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FORMALIZING MICROCREDIT: CROSSING THE BRIDGE BETWEEN NON-GOVERNMENTAL ORGANIZATIONS AND COMMERICAL BANKS

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ABSTRACT

This paper reviews the existing literature on microcredit with a focus on the formalization of commercial banks and an involvement of commercial banks in microcredit operations. It does so primarily through the analysis of microcredit financial methodologies and practices as well as of the specific institutional needs for microcredit operations. The paper contributes to the on-going discussion on the role of microcredit in development, particularly on its role in promoting and extending financial services to the poor and low-income people, especially to those starting-up new businesses.

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Introduction

The area of public policies towards microenterprise development is a rather nascent field. Nevertheless, in recent years micro credit has become a widely accepted development policy tool supported by international donors, development officials, researchers and practitioners. Much of the enthusiasm rests on the notion that the institutions that deliver microfinance, and foremost, the non-governmental organizations (NGOs), are not only effective in reducing poverty but also sustainable as market entities. It is often argued that subsidies and special support policies for micro-enterprise finance institutions are not critical for their operations and that market terms, such as profitability would be a proper gauge of their activities. The proof of a potential for profit is often found in the conversion of many successful NGOs into commercial banks and the involvement of commercial banks into micro-lending operations. This trend fomalizes microcredit and advances its credibility and scope. It allows microcredit institutions to expand without constraints created by donors, government agencies or any other outsiders, and to effectively service the poor. A key to this is the notion of genuine profitability or at least operational efficiency (cost-recovery) of microcredit operations, if certain requirements are fulfilled. They include an effective service delivery methodology and significant institutional and human resource competencies. The experience of numerous NGOs, as well as comercial banks involved in microcredit points to the difficulties of such advancements. The lack of skilled human resources and proper institutional capacities, as well as lack of a developed financial infrastructure and in some cases its absence preclude micro lending institutions from evolving into profitable institutions. Additionally, it appears that the very nature of microcredit presumes high transaction costs and hence, a potential for low profits, unless high interest rates are charged. In some parts of the world with a sparsely distributed population where no formal financial sector exists, the provision of banking services, including microcredit services is extremely costly. Complications also emerge when the demands for high profitability counter developmental convictions. It is common for NGOs transforming into commercial banks to deal with an internal conflict between the goals of servicing the poor and earning maximum profits. The conflict is explicit when the board members of newly created banks –- former micro lending NGOs –- voice opposite views depending on their former backgrounds as NGO patrons or commercial investors. This paper reviews the existing literature on microcredit with a focus on the involvement of commercial banks in microcredit operations. The paper argues that microcredit should be a socio-economic development policy tool. As such it requires financial support and an appropriate regulatory and administrative policy framework.

A. The success of NGOs in microfinance

Objectives

Dedicated to assisting the poor and disadvantaged, particularly women, in developing countries, many non-governmental organizations (NGOs) during the 1980s began supporting the microenterprise sector as a response to the critical income and employment situation of their clientele. These NGOs, recognizing the impact of stable income and capital accumulation on poverty alleviation started providing microenterprises with small credits, often not more than US$ 50, for income generating self-employment activities. The concept of microcredit has derived from the intention to assist the landless poor or small farmers in rural areas in supporting themselves by fostering the long-term sustainable development of their microenterprises. A key characteristic of microcredit is its provision of loans for productive purposes only and not for consumption of any kind. Therefore, in combating poverty microcredit is used as an empowerment tool providing to its targeted beneficiaries an access to loans, rather than to subsidies. It is justified by the need of supporting clients in becoming sustainable and independent.

Grameen Bank of Bangladesh, the world's best known provider of microcredit, practically initiated the microfinance movement in the early 1980s. Initiated with a programme of providing less than US$ 50 to some 20 families in rural Bangladesh, Grameen Bank today operates in more than half of the villages in the country with over 110 million clients and loans exceeding over US$ 400 million annually to the poor.[1] Out of all the customers of the Bank, approximately 95% are women. The experience of Grameen Bank is commonly cited as a successful realization of microcredit objectives and strategies.

Based on well-documented experiences in banking with the poor in a number of developing countries, long-standing and fundamental assumptions about the ability of the poor to take on loans have been overturned. Highly effective microfinance programs have demonstrated that low-income clients can use small loans productively, ensure full repayment in the timeframe given and are willing to pay high real interest rates on these loans. Moreover, these clients have indicated their needs for savings services in addition to the loans provided and have proven their capacities to save.[2]

As the
has been growing over the last years,
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activities. While the key operational and financial
microlending schemes by

as well as the nature and scope of non-lending
v , such as skills training, management

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lending services, which sometimes mark more than

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advise and related services. It should be noted that
MFIs could be attributed to a

infrastructure already in place.

Features of The key
a microlending scheme operated by an
l

- The landless and
  clients.

  nu bering between 10 to 20 people, which

  and r payment plans; hence, to keep defaults

- Women are usually given preference; in fact

  total borrowers of
- Loans do not require financial collateral.

  with a maturity of 50 weeks with weekly
  y
- Financial transactions are recorded in individual

[1] Rhyne 1994;

Lessard

with the aim of enhancing transparency and self-monitoring

- MFIs start off with providing small credits of under US$100. Once the repayment conditions have been satisfied, new loans of increased amounts are provided.
- Usually institutions have loan upper limits.
- Borrowers have the freedom to choose the activity to be financed by the loan, which are mostly rural non-farm activities with a short gestation and daily sales such as poultry farming, petty trade and shopkeeping, cattle raising or handicrafts.[4]

Borrowers. Two questions arise when one examines the clients of microlending NGOs more closely. First of all, it is of great interest, whether the clients of those institutions belong to the formal or the informal sector . Secondly, the requirements that clients need to fulfill in order to receive a credit or other services deserve attention as well.

In developing countries about one third of the labor force earns its living in the so-called "informal sector".[5]This sector is comprised of self-employed people who own very small, or "microenterprises", that are in most cases not registered, taxed or counted in any national statistic. As any other business, these microenterprises do require working capital however, which has been traditionally considered as not forthcoming by the formal financial sector that deals with formal registered businesses, as well as private persons. The reasons for such an exclusion include firstly, an inability of these poor to provide collateral and, secondly, the high transaction costs which are associated with a large number of small loans. Traditionally, banks generally prefer large clients since they earn the bulk of their profits from issuing large loans to big businesses; therefore, small businesses and microentrepreneurs in most cases have no chance to access any credits from the formal sector financial intermediaries. The massive microenterprise sector with its large dynamic economic activity has traditionally functioned with no access to the formal financial sector. As a result, the microfinance movement was born with microfinancing NGOs embracing this informal sector as their main clientele.[6]

With regard to requirements for obtaining a credit, two characteristics are found in the operations of most NGOs in microfinance. First of all, loans in most cases are provided only for productive activities and not for consumption, as MFIs strive for sustainable development and long-term improvements in the financial conditions of the poor through self-sustainance. Secondly, little emphasis is placed on the financial collateral, assets and cash flow and more on “solidarity groups”.[7]

Group lending. Group credit is a part of the mechanism used by the microcredit institutions to place a tight grip on defaults. The concept of group credit is associated with features, such as social collateral, peer selection, supervision and pressure, all of which are based on 'local information' and 'connectedness' to ensure high repayment rates. As a means of obtaining social collateral, small credits are issued to groups of individuals who are mutually responsible for the regular repayment of each other's loans to keep defaults down and profits up.[8]

Initially borrowers are given small loans and their loans have to be repaid in small installments over a short period. Additional, higher credits with longer loan terms are only provided as the clients have proved their trustworthiness by strictly adhering to the repayment plans that have been set up between the loan officer and the borrower.

Group lending can cause, though, serious inefficiencies as well internal confrontations associated with the common ownership and team production. Even one of the most successful NGOs, such as Grameen Bank is often criticized for its use of coercion methods and severe social pressure applied on a defaulting group member to ensure loan repayment. Oftentimes every action by an individual group member becomes the subject of a thorough review by peers, who find it necessary to give advice or instructions to the possible defaulters.

Additionally, difficulties arise related to the cultural acceptability of group lending. The method of group credit can hardly be applied universally to all cultures. During the launch of microfinance programmes in Egypt, for example, it immediately became obvious, that entrepreneurs were unwilling to borrow in groups due to their unique business culture. Therefore, lending methods that avoid joint responsibility structures are being designed and introduced to eliminate the difficulties faced by borrowers. In some instances, measures, such as close monitoring by the lending officers and rigorous

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[4] Hasan 1996
[5] In this paper “informal sector” refers to small businesses not formally registered
[6] CIPE 1995
[7] Adams; Smith 1996
[8] Jain 1996

nsured a default-rate under 1%
9

The lending method
i troduced by the start-up fund in South Africa has enforced prudence and achieved sustainability, avoiding the need for group collateral. The method adopted is characterized by the absence of direct

as the supervision and default enforcement. The Start-up fund relies on mechanisms for self-selection

qualify for a loan, prospective borrowers must pay and complete an approved small business programme

fol
also has to be paid for by the prospective borrower. These requirements by themselves ensure the pre-

confident about potential high profits or serious about their business
programme. The loan program is phased, so that a new borrower can only receive a small loan and is

repayment of the initial loan. Diligent repayment records are also rewarded by special bonuses. Both
yments are made through the

banks. Therefore, the operations of the Start-up fund rest on the large e isting network of commercial banks. Borrowers are issued a “loan book” in which

transparency from both sides. In addition to credit services, the Start-up fund provides life insurance and

South Africa has demonstrated its feasibility and viability as well as its potential for high pro its.[10]

Critical observations

Even though the
credit great successes in many developing countries around the world, evidence has grown, that providing

CIPE 1995
Penke 1998

that poverty alleviation cannot be achieved by the finance sector alone as the causes of poverty are very
deep rooted and also ever changing.
Micr credit can provide an extremely useful tool to achieve outreach or even sustainability.
emains only one out of a wide range

productivity of the poor. The long-term eradication of poverty on a broader level can only be achieved once

instruments is pur [11]
First and foremost, it is crucial to combine
ocredit with access to better technologies as well

participation of borrowers in planning and implementing
that they have a stake in making their enterprise a success. In various semi
as at the "International Forum on Microenterprise"

Agency (CIDA) in 1995, participants agreed, that there is a need to provide non-financial business

Provision of information and access to markets and skills training for entrepreneurs, are important
13

Another observation is commonly made with regard
microfinance services. Many cases demonstrate, that despite the great success of
ocredit facilities in improving the welfare and
ctivity of many poor and low-income people in

out. It is argued that even Grameen Bank reaches

half of the poor - the hard core poor - rarely partic pate in its microfinance programmes. It is the poo est of the poor who have overwhelming needs for basic survival; and therefore, in terms of credit
vices, for consumer loans for their daily life.
microcredit
pr grammes, the poor require basic training on business conduct and financial services. This requires

of en
advi
addition to microcredit services.

Transformation of microlending NGOs into commercial banks

[11] v. Pischke/Schneider/Zander, Al-Sultan 1997
[12] Al -Sultan 1998
[13] Lessard 1995
[14] v. Pischke/Schneider/Zander 1997, Millar 1997

Motives for NGOs to undertake a transformation

More and more NGOs take the decision to transform into commercial banks. One of the well known and successful examples is Banco Sol from Bolivia, a commercial bank that is the result of the transformation of the NGO PRODEM which maintained its activities in the microfinance sector. Faced with a number of constraints, in Peru, the NGO Accion Comunitaria del Peru (ACP) opted also to transform into a bank. With the support of various international organizations and two major Peruvian Banks it has formed a new regulated financial institution, the commercial bank MiBanco.
Microlending NGOs are prompted to transform into commercial banks to achieve mainly the following objectives:
Increase the organization's outreach and impact

- Being a commercial bank allows the microlending institution to offer new financial services, and particularly to expand into the field of savings services.
- The resulting improvement of services attracts a larger clientele and increases the impact of the institution.
- Savings mobilization as a source of operations allows an increase in the scale of operations, enhancing the impact as well as the efficiency of operations.
- Banks have an easy access to the formal financial infrastructure and to all the services provided to the sector by the government. Having the status of a commercial bank implies improved operations, hence, the sustainability of the institution. [15]

Institutional growth and stability

Among the poor there is a huge demand for microloans and other financial services that cannot be met alone by microlending NGOs. Moreover, NGOs are predominantly dependent on their donors whose funds are limited nationally as well as internationally. The limited capital available does not allow NGOs to increase their loan portfolios to an extent that meets the demand for credits at the local level. "There are not enough donor and government funds to meet a significant proportion of the worldwide demand for microfinance." [16]The case of NGO Accion Comunitara del Peru (ACP) clearly demonstrates the limitations of growth and the inability to meet existing demands. In 1997 ACP disbursed US$ 61 million in loans reaching over 33,500 clients., which according to the institution's estimates represented only 3.3 % of the total market for microfinance in Peru's capital Lima.[17] In addressing this dilemma, many microfinance experts around the world conclude, that the only sources of funding that can accommodate existing high volumes of demand are commercial sources of capital.[18]
The access of NGOs to the vast capital available in commercial markets is very limited and in many countries, where NGOs are legally restricted to raise private funds, even impossible. Apart from the legal barriers existing in different countries, attracting investors requires on the part of NGOs an ability to deal with some elements that influence investment decisions, such as the institution's operational maturity, commitment to transformation and sustainability, existence of a conducive regulatory and political environment, level of profitability and many more. The majority of NGOs yet do not fulfil the criteria set by investors in the above areas, especially not in terms of financial sustainability.[19]
Up to now, for example, most MFIs have been characterized by a conspicuous absence of transparency, while commercial sources of capital require transparency so that investors can assess risks.[20]
The limitations for growth and expansion of microfinance services within NGOs as well as the inflexibility and lack of sustainability resulting from this, have motivated many NGOs to take finally a decision to transform themselves into commercial banks. To cite an instance, the Bolivian NGO PRODEM, a strong and successful microfinance institution is now a commercial bank - BancoSol. PRODEM felt that it had reached its growth limits as an NGO, as it was not able to meet even 2 per cent of the estimated demand for loans, although its overall performance as a financial institution was very strong.
The formalization as a bank opens the ground for MFIs to mobilize loanable funds from the private sector, such as deposits from the public, inter-bank loans, bonds placed in the domestic and international capital market or access to central bank rediscounts and other lines of credit. These market funds allow the microfinance institution to respond to substantial and clearly identifiable demands for credit in a flexible manner even though the interest rates for

[15] Montoya 1997
[16] Robinson 1995
[17] Montoya 1997
[18] v. Stauffenberg 1996
[19] Maholltra 1996
[20] v. Stauffenberg 1996; Robinson 1995

market funds are usually higher and maturities, as well as grace periods are shorter than those of funds from donors.[21] BancoSol as well as, other examples are indicative of the fact that converting into a commercial bank contributes to a more efficient management of the bank's liabilities; therefore promoting the rapid and stable growth of the institution. Access to these new sources of funds has helped the institution to avoid the high transaction costs and lack of opportune disbursement it sometimes had experienced as an NGO.[22]

Savings mobilization and extended financial services

While providing credits to the rural poor, many NGOs realized that their clients require a full range of banking services in addition to credits. They realized in particular, that savings services are a major tool in fostering the sustainable development of their clients and their microenterprises. Savings not only promote financial sustainability and the stability of microentrepreneurs, but also prepare them in the long-run for their direct interactions with the traditional banking system. Additionally, the strengthening of local savings, generally provides customers with positive real returns and, hence, contributes to economic development at the local level.

Yet, the poor commonly are excluded from the full range of banking services, including savings services, since they are excluded from the traditional banking system, while microlending NGOs are legally restricted from offering any kind of savings services in most countries of the world. A study conducted by K-REP, a microlending institution in Kenya, recommended the commercial banks as the best types of financial institutions to service the poor given their capacity to provide a wide range of financial services.[23]

A Working Group on Savings organized jointly by the Consultative Group to Assist the Poorest (CGAP) and the German Technical Cooperation (GTZ) recently completed several case studies of four deposit taking MFIs in which they identified the following benefits of savings mobilization in MFIs:

i) Savings mobilization helps MFIs to improve their outreach. Very poor households were found to rely on savings before they actually demanded credits. Apart from that, as a stable funding source, public savings foster an expansion in lending operations.
ii) Mobilizing small and micro-savings can supply MFIs with additional funds that are also significantly cheaper than those that can be obtained from the inter-bank market. Therefore, these savings contribute greatly to financial sustainability.
iii) Last but not least, attracting depositors may instill a stronger demand-orientation and thriftiness in MFIs operations and increase public confidence.[24]

When the NGO PRODEM was transforming into the commercial bank BancoSol, savings mobilization represented an important factor in its progress towards financial sustainability by gaining independence from external donor funding. By offering these savings services, BancoSol could finally access new, viable sources of funding from the private sector enabling its loan program expansion, and hence, its overall growth as an institution.

Bank Raykat Indonesia (BRI) also emphasized the importance of savings. For BRI there were four main reasons for their entry into the field of savings services. Namely they aimed:

iv) To encourage private sector savings and investment to facilitate organizational growth.
v) To meet the demand at the local level for credit at commercial interest rates.
vi) To limit dependence on government funds.
vii) To encourage local level savings and to contribute to economic development at the local level.[25]

Deposit mobilization played a key role in the process of transforming BRI into a sustainable microfinance institution. BRI 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.[26]

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[21] Gonzalez-Vega et al. 1997
[22] Gonzalez-Vega et al. 1997
[23] Mutua 1996
[24] Mukherjee/Wisniwski 1998
[25] BRI was formerly a government-subsidized credit delivery before it was restructured and transformed into a profitable, sustainable bank at the local level. Although BRI has not been converted from an NGO it is nevertheless a good example of the importance of savings in the portfolio of MFIs and it reflects some of the reasons why may NGOs actually transform themselves into commercial banks to tnable themselves to offer those servcies.
[26] Robinson 1995b.

Financial sustainability

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.[27] 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. In 1993, ACEP in Senegal, Banco Solidaro S. A. (BancoSol) in Bolivia and LPD in Indonesia - all of them former NGOs turned into commercial banks - were covering 100, 103 and 137 per cent of their costs respectively. As of June 1996 an estimated 5 per cent out of 116 MFIs that applied for funding from the CGAP Secretariat actually covered their expenses from revenues although most had been operating for more than 3 years.[28]

In her study on "A paradigm shift in microfinance", Robinson (1995) has pointed out clearly, that the Grameen model of a microlending institution, though it has been successful for many years, is globally not affordable.[29] Moreover, recent developments in Bangladesh have shown that even the most successful and experienced NGOs can find themselves suddenly exposed due to external circumstances.

After the dramatic floods in Bangladesh, up to half of the borrowers of Bangladeshi Grameen Bank, for instance, had failed to make their weekly repayments over the past two months as their livestock, crops and houses had been wiped out. Microlending institutions all over the country, including the Grameen Bank have outstanding repayments of more than US$ 500 million in total. However, their financial reserves are too small to be able to freeze repayments while extending fresh bridge loans, which would help the poor to re-reestablish their livelihood. According to Muhammad Yunus, the Managing Director of Grameen Bank, his institution alone would need US$100 million to survive. BRAC, another microlending institution in Bangladesh, will need an estimated amount of US$50 million of additional funding to get back on its feet. Although natural disasters have affected almost every aspect of economic life in Bangladesh, the institutions with a small financial base, excluded from the formal system demonstrate greater vulnerability to shocks. Ranging from the floods in Bangladesh to the potato blight in Peru and to the catastrophic hurricanes and storms in the Caribbean, natural disasters undermine the livelihood of almost the entire client base of MFIs.[30]

Due to these and other experiences, numerous microfinance experts worldwide believe that the future potential of microfinance is defined by the microlending institutions that are financially and commercially viable. The institutions unable to ensure commercial returns, are destined to live always off the uncertain charity of development aid and other external funding. Therefore, the trend to become more commercial with the aim of turning into a financially sustainable microlending institution is often seen as the best way to secure the microfinance movement as a whole.[31] Gonzalez-Vega (1994) saw that "Sustainability generates compatible incentives for all those with an interest in its [the organizations] survival, such as clients, managers, and staff, because it underpins perceptions of the microfinance organization's permanency."[32]

The level of sustainability and self-sufficiency of any microfinance institution is related to the institution's sources of funding. Indeed, there are major differences between commercial banks and NGOs with regard to self-sufficiency, as well as, sources of funding, which is to a certain extent a result of differing regulations and environments. From the perspective of financing sources, the main difference between NGOs and commercial banks is that the latter can access voluntary client savings and inter-bank borrowings, as well as private capital. The financial capital of NGOs -xternal donor funds are stable and certain as the NGOs have hardly any influence on the amount of capital flow. Therefore, it is common that the success or failure of MFIs is dependent on external donors.

[27] Webster 1995
[28] Malhotra 1996
[29] Robinson 1995
[30] Chazan 1998
[31] Chazan 1998
[32] Gonzalez-Vega 1994

In "Maximizing the Outreach," Christen, Rhyne and Vogel (1994) outline three levels of self-sufficiency. Barbara Calvin, Director of International Operations from Calmeadow in Canada has presented a new model that expands on that framework by inserting a fourth level as shown in Table 1. [33]

Table 1. Relation of Sources of Funding to the Level of Self-sufficiency[34]

	Description	Source of Funding	Possible Leverage
Level I	Start-up	▪ Grant funded ▪ Forced Savings	1:1
Level II	Operational Self-sufficiency	▪ Commercial or Donor Loans with Guarantees and/ or Collateral ▪ Leverage of Client Savings	1:2-3
Level III	Financial Self-sufficiency	▪ see Table 2	1:4-8
Level IV	Full Self-sufficiency (with commercial level return)	▪ see Table 2	1:9-12

Source: Calvin (1995)

Following a start up period with funded grants and forced savings, the institution can transfer to Level II which is characterized by operational self-sufficiency once it manages to attract commercial or donor loans and leverage client savings. The intermediate stage of financial self-sufficiency, Level III, represents an institution that covers its operational and financing costs, yet not achieving a commercial level of return. At Level III, the institution can remain as an NGO or transform into a regulated financial institution – a commercial bank.

The difference between Levels III and IV lie in the levels of leverage and retained earnings that can be achieved as displayed in Table 2. When institutions plan their financing, they need to consider sources for both liabilities and equity. Level III institutions do not achieve commercial levels of returns but have some retained earnings, which can be added to their equity base to fuel growth. Level IV institutions, on the other hand, can amass significant retained earnings. Level IV institutions can also attract commercial equity so, in theory, there is no limit to their growth; whereas Level III institutions that rely on social equity investments may find those sources dissipating over time. Once there are several examples of MFIs achieving commercial levels of return, the sector should experience an influx of capital to service this market.

[33] Calvin 1995
[34] Calvin 1995

Table 2. Financial Self-Sufficiency vs. Full Self-Sufficiency[35]

	Level III Financial Self-Sufficiency		Level IV Full Self-Sufficiency	
	Leverage 1:4-8		Leverage 1:9-12	
Liabilities	NGO	Commercial Bank	NGO	Commercial Bank
Donor Loans				
Commercial Loans				
Bonds				
Securitization				
Voluntary Savings				
Certificates of Deposit				
Interbank Borrowing				
Equity				
Some Retained Earnings				
Significant Retained Earnings				
Social Investment Equity				
Commercial Equity				

Governance and ownership issues

The fact that more and more NGOs are converting into commercial banks has placed the issues of ownership and governance in the forefront of the discussion on microfinance. One of the key roles of the shareholders of 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.

Microlending NGOs do not have any structure of ownership as the capital of the organization is derived from external donors. Neither at the board level nor at the management level do members have a financial stake in the institution and consequently none of the members face any financial risks. A board driven by social ownership which contrasts to private ownership governs these organizations. The motivation of members of the board to take responsibility for the governance of an NGO mainly derives from a feeling of strong social responsibility to the respective market as well as a feeling of contributing to the development of their society rather than from an interest in monetary gain. Other motivations are the possibility to enhance personal visibility, credibility and prestige.

[35] Calvin 1995

As the participating individuals do not carry any financial responsibility for the organization, most of the boards in microlending NGOs are rather passive in their work. Usually they do not fulfill the board's fiduciary role by assuming responsibility for the institutions financial resources, especially those by donors. This often results in inefficient operations, lack of sustainability and instability of the institution.[36] However, once an NGO converts into a microlending commercial bank this can change fundamentally. Various investors get involved in the organization through the ownership of shares, for example. Their motivation and expectations on their return on investment are different from, for example the NGOs founder who has strong social ownership in his organization.

Commercial investors are interested basically in the returns on their investment. There are supporting organizations, though, such as ACCION International that focus on bringing technical guidance and expertise into the organization and would like also the organization to fulfil its pre-determined mission. Additionally, there are donors who mainly invest for reasons of social responsibility but do not have the specialized expertise on investments, as well as private individuals, who represent local interests. Another group would be the multilateral institution investors, such as the International Finance Corporation (IFC).

All of these different groups, which contribute their share to the institution, though for different reasons, want to be represented in the institutions Board of Directors to ensure that their interests are taken care of. The challenge, therefore, is to balance all the different motivations and expectations to ensure a well functioning Board while providing institutional stability and growth. If the owners and their directors do not have a common vision for the future of the organization, it is difficult to provide the management with a clear mandate to lead the organization. Thus, the process of transformation requires a long-term vision and foresight among the founders of the original NGO to bring an appropriate and balanced group of investors and owners.

The challenge for the microfinance community in this situation is to design the best solution possible and this may involve combining various types of owners to reflect the social as well as the commercial mission of the microlending institution. Overall, different types of owners can even bring various benefits to the institution in the form of improved sustainability over time, good governance and management expertise, that can ultimately benefit more people and have a greater social impact.

Another critical issue in NGOs' transformations is the management. The role of the Board members is to review, confirm and approve the plans and the performance of the senior management in the institution. Yet, in NGOs most Board members usually do not have experience in governing banks or running a commercial business at all. This can cause fundamental problems once these people are part of a new board in the transformed microlending institution. While proposing and appointing Board members for the new institution, it is vital, that the candidates do have proven experience in managing a commercial business. Apart from that, Boards also need to be able to assume new legal responsibilities. Therefore, it has to be ensured that the Board members are able to handle the related aspects of a more sophisticated financial institution. For Finansol, a regulated microfinance intermediary in Colombia, the importance of these and other aspects of governance in a transformed microlending institution became evident after its bout with a severe crisis. Although Finansol was a private business, its roots as an NGO meant that it did not have as appropriate governance system, which could have prevented or managed the crisis. The Board members of Finansol had neither the means to raise capital for the ailing institution nor did they have deep financial resources. Without the support of several other organizations and other commercial banks, Finansol would not have been able to overcome this crisis as their Board and the governance capacities were inadequate. [37]

- The issue of governance as applied to MFIs is crucial for the future development and success of the whole microfinance industry. The most important issues that have to be tackled in the near future are:
- Role of the director in a Board and necessary skills for the members of an MFI Board.
- Training for directors.
- Role of independent directors and conflicts of interest
- Ways of aligning incentives and compensation for senior management and directors with the social objectives of the institution.[38]

C. Microcredit in commercial

[36] Clarkston/Deck 1997

[37] Iglesias/Castello 1996

[38] Clarkson/Deck 1997

banks

Background and reasons for the expansion of commercial banks into microfinance

While the microcredit movement has significantly expanded and developed throughout the various regions, commercial banks have been notably absent from this field. For most of the history of microfinance, the operating vehicle has been the NGO rather than the commercial banks. Most bankers did not enter the microfinance market, as they believed it to be unprofitable. The following three basic concerns preoccupied their thinking.

- Too risky - the poor and the microbusiness sector were perceived as being not trustworthy. Most bankers believed that the poor could not or would not repay their credits, as they had no stable, sustainable business from which they could generate their repayments; they lacked capital and property collateral to guarantee the loan. Finally, traditional banks did not have appropriate lending methods to meet the needs of these clients.
- Too expensive - by their nature, microloans are small and short-term. The representatives of the traditional commercial banks were convinced that the related bank operations would be inefficient and too costly to be profitable.
- Socio-Economic Barriers - microentrepreneurs and the poor in general have difficulties with banking operations due to their lack of education and lack of business records with cash flow. Traditional banking systems in many developing counties do not allow for an easy relationship with the poor due to social, cultural and language barriers.

These three basic concerns on the microenterprise sector were holding most commercial banks from getting involved in the field of microcredit. It has been only recently, that a large number of commercial banks in developing countries seriously started to examine the microfinance market. From a USAID-funded survey conducted among 17 banks in microfinance, the following reasons for that change of mind and action could be identified:[39]

- Need for diversification in the banking sector - The growing competition in the banking sector in developing countries has forced many banks to look into opportunities for diversification into new markets, including the microfinance market. The environment necessary to pursue these opportunities has been created by the deregulation of the financial markets in many countries.
- Public image - Some banks seek to create a new public image of their institution. The involvement in the microfinance sector appears to many as a good opportunity to portray themselves as a socially responsible institution.
- Increase profits - The success and the profits of several microfinance banks in Indonesia and some other NGOs-turned-banks in other countries made microfinance attractive to some commercial banks. Microfinance is increasingly seen as a new way to increase bank profits.

For about five years commercial banks have been exploring and entering the area of microfinance. The process has been facilitated by donor-funded loan guarantees, central-bank rediscount lines and specific technical assistance. With a more widespread diffusion of innovations in financial methodologies, reduced risks and costs of microlending, today's leading MFIs do hope that more banks will begin to incorporate microentrepreneurs into their portfolios. Overall, banks seem to be well positioned to offer financial services to an ever-increasing number of microentrepreneurs and to earn profits as they have some advantages over microlending NGOs, namely:

- Being regulated institutions, commercial banks fulfil the conditions of ownership, financial disclosure and capital adequacy that help to ensure prudent financial management.
- They usually have a physical infrastructure including a large network of branches that can serve as a basis to expand from to reach out a substantial number of clients.
- Commercial banks have well established internal controls as well as administrative and accounting systems to track the transactions.
- Existing ownership structures based on private capital usually support sound governance structures, cost-effectiveness and profitability and thereby foster the organization’s sustainability.
- Having their own sources of funds (deposit equity funds), commercial banks are independent from scarce and volatile donor resources unlike NGOs.

[39] Baydas/Graham/Valenzuela 1997

- They offer a wide range of financial services that are attractive to a microfinance clientele such as loans, deposits and others.[40]

Those special features of commercial banks offer these institutions a special advantage over microlending NGOs in providing microfinance services to the poor.

Commercial microfinance in the 1970s and 1990s

In the 1970s a number of governments established units to provide subsidized government loans to farmers. In Indonesia more than 3,600 local bank units were established, functioning primarily as channeling agents for subsidized rural lending programmes. The results were close to those found in many other countries. First, the low interest, and therefore desirable loans tended to reach local elites who had the influence to obtain them. Secondly, lower-income people typically did without credit or borrowed on the informal financial market at much higher rates. Thirdly, losses were high.

Savings accounts began to be offered in the mid-1970s . However, annual interest rates were set by the government at 12 per cent for loans and 15 per cent for most deposits; given this negative spread, the banks could not cover the operating and other costs required to attract voluntary savings. During the 1970s, the unit banking system had mobilized deposits of only about $17 million nation-wide. This was widely attributed within government circles and the formal financial sector to the lack of local demand for financial services, absence of “bank-mindedness” and mistrust on the banks that were assumed to characterize Indonesia’s rural population. By 1983, the unit banking system had reached a point at which it had to be either closed down or converted into a fundamentally different system.[41]

A number of reasons are attributed to the failure of rural credit programs. First, formal credit institutions by their design are less prone to employing social, economic and cultural networks, which are necessary when small, poor, often illiterate, borrowers are concerned. Second, conventional financial practices used by them are practically unable to overcome issues associated with information asymmetries, screening and enforcement, and high transaction costs involved in credit programs where markets are underdeveloped.[42] Additionally, some negative effects were reported to be associated with rural credit programmes, such as increased lending rates due to increased enforcement costs. Since lending programmes by governments and donors with soft repayment requirements promote a default culture, it makes it harder for money lenders to enforce repayments on their loans as well. As a result, moneylenders have to raise lending rates for the poor, who, unlike big farmers, have no other option but to borrow from them.[43]

The regulatory framework was found to be easier to alter. The changes produced dissimilar effects on the development of microcredit lending in banks in different parts of the world. In Africa until recently most banks provided financial services primarily for export and import trade and for public enterprises. Services were rationed and low-income people were not given high priority in times of rationing. Although many controls have been lifted in recent years, there is little indication that the banks have increased their outreach. Rather, they remain constrained by the lack of regulations that enforce contracts, by poorly functioning information systems, and by the high costs of small transactions.[44]

In Indonesia in 1983 the first of a series of major financial reforms was announced. Government banks were permitted to set their own interest rates on most loans and deposits. Among its other purposes, this deregulation programme served to provide an enabling environment for the transformation of Bank Rakyat Indonesia’s (BRI) local banking system. Following the reforms, the government decided that the subsidized unit banks would be transferred into a sustainable system of commercial banking at the local level (KUPEDES), and that a programme of general rural credit at commercial interest rates would be implemented through the unit banking system. Commercial microfinance within the unit banks began operating in 1984 in the rural areas and in 1989 the unit banking system was extended to urban areas as well.

In January 1984 BRI began its new programme of general rural credit offered through its unit banking network, and by 1986 a new set of savings instruments had been introduced providing, for the first time at the local level, the much-in-demand combination of security, convenience, confidentiality, liquidity, and returns. They were offered by BRI’s unit banks throughout the country. The spread

[40] Baydas/Graham/Valenzuela 1997
[41] Parts of the discussion on Bank Rakyat Indonesia draws on M. Robinson 1997
[42] v. Pischke et al 1983
[43] Hoff, Stiglitz 1997
[44] Weibster and Fidler 1996

between loan and deposit interest rates was set to cover all costs and to return a profit.

Since 1984, BRI's unit banking system performed splendidly. At the end of 1995 it held deposits of about US$2.7 billion, ith about 14.5 million in KUPEDES credit outstanding to about 2.3 million borrowers. In 1995 the return on assets for the unit banking system was 6.5 per cent. Unit bank deposits, a highly stable source of funds, financed all KUPEDES loans. BRI's banks offer a flat monthly interest rate that is at or below 1.5 per cent on the original balance of the loan. Although these rates are higher than those charged by the large urban banks, they are lower than those at which poor people are able to obtain loans otherwise. High interest rates are associated with transaction costs of delivering financial services to many customers in many locations. BRI's experience demonstrates that the high costs of small loans can be substantially reduced and that financial institutions can profitably provide microcredit to a large numbers of borrowers for informal commercial credit.

D. Barriers in formalizing microcredit

Conflicting social and financial objectives and commitment

The issue of composition of Boards of newly transformed MFIs is a source of potential internal conflicts. It is common that individual Board members are in favor of one of two objectives - social or financial - mostly depending on whether they have been part of the former microlending NGO or whether they are a commercial investor in the newly formed commercial bank. The right composition of the Board of Directors of the organization is crucial in terms of dealing with these conflicting objectives. It needs to be ensured that the board strikes an overall balance between these two perspectives and thereby generates creative tension.[45]

[45] Clarkson/Deck 1997

A potential conflict is that between social objectives and profitability. This is a broad issue and extends beyond the mere composition of the Boards. While acknowledging the need for low-cost assistance to the poor at the initial stage of their entrepreneurship, many observers, nevertheless stress the importance of approaching microcredit as a commercially responsible business, not as a charity or welfare.[46] Successful microfinance is not incorporated easily into an institution that has a relief, social service or paternalistic approach to helping the poor.[47]

The fact that there are different objectives within NGOs and commercial banks represents a challenge, as well as an opportunity for the microlending institution, which is transforming into a commercial bank. Investors can bring commercial expertise into the organization contributing to a better management, good governance and an improved form of sustainability – characteristics that most microlending institutions are in lack of.

Many examples demonstrate that MFIs can become commercially viable and still pursue and fulfil a useful social purpose. BancoSol, for instance is dedicated to social objectives on the one hand, and, on the other hand, respects the necessity of ensuring financial stability and professional management, hence avoiding the sole reliance on profit motivation.[48]

In general, however, commercial banks most often face severe difficulties in pursuing microcredit. The commitment to microlending in traditional banks, especially the larger ones, is usually fragile and mostly dependent on a few visionary Board members rather than on institutional mission. Due to the differences between microfinance programs and conventional corporate banking activities, microcredit operations are mostly not understood by the majority of mid-level bankers and sometimes are looked upon as a second-class activity. Such understanding and approaches become critical in cases where the microfinance units or departments have to compete for resources and status with other divisions of the commercial banks. Therefore, successful integration of microlending in the portfolio of a commercial bank requires commitment at all management levels of the banks, particularly at the top and middle levels.

[46] United Nations. Report of the Secretary-General. *Role of the Microcredit in Eradication of Poverty.* 1998.

[47] Krammen 1998

[48] Chazan 1998

Policy environment

The area of policy is strategically very important for all banks getting involved in microfinance, no matter whether they are transformed NGOs or traditional commercial banks that expand their portfolio to microfinance. As an NGO, MFIs are not subject to regulatory interest rate ceilings, high reserve requirements and selective credit policies characterizing this market. Therefore, they can operate in a repressed financial market environment. However, this does not apply to commercial banks, as they cannot escape all these regulations, which, in the end, reduce their profit margins. Commercial banks in countries with a regime of financial repression have far fewer opportunities to experiment and get involved with microfinance, than those in countries which have undertaken substantial financial liberalization. The attempts of several banks, like Banco Empresarial in Guatemala for instance, to get involved in microfinance were slowed down by the high reserve requirements constraining their profit potential. The higher the reserve requirements are, the less is the deposit base available for lending and the lower are the profits. Most commercial banks, therefore, had not entered microfinance until the early 1990s when the reserve requirements in many countries were lowered from around 50 per cent to a more modest level of 10-30 per cent.

All the commercial banks that have been successfully involved in microfinance over a longer period of time operate in countries that have undertaken stabilization efforts in the 1980s and most of them profit from deregulated deposit and loan interest rates. Deregulation initiatives allow banks to charge relatively high interest rates on micro-loans, to cover transaction costs, default-risks as well as the opportunity costs, therefore, encouraging them to enter the microfinance market. These and other examples prove that the policy environment can represent a major barrier for the involvement of commercial banks in microfinance as well as for the formalization of microlending NGOs

Administrative structure and financial methodologies

Conventional banks are not structured to be profitable in providing loans of a size commensurate with the needs of microenterprises. With their heavy infrastructure of multiple layers of professionals and extensive plant, property and equipment, conventional banks are internally organized to handle a relatively low number of large loans. It is difficult for traditional banks to minimize their processing costs, increase staff productivity and rapidly expand their microfinance loan portfolio – all activities that are necessary to cover costs and earn profits in this business. Most commercial banks lack the financial methodologies to reach and retain low-income clients, who require small amounts of capital, and to handle thousands of small transactions efficiently. Even though large commercial banks have important advantages in reaching out to a large number of clients through their network branches (as described in the previous section), these advantages do not easily translate into an expanded pool of clients as long as conventional banking methodology is utilized. They lack the financial innovations that permit the bank to analyze the creditworthiness of the clients in a cost-effective way and adopt effective collateral substitutes.

Finally, commercial banks dedicate a great portion of their efforts towards some issues that are crucial for their own leadership and important to their formal sector clients. These issues include, among others, international trade capabilities, trading desks, foreign exchange desks and syndication capabilities. However, those issues are meaningless to poor microentrepreneurs in the informal sector.

Human Resources

Given the fact that microfinance programs are in many ways radically different from traditional banking, the human resource needs for the launching of microfinance activities prove to be critical. Traditional bank staff in many ways is not appropriately trained to handle microlending activities. Microfinance operations are very labor intensive and require various specialized skills. Staff members need to be highly receptive to the special mission, as well as to the practices of the microfinance program. Therefore, recruitment, training of staff as well as performance-related incentives require special consideration and efforts within the banks embarking on microcredit.

Trust and transparency between clients and loan officers are crucial in the success of a microcredit program. The loan officers should aim at establishing and maintaining a close link with their clients, based on their detailed knowledge of the needs of their clients. Most bank staff members are not equipped to meet these requirements and fulfill these essential functions. Another challenge is related to human resources policies. They need to safeguard better the continuity of the staff service, because in microcredit operations a stronger direct relationship has been identified between staff turnover and clients' desertion. Therefore, proper human resources policies and specialized training programmes for staff members are a necessity, which often comes at a great cost to the commercial banks with no prior experience in microfinance.

Microlending NGOs have developed various training methods, incentives systems and management practices to handle human resources successfully. However, not all of these methods can be replicated in commercial banks. For example, performance-based incentives commonly used in NGOs as a remuneration for loan officer, at commercial banks can become a source of tensions as they create two different categories of bank employees – thoses receiving and those not receiving these remunerations.[49]

Cost effectiveness

Most commercial banks experimenting with microfinance continue to conside the costs of microfinance to be too high, although their respective operations are mostly profitable. Traditional banking mechanisms and overhead structures make it difficult for commercial banks to minimize processing costs, increase staff productivity and expand rapidly their microfinance loan portfolios – basically, conditions necessary to generate high profits. Additionally, it has become clear that indeed microlending due to its nature is far more expensive than conventional banking.

In deciding to get involved in microcredit, banks need to be aware that factors, such as the high costs of operations could become a major barrier for their success in microfinance, if not considered carefully. There are several strategies which if adopted would reduce the operational costs of microlending operations. Banks, for example, can immediately embark on the use of special lending techniques proven to be effective in microfinance operations or envisage a deep involvement into microfinance that would exploit economies of scale to reduce costs. These strategies, however, are hardly applicable to banks that are newcomers in the field, interested in experimenting to begin with.

Instead of investing into the long-term reduction in costs, many banks simply raise their interest rates to match the higher transaction costs of microlending as they simply accept that their involvement in this sector is more costly. But the higher interest rates imply that they are less likely to reach the people who need microcredits the most - the poor. Most of the potential clients from this group are not able to pay these high interest rates, and are hence, excluded from this service. The effectiveness of microcredit as a development tool is thus negated. Microcredit programs as development tools aimed at reducing poverty through their support of the poor in launching their microbusinesses require various incentives to MFIs which could include advice and training on microcredit.

[49] Baydas/Grahm/Valenzuela 1997

E. Conclusion

As the various experiences demonstrate, a recognizable move towards the formalization of microcredit has been evolving in recent years. A number of successful NGOs have taken the initiative of transforming themselves into formal banking institutions. They have been prompted to do so by the demands and desires to expand and improve their services, through savings mobilization, exploitation of new sources of financing, strengthened linkages and integration into the formal financial sector. At the same time, many banking institutions driven by the stiff competition in the sector have started exploring new services, such as microcredit. This gives them an opportunity to diversify into new markets and raise profits while cultivating their public image as socially responsible institutions.

However, 'crossing the bridge' between NGOs and commercial banks seems to be a difficult process that might even hinder the very idea of microcredit as a means of bringing development to the poor. When the purpose of a microcredit program is to deliver banking services to the poor, then the provision of small loans to the poor living in isolated areas with undeveloped infrastructure, implies subsidies and operational practices inconsistent with banking practices.

To effectively initiate and implement microcredit, the banks and NGOs likewise will have to consider significant investments to adjust their structures, operations and human resources. Also when microcredit is considered within the context of small enterprise sector development, as it is often the case, some additional concerns arise. Programs such as training and information and advice to small entrepreneurs, generally do not recover their costs, although they often constitute pre-requisites for the success of a microcredit programme.

Mechanisms fostering financial sustainability require further exploration. This includes among others, lending techniques and institutional improvements. Many MFIs have developed and utilize lending technologies that enable the delivery of small loans to a large number of poor clients on terms and conditions suitable to them. They exploit economies of scale and a variety of approaches to clientele in order to attain minimum transaction costs and high repayment rates. These experiences analyzed and documented can serve as guidelines or options for other microcredit institutions to adopt. On the other hand, better understanding is needed on the administrative structures and processes applicable to microcredit institutions that ensure transparency and control of operations, and at the same time enhance their flexibility and knowledge base to deal with the gradually changing environment or unexpected shocks.

Annex - Further resources on microfinance

Microlending institutions worldwide

The "Worldwide inventory of MFIs" is providing detailed contact information of several hundred MFIs worldwide. This inventory can be used or downloaded from the following WebPages:

www-esd.worldbank.org/sbp/CONTLST.htm

Selected MFIs

Association for Social Advancement (ASA)	Bangladesh	Asa@drik.bgd.toolnet.org
Banco Solidaro S.A. (BancoSol)	Bolivia	
Bangladesh Rural Advancement Committee (BRAC)	Bangladesh	General@brac.bdmail.net brac@drik.bgd.toolnet.org
Bank of Agriculture and Agricultural Cooperatives (BAAC)	Thailand	
Bank Raykat Indonesia (BRI)	Indonesia	
Buro-Tangail		Burot@bdmail.net
The Grameen Bank	Bangladesh	www.grameen.com
K-REP	Kenya	
MYRADA		www.myrada.org

Microfinance networks and conferences

International Development Network (IDN)	www.idn.org
Microcredit Summit 1998	www.microcreditsummit.org
Microfinance in South-Asia	www.south-asia.com Regular updates and articles on microfinance activities in South-Asia
Microfinance Network	www.bellanet.org/partners/mfn
Small Enterprise Education and Promotion Network (SEEP)	Seepny@undp.org For a list of all SEEP publications see Pact Pub
South Asian Network of Microfinance (SANMFI)	www.soc.titech.ac.jp/icm/sanmfi/brochure.html

Organizations supporting MFIs

ACCIÓN International	www.accion.org
Actionaid	www.oneworld.org/actionaid/home.htm
American Council for Voluntary International Action (InterAction)	www.interaction.org
Asian Pacific Rural and Agricultural Credit Association (APRACA)	www.soc.titech.ac.jp/icm/apraca/intro.html Publish quarterly magazine "Asia-Pacific Rural Finance"
Banking with the Poor (BWTP)	Check Worldbank Homepage
Canadian International Development Agency	www.acdi-cida.gc.ca

(CIDA)	
Center for International Private Enterprise (CIPE)	www.cipe.org
Community Development Financial Institutions	www.cdfi.org/cdfi
Consultative Group to Assist the Poorest (CGAP)	www.worldbank.org/html/cgap/cgap.htm
Enterprise Development	www.enterweb.org
FINCA International	www.villagebanking.org
German Foundation for International Development (DSE) - Economic and Social Development Centre (DSE-ZWS)	www.dse.de, dse@dse.de, Zws@dse.de Special: Online database with literature on development and cooperation
Latin American Development Fund	www.folade.org
Microenterprise Innovation Project (MIP)	www.mip.org
United States Agency for International Development (USAID)	www.info.usaid.gov Offers selected materials in microenterprise development and microfinance; also mailings lists on those issues

Universities dealing with issues of microfinance

Georgetown University	www.georgetown.edu/departments/pjp/microfinance/index.html
Harvard University	www.hiid.harvard.edu Harvard Institute for International Development (HIID)
Ohio State University	www-agecon.org.ohio-state.edu/ruralfinance
University of Colorado	www.colorado.edu/economicsinstitute
University of Texas	www.bus.utexas.edu

Listings and databases of publications on microfinance

Pact Publications	www.pactpub.com
Bellanet - Global Development Connections	www.bellanet.org
EnterWeb	www.enterweb.org Search engine specialized on small and microenterprises, finance, entrepreneurship and related development issues, economics
Microfinance Network - Links	www.bellanet.org/partners/mfn/links.html
The Virtual Library on Microcredit	www.soc.titech.ac.jp/icm

Pact Publications	www.pactpub.com
	Provide a very detailed overview on further internet resources!

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