, individual loans, business loans, current accounts, group savings, involuntary savings, voluntary savings, regular savings accounts, letters of credit, foreign currency dealings and ATM services. The various group loans that the bank extends to its customers require mandatory weekly savings of at least US$1.30. Total loans outstanding by September 2003 was US$20 million with 42,000 active borrowers and 55,830 active savers. As at May 2005, K-Rep had 12 branches and 22 field officials. Its share capital was US$9.5 million in 2002 and it achieved an average return on equity of 7.05% over the period 2000-2003. K-Rep Bank has a long-term credit rating of BBB+ from Global Credit Rating Co. and MicroRate in 2003.

3.2.3. The Vietnam Bank for Agriculture and Rural Development

The Vietnam Bank for Agriculture and Rural Development (VBARD) introduced the mobile banking programme (MBP) in 1998, similar in conception to those in Bangladesh
and Malaysia. It acquired 159 vehicles, which enabled loan officers to reach remote areas to process loan applications, disburse money, collect repayments and mobilize savings deposits. The visits were scheduled to coincide with weekly village markets and saved borrowers traveling time and transportation costs. There were no collaterals for loans up to US$645 (later raised to US$1,290). Savings by borrowers was voluntary but incentives were offered to people to open savings accounts. The bank guaranteed safety for deposits and offered attractive interest rates for different maturities. After one year, each mobile bank began to add 200 new accounts every month. The VBARD uses both individual and group loans. It does not require individuals to join groups but rewards those who do through simpler lending procedures, longer-term loans, installment payments, and other services (Hung, 2004). Because it costs more to provide credit in the rural areas compared to urban areas, VBARD charged rural borrowers 12% interest rate per year while urban loans attracted 8.4% under the MBP. The repayment rates on the loans were 97%. In its first five years of operation, the MBP proved a cost effective operation as it provided financial services to 315,000 poor households, which was 6% of VBARD’s clients. On the average, each mobile bank disbursed 1,921 loans, collected 1,387 payments and transported cash on 75 occasions to 16 local points monthly. The MBP has been successful as each vehicle on average recorded a modest profit of $1,000 a month after providing for the cost of funds, gasoline, depreciation and staff.

3.2.4. Bank for Agriculture and Agricultural Cooperative (BAAC) in Thailand

BAAC was established in 1966, with the government providing all the capital for its operations. Allocations were irregular and sometimes came out of season to be of much assistance to farmers. There was thus chronic funds shortage. Loan recovery rates were very low, 51% in the early 1970s and administrative costs were high, 8% in 1974 (Seibeil, 2000). A turning point in the operations of BAAC came in 1975 when the Bank of Thailand in its credit policy of that year stipulated that commercial banks should lend 5% (later 20%) of their portfolios to the agricultural sector. The banks deposited any portion of this quota they could not lend directly with the BAAC for lending to farmers. This made commercial banks funds to begin to make up for BAAC’s shortage of funds.
In addition, a policy shift by BAAC saw it move from wholesale lending through agricultural cooperatives to retail lending to individual farmers organized into joint-liability groups. Accordingly, by 1987, BAAC was working with 100,000 joint-liability groups involving 1.5 million members compared with 821 agricultural cooperatives. The series of liberalizing policies in the financial sector pursued by the Bank of Thailand between 1988 and 1996 also boosted the growth of BAAC. These included the elimination of interest rate ceilings on the fixed deposits of commercial banks, the eventual liberalization of all interest rates, the removal of restrictions on the opening of branches, and permission given commercial banks to offer a wide range of financial products in the rural areas. Taking advantage of these developments, BAAC increased its branch network to 532 in 1998 from the previous 82, and increased its savings mobilization such that rural deposits became the main source of its funding.

BAAC came under the supervision of the Bank of Thailand in October 1998 and now has about 4.8 million clients, representing about 86% of all farm households in Thailand. Since 1998, BAAC with the assistance of GTZ has been involved in micro finance. Its products for low-income individuals and micro-entrepreneurs include: working capital loans, education loans, time deposits, saving for special events, old age savings, health insurance, natural disaster protection, life insurance etc. The security and collateral for its loans include personal guarantee, personal asset collateral, saving account balance and group guarantee. BAAC had, by 2001, 10.43 million micro savings clients and US$3.08 billion in micro account portfolio.

3.2.5. Bank Rakyat Indonesia (BRI)

BRI was founded in 1895 but its status as a government-owned commercial bank began with its nationalization in 1945. It then functioned as an agricultural development bank but the government reserved the right to approve its loans and required the bank to pay more for its deposits than it charged for its loans (Easton, 2005). This made the bank to abandon deposit collection and many of its borrowers defaulted on their loans. In order to stave off imminent collapse, BRI embarked on a complete re-organisation of its operations in 1983, reversing every policy. Among its recovery measures were:
• An increase in loan rates by half.
• Shift in target client group from the well connected to the rural poor, through the introduction of microfinance products and services in 1984.
• Active marketing of deposits.
• Abolition of minimum limit on accounts.
• Massive staff re-training programme.
• Transformation of sub-branches into self-sustaining profit centers.
• Introduction of profit-sharing incentives to the staff.

BRI also benefited from the deregulation of interest rates in Indonesia in the mid 1980s. The success of BRI’s microfinance project was such that by 1989, it was fully financing its village lending activities from locally mobilized savings. Also, since 1989 the growth of savings has outpaced that of loans, testifying to a strong demand by the rural poor for deposit services. In 1999, BRI had 3,700 rural sub-branches, 2.5 million active borrowers and 20 million savings accounts. As at December 2001 BRI had 3.1 million micro loans clients, with a micro loans portfolio of US$1.7 billion while the micro savings portfolio was US$3.23 billion. Microfinance as percentage of total portfolio was 31% (micro loans) and 38% (micro savings). BRI has a long-term loan loss ratio of only 2.1% (Seibeil, 2000).

BRI’s micro products include working capital loans, checking accounts, passbook savings and time deposits. The security and collateral requirement for the BRI loans include: personal asset collateral, savings account balances, co-signature, property collateral, and employment/paycheck. In 2003, government reduced its holding in the bank to 70%, selling 30% of its shares through an initial public offer (IPO). The sound financial footing of BRI was demonstrated during the East Asian financial crisis of 1997 when its operations were largely unaffected.
3.2.6. Grameen Bank (Bangladesh)

Grameen Bank, meaning “bank of the village” was founded by Dr Muhammad Yunus in 1976. The idea of the bank can be traced to two events involving Dr Yunus. The first was in 1974 when he gave a loan of US$27 to a group of 42 families during the Bangladesh famine of 1974 for them to produce small items for sale without relying on shylock moneylenders. All the loans were repaid. Secondly, in 1976, the Research Project led by Yunus and the Rural Economics Project of the University of Chittagong experimented on a new method of providing credit and banking services to the rural poor in Jobra and other villages surrounding the University. The immense success of the bank led to its extension, with government support, to other districts in Bangladesh. In 1983, government legislation transformed Grameen Bank into an independent bank and it continued its expansion across the country. The equity of Grameen bank is owned 94% by the poor borrowers of the bank while the government of Bangladesh owns the remaining 6%. Its operations cover 71,371 villages with a total of 2,259 branches as at May 2006, 6.74 million borrowers and 18,795 staff (Wikipedia, 2006). The Grameen bank now consists of over twenty-four enterprises, spanning communications, energy, education, fisheries, etc.

The Grameen Bank does not require any collateral for its loans. Although each borrower must belong to a five-member group, the group is not required to give any guarantee for a loan to its members. The individual borrower is solely responsible for his loan repayment. However, if any member of a group defaults in repayment the whole group is denied further credit. The bank finances 100% of its outstanding loans from its deposits and over 63% of its deposits come from its own borrowers. Deposits as at August 2006 were US$564.16 million, which was equivalent to 123% of the outstanding loans. Since inception, the bank’s total loan disbursements was US$5.72 billion out of which US$5.07 billion has been repaid. The monthly average loan disbursements for the 12-month period ending August 2006 were US$58.87 million. The bank received the last instalment of donor funds in 1998, following its decision in 1995 not to receive any more donor funds.
Grameen Bank has been a profitable enterprise, making profit in every year of operation since inception except in 1983, 1991 and 1992. For instance, from gross revenue of US$112.40 million in 2005, it made a profit of US$15.21 million, which was transferred to a Rehabilitation Fund created to cope with disaster situations. This was a requirement of the government for exempting the bank from paying corporate income tax. The interest rate for government-run micro-credit programmes in Bangladesh is a flat rate of 11% fixed by the government. Grameen bank’s loan interest rates are, however, lower than the government fixed rates. The bank’s minimum deposit interest rate is 8.5% while the maximum is 12%. The bank has numerous products including the Struggling Members’ Programme, under which interest-free loans are extended to beggars, housing loans, micro-enterprise loans which provide large-size loans to individuals moving faster than others in their businesses, higher education loans, loan insurance, life insurance, and Old Age Pension Fund. Grameen bank has computerized Management Information System (MIS) and Accounting System in nearly all its branches. A new branch of Grameen Bank is required to break even within the first year of its operation.

4. LESSONS OF EXPERIENCE: SUMMARY

- Commercial banks that have the greatest growth potential for microfinance are constrained by high risk of lending to and the high cost of taking deposits from the poor.
- Attempts by governments to promote microfinance generally fail due to the limited range and focus of their microfinance services, the programmes generally do not link deposit-taking to extension of credit and restricted loans to only specified activities, such as agriculture, instead of covering all rural-income generating enterprises.
- Interest rate capping, exemption from prudential regulations and managerial deficiencies are other causes of failure of publicly promoted microfinance programmes.
- The use of group loans, which substitutes group guarantees for collaterals, is one major way microfinance seeks to reduce credit risk. However, group loans are
more appropriate in rural areas while individuals loans are more effective for urban dwellers.

- Private investors and governments can partner in the provision of microfinance. In addition, government can use fiscal incentives to promote the viability of MFIs.
- Sustainability of microfinance and MFIs requires commercial operation, which in turn requires effective transformation from a culture of charity to a proper business culture. Management must be strongly concerned with financial viability, charging the loan rate that covers costs and having zero tolerance for loan delinquency. Microfinance loans attract higher than commercial interest rates.
- Access to credit is more important than its cost to the poor.
- Growth in outreach requires MFIs to not only increasingly serve more customers but also to expand their products to include all financial products available in sophisticated markets.
- Big banks, local and international, have entered microfinance through a variety of channels, including creating wholly owned subsidiaries, lending to MFIs for on-lending to micro loans applicants, taking up equity investments in MFIs, or contributing to microfinance investment pools.
- Greater reliance on information communications technology to drive operations is the major means of reducing cost in microfinance by reducing its manpower-intensity.
- Providing microfinance does not necessarily require new institutions. In most cases all that is needed is effective transformation of existing institutions so that they become more business-minded. Financial-sector liberalisation was sufficient to turn around the fortunes of public agencies with mandates for credit delivery and direct their business focus to microfinance.
- Use of mobile banks is a cost-effective method of providing microfinance to scattered/sparsely-populated regions.
- Successful microfinance provision has greatly benefited from technical assistance and funding provided by international aid agencies.
• Regulatory requirements for MFIs are generally less stringent than for other regulated institutions because of the peculiar features of their portfolios.

5. POLICY RECOMMENDATIONS

Given the findings of this paper on microfinance best practices, we highlight some important issues for donors, governments and other stakeholders to note in the effort to build viable microfinance institutions. These include:

1. Avoid subsidizing loan portfolio, which results either in low outreach for loans, or massive continuing subsidies that are not replicable elsewhere. It distorts the market and discourages MFIs from providing financial services in spite of huge demand.

2. Improve the legal environment: The extent to which legal contracts are enforceable and sanctions for default, fraud or theft are applied influences an MFI’s ability to manage its loan portfolio quality and become viable.

3. Address the problems of microfinance industry infrastructure such as the lack of a credit information exchange mechanism and appropriate external audit services, and improve on information flows, networking opportunities, and coordination within the rapidly growing sectors.

4. Improve the regulatory and policy environment: It is important to keep in mind that the essence of regulation is to protect depositors and prevent risks to the financial system. Credit-only MFIs that do not take deposits from the public posed no risk to the financial system and should not be required to come under burdensome regulations. Regulation is needed for MFIs that want to start deposit collection. By providing industry benchmarks, regulatory framework could serve as incentive for MFIs to become viable, so that they could get license to mobilize deposits, access capital market and expand their portfolio.

5. Improve the macroeconomic environment: Building a viable MFI requires maintenance of macroeconomic stability and avoidance of interest-rate cap that would prevent the MFIs from covering their cost and thus achieving operational sustainability.
6. Develop high-level political support for commercial microfinance: The future of microfinance lies in developing commercial financial services delivery to the poor. The poor has proven that he can pay the cost of service delivery by the MFIs and other providers. Leaders and the public at large need to be informed on the reasons why commercial microfinance is beneficial to the poor, the economy and the society.

7. Support the upgrading of MFI ownership, governance, and microfinance management: Donors and governments should ensure that MFIs have good, reputable, educated and committed Board members and management staff. They should also improve their funding of technical assistance to step up capacity building in order to institutionalize formal organizational culture.

8. Develop and promote financial and other tools for commercial microfinance and awareness of industry standard: A regulatory framework has to provide some benchmarks and operational standards. Similarly, prospective MFIs could be exposed to international best practices, standards and ratings.

9. Support the development of groups/associations of tradesmen, artisans, producers, and workers, preferably as cooperatives to enhance the scope for the use of peer group monitoring of credit.

10. NGOs transforming into regulated MFIs should attempt to strike the desired balance between commercial and social objectives in the development of their new vision and mission. A well-defined mission statement can help guide the NGO through the Board and management selection process and establish an effective business model/policy for the enterprise.

11. It is necessary that NGO-founded regulated MFIs should aim at diversified ownership base as the regulators will want to see a group of individuals, firms and not donors who have put funds at risk. A dominance of NGO’s ownership can reduce the intended benefits from private ownership of increased accountability and access to additional sources of capital.

12. As the initial capitalization of a regulated MFI is determined by two factors, the regulatory requirements in the country and the institution’s business plan, it is
advisable that promoters of MFBs should aim at capitalization levels well in excess of the regulatory minimum.

13. In the process of transformation of financial NGOs into regulated institutions, adequate attention need to be paid to the issue of asset and liability transfer. NGOs that have sourced funds from commercial or other lenders need to negotiate carefully either a transfer of this liability to the regulated institution or some other arrangement that will allow the NGO to continue to pay off the debt with resources from the regulated institution.

14. Address organizational development changes as an evolutionary process. Identify a new mission for the founding NGO, and let the leadership of the new institution communicate its vision to employees and clients in a way that generates enthusiasm without creating unrealistic expectations.
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