

## Transformation of Micro-finance Operations & implications

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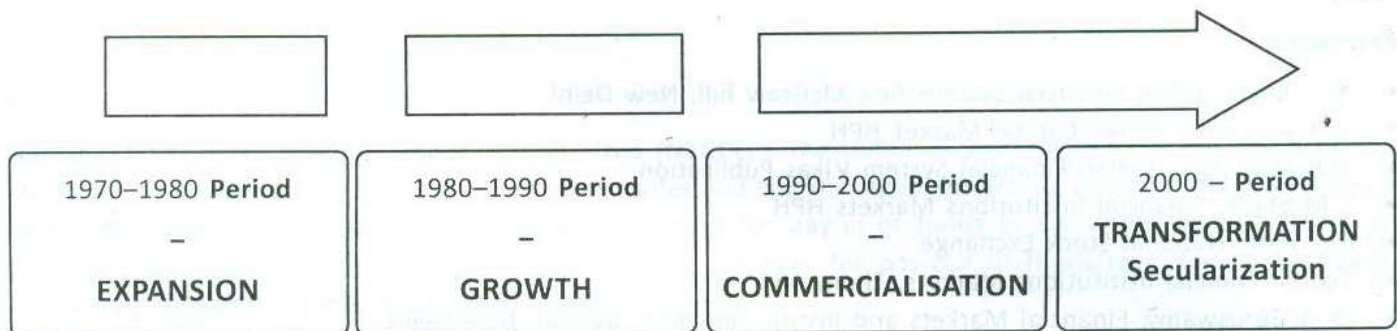
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### Preamble :

The present MFI model wasn't just about giving loans. It was also about creating livelihood mechanisms, which would build capacity among the poor to repay their loans easily, and leave them better off than before. While microfinance institutions are experiencing different forms of transformation, this paper focuses on the transformation of NGOs into commercial, regulated financial institutions. An overview of the transformation experience in micro-finance is also summarized in this paper.

Microfinance is not anything new; it follows humankind since the ancient era. It markedly appeared already in the 18th century (e.g. Jonathan Swift inspired the Irish Loan Funds) and especially in the first half of the 19th century in the middle Europe. Several credit union systems and cooperative banks have been named after Raffeisen, Kampelik etc. Robert Owen, William King, G.D.H. Cole, Charles Gide and others were very well known theorists in this period. The development of the MFIs accelerated right in the period of decolonization when new states originated. next development of the microfinance in Less Developed Countries(LDCs) in the 70s of the last century, were above all Muhammad Yunus (Grameen Bank), John Kaith Hatch (FINCA system), Akhtar Hameed Khan (Tameer Bank), Ela Blatt (SEWA – Self-Employed Women's Association), Michaela Walsh (WWB – Women's World Banking) and others.

Development stages of micro-financing in LDCs : Figure 1 : Source - Srnec (2007)



- EXPANSION PERIOD** : • Spreading to the most of the LDC • Poverty reduction  
• Prevalent support 'bottom-up' • Most informal types MFIs
- GROWTH PERIOD** : • Significant financial dualism • Considerable support 'top-down'  
• Rapid growth in number of MFIs and served clients
- COMMERCIALISATION PERIOD** : • Important growth of formal types of MFIs  
• Considerable support of NGOs and governmental organization  
• Rapid growth in number of served client
- SECULARIZATION PERIOD** : • Acceleration of transformation of informal to formal types of MFIs of international, state and private organization • Financial business  
• Considerable support prevails the charity.

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**First period :** The first period is characterised mainly by

- Providing social benefits and taking priority over the raising of the MFIs' profitability;
- Loaned (start-up) money is paid back, but without dividends (interest, profit);
- The principle of mutual guarantee in terms of Peering Groups, Self-Help Groups or in the initiative informal micro- financial activities;
- Micro- financial activities are characterised as: self-sustaining, self-expanding and self-perpetuating;
- Different voluntary groupings are established (e.g. Grameen Groups, ROSCA, ASCRA);
- High level of enthusiasm among persons who were at the beginning of this movement (e.g. Muhammad Yunus);
- Appeal on poverty reduction.

**Second period :** The second period is characterised by a rapid development of the formal MFIs. Different types of formal MFIs began to evolve in the second half of 80s of the last century. It concerns especially the South-East Asia and Latin America. The development in India refelects the qualitative change (Figure 2).

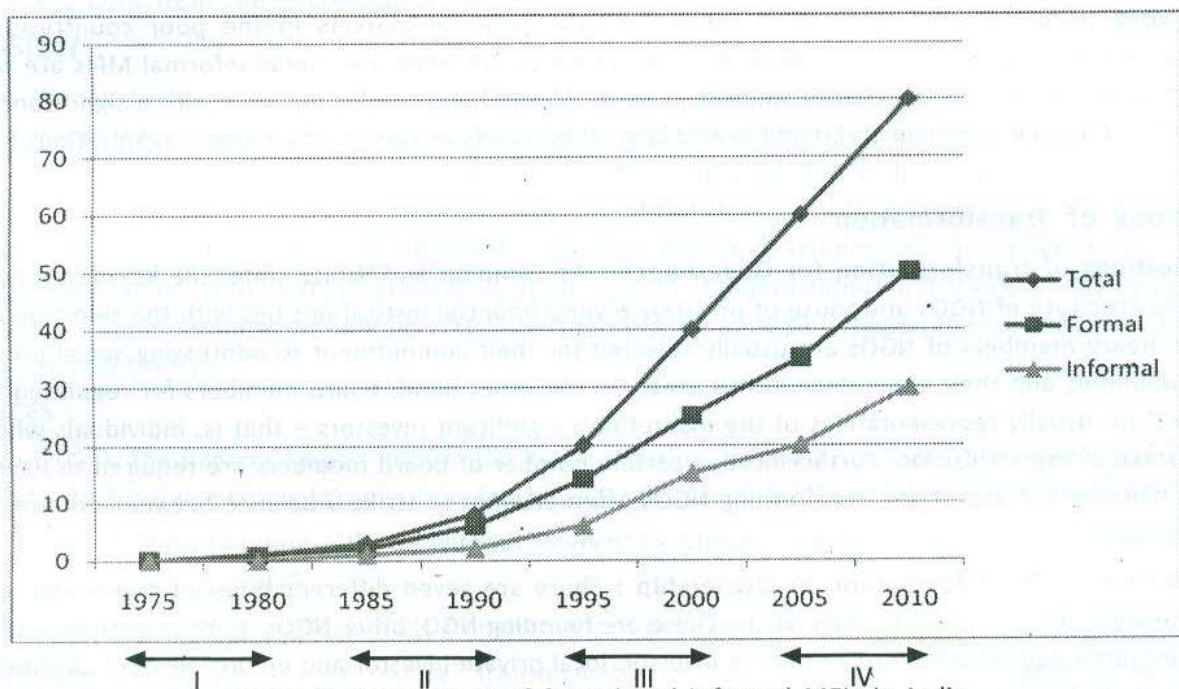


Figure 2. Comparison of formal and informal MFIs in India  
Source : Srneec (2007)

The coexistence of formal and informal microfinance system commonly used in LDCs is the so-called 'financial dualism'. The modern and transparent formal system dominates in the municipal environment, but it is less accessible to the poor clients. The informal system is more spread in rural areas where it is accessible to the very poor clients and it is cheap but not quite transparent. The formal system is commonly much more known than the informal one in which the understanding is obvious from the financial relations between creditors and debtors. These relations are mostly based on historical, tribal, familiar and traditional relationships. The principle of these relations is honour and promise which is stronger than a written agreement or pledge.

**Third period :** This period is characterized not only by the ongoing growth of microfinance activities, but mainly by the acceleration of transformation of the informal types of MFIs to formal ones.

The main scientific question in this period was an assessment of the objective framework: 'When is the informal MFI suitable for a transformation?'

The conditions and suitability for transformation of informal MFIs to formal ones are highlighted in the scheme of the three triangles – the institution has to meet three requirements:

- (1) stability maintenance in the environment in which the MFIs operate; the critical triangle
- (2) outside sustainable development of the MFI– outside institution’s stability; the triangle of outside economic stability (Zeller, Meyer 2002)
- (3) inside economic sustainability of MFI– inside institution’s stability; the triangle of inside economic stability

**Fourth period :** Microfinance creates financial markets and builds up civilization structures in isolated and remote regions: that is why some banks buy at present the whole portfolios or even the whole institutions. Initially, microfinance had the character of self-help and charity. In the 21st century, microfinance more and more attract the attention of small- and middle-sized investors. The number of small and poor businessmen without a standard access to the financial sources but with a possibility to use microfinance services was estimated in the year 2007 at about 500–750 million in the world. Nevertheless, the potential and the needs of the developing world are still relatively neglected. The interest rate in informal and mostly self-help MFIs is about 5% p.a. In terms of financial dualism in micro financial markets, MFIs assert more significantly. Their business is mainly of the investment character. The capital costs mean for the investor fulfilling of the target goal – the achievement of the presumed financial returns.

The rapid rising entry of financial investors into the financial markets in the poor countryside led to increasing of interest rates of the microcredit to the range of 30–100% p.a.; Small informal MFIs are mostly of the self-help character with the charity support ('Charity Model') and the formal MFIs with a significant support of NGOs (as a financial intermediary), middle- and large-scale banks as well as other large organizations ('Business Model').

### Implications of Transformation

**a) Implications of transformation for Governance :** As Campion and White state, the key difference in the governance structure of NGOs and those of privately owned financial institutions lies with the selection of board members. Board members of NGOs are usually selected for their commitment to addressing social problems in their communities and their experience in this area. On the other hand, board members for regulated financial institutions are usually representatives of the institution’s significant investors – that is, individuals who have a financial stake in the institution. Furthermore, a certain number of board members are required to have formal financial management expertise. Transforming NGOs often attempt to strike a balance between commercial and social objectives.

**b) Implications of transformation on Ownership :** There are seven different types of ownership identified from the analysis of seven transformed NGOs. These are founding NGO, other NGOs, public development agency/donor, specialized equity fund, foreign private investor, local private investor and employee stock ownership plan (ESOP). None of the institutions had any direct government ownership. All in all, the transformed institutions in Latin America seem to have benefited from specialized equity funds (Bancosol in Bolivia – 34%, Mibanco in Peru – 26%), while those in Africa and Asia have retained a significant ownership by their founding NGOs. The latter may be due to the availability of other sources of capital and the degree of capital market development. This not only encourages poor clients to build an asset base and potentially increase their income, but also contributes to the positive financial performance of the institution. Having a financial stake in the organization may cause them to be more motivated in looking for higher repayment and financial return.

**c) Implications of transformation on Organizational Development :** Once a microfinance NGO decides to transform into a regulated financial institution, it needs to address a whole range of organizational changes. For example, the most challenging issues that have been identified in earlier sections included transformation of the organizational culture, training and hiring of new staff, developing a new management information system and communicating the changes to clients and the staff. If these are not addressed carefully, they can create significant obstacles to the successful transition from NGO to commercial institution. The experience of handling organizational changes during transformation has varied from organization to organization. Another important aspect has to do transition for the client Unless communicated effectively, this could push away many poor

clients who may now see the transformed institution as one of those “traditional banks” that have historically excluded them.

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

#### d) Implications of transformation on social intermediation :

There are two main approaches to microfinance service delivery. The “Minimalist” approach focuses only on financial services, while “holistic” approach takes on providing services beyond credit and savings, such as training, business development services, issue-based campaigns, literacy, health, political literacy training, etc. Most transformed institutions have taken “minimalist” approach and shifted their focus to financial services. Moreover, there is a point of view that true commercialization of the sector will occur when financial institution becomes independent not only of donor funding, but also of donor-dependent NGOs for key development functions. What this means is that the founding NGOs should not be retained to complement “true” commercial microfinance institutions with non-financial services, which, in turn, implies the elimination of non-financial services to the poor from the microfinance industry.

#### CONCLUSION :

‘What change brings a strong entry of financial capital to microfinance activities in the poor regions?’, ‘Charity or business?’, these are the often asked questions. Both ways have their own advantages. It is important that both the Charity and Business model work side by side. Charity appeals in the micro financial market as a factor which influences decreasing of the interest rate load of the clients and it serves especially in the extremely poor regions. The ‘Business model’ is related to the overall economic development in the given region. Investors are the essential factor of the overall poverty solution, for the standardization and transparency of the micro-financial sector. The ethical attitude will be very important and the balance between the contribution to the poor and investors expectancy.

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