THE TRANSFORMATION PROCESS IN MICROFINANCE INSTITUTIONS

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Abstract

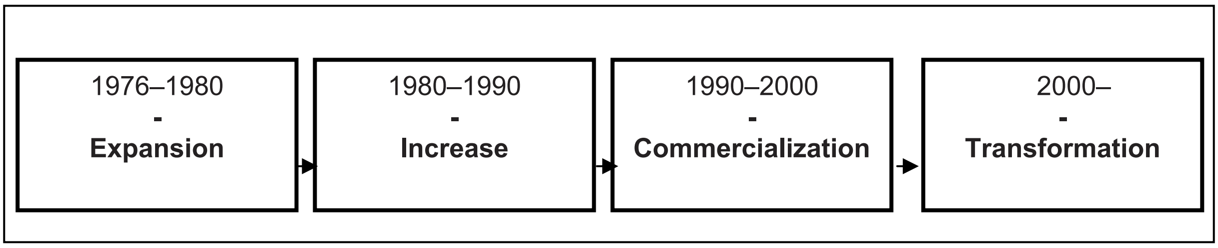
During the past 30 years, microfinance has been proven to be a powerful poverty alleviation tool. It is one of the only development tools with the potential to be financially self-sustaining. However, even after more than 30 years of industry effort, 80 percent of the working poor (more than 400 million families) are still without access to microfinance services. At current growth rates, the gap will not be closed for decades. For microfinance to achieve its potential as a global poverty alleviation tool, the microfinance industry must grow to scale (UNITUS, 2007). The article analyzes differences between informal microfinance institutions (MFIs) and formal types.
In current 6-8 years proceeds the relatively intensive transformation process aiming to accelerate the transition from informal to formal microfinance structure. There will be still many people lacking access to financial sources if there is not the overall economy increase in given state. Although the transformations process has positive impact there are several negatives which are discussed in this article.

Key words: microfinance institutions, microfinance, transformation, capital resources, poverty

INTRODUCTION

Microfinance in developing countries started in 70´ of the last century when prof. Muhammad Yunnus (the Peace Nobel Prize 2006) had established a micro-financial system known as Grameen bank in Bangladesh. Microfinance is rather short in its history in developing countries; it can be divided into four development periods in Figure 1.

Figure 1: The development of microfinance institutions (MFIs) and their activities



Source: Srnec, Havrland (2004)

- Early 80´s – many MFIs (microfinance institutions) have better rate of return than banks, in the 1980s Bank Rakyat Indonesia developed the first large-scale sustainable micro-banking system operating without subsidy (Robinson, 2001).
- Early 90´s – a few MFIs began covering all their costs. In Bolivia, BancoSol pioneered the access of microfinance institutions into domestic and international financial markets and to for-profit investors.
- Modal 90´s – top MFIs began to attract significant commercial funding, no longer limited to a small group of scattered institutions. It is a rapidly growing industry.
- Nowadays – MFIs transformation of informal microfinance institutions to formal institutions. The mix of informal, formal and semiformal components is typical for local financial markets of rural areas and low – income urban neighbourhoods of developing countries (Germidis et al., 1991). Each form has its specifics and roles in financial market.

As listed above, the MFIs can be classified into three fundamental groups for the purpose of the article – basic regulation:

- Formal MFIs – regulated by financial authorities of a country (commercial banks, development banks, rural banks, credit unions, etc.).
- Semiformal MFIs – regulated by non-financing authorities (savings and credit cooperatives, unregulated village banks, etc.).

- Informal MFIs – controlled by customary law and peer pressure as much as possible (ROSCA - Rotation Savings and Credit Ass., ASCRA – Accumulation Savings and Credit Ass., SFGA – Small Farming Groups Ass., SHG – Self Helping Groups, PG – Peering Groups, door step collectors, etc.)

Financial dualism and transformation

Speaking of these main categories of microfinance institutions, formal and informal, it is necessary to point out that formal as well as informal forms are specific by their structure, money sources and also by types of clients. The co-existence of formal and informal financial sectors in financial system of most developing countries is called financial dualism. It is characterized by Figure 2. Presently, the trend is to transform informal to formal MFIs (UNITUS, 2007).

Analytic view on the commercialism and transformation period

Following Figure 3 clearly shows the outreach of informal and formal institutions activity. Both forms of MFIs have their entitlement in developing countries economy. Both have impact on poverty alleviation in given countries, but differ mainly therein that informal types are not stable but provide the financial services even to extremely poor people (mainly in self-help groups form), for those people are essential. On the other hand, formal MFIs are transparent institutions with high internal sustainability.

Figure 2: Informal and formal financial institutions in developing countries – Financial Dualism

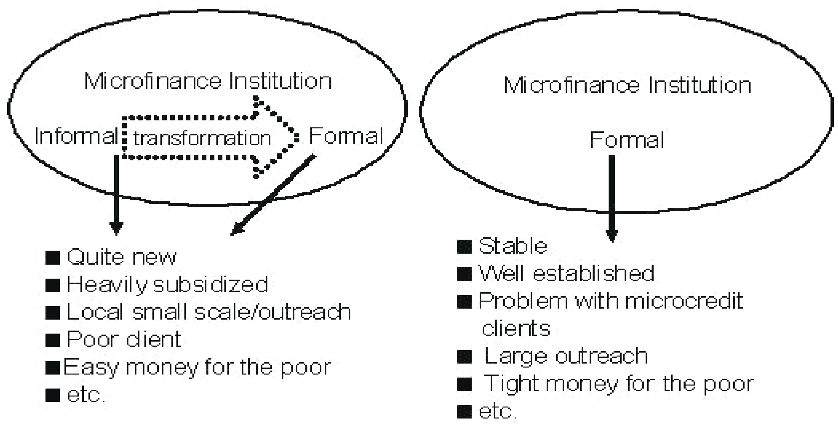
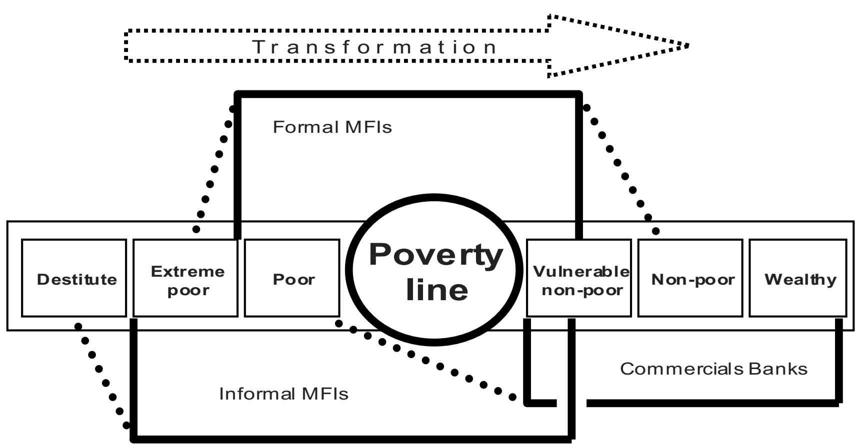


Figure 3: The outreach and impact of format and informal MFIS on powerty line



Source: Microfinancegateway (2006)

Informal MFIs
Informal financial markets serve multiple sectors, financing households and enterprises in a wide range of income levels and geographic areas. Characterized in general by personal relationships, individual operators, ease of access, simple procedures, rapid transactions, and flexible loan terms and amounts, informal financial markets are ubiquitous. Most such markets can have more main components, with many variants in each. For e.g. Rotating savings and credit associations (ROSCAs) in which members both save and borrow or Regular (non-rotating) savings and credit associations (RESCAs) in which all members save but all do not necessarily borrow (Bouman, 1989). The risk of accelerated transformation consists mainly in following influences. E.g., informal MFIs are often donated by many donors, humanitarian institutions, financial middlemen and other supporters. Exactly here are shown the main risks, because there might be the inconsonance between the providing services to clients and providing external financial sources. Mainly the NGO and other humanitarian organizations afford the financial sources irregularly or up to specific time. NGOs lack a formal ownership structure, meaning that Board members and management are not legally responsible for the financial performance of the organization. This lack of financial responsibility is the primary reason that NGOs cannot access significant funding from the capital markets (UNITUS, 2007). Similarly, if these MFIs gain the financial sources from standard commercial and other banks, the risk generates mainly from currency differences (local currency – foreign currency).

Formal MFI
The category of formal MFI is more active on financial market, and thus more dependent on external financial sources than previous category. There is a higher risk by financial services providing to clients (interest rate fluctuation by external sources). The local rural or family relations play very important role in secure recovery of provided actives to MFIs. The position, authority, reputation of local personalities often substitute guarantee instruments which are normally used. Mostly they are not reachable for rural people. These are the reasons for the absence of mutual personal liability.
A wide variety of semiformal financial organizations occupies the middle ranges of this system. These organizations are unlicensed and generally not controlled; nevertheless, they may operate under particular laws and regulations.

The transparent middle and bigger financial institutions

The middle and bigger financial institutions are also active in microfinance area, and thus directly or indirectly.

The direct involvement
The middle and bigger financial institutions do not have such a tight relation with its clients like the previous categories (but if possible, they use local rural structures). These bigger institutions exert by active operation the usually known credit technologies. That is why here are the risks instructions strictly follow. Mainly the principle, that risk should be acceptable for financial institution, irregular, occasional, solvable, countable. Each financial operation is original, non-recurring and is only apparently same. That's the reason for the bank procedures have to be highly heedful and follow the given principles, mainly:
– to gain the maximum of objective information
– to identify the business event
– to make the reserves in connection with possible risk
– if possible to assure the guarantee
– to provide technical-advisor help
– to provide micro-credit
– to provide the formal and in-formal controls by client
– in case of burdens found, immediately solve the problem

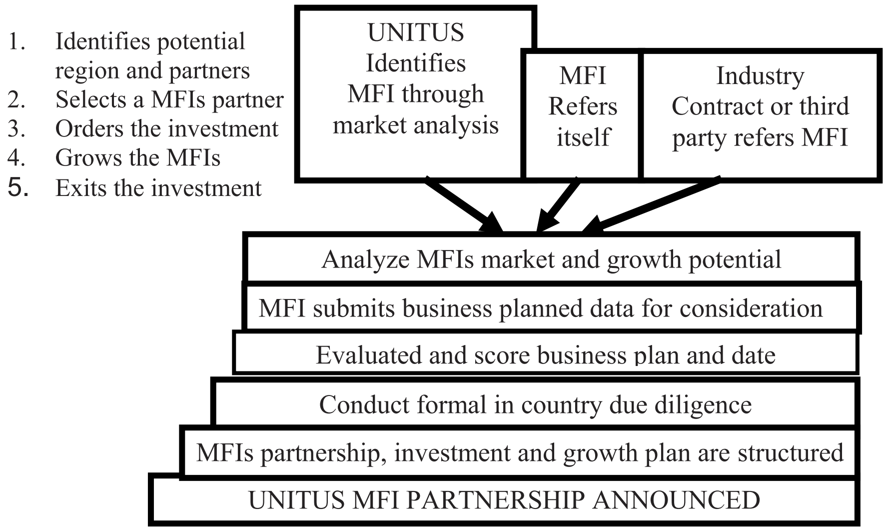
In-direct involvement
Most of them are commercial institutions or developing banks, providing financial sources to smaller institutions, and several advisors agencies. Their outreach usually reach over the local regions or state borders. The international organizations have outreach all over the world. The business risk has another character than by previous categories, their work with other institutions has to be highly professional (detail analysis, not connected only with financial sector). They follow at least 6 main principles how to minimize the possible deprivations:
– the risk avoidance, e.g. in last years there was a perceivable fall of USD to other world currencies, in recent years happens to used currency diversification (by developing help etc.)
– off-setting risk, long hedging, which foregoes the negative currency fluctuations impact (the capital market of given country)
– the risk diversification, means the financial sources allocation to several locations, by international organizations the impact range is whole world, by smaller ones within given state
– consultant service and advisory, it is effective to provide the continuous supervision
– Economical and political atmosphere liberalization, to lower the risks formation atmosphere (the international operations, commitments etc.)
– Historical background and relationships usage, cooperation with the traditional approaches, experiences and rural structure and their suitable implementation into modern technologies etc.

The current status, strategy and outreach of MFIs differ in several worlds' regions. To make microfinance services more sustainable, controlled and more engaged in state economy many of these institutions are in transformation process.

Many significant organizations are intensively engaged in this process, such as UNITUS (Unite-Us), founded in early 2000. UNITUS envisions a world where microfinance is available to every individual, works toward this vision by accelerating the growth of the world's highest-potential emerging microfinance institutions (by combination of best practices from the venture capital, investment banking and strategy consulting industries). It provides capital investments and capacity-building consulting, thus empowering these organizations to scale and provide life-changing financial services to dramatically more of the world's working poor (UNITUS, 2007). Its UNITUS Acceleration Model helps create large-scale, poverty-focused and commercially sustainable microfinance institutions (MFIs). Unitus´s mission, as well as other's MFIs, is to alleviate global poverty by increasing access to microfinance. But only a few microfinance institutions have grown to a size where they make a significant impact in the communities and regions in which they operate. To increase the impact of MFIs on national economy is the transformation needed. The term "transformation," or commercialization, of MFI refers to a change in legal status from an unregulated non-profit or non-governmental organization (NGO) into a regulated, for-profit institution with enhanced service quality and product offering (UNITUS, 2006).

This transformation process has several phases, beginning with identifying of potential region, ending by exit the investment. All phases are shown in Figure 4.

Figure 4: How UNITUS select its microfinance partners



Source: UNITUS (2006)

The system development goes to formal and transparent organizations of several types and size to be more compatible, effective and dirigible. It is necessary that this transformation process follows the socio-economic and politic changes in given developing country. The changes are necessary presumptions for poverty fighting and the equal incorporation into world's structures. This also means that the interpersonal relations will also change, today the disproportioned corruption rate and risks in business. Many bankers, economists, and government officials assume that the informal commercial credit market works efficiently, satisfies demand, and helps the poor (Robinson, 2001).

The MFIs transformation raises the financial sustainability of MFIs as well as the stability of whole financial sector in given developing country. The acceptance part of state budget will intensify and thus are intensified the expenditures of state budget. The economy reaches higher level and thus the standard of living. On the other hand, if we would quicken the transformation process in area with high percentage of extremely poor people, transformation would be contra productive, because of limited outreach of formal financial institutions. For such people would be financial services of those institutions less accessible, more expensive.

Apparently, the transformation acceleration is possible only in areas where is:

- only small group of extremely poor people
- assured the equal economical and standard of living growth
- high solidarity between the rich and the poor
- Steady, liberal political system, etc.

The financial services transparency does not mean only the legal duties fulfilment but also the client duties (collaterals). This situation can sharpen the country destabilization. Figures 5 and 6 show why the financial services are more expensive. Figure 5 shows the lowering of the instalment discipline and the micro-credit costs go higher. Providing microfinance is more expensive than providing standard banking services to larger clients. Yet in a number of countries micro-credit borrowers have shown that they will pay the costs that enable the financing institution to achieve full cost recovery and to earn a profit – if the products and services offered to them are appropriate for their needs (Robinson, 2001).

Figure 6 shows the main objective reason for why the financial services are more expensive. The reason is the financial sources composition. This change in financial sources composition signifies positive development to formal MFIs which are fully involved in national financial system and thus the acceleration of national economy; the presumption is to minimize the amount of extremely poor citizens.

Figure 5: Transformation of the MFIs and microfinance activities

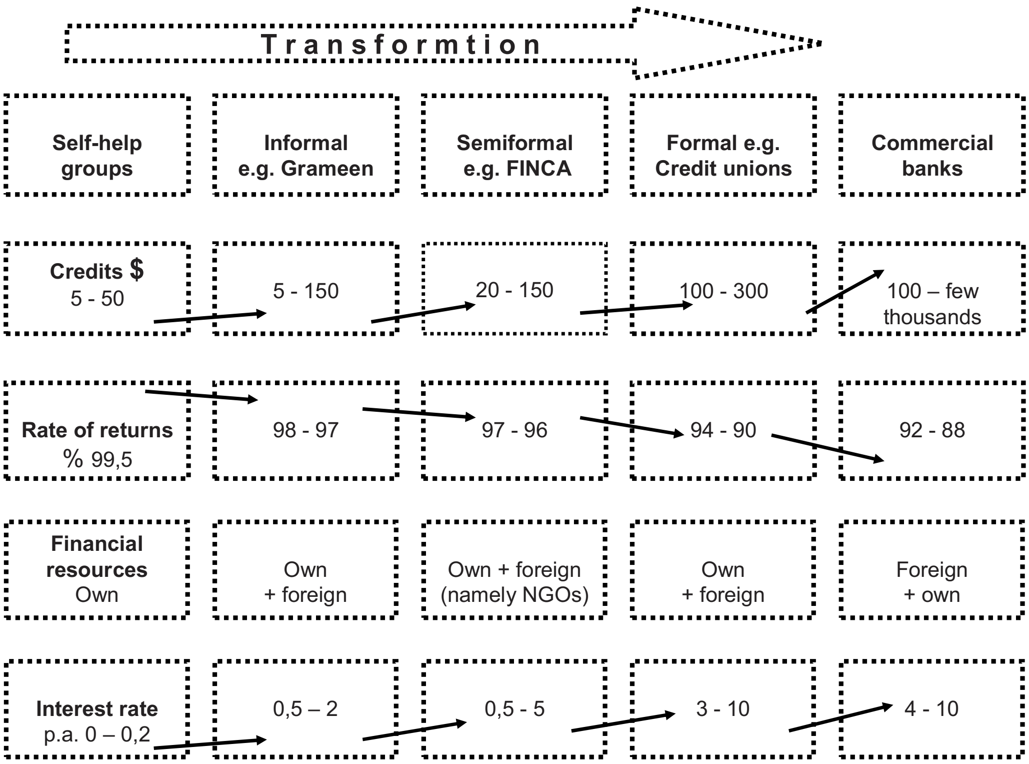
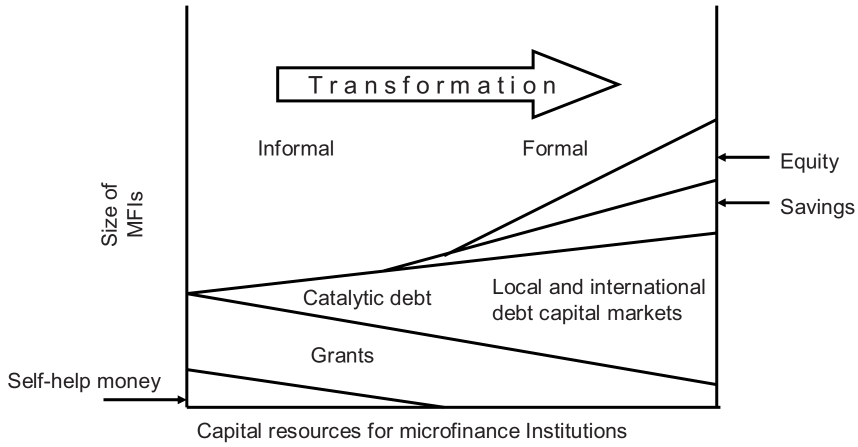


Figure 6: Life-cycle for financial MFIs growth



Source: Srnec, Gebrianova (2006)

CONCLUSION

Micro-finance has been and will continue being an indivisible part of the financial system. It has low risks as compared to standard loans. This is due to the fact that rural environment effectively watches financial resources. On the other hand there is strong need for sustainable, stable and controlled financial system – with microfinance as its competent part. By increasing an MFI's access to stable sources of long-term funds, transformation reduces MFI dependency on donated funds.

The current status of MFIs differs in several worlds' regions. The essential difference consists of e.g., different organizational and economic structure, reach and the amount of providing services, relation to financial-legal system, etc.

The subject of this article was to analyze their different character, system of the services providing in very poor regions in developing countries connected with different risks.

The formal sector dominates in the urban area and informal in rural area. The formal one is transparent, professional but less or not accessible for the suffering poor, on the other hand the main strong point of the informal sector is very the accessibility for the poor. Speaking of developing countries where overwhelming majority lives in remote areas (or in primitive conditions in urban areas) with bad infrastructure, without any property we must submit that informal financial services are necessary – for their outreach.

The transformation process, as the next step in financial development needs to go hand by hand with socio-economic development, with the increase of living standard otherwise the situation in developing countries could come to the point where we would have "modern" formal financial institutions with professional products, no clients, and hungry crowds in front of them.

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