MICROFINANCE
HANDBOOK

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In chapter 3 we introduced the "Systems Framework" in which different institutions can be involved in providing the services demanded by low-income clients. In this chapter the focus is on the primary institution that provides financial services, its institutional structure, and its capacity to meet the demands of its clients.

The majority of MFIs are created as nongovernmental organizations (NGOs). However, as the field of microfinance develops, the focus is changing from the delivery of credit services to a true process of financial intermediation, including the provision of savings and other financial services demanded by the working poor. Furthermore, the shrinking resource base (donor funds) to support the ever-increasing demand implies that MFIs will eventually need to support themselves. Accompanying this change of perspective is a better understanding of the implications of institutional structure for achieving the ends of greater service, scale, and sustainability.

Many MFIs are now beginning to look at the advantages and disadvantages of different institutional structures. This chapter examines the range of institutional types that are appropriate for microfinance and for meeting the objectives of MFIs, including formal, semi-formal, and informal structures. It also addresses other institutional issues, including:

- Institutional growth and transformation
- Ownership and governance
- The accessing of new sources of funding
- Institutional capacity.

Most MFIs have established or are establishing partnerships with other development agencies, such as governments, donors, and international NGOs. When deciding whom to cooperate with, the objectives of both the MFI and the potential development partner must be considered. Partnerships affect the structure of the MFI, its funding sources, and its activities. The first section of this chapter gives an overview of why institutions (and partner institutions) are important and outlines the various institutional types. The remaining sections focus on the institutional issues that arise as MFIs grow and expand their operations.

This chapter will be of interest to donors or consultants who are examining or evaluating MFIs and to practitioners who are considering transforming their institutional structure, examining issues of governance, or developing new funding sources. Practitioners, donors, and international NGOs in the process of selecting partner institutions will also find this chapter interesting.

**The Importance of Institutions**

An institution is a collection of assets—human, financial, and others—combined to perform activities such as granting loans and taking deposits overtime.¹ A one-time activity such as a "project" is not an institution. Thus by its very nature an institution has a function and a certain permanence. However, when one looks at specific providers of financial intermediation to low-income women and men in a given country, one can easily see differences in the degree to which they really are institutions, that is, the degree to

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¹ This section and the following section on institutional types were written by Reinhardt Schmidt, Internationale Projekt Consult (IPC) GmbH.
which they have a well-defined function and are set up and run to perform their function on a permanent basis. Clearly, permanence is important. Poor men and women need permanent and reliable access to savings and credit facilities, and only stable institutions can assure permanence.

**Attributes of a Good Institution**

A good institution has three attributes:

1. It provides services to the relevant target group.
   - *Appropriate services* include the offering of loans that match client demand. This refers to loan size and maturity, collateral requirements, and the procedures applied in granting loans and ensuring repayment. A good MFI must have or be willing to adopt appropriate credit technology, which will enable quality services to be designed and distributed so that they are attractive and accessible to the target group.
   - *The scope of services* must be consistent with the situation of the clientele. In some cases, simply offering loans of a specific type may be all that is needed; in others, an array of different loan types may be necessary, or it may be more important to offer deposit and payment transfer facilities or a combination of all these services.
   - *Prices* that the clients have to pay for the services of the institution are not generally a point of major importance, according to practical experience. However, low transaction costs for clients, a high degree of deposit liquidity, and rapid availability of loans are extremely important features for a target-group-oriented institution to provide.

2. Its activities and offered services are not only demand-ed but also have some identifiable positive impact on the lives of the customers.

3. It is strong, financially sound, and stable.

   Because the people who belong to the target group need a reliable supply of financial services—that is, access to credit facilities—and an institution to which they can entrust their deposits, it is of paramount importance that the MFI be a stable or sustainable institution or at least be clearly on the way to becoming one.

   **Stability** has, first and foremost, a financial dimension. A stable institution is one whose existence and function is not threatened by a lack of funds for making necessary payments; it must be solvent at any given moment and also in the foreseeable future. In addition, a sustainable institution must be able to maintain or expand its scale of operations. This is important for two reasons. One is that only a growing institution can meet the demand that its clientele typically exhibits. The other is that many development finance institutions that cater to poor clients are so small that the unit costs of their operations are too high. Growth is an efficient way to reduce costs.

   Experts sometimes claim that an MFI should not depend on external support but rather should be subsidy independent. This requires that the revenues from its operations be sufficient to cover all of its costs, including loan losses, the opportunity cost of equity, and the full, inflation-adjusted cost of debt. This is a requirement that any mature institution must meet, just like any commercial business. However, in most practical cases the real question is not whether an MFI is already financially self-sufficient—most of them are not—but rather, to what extent their costs exceed their revenues and whether and how fast their dependence on external support decreases over time. An MFI must be able and determined to make visible progress toward financial self-sufficiency.

   Not all aspects of stability can be readily expressed in numbers. One such aspect is organizational stability. A sound MFI must have an organizational and ownership structure that helps to ensure its stability both in a financial sense and with respect to its target group. One cannot call an institution stable if it simply turns away from its original target group of poor clients as soon as it starts to grow and become more efficient and professional. This temptation is great, as poor people are not the most profitable target group or the easiest to deal with. Therefore it is all the more important that an MFI have an ownership and governance structure—that is, a division of roles between the management and the board of directors or the supervisory board—that prevents the institution from "drifting away into social irrelevance."

**The Importance of Partner Institutions**

Most MFIs, with the possible exception of some commercial banks, work with one or more development agencies or partners. These development agencies may be international NGOs, governments, or donors that provide technical assistance, funding, and training to the MFI itself rather than the MFI's clients. (While some partner institutions may in fact provide services directly to the clients of an MFI, here we are considering partners that help to develop the ability of an MFI to provide financial intermediation.)
Table 4.1 Key Characteristics of a Strong Microfinance Institution

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<th>Key areas</th>
<th>Characteristics</th>
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<tr>
<td>Vision</td>
<td>■ A mission statement that defines the target market and services offered and is endorsed by management and staff.</td>
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<td>■ A strong commitment by management to pursuing microfinance as a potentially profitable market niche (in terms of people and funds).</td>
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<td>■ A business plan stating how to reach specific strategic objectives in three to five years.</td>
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<td>Financial services and delivery methods</td>
<td>■ Simple financial services adapted to the local context and in high demand by the clients described in the mission statement.</td>
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<td>■ Decentralization of client selection and financial service delivery.</td>
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<td>Organizational structure and human resources</td>
<td>■ Accurate job descriptions, relevant training, and regular performance reviews.</td>
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<td>■ A business plan spelling out training priorities and a budget allocating adequate funds for internally or externally provided training (or both).</td>
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<td>■ Appropriate performance-based incentives offered to staff and management.</td>
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<td>Administration and finance</td>
<td>■ Loan processing and other activities based on standardized practices and operational manuals and widely understood by staff.</td>
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<td>■ Accounting systems producing accurate, timely, and transparent information as inputs to the management information system.</td>
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<td>■ Internal and external audits carried out at regular intervals.</td>
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<td>■ Budgets and financial projections made regularly and realistically.</td>
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<tr>
<td>Management information system</td>
<td>■ Systems providing timely and accurate information on key indicators that are most relevant to operations and are regularly used by staff and management in monitoring and guiding operations.</td>
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<td>Institutional viability</td>
<td>■ Legal registration and compliance with supervisory requirements.</td>
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<td>■ Clearly defined rights and responsibilities of owners, board of directors, and management.</td>
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<td>■ Strong second level of technically trained managers.</td>
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<td>Outreach and financial sustainability</td>
<td>■ Achievement of significant scale, including a large number of underserved clients (for example, the poor and women).</td>
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<td>■ Coverage of operating and financial costs clearly progressing toward full sustainability (as demonstrated in audited financial statements and financial projections).</td>
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Source: Fruman and Isern 1996.

Both practitioners and donors should consider the importance of partnerships, because the need to strengthen local institutions and build their capacity is essential to meeting the growing demand of low-income clients.

The term "partner" does not suggest a biased relationship in which the more powerful and resourceful side imposes its will and ideas upon the other. Instead, partners discuss and jointly define objectives and ways of attaining them. In a partnership both sides have the same rights to determine what the partners can do and want to do together.

Partnerships are formed when: "organizations seek to mutually strengthen and sustain themselves. It [the partnership] is an empowering process, which relies on trust and confidence, solidarity of vision and approach, and it acknowledges mutual contribution and equality. Both partners have complementary roles, estab-
lished through negotiations and subject to change as the partnership grows and circumstances change. (Long, Daouda, and Cawley 1990, 124)

Local institutions can bring to the partnership the advantage of knowing more about local circumstances: the target group or clientele, their situation and demand for financial services, the local financial market, and the local laws and habits. Furthermore, there are ethical and political considerations that make it advisable for a foreign institution to have a local partner. Last but not least, a local partner is needed when an institution has been established and the foreign partner is planning to withdraw from the MFI and leave it in the hands of local people. The failure of thousands of development finance projects in the past demonstrates that it is necessary to have not only an institutional basis but also strong local partners if a permanent institution with a lasting impact for low-income women and men is to be created.

Foreign partner agencies can bring funding, technical assistance, and training to the partnership. Often foreign partner agencies are familiar with microfinance "best practices" and have at their disposal information and sources to which the local partner may not readily have access.

An American international NGO, Freedom From Hunger, focuses on linking its MFI operations in Africa with local bank and credit unions. This has allowed it to focus primarily on technical assistance while creating sustainable institutions in the countries in which it works (box 4.1).

Partner selection implies cooperation, which is only possible if there is a common purpose, mutual respect and openness, and a willingness by both partners to contribute to the achievement of the common goal. Thus

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**Box 4.1 Freedom From Hunger: Partnering with Local Institutions**

**Freedom From Hunger** (FFH) works extensively in Africa with local partners. Rather than going into a country and setting up its own microfinance activity, Freedom From Hunger selects local formal financial institutions, trains them its own lending model, and provides technical advice. The organization has identified the advantages of this partnership for both parties:

- Freedom From Hunger reduces the cost of delivering services, because the local institution can often fund its own portfolio. Freedom From Hunger's expertise in financial management greatly helps in the start-up and ongoing management. The local partner offers clients access to the formal financial sector. Credit unions, as partners, bring particular advantages because they have a network of contacts, know their clients, and offer other local knowledge.

- The local partner gains access to creditworthy clients using Freedom From Hunger's model, which features a high repayment rate and group loan guarantees. The new borrowers are also savers who build the bank's loan capital and profitability. Finally, reaching out to the clients targeted by Freedom From Hunger represents an investment in the welfare of the poor from which the bank can derive public relations and marketing benefits.

Making this model work requires special attention to a variety of issues. The greatest challenge for the international NGO is finding financial partners who have an interest in the poverty and microbusiness sector and will honestly enter the relationship with a long-term commitment. It is not by chance that Freedom From Hunger's partners are largely credit unions or development banks— institutions with a strong social or development mission. How such an approach might play out with more profit-seeking partners has not been tested.

Determinations that are of subsidiary but significant importance are:

- The financial health of the lending institution
- The source of financing for the portfolio (in some instances it is the bank or credit union, in others cases the international NGO, which may need to supplement the partner's available resources)
- The source of funding for operational costs
- The selection of staff delivering program services
- Responsibility for loan loss.

When these arrangements are worked out successfully, the international NGO can see its activities grow beyond any scale that it could have reached with its own resources: it can achieve a sustainable initiative, whether under its own control or under that of the local financial institution. In the second case it has also achieved the establishment of microfinance within the formal financial system in a way that avoids many of the difficult challenges inherent in other models. The financial services are offered under the aegis of a regulated institution that can provide security and stability to its clients, and the organization does not have to transform itself or create a new financial institution to deliver services to those it most wants to serve.

there is no standard answer to the question, What makes a good local or international partner institution? It depends on who the other partner organization is, what its ideas and objectives are, what it can contribute, and the way in which it is willing to act as a partner.

**Institutional Types**

The following is a brief discussion of each institutional type and includes its suitability as a partner to a donor, international NGO, or government. The suitability of donors, international NGOs, and governments as partners is not discussed.

**Formal institutions** are defined as those that are subject not only to general laws and regulations but also to specific banking regulation and supervision. **Semi-formal institutions** are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial law, but informal insofar as they are, with few exceptions, not under bank regulation and supervision. **Informal providers** (generally not referred to as institutions) are those to which neither special bank law nor general commercial law applies, and whose operations are also so informal that disputes arising from contact with them often cannot be settled by recourse to the legal system.

**Formal Financial Institutions**

The following are the most typical types of formal financial institutions.

**Public development banks.** Development banks are or until quite recently have been, a special type of large, centralized, government-owned bank. Most of them were set up with ample financial support from foreign and international organizations. They were created to provide financial services to strategic sectors such as agriculture or industry. Most are the product of traditional interventionist approaches, which place greater emphasis on disbursements at low, subsidized interest rates than on the quality of lending.

Their traditional clients are large businesses. In the 1970s several development banks started to offer their services to small farmers and small businesses. But because they tried to do this with the same credit technology and organizational structures as they had used before, their success was extremely modest.

**Private development banks** are a special category of banks that exist in some
Box 4.3 Development Banks

Development banks can lend either directly or through intermediaries, as shown in these examples.

Direct lending. The Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand is a state-owned development bank created in 1966 to provide financial assistance to farmers and agriculture-related activities. Since the financial reforms of 1989 the bank’s efforts have been directed predominantly at the low- to medium-income range. At first it lent mostly through agricultural cooperatives, but repayment problems led the bank to start lending directly to farmers.

Lending through intermediaries. The experience of the Banque Nationale de Développement Agricole (BNDA), a state-owned bank in Mali, is quite different. This bank ceased lending directly to clients in rural areas in the early 1990s because of very low repayment rates. Lending to village cooperatives and groups of farmers gave better results. In more recent years the Banque Nationale has started lending to microfinance institutions, such as the caisses villageoises—self-managed village banks—in three regions of the country. These institutions in turn on-lend to their clients. This linkage has been extremely successful, with high repayment rates and very low costs for the bank. The bank now wishes to become directly involved in setting up self-managed village banks in other areas of the country. If its sole motivation is to channel more funds to the rural economy, this may prove to be a dangerous strategy. Indeed, the success of the caisses villageoises in Mali is based on their ownership by the villagers themselves—and this sense of ownership might be weakened if the Banque Nationale is too strongly involved.

Source: Contributed by Cecile Fruman, Sustainable Banking with the Poor Project, World Bank.

developing countries. Their aim is broad economic development directed to fill capital gaps in the productive sector that are considered too risky by commercial standards. They often have lower capital requirements than commercial banks and enjoy some exemptions, either in the form of tax breaks or reduced reserve requirements (box 4.4).

Savings banks and postal savings banks. The legal status and ownership of savings banks varies, but they are typically not owned by the central government of their country, and they often have a mixture of public and private owners. Some, such as those in Peru, were set up and owned by municipalities; others, such as the rural banks in Ghana, are simply small local banks owned by local people.

As the name indicates, savings banks tend to emphasize savings mobilization more than other banks. Their main strength is that they are decentralized, rooted in the local community, and interested in serving local small business.

In many countries there are post office savings banks modeled on patterns imposed by former colonial powers. A typical post office savings bank operates through the counters of post offices, and therefore, has a very large network of outlets; it does not offer credit but only takes deposits and provides money transfer services. A surplus of deposits is normally invested in government securities or simply transferred to the treasury. Most post office savings banks are part of the postal administration of their country (box 4.5).

With a few noteworthy exceptions, post office savings banks are in poor shape, both financially and operationally. Their financial situation is poor because they have to pass their net deposits on to the treasury, which often does not want to acknowledge its indebtedness to the post office savings banks. Their organizational weaknesses derive from the fact that they are managed by the postal service, which has no genuine interest in their success. This state of affairs is all the more regrettable in view of the fact that deposit facilities and money transfer services within easy reach of the majority of poor people are “basic financial needs,” which other institutions tend not to provide with comparably low transaction costs.

Savings banks could be attractive partners for various kinds of microfinance activities. Their main strengths are that they are decentralized, rooted in the local community, and interested in serving local small business. Some savings banks, such as those in Peru, are among the most successful target-group-oriented financial institutions, while others may be good partners for activities aimed at restructuring the savings bank system.
Commercial banks are formal financial institutions that focus on short- and long-term lending to established businesses. A typical commercial bank has little experience in providing financial services.

### Box 4.4 Tulay sa Pag-Unlad’s Transformation into a Private Development Bank

**Tulay sa Pag-Unlad, Inc. (TSPI), in the Philippines,** determined that it would create a private development bank based on the current regulatory environment and its own institutional capacity.

- New banking regulations permit the establishment of private development banks with much lower capital requirements (US$1.7 million, as opposed to US$50 million for commercial banks). However, the new private development banks are only allowed to operate outside Metropolitan Manila, meaning that TSPI will need to consider the location of its branches carefully so as to stay close to its desired client base.
- While TSPI has managed to create a diversified product line, one of its four loan services, Sakbayan, which provides loans to tricycle and taxi drivers, is significantly stronger than the others and will become the anchor product for the bank. This product, however, has limited growth potential because taxi routes are regulated. Strengthening the other product lines is thus a priority task for TSPI.
- TSPI recognizes that it still faces some capacity-building issues, including human resource and systems development. However, the pressure to source additional loan capital and the potentially short regulatory “window of opportunity” are demanding progress toward the creation of a private development bank.

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With these realities in mind, one option under consideration is a *special transitional structure*, with the new bank and the original NGO in one integrated organization with shared personnel and a unifying mission. The bank and the NGO would maintain separate financial statements and transparent intercompany transactions but would share many of the head office functions and some of the operational management. The NGO would be responsible for the Kabuhayan product aimed at the poorest people as well as those branches within Metropolitan Manila that cannot be legally transferred to the bank. The bank would be responsible for the most profitable loan products, located in those branches most ready for bank status.

The transition period would take two to three years as the bank grew and became large enough to operate within Manila and take over the rest of TSPI’s branches. At that point the bank and the NGO would separate all functions and staff. The decision to merge Kabuhayan into the bank would be made at that time or later. If the conclusion was that it would never reach commercial viability, the NGO would continue with a separate head office structure. In the meantime, the unified structure provides TSPI with several clear advantages:

- It controls administrative costs.
- It avoids potential cultural conflicts between the NGO and the bank about the mission.
- It ensures coherent policies, performance measurement, and expectations.

*Source: Calmeadow 1996.*

### Box 4.5 The Savings Bank of Madagascar

**From 1918 to 1985 the Postal Administration in** Madagascar collected savings. In 1985 the Savings Bank of Madagascar (Caisse d’epargne Madagascar) was created under the financial supervision of the Ministry of Finance and the technical supervision of the Ministry of Post and Telecommunications. The Savings Bank of Madagascar began with 46 existing postal offices. In June 1996 it was operating out of 174 windows located in both main cities and remote small towns. For use of the postal outlets the bank pays the postal administration 0.8 percent on savings collected.

*Source: Galludec 1996.*

The Savings Bank of Madagascar provides its clients with savings services only. Clients earn interest on their savings depending on the length of time they are held. Once a year all clients give their transactions books to the bank’s agency or postal office to calculate the accrued interest.

The Savings Bank of Madagascar focuses on poor clients, as evidenced by an average savings balance of less than US$32. This represents 28 percent of GDP. The total number of clients in June 1996 was 372,291, with 46 percent of them women.
to microentrepreneurs and small farmers; however, some commercial banks recently recognized that it might be beneficial to do business with these clients (box 4.6). They also understand that it might be necessary to provide services in ways that differ from the traditional commercial banking approach.

There are 12 basic principles with which banks must comply if they choose to focus part of their operations on low-income clients (Yaron, Benjamin, and Piprek 1997):

1. Ensure appropriate governance
2. Define the institution’s strategies and objectives
3. Learn from the competition in the informal sector
4. Find out what services clients really want
5. Establish appropriate modes of delivery
6. Contain transaction costs
7. Cover costs with appropriate, positive on-lending interest rates
8. Customize loan terms and conditions for the target clientele
9. Monitor and maintain the quality of the assets
10. Manage and diversify risks
11. Mobilize savings resources in the market
12. Motivate staff and invest in them (with information and incentives).

Some banks choose to develop a range of services for microentrepreneurs and rural peasants and then to service them directly by going to the communities. Branch banking is the more traditional approach, with bank tellers providing services in a bank facility. A highly decentralized network of branches is necessary, which must include very small branches with minimal fixed assets, located in central villages where they can serve poor clients in nearby rural areas or in urban slums. This is the most likely approach for banks, but it is costly. Other banks may rely more on intermediaries, acting as a wholesaler rather than a retailer.

“Downscaling” is the technical term used to describe projects that aim to introduce new approaches into a commercial bank that has so far not tried to provide services to a poorer clientele. Downscaling is, for instance, the centerpiece of what the Inter-American Development Bank is practicing in its “micro global” programs in Latin America. Another example is the Russia Small Business Fund established by the European Bank for Reconstruction and Development. In both cases commercial banks are carefully selected and analyzed and, after a positive evaluation, may receive funding and technical assistance to build up departments for small and micro lending.

**Box 4.6 Caja Social: A Colombian Commercial Bank Reaching the Poor**

**Caja Social**, founded in 1911 in Colombia as the St. Francis Xavier Workmen’s Circle and Savings Bank, is an example of a commercial bank that has a significant microfinance portfolio. Its original mandate was to promote savings among the country’s poor. Its success in deposit mobilization led to an expansion of branch savings banks throughout Colombia. In 1991 Caja Social was officially transformed into a commercial bank. Its activities, overseen by the holding company, Fundacion Social, range from mortgage credit to small business loans and leasing.

As of September 1995 Caja Social had 1,159,204 active savings accounts (averaging US$338) and 173,033 outstanding loans (averaging US$2,325). While Caja Social serves numerous middle-income clients, a significant portion of its business is targeted at low-income clients. Nearly 20 percent of its clients earn less than US$3,000 annually, which is 75 percent of the country’s average income per economically active adult. Given the enormous scale of the bank, this translates into well over 225,000 low-income clients. In addition, the Caja has been successful in targeting female clients. Approximately 43 percent of its clients are women.

While Caja Social always has maintained the objective of assisting the country’s poor, it has found this market niche to be financially rewarding. In fact, it has been one of the most profitable banks in the Colombian financial system. Arrears rates remain manageable at 4.5 percent, and the bank has achieved operational and financial self-sufficiency without dependence on subsidies from either national or international organizations. Caja Social’s experience has shown that banking with the poor can be sustainable and profitable.

*Source*: Contributed by Julia Paxton, Sustainable Banking with the Poor Project, World Bank.

**Nonbank Financial Institutions.** In some countries special regulation has been established for nonbank financial institutions. These institutions are set up to circumvent the inability of some MFIs to meet commercial bank standards and requirements due to the nature of their lending. Examples of MFIs regulated as nonbank financial institutions are Caja de Ahorro y Prestamo Los Andes in Bolivia and Accion Comunitaria del Peru (MiBanco) (box 4.7).
Box 4.7 Caja de Ahorro y Prestamo Los Andes

Caja de Ahorro y Prestamo Los Andes was established as the first Bolivian private financial fund in 1995. Los Andes grew out of the nongovernmental microlender Pro-Credito, with the technical assistance of the private consulting firm Internationale Projekt Consult GmbH (IPC), financed by the German development agency, GTZ. The minimum capital requirement for a private financial fund is US$1 million. The majority of the total US$600,000 of paid-in capital to Los Andes came from Pro-Credito.

From its inception as Pro-Credito in 1991, the institution planned to enter the regulated financial sector. No organizational changes were implemented once it became a private financial fund. Sophisticated management information systems, which integrate data on savings and credit operations, were already in place. Consequently, Los Andes has been able to produce the required reports to the central bank and the Bolivian superintendency with few modifications.

In contrast to Los Andes, BancoSol (Banco Solidario S.A.) entered the regulated financial sector as a commercial bank in 1992, because the private financial funds did not yet exist. As a result, BancoSol became the first private commercial bank in the world dedicated solely to providing financial services to the microenterprise sector. This helps to explain why the Bolivian Superintendency of Banks is considered to be one of the most innovative in Latin America. It is making significant strides in creating a competitive financial market and is committed to opening the financial sector to microenterprises.


Finance companies or financiers are nonbank financial intermediaries that channel equity funds, retained earnings, and other borrowed capital to small, unsecured short-term loans. Finance companies are often associated with consumer credit and installment contracts. They are often not allowed to mobilize savings; however, their activities vary by their charters. For example, some are able to mobilize time deposits but not demand deposits. Their form is now being adapted in some countries to provide a regulated vehicle for microfinance with lower barriers to entry than a commercial bank (box 4.8).

Semiformal Financial Institutions

The most common types of semiformal financial institutions are financial cooperatives and financial NGOs.

Credit Unions, Savings and Loan Cooperatives, and Other Financial Cooperatives. There are a great many forms of cooperative financial institutions (often identified as credit unions or savings and loan cooperatives). Such institutions play a significant role in the provision of financial services to poor target groups. In several countries cooperative financial institutions are structured in accordance with the models of the American and Canadian credit union or cooperative systems. Other cooperative institutions, such as Raiffeisen (Germany), Credit Mutuel (France), Alternative Bank (Switzerland), and Triodos (Holland), are inspired by models developed in Europe.

Financial cooperatives provide savings and credit services to individual members. They perform an active financial intermediation function, particularly mediating flows from urban and semi-urban to rural areas, and between net savers and net borrowers, while ensuring

Box 4.8 Accion Comunitaria del Peru

Accion Comunitaria del Peru originally considered transforming itself into a finance company (which requires a minimum capital base of US$2.7 million) or a commercial bank (which requires a minimum capital base of US$6 million). However, the Peruvian development bank, COFIDE, proposed the formation of a new category of nonbank financial institutions to meet the financing needs of small and microenterprises. In December 1994 the superintendency issued a resolution creating a new structure called an Entidades de Desarrollo para la Pequena y Microempresa (EDPYME). As such an entity, an MFI with a minimum capital requirement of US$365,000 can access capital markets, additional bank funding, and special rediscount credit facilities from COFIDE. An EDPYME is required to maintain a loan loss reserve equivalent to 25 percent of capital, and at least 10 percent of after-tax profits must be transferred to this reserve annually. The resolution specifies that it provide financing to persons engaged in activities characterized as small or micro businesses.

that loan resources remain in the communities from which the savings were mobilized" (Magill 1994, 140).

Financial cooperatives are organized and operated according to basic cooperative principles: there are no external shareholders; the members are the owners of the institution, with each member having the right to one vote in the organization. In addition to holding shares redeemable at par, members also may deposit money with the organization or borrow from it. Membership is usually the result of some common bond among members, often through employment or membership in the same community. The policy-making leadership is drawn from the members themselves, and members volunteer or are elected for these positions. Financial cooperatives are rarely subject to banking regulation; instead, they are either unregulated or subject to the special legislation and regulation applicable to cooperatives in general. In some countries specific regulations for credit unions are being developed. In the West African Economic and Monetary Union (with eight countries as members) a law for savings and loan associations was passed in 1994, placing these institutions under the supervision of the Ministry of Finance in each country.

Characteristics of financial cooperatives include:

- Clients who tend to come from low-income and lower-middle-income groups.
- Services that are almost exclusively financial in nature.
- Self-generated capital, typically without any dependence on outside funding to cover operating costs, which are generally kept low.

Individual financial cooperatives often choose to be affiliated with a national league (apex institution), which serves the following purposes: it represents the credit

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**Box 4.9 The Rehabilitation of a Credit Union in Benin**

THE HISTORY OF THE FÉDÉRATION DES CAISSES D'ÉPARGNE et de Crédit Agricole Mutuel dates back to the 1970s. In 1975 the Caisse Nationale de Crédit Agricole, or National Agricultural Credit Bank, was established as a public development bank, followed in 1977 by the first local and regional credit unions. Over the next 10 years 99 local credit unions were created. The Caisse Nationale de Crédit Agricole then assumed the role of a national federation, taking control of the operations of the entire network and excluding the elected directors from management and control. As a result, rules and procedures were developed by the management of the bank and imposed on elected directors and members. Thus the constituencies being served were unable to voice their concerns and demands. This top-down approach proved to be highly detrimental.

The financial performance of the network slowly deteriorated, and savings were no longer secure. In November 1987 the Caisse Nationale de Crédit Agricole was liquidated. Nevertheless, a study carried out in 1988 showed that the local credit unions had continued to operate throughout the crisis and member savings had continued to grow. To strengthen the autonomy of the network, the Government of Benin decided to initiate a rehabilitation program. It emphasized the importance of the total freedom of local credit unions to define their own policies, including the choice of interest rates. The first phase of the rehabilitation program (1989-93) was developed in collaboration with the government, members of the network, and donors that contributed funds to reimburse depositors, finance studies, and cover the operating shortfall of the network. The results of the first phase were very encouraging insofar as the project met its principal objectives: restoring the rural population's confidence in the network, strengthening management by elected directors, and improving financial discipline.

In light of the results of the first phase, particularly the enthusiasm demonstrated by the principal participants, a second phase of rehabilitation (1994-98) began. The objectives of the second phase—are as follows:

- Financial restructuring of the network, both to mobilize deposits for on-lending and to generate revenue to cover operational expenses
- A transfer of responsibility to elected directors through the creation of a national federation to govern network expansion, structure, and training of staff and directors
- The creation of the technical secretariat of the federation to supply specific technical support (such as training and inspection) and ensure implementation of general policies.

The second phase of rehabilitation is ongoing, but for the most part its objectives have already been met. The network's growth has greatly exceeded expectations. The transition from mere project status to that of an operational, autonomous network offering a wide array of credit and savings services is nearly complete.

**Source:** Fruman 1997.
unions at the national level, provides training and technical assistance to affiliated credit unions, acts as a central deposit and inter-lending facility, and, in some cases, channels resources from external donors to the national cooperative system. Contacts with foreign partners are typically handled by an apex institution. Affiliation involves purchasing share capital and paying annual dues to the national or regional apex. Membership provides the right to vote on national leadership and policies and to participate in nationally sponsored services and programs.

Savings services are a key feature for raising capital and are often tied to receiving a loan. Credit is generally delivered under the “minimalist” approach. Cooperative lending requires little collateral and is based on character references and cosigning for loans between members.

Without any doubt, there are well-functioning cooperative systems. Beyond that, the sheer number of people who are members of these systems and the aggregate amounts of deposits and loans are impressive. Nevertheless, many systems do not function as well as their basic philosophy would lead one to expect. At the same time, they are very difficult partners for foreign institutions. The reason for both of these difficulties is their structure and the mechanism, which in principle should make them work.

- The group that constitutes the organization is small enough so that members know each other well.
- The members regularly change their roles from net depositors to net borrowers and vice versa.

If these conditions are not met, a cooperative becomes unstable: the management cannot be monitored, and a structural conflict arises between borrowers (who prefer low interest rates and little pressure for repayment) and net depositors (who prefer high interest and a very cautious application of their deposits).

**Financial NGOs.** NGOs are the most common institutional type for MFIs. The World Bank’s “Worldwide Inventory of Microfinance Institutions” found that of the 206 institutions responding to a two-page questionnaire, 150 were NGOs (Paxton 1996).

Even more than with other types of institutions, a discussion of NGOs that provide financial services has to start by emphasizing that they are indeed a very diverse group. The general definition of an NGO is based on what it is not: neither government-related nor profit-oriented. This already indicates their specific strengths, which are the main reason that they are common institutional types for MFIs.

Financial NGOs should be distinguished from two other types of nongovernmental and not-for-profit institutions: self-help groups and cooperatives. These institutions are member-based, whereas NGOs are set up and managed not by members of the target group, but by outsiders, who are often men and women from the middle class of the country who want to support poorer people for social, ethical, and political reasons. For example, one of the first Latin American NGOs providing loans to local microentrepreneurs, a Cali-based organization called DESAP, was started and managed by a son of one of the wealthiest families in Colombia, who regarded the government’s neglect of microbusiness as a serious threat to the political stability of his country.

In spite of the fact that they are not member-based, many NGOs are close to the target group, in terms of both location and understanding. An NGO set up by local business people to provide services to microentrepreneurs may indeed be better placed to respond to the needs of its clients than an institution managed by government officials or traditional bankers.

All this indicates that financial NGOs are particularly promising candidates for foreign institutions in search of a local partner. However, there are some factors that make NGOs less attractive. The weaknesses of many, though certainly not all, NGOs can be attributed to a combination of the following factors (not all of which are unique to them):

- The lack of business acumen with which some NGOs are set up and operated
- Overly ambitious aspirations with regard to their social relevance
- The limited scale of their operations, which does not permit them to benefit from elementary economies of scale
- The frequent use of donated funds or soft loans from foreign development organizations
- The influence of people who do not belong to the target group and thus are not subject to peer pressure and are not directly hurt if the institution’s money is eventually lost.

All these factors can work together to create a situation in which the business and financial side of a financial NGO is not treated with as much care as it ought to be. Nonetheless, business expertise and stability are indis-
pensable if the institution wants to have a permanent positive effect on the target group.

Another weakness of many NGOs is their lack of a longer-term perspective and strategy (or of effective business planning). The questions that a look into the future would pose are: Where will the institution stand in a few years? Will it still exist, will it collapse in the course of time, or will it survive and even prosper? How is survival possible? Will it turn away from its original target group merely to survive financially? According to available evidence and experience, for most financial NGOs to survive without losing their target-group orientation, they must first change into professional institutions and then, if desired, expand and ultimately transform their institutional structure.

Informal Financial Providers

Informal finance is probably much more important for the financial management of poor households than the provision of services by formal and semiformal financial institutions. For obvious reasons, informal finance comes in many forms and not always in one that can be called a financial institution. Some agents in informal financial markets have at least some aspect of a financial institution about them. This applies to moneylenders and money collectors—known, for example, as “susu men” in Ghana—and to the millions of rotating savings and credit associations that exist and operate in many variants and under many different names in almost every country of the developing world. Self-help groups are also a type of informal (sometimes semiformal) financial institution. It seems less appropriate to apply the term “financial institution” to traders and manufacturers who provide trade credit to their customers, and such a classification is completely inappropriate for a most important source of informal finance, namely, the network of friends and family members.

A certain degree of institutionalization and functional specialization is necessary for an entity in a developing country to be a potential partner in the context of a finance-related development project. Only very few informal institutions can play the role of a local partner. This

Box 4.10 CARE Guatemala: The Women’s Village Banking Program

CARE IS AN INTERNATIONAL NONPROFIT ORGANIZATION founded in 1946. It was created to provide assistance and development programs to the needy. In the middle to late 1980s CARE International became increasingly interested in microenterprise programs. These programs, notably microfinance, gained worldwide recognition during the 1980s, spawned in part by the success of microfinance programs such as Grameen Bank and Bank Rakyat Indonesia. While lacking expertise in this field, CARE International became interested in experimenting with microenterprise development and hired external consultants to facilitate and supervise early experiments in this area. CARE Guatemala was one of the programs selected for microenterprise development work.

While CARE Guatemala began providing health, education, and income-generating programs as early as 1959, the women’s village banking program of CARE was founded in 1989. In its short history, this program has made inroads into providing microfinance services to some of the most marginalized people in Latin America. Using a village bank methodology, the program has provided loans averaging only US$170 in 1995 to some 10,000 rural women in Guatemala.

The performance of the CARE village banking program has shown steady improvement. All indicators of outreach, cost, repayment, sustainability, and profit became more favorable during 1991–95. However, the mere improvement of these figures does not necessarily indicate that the program is on a sustainable trajectory. The program is still burdened by high overhead costs and donor dependency, which, unless rectified, will prevent it from becoming sustainable.

The village banking program represents a departure from the other humanitarian programs of CARE Guatemala. For the first time a program is bringing in revenue from the very poor it serves. Like many nonprofit organizations that enter into microfinance, dual objectives pull the village banking program in two directions. Often the microfinance programs of NGOs worldwide were created to improve the lives of the poor regardless of cost, repayment, or sustainability. As programs have proliferated and donors have become more insistent on financial performance, a secondary goal of sustainability has been introduced. Given its long-standing culture of donor dependence and subsidization, the CARE village banking program has found it difficult to unilaterally reject donor assistance and insist on complete financial sustainability.

Source: Contributed by Julia Paxton, Sustainable Banking with the Poor Project, World Bank.
is regrettable because if they could be made partners, several types of informal providers of financial services might work very well, as they are certainly able to reach the target group and their permanent existence proves that they are sustainable. But many informal arrangements, such as rotating savings and credit associations, would probably only be destabilized by efforts to enlist them as partners, because the mechanisms on which they are based depend on their unfettered informality.

The important exception to be mentioned here is self-help groups. There are many self-help groups, consisting of self-employed women who informally support the economic activities of their members by providing mutual guarantees that facilitate their members' access to bank loans, by borrowing and lending among themselves, or by encouraging each other to save regularly (box 4.11). Yet, at the same time these groups are visible or "formal" enough to establish contact with some development agencies. There are

Box 4.11 The Use of Self-Help Groups in Nepal

There are many international NGOs and government programs in Nepal that utilize local self-help groups or savings and credit cooperatives in the provision of microfinance. They provide some or all of the following services:
- Revolving funds for on-lending
- Grants to cover operating costs, including staff and other operating expenses
- Matching funds, whereby the international NGO matches (or provides a multiple of) the amount of savings collected by the savings and credit cooperative from its members
- Technical assistance, including program development, group formation, staff and client training, and financial management.

Target Market. Many international NGOs supporting savings and credit cooperatives focus on reaching the "poorest of the poor" with financial services. In addition, many specifically target women, believing that the benefits of increased economic power will be greater for women because they are generally responsible for the health and education of their children and the welfare of the community itself. However, these organizations frequently combine the delivery of financial services with social services. This often results in lower rates of repayment, because the social services are usually delivered free of charge while financial services are not.

Methodology. In programs supported by both government and international NGOs, the savings and credit cooperatives are responsible for the delivery of financial services to clients. The cooperatives use groups for lending and savings collection. Loan sizes from the cooperatives are generally small and no physical collateral is required. Instead, group guarantees are provided. The savings and credit cooperatives, with few exceptions, provide loans for relatively short terms, generally less than one year, over half for less than six months. Loan appraisal is generally done by the group with some guidance from the staff. Interest rates on loans to end-borrowers are between 10 and 36 percent, with the higher rates charged by nongovernment-funded programs. Some programs of international NGOs, particularly those providing microfinance as a minor activity, charge very low rates of interest, sometimes as low as 1 percent. Not surprisingly, repayment of these loans is very poor, because borrowers tend to view them as grants rather than loans.

Savings are usually compulsory and are required on a weekly or monthly basis. For the most part these savings cannot be withdrawn, resulting in significantly higher effective borrowing rates. Interest rates paid on these savings range from 0 percent to 8 percent, with the majority paying 8 percent. (Interest paid is usually simply added to the savings held.) Savings are often managed by the group itself, resulting in access to both "internal loans" (those made from the group savings) and "external loans" (those made by the cooperative). It is worth noting that interest rates on internal loans, which are set by the group, are often substantially higher than those on external loans, even within the same groups. This indicates that borrowers can pay higher rates of interest and do not require subsidized interest rates. It also indicates that the "ownership" of funds greatly influences the interest rate set on loans and the repayment of loans, in turn contributing to financial sustainability.

The success of savings and credit cooperatives providing microfinance services supported by government and international NGOs is greater than that of government-mandated programs that do not use the cooperatives. Experience over the past five years indicates that the savings and credit cooperatives can deliver financial services at a much lower cost than the government itself to reach the intended target market. However, these programs still suffer from high loan losses and inefficient management.

some identifiable characteristics of a good self-help group: it exhibits a high degree of coherence and strong common interests among its members; it has a democratic structure and, at the same time, a strong leadership; and empowerment of its members is an important objective.

However, development projects rarely use these groups as their main partners. Instead, some of them try to establish a network composed of various partners, including self-help groups and institutions that provide financial services to the self-help groups or their members. Only in very few exceptional cases could self-help groups of poor people with a focus on financial matters be partners in the context of projects aiming to create semiformal financial institutions such as cooperatives or NGOs.

**Institutional Growth and Transformation**

For the most part, MFIs are created as semiformal institutions—either as NGOs or as some form of savings and credit cooperative. Given these institutional structures, they are often limited by a lack of funding sources and the inability to provide additional products. Unless the MFI is licensed and capable of mobilizing deposits or has achieved financial sustainability and is thus able to access commercial funding sources, access is often restricted to donor funding. Furthermore, as MFIs grow the need for effective governance and the question of ownership arise.

For MFIs that are structured as formal financial institutions, that is, development or commercial banks, the issues of growth and transformation are not as significant. Generally, growth within a formal institution can be accommodated within the existing structure. Transformation is rarely an issue. An exception to this is when a commercial or development bank creates an MFI subsidiary, such as the Banco Desarrollo in Chile; however, this is a rare occurrence. Often formal institutions have the systems in place to accommodate this change.

The following discussion is adapted from SEEP Network 1996a and focuses on semiformal institutions and ways in which they manage their institutional growth. Three options are presented: maintaining the existing structure and managing growth within that structure; forming an apex institution to support the work of existing MFIs; and transforming to a new, formalized financial institution. This is followed by a discussion of governance and ownership and accessing capital markets—issues that arise as the MFI expands.

**Expansion Within an Existing Structure**

Depending on the objectives of the MFI and the contextual factors in the country in which it works, an NGO or cooperative may be the most appropriate institutional structure, providing the MFI can continue to grow and meet the demands of the target market. Existing structures may be most appropriate, because formalizing their institutions can require substantial capital and reserve requirements. As formal financial intermediaries, they may become subject to usury laws or other regulations that limit the MFI's ability to operate.

For example, Centro de Creditos y Capacitacion Humanistica, Integral y Sistematica para la Pequena y Microempresa, a microfinance NGO in Nicaragua, wanted to expand its microlending services (see box 4.12). It considered creating a formal bank but found that the regulatory environment in Nicaragua was not suitable. This example demonstrates how local contextual factors can constrain as well as facilitate the choice of institutional structure.

**Creating an Apex Institution**

Some MFIs, particularly those partnering with international NGOs, may choose to create an apex institution as a means of managing growth and accessing additional funding. An apex institution is a legally registered wholesale institution that provides financial, management, and other services to retail MFIs. These apex institutions are similar to apex institutions for financial cooperatives. However, in this case the MFI or more likely its foreign partner or donor determines that a second-tier organization is required to provide wholesale funding and facilitate the exchange of information and “best practices.” Rather than being member based, the apex institution is set up and owned by an external organization. Apex institutions do not provide services directly to microentrepreneurs; rather, they provide services that enable retail MFIs (primary institutions) to pool and access resources. An apex institution can:

- Provide a mechanism for more efficient allocation of resources by increasing the pool of borrowers and savers beyond the primary unit
Box 4.12 Using the Nongovernmental Organization as a Strategic Step in Expansion

**CENTRO DE CREDITOS Y CAPACITACION HUMANISTICA** (CHISPA), a program of the NGO Mennonite Economic Development Association (MEDA), targets the poorest of the economically active in the productive, service, and commercial sectors in and around the secondary city of Masaya in Nicaragua. Established in 1991, the loan fund was valued at US$740,000, with more than 3,500 active loans in 1996. The portfolio includes solidarity groups and individual clients. Fifty-eight percent of the clients are women.

In 1996 the portfolio had a 97 percent repayment rate, a 27.5 percent nominal interest rate, a cost per dollar loaned of less than 15 cents, and a 62 percent self-sufficiency level, including financial costs, with full self-sufficiency expected by mid-1997. The program’s business plan calls for scaling up to reach almost 9,000 active clients by the end of 1999, increasing the loan portfolio from US$890,000 to US$1.6 million, and developing a local institution with a legal framework that allows for credit and savings activities.

Based on these growth projections, CHISPA considered the options of forming either a bank or a credit union. While the regulatory environment for banks in Nicaragua is relatively favorable, the US$2 million paid-in capital requirement is double its current portfolio, and to be efficient a bank should be leveraged at least four or five times. Therefore, the projected scale of operations should really be about US$8 million before contemplating a bank. There is also a legal reserve requirement on savings deposits (15 percent for Cordobas accounts and 25 percent for dollar accounts), which need to be placed in non-interest-bearing accounts at the central bank.

**Source:** Bremner 1996.

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- Conduct market research and product development for the benefit of its primary institutions
- Offer innovative sources of funds, such as guarantee funds or access to a line of credit from external sources
- Serve as a source of technical assistance for improving operations, including the development of management information systems and training courses
- Act as an advocate in policy dialogue for MFIs

The experience of apex institutions has been mixed. Apex institutions that focus on providing funds to retail MFIs, often at subsidized rates, have found limited retail capacity to absorb those funds. What MFIs most often need is not additional funding sources but institutional capacity building. Furthermore, by providing wholesale funds in the marketplace, apex institutions remove the incentive for retail MFIs to mobilize deposits.

There are other potential weaknesses of apex institutions (SEEP Network 1996a):
- Vision and governance issues are made more complex by the number of parties involved.
- The level of commitment to expansion and self-sufficiency may vary among the members, affecting the pace of expansion and the ultimate scale achieved.

The commitment to market-oriented operating principles may also vary, affecting the ability of the group to operate in an unsubsidized fashion.
Differential growth rates among the partners can also strain their relationship, especially when their needs for resources and technical support widen dramatically.

- Monitoring and supervision are essential to good performance but are made difficult by the number of partners. If there are weaknesses in financial reporting and management at the primary level, these can adversely affect the second-tier operation.

- Unless both the primary institutions and the apex are efficient, the ultimate costs to the client can be high. There needs to be constant attention to issues of productivity and performance.

While there are many disadvantages to apex institutions, if structured appropriately and set up with clear and market-oriented objectives, they can add value and aid in the development of microfinance.

“For the most part, microfinance apex institutions provide more than just liquidity in the market. Usually the apex is set up when everyone agrees that there is a drastic shortage of retail capacity. The advertised objective of the apex is to foment the development of stronger retailers capable of reaching a much more substantial portion of the microfinance clientele.” (Rosenberg 1996)

Apex institutions that focus on pooling member-mobilized funds and on-lending these funds at market rates to their members represent a far better approach than those wholesaling donor or government funds. Also, apex institutions should not be creating microfinance retailers. Rather, they are most helpful when many existing MFIs participate and benefit from doing so.

Apex institutions may also be useful in the following situations (Von Pischke 1996):

Box 4.13 Catholic Relief Services: Using the Apex Model for Expansion

CATHOLIC RELIEF SERVICES SUPPORTED THE ESTABLISHMENT of the Small Enterprise Development Company, Ltd., a finance company in Thailand, to provide financial intermediation and institutional strengthening services to its NGO and (currently five) credit union counterparts implementing the village bank methodology. The company can facilitate the use of collective savings as well as attract donors and bankers. It is expected to achieve financial self-sufficiency by 1999, when it will be managing a US$910,000 portfolio and charging a 6 to 10 percent spread. In turn, the counterparts will be lending funds to 175 village banks with almost 11,000 members.

In Indonesia Catholic Relief Services is supporting the development of formal financial services at two levels: the creation of 20 subdistrict credit banks, called Bank Perkreditan Rakyats, and the formation of a national-scale limited liability company, called the Self Reliance Corporation. Catholic Relief Services' traditional target groups, the Usaha Bersamas (rural savings and credit groups), will receive financial services directly from the subdistrict credit banks. As for profit subsidiaries of Catholic Relief Services' NGO partners, the subdistrict credit banks will help them increase the clients served from 16,000 to more than 30,000 in 5 years, with loans averaging US$150. Self sufficiency of the banks is expected in 24 months. The Self Reliance Corporation will function as an Indonesian registered company and will assist with the start-up and management of the credit banks. The corporation will seek a 51 percent equity investment in all new credit banks, with the counterparts owning between 20 and 49 percent. Revenues should enable the corporation to achieve financial self-sufficiency toward the end of the third year.

In Peru Catholic Relief Services is assisting eight members of COPEME, a local consortium of enterprise NGOs, to form an Entidades de Desarrollo para la Pequena y Microempresa or finance company to serve the departments of Lima, Callao, Lambayeque, Arequipa, Piura, and Trujillo. Operating as a for-profit institution funded by commercial investments, the company will provide financing services enabling the partners to provide 20,000 loans, averaging between US$50 and US$200 and valued at US$425,000, by the end of three years.

Catholic Relief Services identifies four key attributes of these models:

- They are based on consistent involvement of experienced NGOs, which, in every case, remain key actors with significant decisionmaking power.
- All parties have demonstrated a willingness to experiment with new speculative models that take advantage of many regulatory innovations.
- They avoid the large capital requirements of the commercial bank form.
- Lending through diverse partners also mitigates risks associated with these transformations.

When they are lenders of last resort, not necessarily in situations of crisis but on the basis of cost. Retail lenders regard an apex institution as a good source of expensive funds and presumably use them sparingly and only for highly important and profitable programs.

When the apex institution fills in seasonally. Agricultural-based retail lenders might want to borrow seasonally as a means of managing cash flow. Again, the funds should not have to be provided by the apex institution at anything less than commercial rates.

When the apex institution becomes a shareholder in the retail MFIs, in the expectation that this would provide an attractive overall return. In this case the apex institution would expect to add value by providing expertise and oversight as well as funds in the form of equity and quite possibly debt.

When retail lenders are not permitted to take deposits. Apex institutions could then play a useful role if they added value through their terms and conditions and behaved commercially.

An apex institution appears to be most successful when a critical mass of strong MFI retailers already exists and when it is focused on working with existing formal financial institutions that are “downscaling” to meet the demands of low-income clients. (For further information about apex institutions, see Gonzalez-Vega 1998.)

Creating a Formal Financial Intermediary

Recently the field of microfinance has focused on the transformation of financial NGOs into formal financial institutions. This approach involves the transfer of the NGO’s or cooperative’s operations to a newly created financial intermediary, while the original institution is either phased out or continues to exist alongside the new intermediary. In most cases, the original MFI’s assets, staff, methodology, and systems are transferred to the new institution and adapted to meet the more rigorous requirements of a financial intermediary. Various means may be established to determine a transfer price for the assets and operations of the NGO or cooperative to the new entity. It is imperative, however, that the transfer price mechanism be transparent (box 4.14).

The rationale for developing a formal financial institution is compelling: the potential to access both savings and commercial funding may help solve an MFI’s funding constraints and increase its ability to provide additional financial services to the target market. However, creating a formal financial institution also implies additional costs and restrictions as the MFI becomes regulated and supervised (see chapter 1). Capital requirements may be much higher than anticipated, and unless the MFI has reached financial self-sufficiency it will be difficult (and costly) to attract equity investors and commercial debt (see the section below on accessing capital markets). And finally, the MFI must develop the institutional capacity to manage a number of different products and services, mobilize resources (both debt and equity as well as human resources), and enhance management information systems to adhere to regulatory reporting requirements and manage additional products (see the section below on institutional capacity building). While transformation may seem like an ideal path, MFIs should consider the substantial changes that are required when transforming to a formal financial institution. They must also thoroughly examine their institutional capacity and determine if it meets the requirements for transformation (Appendix 1 provides a framework for conducting this analysis).

The costs to convert into a formal financial institution are often exceedingly high: they include feasibility and pre-start-up work, capital requirements, as well as the changes in management and systems that must be implemented. Each MFI must consider the various types of formal institutions described above and determine which one best suits their needs (box 4.15). For example, PRODEM’s choice of the commercial bank model for BancoSol was due to its great leverage potential and ability to offer savings and other financial products, matched by the right combination of political and financial support. On the other hand, Accion Comunitaria del Peru and COPEME, an association of NGOs partnered with Catholic Relief Services, decided to establish finance companies in accordance with special legislation supporting these forms. Although unable to capture savings, these structures do provide regulated vehicles that have leverage potential and can begin operations with lower capital (SEEP Network 1996a).

Finally, if an NGO in the transformation process remains a separate institution, the two organizations (the NGO and new financial intermediary) must develop a working relationship that benefits both parties and that solidifies the bridge between them. Some useful bridging
Box 4.14 Transformation from a Nongovernmental Organization to Financiera Calpia

IN 1988 THE GERMAN AID INSTITUTIONS CREATED A ROTATING credit fund for the Association of Micro and Small Entrepreneurs (AMPES) of El Salvador. The objective of this project was to improve the supply of credit for small business people on a lasting basis. Plans were made with the association to create a stable and professional institution that could ultimately be transformed into a small target-group-oriented formal financial institution.

From the beginning, credit operations were organized separately from the association's other business, both to assure professionalism and also to limit undue personal influence. While the association was the owner of AMPES-Servicio Crediticio, it did not run the operations. Also, the donor institutions insisted that the purchasing power of the fund be maintained. Accordingly, interest rates were set at an unusually high level (effective rates between 25 percent and 40 percent). Finally, strict lending policies were implemented and a system of financial incentives for loan officers was created, which kept loan losses below 1 percent.

With external funding from the Inter-American Development Bank the loan portfolio and the number of borrowers doubled every year. At the end of 1996 the number of borrowers was around 20,000 and the loan portfolio had grown to the equivalent of US$14 million. During this phase of rapid growth, the fund was transformed into Financiera Calpia, a small, strictly targeted group-oriented formal bank. The transformation was undertaken with the full support of the Association of Micro and Small Entrepreneurs, which, through its Fundación Calpia, is now the main shareholder of Financiera Calpia. The other shareholders are local and international development institutions.

Transformation and formalization were necessary for two reasons. To satisfy the high demand for small and very small loans, the institution needed the right to accept savings deposits from its customers and to have access to the interbank market. And because of the challenges and dangers of the extremely dynamic expansion of its operations, the institution needed—and wanted—the increased stability and tighter control that the new status provides by making Calpia still more independent from the association and putting it under the formal control of the superintendency of banks.

Currently, Calpia is the most important specialized lender to the small business community of El Salvador. It has opened eight branches to date. Because of its high positive (inflation-adjusted) return on equity and its institutional stability, other banks in the country regard it as highly credit worthy, improving the availability of loan funds to on-lend to the target population.

Source: Contributed by Reinhard Schmidt, Internationale Projekt Consult GmbH (IPC).

Box 4.15 Catholic Relief Services' Guatemala Development Bank

CATHOLIC RELIEF SERVICES' PARTNER IN GUATEMALA, Cooperative Association for Western Rural Development, is planning to establish a development bank, because its organizing principles are more amenable than a commercial bank to the social development mission that the association supports. This mission involves:

- A focus on the very poor, the core constituency of Catholic Relief Services and its partners
- An emphasis on savings
- Accessibility for NGOs and popular organizations in terms of the initial investment requirements and administrative operations
- Easy replicability.

This last characteristic is seen as essential both to support rapid scale-up and to encourage diversification rather than financial concentration.


Mechanisms include the following (SEEP Network 1996a):

- Overlapping directorates
- Cost sharing of head office functions, branch space, insurance, and so forth
- Joint resource mobilization, with the NGO attracting the social investment capital that the financial intermediary may not qualify for directly
- Coordinating policies for product development, target areas, and populations.

Governance and Ownership

MFIs, particularly those set up as financial NGOs, are often formed by a visionary. These visionaries are not usually interested in profits but rather have a social objective to improve the lives of low-income members of their community. Only after the MFI begins to grow does the visionary reach the conclusion that the MFI needs to adopt a more business-like approach. This is
often the result of limited donor funds, demands on the target market, and a general shift in the field of microfinance toward formalized institutions.

As the MFI grows and management systems are developed, the need for governance arises to ensure effective management of the MFI and, potentially, to attract people with much-needed skills (usually from the private sector). While governance does not always result in a change of vision for the MFI, it does establish a means of holding management accountable. Furthermore, as the MFI grows the issue of ownership becomes apparent. This is particularly important as the MFI begins to create a more formalized structure.

**Governance.** (Adapted from Clarkson and Deck 1997.) Governance refers to a system of checks and balances whereby a board of directors is established to oversee the management of the MFI. The board of directors is responsible for reviewing, confirming, and approving the plans and performance of senior management and ensuring that the vision of the MFI is maintained. Management is responsible for the daily operations of putting the vision into action.

The basic responsibilities of the board are:

- **Fiduciary.** The board has the responsibility to safeguard the interests of all of the institution's stakeholders. It serves as a check and balance to ensure the MFI's investors, staff, clients, and other key stakeholders that the managers will operate in the best interest of the MFI.
- **Strategic.** The board participates in the MFI's long-term strategy by critically considering the principal risks to which the organization is exposed and approving plans presented by the management. The board does not generate corporate strategy but instead reviews management's business plans in light of the institution's mission and approves them accordingly.
- **Supervisory.** The board delegates the authority for operations to the management through the executive director or chief executive officer. The board supervises management in the execution of the approved strategic plan and evaluates the performance of management in the context of the goals and time frame outlined in the plan.
- **Management development.** The board supervises the selection, evaluation, and compensation of the senior management team. This includes succession planning for the executive. In the transition from a small, growing entrepreneurial organization to an established institution, effective governance ensures that the company survives. Governance moves an institution beyond dependency on the visionary.

The board should comprise members who have a number of different skills, including financial, legal, and managerial. In particular, representation from the private sector is important. Also, the ability to critically analyze management's plans as well as provide effective guidance is paramount when selecting a board. An MFI must define the following:

- The role of board members both within the board and with regard to external alliances
- The desired areas of expertise
- The existence of committees to oversee specific areas of operation
- Term limits for board seats
- The process for replacing board members
- The role of the executive director in selecting board members
- The optimum number of board members
- Mechanisms to evaluate the contribution of individual members.

Board members must be provided with and agree to clear and common objectives. Furthermore, it is important that members be independent from the MFI and be chosen for their expertise rather than their own interests or political agendas or those of the senior management. Board members should act in such a way that they create accountability and enable stakeholders to trust one another. Governance gives shareholders, donors, governments, and regulators confidence that managers are being appropriately supervised. Thus board members should not receive any personal or material gain other than the approved remuneration.

**Ownership.** (Adapted from Otero 1998.) It is the owners of the MFI that elect (or at times compose) the governing body of the institution. Owners, through their agents on the board, hold management accountable. Ownership is an important but often nebulous issue for MFIs, particularly as many are funded with donor contributions.

Neither formal financial institutions nor NGOs have owners per se. Formal MFIs have shareholders who own shares that give them a residual claim to the assets of the MFI if there is anything remaining after it has discharged all of its obligations. Shareholders have the
right to vote their shares to elect board members, who in turn control the company. Having shareholders results in clear lines of accountability between the board members and the MFI.

NGOs do not generally have shareholders; rather, management usually elects the board members. This can (but does not always) result in a conflict of interest if management selects board members who will conform to the interests of senior management. Furthermore, NGO board members do not usually fulfill the board’s fiduciary role by assuming responsibility for the institution’s financial resources, especially those provided by donors.

As MFIs formalize their structures (that is, change from being an NGO into a formal financial institution) and begin to access funding beyond the donor community, the “owners” or those that have a financial stake in the institution can change. If the NGO remains as a separate entity, it often owns a majority of the shares of the new institution. In spite of this majority ownership, it is important that the relationship between the MFI and the NGO be kept at arm’s length and include a transparent and clear system of transfer pricing.

“Owners” of formalized MFIs can generally be divided into four categories:
- NGOs
- Private investors
- Public entities
- Specialized equity funds.

All of these owners are concerned with receiving an adequate return on their investment. However, NGOs and public entities may have other priorities as well. For example, they may be concerned with a social return or positive impact in the lives of the clients (table 4.2).

Owners may be heavily involved in the operations of the MFI or may take on a more passive role. Owners that play a more active role must have adequate skills and the ability to spend the time required. Owners are often also called upon to access additional capital, par-

***Table 4.2 What Is at Stake for Microfinance Owners?***

<table>
<thead>
<tr>
<th>Nongovernmental organization</th>
<th>Private investors</th>
<th>Public entities</th>
<th>Specialized equity funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moral responsibility</td>
<td>Return on investment</td>
<td>Political concern</td>
<td>Return on investment</td>
</tr>
<tr>
<td>Institutional mission</td>
<td>Capital preservation</td>
<td>Entry into the field</td>
<td>Institutional mission</td>
</tr>
<tr>
<td>Return on investment</td>
<td>Sense of social responsibility</td>
<td>Return on investment</td>
<td>Long-term concern</td>
</tr>
<tr>
<td>Long-term concern</td>
<td></td>
<td>Good project</td>
<td></td>
</tr>
<tr>
<td>Institutional creditability or image</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Otero 1998.
ticularly equity capital. As owners they may wish to maintain their stake as the MFI grows and takes on additional capital. This implies that they also must have continued access to capital.

**Accessing Capital Markets**

The majority of MFIs fund their activities with donor or government funding through grants or concessional loans. However, it is becoming evident that donor funding is limited. As MFIs expand and reach a critical stage of growth, they find that they cannot sustain their growth with only donor support. Some are beginning to access capital markets. There are various ways that an MFI can access new capital, including:

- Debt accessed through guarantee funds, loans, and deposit mobilization
- Equity
- Equity investment funds
- Socially responsible mutual funds
- Securitization of the loan portfolio.

**Accessing Debt.** For the most part it is necessary to be financially self-sufficient to access commercial sources of funds. However, with the backing of guarantees by donors or international NGOs, some MFIs, if they earn enough revenue to at least cover their cash costs, may be able to leverage their donor funds with commercial loans in amounts equal to the donor funds.

**Guarantee funds** are financial mechanisms that reduce the risk to a financial institution by ensuring repayment of some portion of a loan (adapted from Stearns 1993). Guarantee funds are used to encourage formal sector bank lending to the microenterprise sector. They can be used to guarantee a loan made by a commercial bank to an MFI, which then on-lends funds to its clients, or loans from a bank directly to microentrepreneurs. There are three types of guarantee funds that cover the risks of making loans. These risk-related design features are some of the most important determinants of the acceptance and use of a guarantee mechanism by banks. They are guarantees covering:

- A percentage of the loan principal
- A percentage of the loan principal and the interest lost
- A certain amount of the loan (say, the first 50 percent).

By reducing risk and transaction costs faced by the financial institution, guarantee funds can function as “research and development” for commercial lenders considering entry into a new market (either lending to MFIs or directly to clients). Guarantee funds are usually designed to leverage resources. For example, a guarantee fund of US$5 million may encourage banks to lend US$10 million to microentrepreneurs, thereby leveraging the fund’s resources by a factor of two to one. The more effective the guarantee mechanism the higher the leverage factor becomes (the guarantee fund backs an increasingly large loan portfolio). Ultimately, the aim is to gradually transfer the risk from the guarantee mechanism to the participating financial institutions.

For example, ACCION’s Bridge Fund provides its NGO affiliates with access to commercial loans that they otherwise might not have. The Bridge Fund puts cash deposits, securities, or letters of credit with commercial banks, which in turn on-lend to the NGO affiliate at market rates. Eventually, some affiliates have been able to borrow directly without the use of the guarantee scheme.

However, the costs of guarantee schemes must be considered relative to the benefits (box 4.17). Vogel and Adams (1997) claim that there are three categories of costs that accompany loan guarantee programs: the costs of setting up the program, the costs of funding the subsidy needed to energize and sustain the program, and the additional cost incurred by the financial system of running and participating in the guarantee program. The benefits of a loan guarantee program are the additional lending induced by the transfer of part of the lender’s risk to the guaranteeing organization. Both borrowers and society benefit from the increases in net income realized by borrowers. Vogel and Adams suggest that the benefits are hard to measure, because it is difficult to determine if the guarantee scheme resulted in true additionality (that is, additional lending to the target market). Furthermore, substitution can also occur whereby the bank simply transfers part or all of the qualifying portion of its existing loan portfolio to the guarantee programs or to an NGO, in this way benefiting from the subsidized guarantee program that takes borrowing clients away from other NGOs not benefiting from the subsidies.

At the very least, few guarantee schemes are financially sustainable without some form of subsidy. However, they appear to be more beneficial than direct subsidies to clients. (For further information on guarantee schemes for microenterprises see Stearns 1993, and on guarantee...
schemes for small and medium-size enterprises see Gudger 1997; Levitsky 1997).

As an MFI continues to expand and eventually reaches financial self-sufficiency (revenue earned covers all costs, including inflation and an imputed cost of capital; see chapter 8), its ability to leverage its equity (donor funds and retained surpluses) increases. If it becomes a formally regulated financial institution, it can achieve leverage ratios of up to 12 times its equity by borrowing directly from commercial sources or mobilizing deposits (if regulated to do so). However, mobilizing savings requires substantial changes to the MFI, which are discussed fully in chapter 6.

An MFI is ready to access commercial financing when it has built an equity base through past donor grants and has a positive net worth (see box 4.18).

**Box 4.17 Guarantee Scheme in Sri Lanka**

The guarantee scheme in Sri Lanka was started in 1979 and operated by the central bank. The scheme covered 60 percent of the loan amount and was instituted as an incentive for the commercial banks to participate in the credit line channeled through the National Development Bank, financed by the World Bank.

Between 1979 and 1995 the World Bank approved four loans for small and medium-size enterprises for a total of US$105 million. Repayment rates on the subloans given from the first two World Bank loans were low (70–73 percent), but this improved significantly to more than 90 percent in the later bank loans.

In the earlier years of operation claims were high—7 percent of guarantees claimed in 1979–80 and 13 percent in 1982–85. Substantial changes were made and claims dropped to 2 percent in 1991–95.

In 1979–96, 18,500 guarantees were given, and there were subsequently 696 claims for guarantee payment (89 rejected and 417 paid out) up to the end of 1994, for a total of US$1.36 million. Outstanding guarantees for which the central bank has a contingent liability were estimated at a maximum total claim of US$0.88 million. The actual and potential total loss on guarantees paid on bad debt was US$2.2 million. With 18,850 guarantees this was a cost to the state of US$118 per entrepreneur assisted. This amount was estimated to be more than offset by additional tax generated.

**Box 4.18 Key Measures for Accessing Commercial Financing**

MFIs are ready to access commercial financing if they:

- Have perfected their service delivery methods and product design to respond to the demands of their market in a rapid and efficient way, ensuring an increased volume of operations and repeat borrowing
- Have a strong sense of mission and a sound governing structure that is free from political interference, so that they can make policy decisions that protect their financial health
- Have a management team that focuses on efficient service delivery and productivity, on profits rather than volume, and sets productivity goals and incentive schemes
- Have information systems that produce clear, accurate, timely, and relevant information for management decisionmaking and that focus on well-developed loan tracking and financial reporting systems, reporting on costs and income both on a profit-center basis and for the MFI as a whole
- Have a record of achieving high levels of financial performance, of incorporating appropriate pricing policies based on the full cost of delivering the services, and of maintaining the value of donated equity
- Maintain low levels of delinquency (well below 5 percent to 8 percent of outstanding portfolio, with loan loss rates below 2 percent) to ensure optimum income and prevent asset erosion.

Source: Clark 1997.
Box 4.19 Accessing Capital Markets by Issuing Financial Paper

Issuing financial paper refers to a formal IOU given by the MFI to investors in exchange for their funds. Financial paper is issued with a fixed date on which the debt will be paid (maturity) and a preestablished interest payment (yield). The financial market then evaluates the paper in terms of yield versus risk, comparing it with every other investment opportunity available. To succeed in the financial market an MFI must offer at least an equally attractive yield to alternatives that are perceived to have the same level of risk. Accordingly, for a new entrant in the market whose risk profile is unknown, a higher yield may be necessary.

Establishing the correct risk is especially important for an MFI operating in an industry that is itself unknown. For example, in 1994, when ACCION was placing paper issued by BancoSol to North American financial institutions, investors began with an expectation of returns reflecting both country and venture capital risk. While Bolivian country risk was unquestionably a relevant consideration, ACCION argued successfully that the appropriate business risk, instead of being compared to venture capital, should reflect a methodology proven by microlending activities deployed since 1987 by BancoSol’s predecessor, PRODEM. This long track record of success is evidenced by a consistent historical loss record of less than 1 percent of portfolio. On that basis the yield offered by BancoSol paper was highly attractive relative to its real rather than perceived risk.

It is not necessary to become a regulated financial institution before issuing financial paper. For example, in 1995 the ACCION affiliate in Paraguay, Fundación Paraguaya de Cooperación y Desarrollo, as an NGO issued 350 million guaranies in debt through the Asuncion Securities Exchange.

In addition, it may not even be necessary for the issuing institutions to be 100 percent financially self-sufficient to issue paper, although it is clearly preferable, as in the case of the Grameen Bank in Bangladesh. In the debt market it is possible to find buyers as long as there is the firm expectation that the cash flow (whether generated by operations or donations) is sufficient to service the debt.

Source: Chu 1996b.

be some time before equity investors play an important role in the funding mechanisms of MFIs. However, some equity investment funds are being developed specifically to invest in growing, sustainable MFIs.

Box 4.20 ProFund—an Equity Investment Fund for Latin America

ProFund is an investment fund incorporated in Panama and administered from Costa Rica. It was created to support the growth of regulated and efficient financial intermediaries that serve the small business and microenterprise market in Latin America and the Caribbean. It operates on a profit basis, providing equity and quasi-equity to eligible financial institutions so that they can expand their operations on a sustainable and large-scale base. By supporting the growth of efficient intermediaries, ProFund aims to achieve superior financial returns for its investors through long-term capital appreciation of the MFIs in which it invests.

At the end of 1997 ProFund was capitalized by a group of 16 investors who have subscribed a total of more than US$222 million with 63 percent of the capital paid in


Equity Investment Funds. Equity investment funds provide equity and quasi-equity (subordinated debt) to selected organizations. ProFund is one such investment fund that was set up for the sole purpose of investing in expanding MFIs in Latin America (box 4.20). Efforts

(ProFund Internacional 1996–97). ProFund’s sponsors (original investors) are Calmeadow, ACCION International, FUNDES (a Swiss foundation), and Société d’Investissement et de Développement International (SIDI), a French NGO consortium. Other investors include the International Finance Corporation, the International Development Bank’s Multilateral Investment Fund, and the Rockefeller Foundation.

By 1997 ProFund had made seven investments, with total commitments of US$12.2 million. MFIs invested in include Accion Comunitaria del Peru, Banco Empresarial (Guatemala), BancoSol (Bolivia), Banco Solidario (Ecuador), Caja de Ahorro y Prestamo Los Andes (Bolivia), Finansol (Colombia), and Servicredit (Nicaragua).
are under way to establish similar funds in Africa and Asia.

**Socially Responsible Mutual Funds.** There are two types of socially responsible mutual funds: screened and shared-return funds. With screened mutual funds, managers screen companies for social criteria. Profits are paid to shareholders who choose to invest in these funds because they want to support socially responsible companies. The Calvert Group mutual fund is an example of a screened mutual fund (box 4.21).

Shared return funds are mutual funds owned by member organizations (MFIs). Shareholders agree to donate (share) a percentage of the return to the member organizations. DEVCAP (Development Capital Fund) is an example of a shared mutual fund owned by MFI member organizations (box 4.22).

**Securitization.** Securitization links microfinance institutions to capital markets by issuing corporate debentures backed by (and serviced by) the MFI’s portfolio (adapted from Chu 1996a). The structure requires the creation of a single purpose corporation, which buys the microenterprise portfolio and capitalizes itself by issuing debentures into the capital market.

The purpose of creating a single purpose corporation is to acquire the microenterprise portfolios of known entities without taking on other risks. The equity of the single purpose corporation comes from the microfinance organization and its partners. The single purpose corporation uses its funds to purchase the portfolio from an MFI, which it does at a discount—that is, for less than its face value. The amount of discount is based on the quality of the portfolio. For example, if the single purpose corporation purchases US$105 of portfolio for only US$100, the additional US$5 is held in a reserve to protect the corporation against any portfolio losses. This reserve amounts to roughly 5 percent of the portfolio. In this case the historic rate of default must be lower than 5 percent and likely less than 2 percent (the reserve should be greater than the historic loan loss to provide comfort for investors). In addition, the single purpose corporation has substantial equity so anyone who buys paper issued by it is highly protected.

The single purpose corporation then sells commercial paper through its financial partner, a leading brokerage firm in the local financial market. For securitization to succeed, the partner must be significant and well respected with an established network of buyers. The partner receives a management fee and an investment banking fee.

The object of securitization is to increase the availability of funds and, at the same time, reduce the cost of funds. Grameen Bank and ACCION International and its affiliate, the Fundación Ecuatoriana de Desarrollo (FED) in Ecuador, are two MFIs that are either consider-

**Box 4.21 The Calvert Group—a Screened Mutual Fund**

One to 3 percent of the Calvert Group’s assets are invested in “high social impact” instruments such as MFIs. Eligible institutions must have loan capital of at least US$300,000 from diverse sources and demonstrate the need for more capital. The cost of borrowing by the MFIs is generally below market rates by 3 percent or 4 percent. Renewable loan terms are for one year, and the average loan amount is US$100,000. Investors risk receiving a lower return than from other mutual funds, depending on the success of the overall investment strategy of the fund.

*Source: Calvert Group.*

**Box 4.22 DEVCAP—a Shared-Return Fund**

DEVCAP (Development Capital Fund) is a mutual fund designed to provide financial returns to its investors as well as provide its members with revenue. DEVCAP represents a consortium of MFIs that invested initial capital to develop an asset base for the fund. Additional capital is provided by public investors. The assets of the fund are invested in a leading socially screened portfolio (social equity portfolio) based on the Domini Social Index, which consists of the stocks of approximately 400 U.S. companies chosen for their corporate and social responsibility as well as their financial performance. The return earned on the investments is shared between the investor and DEVCAP. The tax-deductible donation made by the investor ranges from 50 percent to 100 percent of the return earned.

The return earned by DEVCAP is shared among its member MFIs. Members include Appropriate Technology International, Catholic Relief Services, Save the Children, and the Seed Capital Development Fund.

*Source: Development Capital Fund.*
ing or have successfully achieved securitization of their portfolios. (For an explanation of the structure that FED used for securitizing its portfolio, see Chu 1996a.)

Because both debt and equity represent a willingness to accept financial risk, the fundamental factor that determines the sustainability of access to capital markets is the institution’s credibility as perceived by investors, whether they are lenders or shareholders. To link with capital markets MFIs must provide clear and solid answers to such critical questions of governance as (Chu 1996b):

- Can MFIs that are NGOs or have NGO owners provide financial markets with the assurance that they will make decisions with the same standards of prudence as enterprises that have traditional shareholders with commercial monies at risk?
- Will NGOs be able to resist the temptation to let nonfinancial considerations—whether lofty or base—overwhelm return considerations, because, in the absence of commercial shareholders, they are ultimately accountable only to their institutional mission?
- Can boards of directors of NGOs effectively control management?
- Will donor agencies be able to distinguish between those NGOs that can live up to the required standards and those that cannot?
- In some cases, particularly in Asia, clients become shareholders as part of the methodology. Will such atomized owners be able to participate in a meaningful way, and, if so, will the cumulative effect of minuscule portions of ownership lead to commercially sound results?
- Will NGOs that have generated their equity through grants and donations be able to exhibit the same discipline and rigor as a private investor? For example, can an institution like ACCION invest in BancoSol with funds provided by donor agencies and behave like a commercial investor?

Answers to these questions will become apparent as the field of microfinance grows and more MFIs begin to access capital markets.

**Institutional Capacity Building**

Regardless of institutional type and ways of managing growth, all MFIs need to periodically review their institutional capacity and consider where they might make improvements. For more formalized institutions this may require a greater focus on client needs through improved product development and human resource management. For NGOs this may include the adoption of a formal business planning process, improved financial and productivity management, and new funding sources.

Since the purpose of this handbook is to improve the institutional capacity of MFIs, it is useful to briefly highlight the institutional capacity issues that many MFIs are facing and to identify where these issues are addressed in this and following chapters.

Institutional capacity issues include (SEEP Network 1996a):

- **Business planning.** An MFI needs to be able to translate its strategic vision into a set of operational plans based on detailed market and organizational analysis, financial projections, and profitability analyses. Appendix 2 provides an outline for business planning.

- **Product development.** An MFI must be able to diversify beyond its original credit products (usually individual, solidarity group lending, or both) into other areas such as savings, which can provide desired services to clients and accommodate their growth. An MFI must also be able to price its products on the basis of operating and financial costs and demand in the marketplace. This requires periodic review to ensure appropriate pricing. (For more on the development and pricing of credit and savings products, see chapters 5 and 6 respectively.)

- **Management information systems.** As MFIs grow one of their greatest limitations is often their management information system. It is imperative that an MFI have adequate information systems for financial and human resource management. For example, establishing an effective incentive system depends critically on the existence of a good management information system, which then allows management to track the various indicators of performance that it wants to reward. (For a more detailed discussion of management information systems, see chapter 7.)

- **Financial management.** Improvements in accounting and budgeting are often required to monitor loan portfolio quality, donor subsidies, and the growing volume of operations. Additional skills are required in:
  - The adjustment of financial statements for subsidies and inflation
- Portfolio risk management, including appropriate risk classification, loan loss provisioning, and write-offs
- Performance management, including profitability and financial viability
- Liquidity and risk management, focused on effectively administering portfolios largely based on short-term loans
- Asset and liability management, including appropriate matching of amortization periods in relation to the loan portfolio and asset management and capital budgeting processes that are inflation sensitive.

(For a discussion of financial management see chapters 8 through 10.)

Efficiency and productivity enhancement. MFIs must be able to operate in a way that best combines standardization, decentralization, and incentives to achieve the greatest output with the least cost. They must also develop systems for staff recruitment and selection, compensation, training, and motivation to support staff commitment and accountability. (For further information about efficiency and productivity enhancement see chapter 10.)

The credit unions in Guatemala present a good example of the importance of periodic reviews and a focus on institutional capacity building (box 4.23).

Appendix 1. MFI Operational Review

The following outline is from SEEP Network 1996b and was developed by Calmeadow, Toronto, Canada.

Definition

The operational review is a tool used to evaluate the institutional maturity of a microfinance organization. An operational review helps an NGO planning to transform into a self-sufficient microfinance intermediary to evaluate its readiness. This tool draws on lessons from the formal banking sector, from Calmeadow's own observations working with microfinance institutions, and from recent publications on institutional development.

Box 4.23 Credit Unions Retooled

In mid-1987 the U.S. Agency for International Development contracted the World Council of Credit Unions to provide technical and financial assistance to the National Credit Union Federation. During the course of the project a major restructuring of the Guatemalan credit union movement took place. New financial tools and disciplines were developed and tested in 20 community credit unions nationwide. Their use transformed the credit unions into modern, effective financial intermediaries, capable of competing in commercial financial markets.

Guatemalan credit unions had followed a traditional development model for 25 years. This model was based on the theory that the rural poor lacked the resources necessary to save and thereby fuel their development potential. International donors responded to the lack of local resources by providing credit unions with external capital at subsidized rates for on-lending to their members. Loan sizes were based on a multiple of the amount of shares a member held in the credit union rather than on the member's repayment capacity. Shares earned very low returns, so the only purpose in saving was to access a loan. The traditional model discouraged saving, encouraged borrowing, and forced those who saved to subsidize those who borrowed. Over time, the response of many members was to find a way to borrow-out their share savings with no intention of ever repaying the loan.

In the new model created through the project, the focus was shifted from share savings to voluntary deposits with a competitive rate of return. Subsidized external financing was eliminated, and because all funding came from internally mobilized deposits, loans were priced based on market rates. Loan approvals were based on the repayment capacity of the borrower. Earnings were capitalized rather than distributed to members, so that the credit unions' capital maintained its value. The credit unions undertook a market-based, results-oriented business planning process. And finally, improved financial reporting control and evaluation was instituted through intensive training.

While the process was slow and difficult and required significant changes in the attitudes of elected leaders, employees, and the member-owners, the result was greater financial independence, stronger and safer credit union operations, and superior, member-driven financial services.

Source: Richardson, Lennon, and Branch 1993.