Financing Microfinance Institutions: Impacts on Organizational Strategy and Performance

Philosophical and Methodological Implications

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Abstract

This paper outlines the author's PhD research in progress particularly focusing on the main philosophical and methodological implications of the research which is interested in examining the financing side of Microfinance institutions (MFIs) and demonstrating to what extent it influences their strategies. The research design combining both quantitative and qualitative tools is described. Particular issues in relation to undertaking the both research tools and integrating later results obtained from the two methods should be dealt with. After having presented briefly the possible methodological constraints some concluding remarks are drawn out in relation to this particular project we describe.

Keywords: *Microfinance, relationship-based financing, social impact, poverty alleviation.*

Introduction

The objective of the present paper is to demonstrate both the philosophical and methodological implications of the author's research which is interested in looking at the Microfinance institutions (MFIs) from the financing side and examining its impact on their strategies. First, we start with an introduction to the research being undertaken by emphasizing the background from where the research question arises and this is followed by in-depth demonstration of the philosophical and methodological implications of the research. The last section will come to present also consideration of possible constraints resulting from the fact that Microfinance industry, being newly developing industry in non-conventional financial sector, is extremely divergent and heterogeneous from one country to another. Finally, the paper finishes with concluding remarks in relation to this research.

1. Background

This paper refers to a research to be carried out on Microfinance industry. More particularly, it is interested in the funding side of MFIs: how they obtain financing, what are the terms, how it can affect strategies of MFIs?

Over the past few years, Microfinance has proven to be amid global scale strategies of poverty alleviation, social inclusion and self-employment. It has become a very important tool in sustainable development policies which concerns the combination of financial intermediation with social development. Until recently, much of Microfinance development has been focused on developing the asset side of MFIs – their sources, programs and client portfolios- and very little attention has been paid to the funding side of these institutions- who they are being financed and how they acquire financial resources.

Little is known in academic literature on how the nature of relationship between MFIs and traditional donor financial institutions[1] influences the relationship between MFIs and their clients- both households and microenterprises. In the context of rapidly developing Microfinance industry this issue requires deeper theoretical as well as empirical evidences.

The main research questions which are raised in this research are the following:

Does the origin of funding influence MFIs' strategies? To what extent does it affect MFIs relationship with clients?

As of today more than the half of MFIs is being funded by conventional banking institutions or private donors. MFIs have a need for financial sources in order to fulfill their commitment in long term; hence the role of funding institutions is very important. As to economic theories (Stiglitz and Weiss, 1981) market frictions such as information asymmetries and agency costs may explain why capital does not always flow to firms with profitable investment opportunities. This main reason for lack of appropriate institutional precautions results in

[1] Within the framework of this research we speak about traditional financial institutions as consisted of different types of government

the problems of “adverse selection” and “moral hazard” so often cited in the literature.

As a potential solution to information asymmetry problems in the distribution of credit to the poor and to small businesses relationship-based financing has been promoted (J. Jordan Pollinger, John Outhwaite and Hector Cordero-Guzmán, 2007). The presence of good relationship management and ability to find effective ways for collection of adequate information strengthens the role of MFIs as successful tool for providing financing to poor households and microentrepreneurs in local communities, small rural or urban areas. Having the informational advantage which is also due to small organizational structure and hierarchy of MFIs makes the use of relationship-based financing an effective concept of financial intermediation.

Focusing on relationship between MFIs and conventional financial institutions on one hand and on its impact on relations between MFIs and their clients on the other hand the research is interested in the following key questions: When attributing subsidies to MFIs what kind of influence or control do financial organizations exercise? How does this affect the decision of MFIs to be more client rather than profitability oriented? Based on results it will be possible to develop ways and views from different angles of optimal strategies which allow MFIs to sustain long term financial viability by developing at the same time aid for poverty reduction, thus stressing on social characteristics and well-being of the society, and also organizational learning practices.

1.1. Theoretical background

In order to follow the scope of this paper the general and broad literature reviewed for the present study will not be presented. However mentioning certain relevant studies is important in terms of understanding conceptual framework. When speaking about Microfinance activities it is crucial to define clearly the notion of Microfinance which is being used in very different ways. Within the Microfinance industry evolution path the definition has also evolved. The definition that goes more closely in line with our research is the one given by J. Ledgerwood (1999): “The term Microfinance refers to provision of financial services to low-income clients: credit and savings, insurance, payment services. In addition to this financial intermediation, group formation, development of self-confidence and training lead to social intermediation. The definition of Microfinance combines both financial and social intermediation”.

Fundamental services provided by MFIs are the same that conventional financial institutions offer to their customers. What creates the difference is the scale and method of service delivery.

Hence, in this research Microfinance is seen a multidimensional concept which aims to first, offer small scale financial services such as loans, savings and a range of less practiced services (insurance, money transfers) to a clientele poorer and more vulnerable than traditional bank clients; and second, to enhance social well-being and inclusion among poor borrowers.

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and commercial banks, financial and mortgage companies, credit unions.

2. Philosophical and methodological implications

This study adopts two methodological directions: theoretical and empirical.

The first step in this research deals with reviewing relevant scientific literature, summarizing the existing empirical evidence and by building a new typology of relationship between social and economic performance and organizational structure applied on a group of observed countries. The objective is to determine distinctive features of MFIs, focusing more particularly on their organizational structure and knowledge transfer ("hard" and "soft" information, Stein 2002). A feature which makes it interesting to study this particular sector lies in informational advantages - human relationship, mutual trust, reliability, nontraditional contracts - MFIs have as compared to large-scale financial institutions. Commercial banks have incomplete information about poor borrowers and there is a lack of collateral of the poor borrowers as security to banks (B. Armendariz and J. Morduch, 2007). Aiming to better understand relationship aspects, information flow, and process of MFIs acquisition of tacit knowledge and experience concepts of knowledge economy will be applied. The relationship-based financing approach, pioneered by M. Petersen and R. Rajan (1994) simply tested its relevance for commercial banks. This approach will be tested for MFIs where knowledge is very unlikely to be acquired by formal education and training rather it requires a continuous cycle of dissemination and sharing understandings. Believing that knowledge management applied in Microfinance sector can help MFIs to deal with cost and risk management in relationship lending we take this sector as a specific case study of knowledge economy by introducing in this part of theoretical study the notion of relationship-based finance. Using tools of knowledge economy will help to understand how knowledge transfer is organized between MFIs and external actors: financial suppliers and clients.

The second step is the empirical aspect to validate defined hypotheses with the help of quantitative (i.e. model) and qualitative (i.e. case studies and interviews) studies on a sample of MFIs operating in six countries of Eastern Europe (Poland, Romainia, Bulgaria, Ukraine, Turkey, Moldova). There are certain common characteristics among the countries in the region which all started moving from centrally-planned to market economy in the early 1990s. Many of Eastern European countries have developed a culture of financial intermediation only after the fall of Communism in 1989. Development of market economy and privatization were driving forces for Microfinance to be emerged in the region. This explains why MFIs in this region are younger and the industry has significant development potential. The main reason of the choice of MFIs in this region is justified by the possibility to have access to the database of the regional network organization, the Microfinance Center for Central and Eastern Europe and the Newly Independent States (MFC for CEE and the NIS) based in Warsaw, Poland.

We first construct a model the purpose of which is to simplify the reality. It is distinct from already existing models (Ghattak, 1999; Van Tassel, 1999; Egli, 2004; Bhole and Ogden, 2010; Tedeschi, 2006) in combining at the same time incentivizing and revealing mechanisms. Obtained results later will be verified and validated by qualitative research tools. Case studies and interviews will be therefore helpful in order to comprehend a complex issue specific to given MFIs in each country of the sample.

The principal data collection method consists of in-depth interviews with MFIs managers which can also be completed by documentary evidence (annual reports, financial statements of MFIs).

Thus, data collection and sampling for carrying out the research will be based on:

Primary sources	Interviews Case studies
Secondary sources	Microfinance Center for Central and Eastern Europe and the Newly Independent States (MFC for CEE and the NIS) based in Warsaw, Poland Rating reports of five rating agencies (MicroRate, Microfinanza, Planet Rating, Crisil and MCril): www.ratingfund.org MixMarket (includes basic financial measures for a large number of participating organizations) : http://www.mixmarket.org MicroBanking Bulletin (reports more detailed financial information, adjusted in certain ways for comparability): http://www.mixmbb.org/en/index.html Microcredit Summit Database (contains information on the largest number of microfinance institutions): http://www.microcreditsummit.org

The main implications of this research encompasses can be grouped into the following twofold objectives:

a) First, contribute to the enhancement of MFIs role in financial development and strengthening the link between economic growth and poverty alleviation. The more MFI strategy is oriented to its clients the higher is its efficiency and profitability.

b) Second, infer on indicators of social well-being and social inclusion of the poor by contribution to social and economic development polices: alleviation of poverty, enhancement of social well-being, self-employment. This will help to increase the role of the social impact of Microfinance.

The fact that Microfinance industry is relatively a recent phenomenon still in its early stages of development has its limits on many methodological aspects of the research. The main areas to be influenced by this are the following: a) choice of methodology and b) harmonization of MFIs database.

a) Choice of methodology

As already explained above the research methodology is to complete quantitative study results with qualitative study. The difficulty lies in verifying and validating the same hypotheses based on results obtained from the model and later with the help of interviews and case studies in different MFIs exercising various practices in the six countries of the defined sample.

b) Harmonization of MFIs database

One of the main constraints in terms of data collection lies in the fact that Microfinance sector is extremely heterogeneous and it varies significantly in size and composition in different countries throughout the region itself. The diversity of organizational types in Microfinance industry - MFIs organized as non-governmental organizations (NGOs), banks, credit cooperatives or non-financial institutions – will complicate the analysis as it makes it difficult to choose appropriate conceptual framework.

Conclusion

This paper has discussed the research in progress on financing MFIs and its influence on their strategies in the context of its philosophical and methodological implications. Twofold objectives will be covered with the help of combining both quantitative and qualitative research methods. We have empathized on the fact that this research takes place in a recently developing non-conventional financial sector which is highly heterogeneous in different countries. As a result this creates certain constraints in the research methodology and these limitations are to be taken into consideration.

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