FROM NGOs TO FFIs IN MICROFINANCE SERVICES:
CONVERSION ROAD MAP AND ITS CHALLENGES
Comparative study of nine Eastern European MFIs

POLICY PAPER

Introduction

For more than three decades global microfinance services have been dominantly carried out by coalitions of non-for-profit organizations dedicated to providing opportunities for people in poverty to transform their lives through small and micro business loans, training, and financial services that enable them to develop and sustain income-generating and job-creating enterprises. Most of them have been motivated by their vision and mission that include outreach - number of clients served, financial viability - measured by the sustainability of their programs and transformational impact - measurable impact on the lives of their clients.

Opportunity International (OI) is one of those global networks of microfinance institutions and funding partners dedicated to achieve a triple bottom line of outreach, financial viability and impact on their clients. In order to better achieve its goals, as many other global coalitions, several years ago OI made a strategic decision to focus on creating regulated (formal) rather than unregulated (informal) microfinance institutions, including conversion of those in existence, established through the years as non-governmental organizations (NGOs).

The primary reason for this orientation has been to overcome legal barriers and governance limitations inherent in unregulated organizations which restrict outreach and access to capital. According to what the new concept affirmed, the significant outcomes should have been increased access to capital by regulated microfinance institutions in a form of wholesale debt, deposits and investor equity, the ability to offer additional services such as savings and insurance products, and the ability to attract investors that may not have otherwise participated. Given these advantages, it is projected that regulated microfinance institutions are able to reach far greater number of poor micro-entrepreneurs while reducing dependency on donated funds.

“Microfinance in the 1990s has been marked by a major debate between two leading views: the financial systems approach and the poverty lending approach”, underlines Robinson. As the tendency for creating regulated financial institutions rather than historically preferred NGOs globally faces pro and contra argumentation, the project proposes the rationale for conversion to be based on the particular experiences, as well as on qualitatively and quantitatively analyzed performances of nine East

European MFIs: PShM (Albania), Nachala (Bulgaria), NOA (Croatia), Moznosti (Macedonia), OBM (Montenegro), Inicjatywa Mikro (Poland), OMRO (Romania), FORA (Russia) and OIS (Serbia). Although all members of OI Network each of these microfinance entities belong to different social and legal environment, therefore being in different paths and phases of conversion.

Problem Description

About two decades after the time when "development academics, sponsored by USAID, were busy mounting an assault on the whole idea of subsidised development finance", it is obvious that microfinance is becoming more commercial worldwide. Not only are traditional non-governmental organizations dedicated to microfinance transforming into licensed banks and non-bank financial intermediaries in order to access public funds or small savings deposits, but some banks and finance companies are noticing the potential of micro-credit to enhance their own products.

"The early success of non-profit grassroots organizations in serving this sector has led to two important developments" says Jansson. "First, commercial banks, realizing that there might be a profit to be made in microfinance, are starting to pay serious attention to how they can serve this segment of the market. Second, between grassroots non-profit organizations and profit-driven commercial banks, there is an emerging breed of professional financial institutions that specialize in microfinance. These are former non-profit organizations that have requested and received a license to operate as regulated and supervised finance companies or banks".

At the same time, credit unions are revitalizing themselves and seeking to regain their leading role as suppliers of full-range financial services to the poor. Central Bank authorities and governments are examining whether microfinance represents a feasible option for rescuing troubled state-owned development, agricultural, savings, postal, trading and commercial banks. All of these organizations regard microfinance as a potentially viable business, regardless of whether they are constituted as profit-maximizing entities. An increasing number of people in the field regard commercialization as a necessary step to provide better quality financial services to the poor. "The microfinance revolution is a commercial revolution", explains Robinson, simply opposing the claims that "the *win-win* rhetoric promising poverty alleviation with profits has moved far ahead of the evidence".

In that respect, when trying to analyse the tendencies that were preceding commercialization, two major causes can be easily recognised: declination of technical donor grants and an increased array of social investments funds, as well as bilateral and multilateral investments.

Namely, there is evidence in the past years that donors are getting tired of funding microfinance projects, for a variety of reasons. First, they feel like they have invested a lot of money in this sector over the last decade, but have not seen any appreciable change in the rates of poverty. Second, they find the risks in this field very high. While the industry has a few showcase success stories, it has many more examples of fraud and mismanagement. Third, most of the donor governments are directing their foreign aid funds to deal with world's urgent problems, leaving less money for microfinance. Unless something can be done to radically change donors' perceptions of the risks and rewards in this sector, it can be expected for this trend to continue. "Technical donor grant funding peaked in 1999/2000 at almost USD 1 billion for microfinance and small business development programs. Amounts have been declining since 2000 and will be about USD 400 million in 2005", says Vander Weele.

While donor funds are trending down over time, funds from government and social investment funds have greatly increased. "Major bilateral and multilateral investment entities report increasing commitment to micro and small business financing, from USD 600 million in 2000 to almost USD 1 billion per year", while CGAP reports that social investment funds will grow from about USD 100 million in 2003 to USD 200 million by 2006.

In addition, many local governments are also providing loans to microfinance organizations, often with funds that come from the World Bank. It is now much easier to borrow funds than to get a grant. The International Finance Corporation is emerging as a key gatekeeper and a leader in this investment arena for microfinance. Beyond these sources, the next huge wave of investment funds could come from commercial investors who find microfinance to be a stable investment.

In that sense, the other path in the process of commercialization of the microfinance industry is seen with more full scale banks entering into the market through downscaling of their operations. The bottom-line in microfinance is that there is money in it. It is seen in a way that there is money to be made in microfinance, that microfinance is good for the business, and what is good for the business should also be good for the community.

Non-governmental organizations have been working in the area of microfinance for many years. As said, they are starting to formalize because they have found out that the type of services that they provide to the poor and other marginalized groups, are insufficient. Only by formalizing can they go into a deposit-taking mode and offer other services for which the micro-entrepreneurs that have progressed to a certain level are in need of. Therefore, the primary reason for this strategy is to overcome legal barriers and governance limitations inherent in unregulated organizations which restrict outreach and access to capital, also not forgetting the "limitations of the NGO modality arising from the lack of owners".

The significant outcomes of this approach are increased access to capital in the form of wholesale debt, deposits and investor equity, the ability to offer additional services such as savings and insurance products, and the ability to attract investors that may not have otherwise participated. Given these advantages, regulated microfinance institutions are able to reach far greater numbers of the poor while reducing dependency on donated funds.

Yet, while focused on the rationale for conversion, various authors develop their own argumentation. White and Campion, for example, note that "the desire to join the financial system is a reflection of many microfinance NGOs' twin goals of reducing donor dependence and exponentially increasing the number of clients with access to microfinance". For Rosengard the main reason for an NGO to become a regulated financial institution has been to achieve long-term sustainability, via a combination of the following factors:

- Growth in the scale and scope of operations, which in turn increases the magnitude of development impact while reducing operational costs and diversifying operational risks;
- Access to funds, whether in the form of local voluntary savings, large investor deposits, inter-bank loans, or capital market debt or equity, which decreases funding dependency and uncertainty while increasing capital leverage and the scope for business expansion;
- Improved governance and operations, usually the result of regulations regarding ownership composition, management standards, prudential norms, and accounting and reporting requirements; and
- Enhanced customer service, in the form of a wider range of products and delivery systems, together with the increased likelihood of developing a long-term banking relationship for savings, credit, and other financial services.

Similar approach has been taken by Campion. She lists, namely, five short objectives of conversion:

- Access to commercial capital;
- Expand client outreach;
- Offer savings products;
- Improve customer service;
- Improve governance and accountability through private sector ownership.

So, based on the referred classifications, one overall view might define three major elements that are backing the rationale for NGO conversion:

- Meeting demand for credit. As an NGO, MFI is unable to expand at the desired rate to meet demand for credit, even if that is part of the original NGO mandate. There is a need for additional financing to expand services, including the need for obtaining funds to increase its loan portfolio. At the same time, financing of the NGO faces decrease while the demand is increasing faster than funds are arriving;
- Capturing savings. It is known that NGOs are restricted from using client's savings, commercial debt, shareholder investments and loans from the Central Bank for the purpose of financing, which means that they are legally restricted from offering full financial

services to their clients. In addition, in some countries there is a problem with inflation and saving in banks can offer security on the value of clients' funds;

- Launching market driven approach. Some NGOs want to create market-driven approach to micro-lending. By paying for its funds through interest on savings deposits, dividends, inter-bank loans and other means available to regulated financial institutions, converted NGOs could accomplish expansion, be market driven and be independent from the donated funds. NGO might be sustainable but significant expansion calls for more funds. In this way, they are solving long-term economic challenge, serving clients not beneficiaries and funding programs though investors not donors.

Policy Options

Based on what has been offered in the previous sections of this paper, both as theoretical and empirical argumentation, it is hard to deny that NGOs conversion into FFIs has positive impact on what has been drafted as general objective of the microfinance industry for the next decade. As a matter of fact, there are still views that "this development in the NGO micro-credit sub-sector is ironic because NGOs began micro-credit provision initially because of the failure of RFIs, commercial banks in particular, to serve the poor and low-income households", but this kind of divisions, among other into *institutionists* and *welfarists* seem to be completely outdated.

Yet, what is seen after examining the nine OI partners is some sort of competition among institutions. Generally, as everywhere else, competition is seen as good for the consumer - competition in industry has improved service quality, driven innovations, and brought about new ways of doing things.

In that sense, the performances indicated in the previous sections of this paper show that in many cases there is no compulsory relationship between MFI's success, as broadly understood notion, and its formal/informal status. Measurable by performance indicators available, within the nine MFIs examined in this paper there are examples of successful NGOs, co-operative, savings houses/banks and a full service bank. On the other side, although a very exact activity, provision of microfinance services might be never successful enough for the ultimate goal of the whole concept which is to eradicate poverty over the globe. In that respect, it is not easy to determine how much the conversion itself contributed to the level of particular success. Namely, some political and economic developments in particular countries influence the success. Specific regulator's requirements have their own influence, therefore making the skilfulness and wisdom - by which the conversion process is guided - to be important but not the decisive factor.

The number of clients served seems to be the most useful indicator for the purpose of illustration of this dilemma. Eight of nine of the examined MFIs, both regulated and unregulated, have continuous increase of this parameter. Even more, the highest rate (48%) of client growth in 2004 has been performed by a finance company (PShM - Albania), while both a full service bank (OBM - Montenegro) and the only NGO in this group of nine (FORA - Russia) in the same period accomplished similar client growth of 28-29%. These findings therefore make this indicator not very relevant to the subject of this research.

Additional indicator of the success of the MFI is the increase of the portfolio. As with the client outreach indicators, the willingness of the investors, including those with social motivation, is highly dependent not only on the institutional status of the MFI, but also on the political and economic situation in the particular country. In that sense, decrease in performance figures sometimes has been caused by wider economic or political crisis, unfair competition, organizational weakness, changes in the management etc. rather than the poor performance of the MFI caused by its regulated/unregulated status.

In the similar manner, increase in performance figures sometimes has been caused by external factors (new grant, if portfolio is concerned), rather than the excellence in performance. Implementation of complementary step (increase of the number of clients as a consequence of downgrading the average loan size) might also lead to misleading conclusions.

In that sense, if the need for strong performance is taken as crucial reason for conversion, Russian FORA denies that stand also in another area - loan portfolio quality: with the number of clients being almost tripled in three years, portfolio in arrears more than 1 day (!) has been kept on 0.4%. As said, these results have been achieved as an NGO and are the leading ones within the whole OI Network.

Another argumentation in favour of the stand of conditional relevance of the formal status for the performance can be found in the two co-operatives' case: current difficulties and modest performance of NOA (Croatia) namely, have little to do with their institutional status, but are result of a specific problem with the Croatian tax legislation. At the same time, the other co-operative (Nachala - Bulgaria) performs very well, attracting continuous grant funding from USAID. Nachala namely, was the only one of the microfinance institutions in Bulgaria to receive an expansion grant, which is the direct result of an extremely positive and complimentary evaluation, conducted by an independent consulting firm engaged by USAID.

An interesting characterization, related not only to performance figures but also to the governance challenges, applies to Moznosti (Macedonia). Being FFI (savings house/bank since 2000) but at the same time being refused upon application for full service bank, Moznosti kept excellent performance. Even more, a year after refusal, Moznosti has been given highest possible grade for FFI in the country by the very same authority (Central Bank). All this happened with exactly the same governing board and management that were running Moznosti as NGO.

Polish and Romanian (IM and OMRO) cases, on the other hand, might be good examples in supporting the conversion logic. Both non-deposit taking finance companies, they are in relative stagnation caused mainly by the lack of funds. Although it is said that there are no present plans to convert them into banks, their current status might be a good reason to believe that as FFIs they would have done much better with the attraction of capital. Certainly, good will for conversion cannot be enough as some other open questions are to be analysed and solved first: capacity to attract the capital, unfavourable legislation (high level of capital required for bank establishment), strong competition on the market, etc.

Finally, the textbook example of the right time decision to convert (right after the new banking law has been passed, with the new Montenegrin Central Bank just established), altogether with the right method and the right people put in place, has been that of the OBM (Montenegro). It is a case that justifies all previously listed objectives of the conversion. OBM's results to date, namely, offer a dramatic example of the potential scope and scale of outreach and coverage if microfinance is done in a sustainable manner through a commercial bank. Even more, fears that a commitment to sustainability (profit) virtually guarantees that an MFI will move up market, abandoning poorer clients, in this case have appeared ungrounded. In fact, contrary to the critics of commercialization who frequently note that the average loan size of commercialized microfinance institutions is significantly higher than that of non-profit MFIs, OBM's figure raised reasonably, at the end of 2004 being at an acceptable (for European standards) level of 4,486 USD.

This does not mean again, that the success of OBM is a direct consequence of the conversion itself. As argued in various sections of this paper, conversion is doing a lot but not doing it all. In that sense, this paper does not suggest to "disregard [the] microfinance evangelists proselytizing one way of doing business". What this paper is advocating for is to be careful with the expectations from the conversion itself. It is not a panacea. Competition among institutions and "one size does not fit all" logic will sustain for at least some time in the future, and if regulated microfinance institutions are not going to be regarded as an end in themselves, they are now in the best position to prove their advantages.