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FINANCE for the POOR

Commercial Microfinance: The Right Choice for Everyone?

BY HEATHER CLARK
Microfinance Advisor

For many, the term commercialization of microfinance conjures up images of cold-hearted bankers working with people they do not understand. Yet over the past decade, the commercial approach to microfinance has gained momentum and has shown results beyond what was believed possible in the early 1990's. The Asian region has a long history in the practice of commercial microfinance. It is also a region where considerable challenges to adopting a commercial approach to microfinance remain.

I. What is commercial microfinance?

Microfinance services are provided by commercial organizations that are part of the formal financial system—banks, credit unions, specialized banks, and a range of nonbank financial institutions that operate with special licenses generally as part of a tiered regulatory framework under the banking law. These organizations are financed by commercial capital—deposits, commercial borrowings, bond issues, and private and public shareholder equity.

Commercialization implies a transition to the marketplace. An organization that was not originally a business has now become one; products and services that were not provided by a business are now provided by one. Nongovernment organization (NGO) transformations and "downscaling" commercial banks feature prominently here.

Commercialization of microfinance has also come to mean non-commercial organizations acting in a more business-like fashion, covering the full cost of delivering the services, even if they do not intend to source commercial capital. Their commercial strategy is capitalization through retained earnings.

Commercial microfinance is more than an increasing number of retail organizations. Support institutions, policy-making bodies, and a legal and regulatory framework are critical for making financial markets work for the poor. New players appear on the scene and others take on roles that build capacity and enhance transparency. They include technical networks, banking associations, rating agencies, and supervisory bodies.

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Commercial Microfinance

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II. Outreach to the Poor and Commercial Microfinance: Drift or On-course?

A discussion of commercial microfinance would not be complete without meeting head-on one of the most controversial issues in the region. Can commercial microfinance reach and continue to reach the poor? Is it "high-minded" now that it has found the "right" business approach? Is there mission drift, suggesting that once a not-for-profit NGO transforms into a commercial entity it will leave behind it's traditional customers—poor borrowers?

Mission drift implies that no one is in control. Going upmarket is not automatic, nor is it without risk; it is a strategic choice that commercial microfinance providers make by weighing the risks and their capacity to manage them. There are cases where microfinance institutions (MFIs) have chosen to position themselves in the higher end of the small and microenterprise lending market as a deliberate growth strategy. There are, however, an equal number of cases where the reverse is true. And it is here as a field, where we can learn a great deal from these early adopters of a commercial approach to microfinance that will allay some of the fears of the market.

The preponderance of evidence in Asia suggests that after transformation to a commercial entity, outreach is greater in absolute numbers, broader-reaching new customers with diverse products and services, and, deeper-reaching areas and people previously excluded from any financial service. Analysis of pre- and post-transformation performance of MFIs in the region also indicates that depth of poverty outreach appears to increase (Fernando 2004; White and Campion 2002; Gibbons and Meehan 2000).

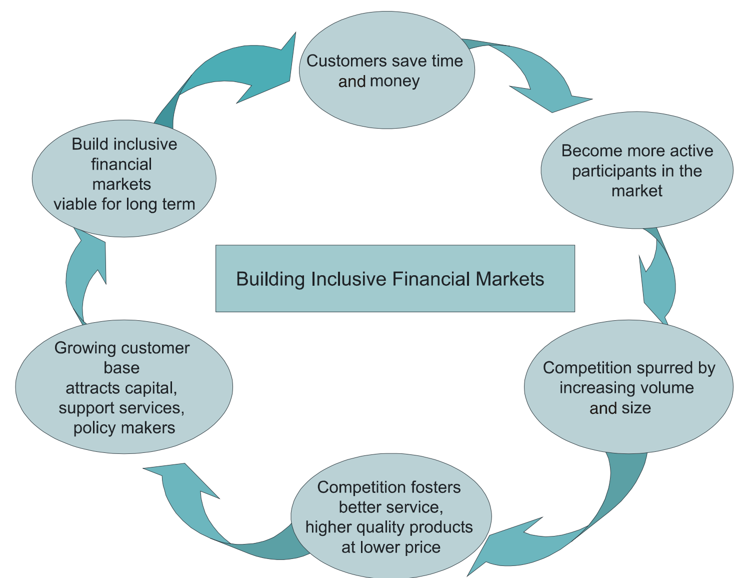
Maintaining Traditional Business: Lending to the Poor

Lending to the poor is an institutional choice for a commercial provider of microfinance. If an organization's original target market was poor and low-income people, it tends to expand in that market, while venturing outward to others. Recent studies indicate some institutions will choose to go upmarket as part of a growth strategy (von Stauffenberg 2001) and some privately chartered commercial banks will have little interest in serving the market or the staying power to adapt the sophisticated technologies needed to support a microfinance operation (Valenzuela 2002).

The evidence suggests that the majority of microcredit NGOs have not left their original market behind once they transform to commercial organizations—quite the contrary. They have greatly expanded traditional products to their existing customer base and continued to lend to their original markets at an increased pace and breadth (Fernando 2004).

From a strictly business perspective: Why leave a profitable market? Why leave a market that the institution has taken years to build? Why abandon quality products, technologies, and staff capacities that have been developed, at significant cost, to serve this market? The management of many transformed NGOs would confirm that it does not make sense to leave their original market behind.

Figure 1: Commercial Microfinance Builds Inclusive Financial Markets



Building Markets: the Inclusive Financial Sector

A commercial approach to microfinance innovates in the marketplace by building financial markets for poor people. Customers save time and money and become more active consumers of financial services. Spurred by growing demand and competition, new products and services are developed for this market segment, which attract new customers. More customers and a larger volume of transactions attract capital, key support services, and other stakeholders to a growing business sector that can no longer be ignored.

Commercial microfinance operates within the financial system as a good corporate citizen, subject to the "rules of the game." As many of the rules of the game and support mechanisms are set up along with the development of commercial innovations, operating environments conducive to commercial microfinance show a strong interaction among microfinance professionals, banking authorities, policy makers, and other institutions within the society—the legal system, educational system, institutions, networks, associations, information agencies that enhance operations and transparency such as audit firms, credit bureaus, and rating agencies.

The development of commercial microfinance brings with it new and decidedly different roles for donors and governments. Attention is focused on market support mechanisms and building conducive operating and policy environments—not financing retail credit operations. Donors and governments look for ways to support the smooth functioning of market support mechanisms and attract commercial capital—not undermine it with short-sighted political objectives and funding imperatives. Together, commercial organizations and their stakeholders build financial markets that include poor people and respond to them as valued customers.

III. Adoption and Diffusion of Innovation: Early Adopters, Fence-Sitters and Rejecters of the Commercial Approach to Microfinance [1]

The initial innovators of a commercial approach to microfinance are some of the best performing MFIs in the world today. They worked together with the banking authorities, investors, and other key players in the financial sector to influence the way the financial system works at a very profound level. The initial innovation for a commercial approach to microfinance came from the microfinance institutions themselves—those that experienced a constraint on growth due to a lack of available capital. It is doubtful that a market leader can change a financial system on its own. It is equally unlikely that the policy environment alone, without the initial innovators, would have spurred much development in addressing the gap between the supply and the demand for microfinance services in many countries.

Lessons from the Early Adopters

Following quickly in the footsteps of the innovators in the field were the early adopters. The early adopters embraced the principles of commercial microfinance and changed practices to reflect them. Early adopters include microfinance organizations, as well as banking authorities who supported the commercial approach. Despite doubts and bureaucratic inertia in some cases, and the challenges of changing banking laws in all cases, they became champions of a commercial approach to microfinance.

As they came early to the field, early adopters generally experienced steep learning curves as they dealt with innovation. In some cases, they outpaced the initial innovators in the field; in others, they retreated to the comfortable commercial banking practices more in line with their traditional business. In vibrant markets for microfinance, aspiring commercial microfinance providers and banking authorities together hammered out a framework that allowed new entrants into the formal financial system. Several lessons emerged from the experience of these early adopters of the commercial approach to microfinance. These lessons were repeated time and again in many places.

Customers, not donors, are the future. The first lesson both microfinance organizations and banking authorities shared was an understanding that customers, not donors, were the future. In many cases, the trend in decreased donor funding prompted the change in orientation. However, the early adopters were equally concerned about building an independent institution that could respond quickly to changes in the market. They determined to free themselves from the high cost of donor funds that often came with directives and restrictions on the type of customer they could serve, or on products and geographical areas that were more appealing to the donor than the institution.

Donor funding could not meet huge demand. As MFIs adopted a customer-oriented approach, they experienced rapid growth. They learned there was a huge demand which could not be met by donor funding alone. Donor funding tended to be unreliable, slow, and never enough to finance rapidly expanding portfolios. Microfinance organizations often experienced a "liquidity crisis" when demand for credit exceeded their ability to supply it—creating waiting lists for repeat customers, causing hardships for their businesses, igniting delinquency, and affecting relationships between the organization and its borrowers. In some cases, this situation prompted calls for increased donor funding. But the early adopters of a commercial approach to microfinance recognized the sheer number of people outside the banking system, and doubted any donor's ability or willingness to contribute such great amounts. What appeared to be limited and isolated development projects began to grow. Banking authorities took notice and recognized that microfinance was a legitimate part of the financial sector. They also recognized donor funding could not meet huge demand.

"The Genius of the "AND". [2] Is there a reason, they asked, why a formal financial institution cannot choose purpose and profit, continuity and change? They identified and articulated within the institution the core ideology or the fundamental reason for existence beyond making money. The idea of maximizing profit at any cost is a sure recipe for failure in any business venture. In the absence of monopoly, a business that intends to maintain and expand its customer base cares about credibility in the market. Applying business values and purpose maintain this credibility. Banking authorities also recognized "the genius of the AND." They were concerned about competition in the banking system and solid financial performance of existing banking institutions. They were concerned about mitigating risks and opening the system to new entrants that served poor and low-income people who were neglected by commercial banks.

Confront the brutal facts. Early adopters paid attention to analyzing their own performance and systems, not marketing achievements to donors. And when they confronted the brutal facts about their own operations, what they found was often inadequate. Matching political will with the discipline to change operations, they were open to new ideas, quick to grasp them and ready to acquire the technical assistance to accelerate change. They began to follow generally accepted accounting practices; they began to produce information in a transparent way that was well understood in banking circles. The early adopters engaged banking authorities in a dialogue about asset quality, capital adequacy, and liquidity ratios they could meet and maintain. Banking authorities examined current regulatory and legal

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1 The framework—early adopters, fence-sitters and rejecters—is adapted from Everett M. Rogers' model for the adoption and diffusion of technological innovations. The term "early adopters" is one category Rogers developed in his classic 1962 book, *Diffusion of Innovations* (New York: Free Press). Innovativeness is the degree to which an individual or other unit of adoption is relatively earlier in adopting new ideas than other members of a social system. Rogers specified five adopter categories on the basis of their innovativeness: (i) innovators, (ii) early adopters, (iii) early majority, (iv) late majority, and (v) laggards.

2 In his seminal work on management and leadership in the United States corporate sector, Jim Collins coined the terms "the genius of the AND" and "confronting the brutal facts," among other key factors in determining organizational excellence.

frameworks that posed barriers to these new entrants to the financial system. They too learned to confront the brutal facts about their own operations.

Transparency does not convey with a banking license. The early adopters of a commercial approach knew that transparency comes from within the organization; it does not convey with a banking license. They cared about the performance of their institution. Often mislabeled as self-regulation, the behavior of the early adopters promoted the safety and soundness of current operations and built a strong position for the future. Committed governance—management's relentless drive to improve, integrity and transparency in operations—led to the design of systems that provided timely and meaningful information to management and governing boards, particularly if that information was not flattering to the organization. They understood that a commercial approach to microfinance is not about creative accounting and cutting corners to maximize profit; there are fundamental values that are more important, and often costly for the organization. These values run throughout the organization and influence all systems and decisions. They are built by applying consistent actions overtime; and do not convey with a license. The banking authorities already knew this.

Capacity leads; capital follows. The early adopters of a commercial approach to microfinance learned that they had to be strong institutions with excellent performance to attract commercial capital. They learned how to increase staff productivity and efficiency and develop systems that enabled them to add other banking services and new customers without abandoning their traditional clients. They hired talented staff and made an institutional commitment to staff development, despite additional costs of these future investments. And they learned that the learning never stops (Clark 2004). The banking authorities that supported the early adopters learned about microfinance and how it differs from commercial banking. They designed methods that would mitigate risk and allow new entrants into the financial sector. They introduced tiered-systems, allowing these entrants to operate legally and matched minimum capital and other requirements with the charter of the institution and the type of services the organization could legally provide.

These are early adopters. (See figure 2)

The Fence-Sitters

The fence-sitters are an interesting group; they are aware of the principles of commercial microfinance, but current practices remain unchanged. They await proof and motivation to change. The objective is to understand *why they sit, instead of advocating jumping* to one side of the fence or the other. Key questions the fence-sitters need to ask about adopting a commercial approach are internal to the organization and external in the environment.

Can the organization survive as a commercial operation? The internal weaknesses of microfinance operations need to be examined before the jump is made to formalize. In this respect, many fence-sitters may be following a prudent policy on their reluctance to join the formal financial system.

- ***Can a market orientation develop in an institution that has none?*** Fence-sitters have to clarify organizational values. If an organization perceives its role as protection of the poor from market forces, or that market forces are inherently predatory, it is unlikely to adopt a market approach. Many fence-sitters have to ask the fundamental question: are customers or donors vital for the future?

- ***Can the microfinance organizations truly play by the rules of game?*** Formal financial institutions are expected to follow rules that are enforced by banking authorities. Lenders and investors take comfort in meaningful financial statements, and the knowledge that prudential ratios are met and monitored by banking authorities. Banking authorities are reluctant to allow new entrants into the system that have weak ownership structures that cannot meet capital adequacy requirements, fragmented governance structures that cannot provide meaningful management oversight, and management teams that cannot withstand the rigors of meeting standards and requirements.

- ***Do they have the staff and systems capacity?*** The main reason why many MFIs fail is the absence of professional capacity, not lack of access to abundant donor capital. Abundant donor capital enables weak structures to survive unchanged. MFIs that cannot perform well are much more vulnerable when they are flooded with donor money; motivation to improve is weakened until it is too late.

Conveyance of a banking license to a weak microfinance operation offers little benefit to the financial sector and compounds performance difficulties for the organization. Until an organization can meet and maintain requirements for a license, it should not be formalized.

Figure 2. Commercial Microfinance: Where is the Field Now?

	Position	Challenges
Early Adopters	• Embrace principles • Changed practices	• Innovate with technology • Expand institutional capacity • Attract private commercial capital • Contribute to support mechanisms

Fence-Sitters	• Aware of principles
	• Practices unchanged
	• Await proof as a motivation
		• Clarify values
		• Analyze what it takes
		  • Internal constraints
		  • External factors
		• How long will they wait?

Rejecters	• Do not embrace principles • Want more debate	• Analyze why they reject • Question of survival • What is the future?

Is it the market environment that makes the fence-sitters wait? The external environment may offer little incentive to large or small microfinance operations to become commercial.

- ***Is the market perceived as too small to become commercial?*** Perhaps. Evidence suggests that an organization does not have to be a large organization in a huge market to adopt a commercial approach and grow, providing higher quality and more efficient service to its customers.[3]

- ***Is a market leader absent?*** Non-regulated microfinance organizations formalize because they experience competitive disadvantages in the marketplace (Drake and Rhyne 2002). Regulated financial institutions can provide a broader array of products that save people time and money. Has microfinance reached a point in a country where there is really such a competitive disadvantage? Until a commercial leader with a customer oriented approach emerges, others will unlikely enter the market; microfinance is not viewed as a viable business opportunity, but as a development activity.

- ***Are donors and governments distorting incentives for commercial microfinance?*** Overabundance of donor and government funding limits the attractiveness of microfinance to investors. Large subsidies prevent the emergence of commercial operations that can compete. Donor funding, while well intentioned, competes with investor risk capital in mature MFIs that may have overstayed their welcome on the fence.

- ***Is the legal and regulatory framework holding back strong performing new entrants?*** The design of the prudential regulation and supervision framework is critical in the context of commercial microfinance; this framework determines the types of organizations that are allowed to operate in various segments of the market (Christen and Rosenberg 2000). Lack of a legal and regulatory framework can force microfinance organizations out of the market completely by making their operations illegal. Passage of laws that phase out charters as legally recognized forms for microfinance operations, without putting in place others under the banking law, causes confusion and encourages even the most motivated fence-sitter to wait.

The Rejecters

The rejecters do not embrace the principles of commercial microfinance; they want more debate. There generally is no one reason why they reject the commercial approach—a combination of beliefs and incentives that are structured to make rejection the most rational choice in the environment.

Some microfinance operations will choose, if they can, not to formalize or follow a commercial approach. This is a legitimate choice and can be the most rational choice in the environment. As von Stauffenberg (2001) reminds us: why should they subject themselves to the rigors of the banking law and government oversight, pay taxes, and give up donor support? But unless abundant donor capital and government support is guaranteed over the long term, the rejecters will have difficulty growing and may have difficulty weathering crisis.

Is rejection a question of survival or a rationale response to the environment?

Not all commercial microfinance operations survive, and those that are linked to the financial system can be much more vulnerable in times of financial crisis or recession, or as a result of mismanagement. A strong relationship with a donor buffers the rejecters from the reality of a financial crisis and offers a strategy for short-term survival. However, those MFIs, which have chosen not to become commercial operations and have grown, have adopted business principles based on a commercial approach. They may have no valid commercial ownership structure, they may provide only credit, but those—which have become a significant force in the marketplace—have strong management teams, impeccable systems, and solid financial performance.

Clearly, in the region, there are a range of institutions that follow the principles of commercial microfinance, but there are even more that do not. Trends in countries as diverse as Cambodia, India, and Indonesia suggest that as microfinance develops, the larger commercial providers prevail and small providers proliferate (M-CRIL 2004; Charitonenko 2004). Dependence on donors and a preference to serve specific target groups are oft cited reasons for lack of growth. Management constraints and leadership vacuums figure prominently in sluggish growth and often poor performance. More striking, many organizations do not see themselves as becoming part of the formal financial system (Charitonenko 2004). It is unlikely that small operations with such a profile can, or should be convinced that a commercial approach is right for them.

IV. The Future: An Uncommon Vision?

The purpose of the framework is not to change the position of the fence-sitters nor admonish the rejecters. We must remember that the early adopters of the commercial approach to microfinance once rejected the idea of continued reliance of donor funding. As important players in the marketplace, each group has a role to play in bridging the gap between the supply and demand for microfinance.

Early adopters continue to innovate with technology, increasing efficiencies and outreach. As key players in the financial system, they will seek ways to expand institutional capacity and attract private commercial capital, building the support mechanisms that enhance the quality and their rate of growth. Their experience should be widely shared.

[3] See Fernando (2004) on how XAC Bank increased outreach and product diversification in a small market.

Fence-sitters have the key role in analyzing what it takes. By asking the early adopters the right questions they can play a critical role in working with support organizations to develop capacity and engage banking authorities in discussions about the mechanisms that are holding back developments in the field, or conflicting with them.

Rejecters can play a useful role by using the experience of the early adopters to inform their own internal debates, perhaps clarifying why they reject the commercial approach to microfinance. The key is transparency. By regular reporting on meaningful performance indicators, rejecters can contribute to a body of knowledge about the benefits and costs of different approaches in tackling poverty and building inclusive financial markets.

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New ADB Publication on Microfinance

Micro Success Story? Transformation of Nongovernment Organizations into Regulated Financial Institutions.

The Asian Development Bank (ADB) published in June 2004 *Micro Success Story? Transformation of Nongovernment Organizations into Regulated Financial Institutions* by Nimal *A. Fernando.* The study examines the ownership structure, expectations, and achievements of microfinance institutions that have been established by transforming nongovernment organizations (NGOs) in Africa, Asia, and Latin America. Although the number of such institutions is low, they have had a catalytic effect and major influence on the microfinance industry.

The study provides detailed information on the ownership structure of 10 institutions in Latin America, 14 in the Asia and Pacific region, and 1 in Africa. It also includes a brief profile of 39 NGOs that have been transformed between February 1992 and February 2003.

Available: www.adb.org/microfinance

ADB and TSPI Sign Partnership Agreement on ADB-MFI Initiative on Regional Microfinance Statistics

The Asian Development Bank (ADB) and Tulay sa Pag-Unlad Inc. (TSPI), a major microfinance institution in the Philippines, signed a memorandum of agreement on 12 August 2004 aimed at improving the collection of microfinance statistics to monitor more effectively the development of the microfinance industry in five selected countries. Other countries participating in this initiative are Bangladesh, Cambodia, Pakistan, and Sri Lanka. Jan van Heeswijk Director General of ADB's Regional and Sustainable Development Department (right), signed on behalf of ADB, while Ruben de Lara signed for TSPI, as its Executive Director.

Pakistan's First MicroFinance Bank Ltd.

The First MicroFinance Bank Ltd. (FMFBL) was established in November 2001 as a nonlisted public limited company under the Companies Ordinance (1984) and licensed as a microfinance institution under the provisions of the Microfinance Ordinance 2001 in January 2002. The bank commenced its operations in April 2002. Its initial shareholders included only Agha Khan Rural Support Program (AKRSP)—a nongovernment organization with a long history of involvement in microfinance in Pakistan's northern areas—and Agha Khan Fund for Economic Development (AKFED), which is the economic development arm of the Agha Khan Development Network (AKDN). Later on, the International Finance Corporation (IFC) came as a shareholder. Now, AKRSP and AKFED accounts for 46% and 30%, respectively, while IFC accounts for 24% of the ownership. The bank's total shareholder equity is about $12.31 million and its Board consists of 10 members, including its chief executive officer, with a wide range of skills such as banking, accounting, legal, and economic development. IFC is represented on the Board.

FMFBL adopted a strategy to ensure smooth transition of the operations of 14 AKRSP branches/units to its branches, and this process was completed on 31 December 2003 with the establishment of 14 branches and units. AKRSP no longer provides any microfinance services.

FMFBL provides deposit, lending, and other financial services. The savings products that the bank offers are all voluntary. Currently, it offers five different savings products: noninterest bearing current account, ordinary savings account, profit and loss sharing savings account, microcash maximiser account (primarily for large depositors with a minimum deposit of $8,700) and term deposit accounts. The bank has achieved impressive results already in deposit mobilization, indicating that people's trust in the bank is increasing. At the end of May 2004, the bank had 13,578 deposit accounts of various types with a total outstanding deposit volume of $7.7 million.

It also offers a range of loan products that include individual loans (currently restricted to the Northern Areas and Chitral), group loans in rural areas, business committee loans, urban group loans, and business group loans with a service charge between 10% and 16% charged on a flat rate basis. The lending is done on the basis of social collateral, and groups are formed with a minimum of three persons. Mandatory savings are not a condition for borrowing. At the end of May 2004, there were 6,146 active borrowers in its books with a total outstanding loan amount of $2.1 million. Thus, its deposit volume at the end of May 2004 was more than 3 times the loan volume. FMFBL reports that about 80% of its deposit clients have an average deposit balance of about Pakistan rupees (PRs) 500 (about $8). A person needs only his/her National Identity Card and PRs 5 to open an account with the bank. This seems to explain the presence of large number of poor clients in its books.

FMFBL is not complacent, with just deposit and traditional loan products and services. It has successfully launched a domestic electronic funds transfer service that allows customers to remit funds across the country in a secure manner and quickly. The demand for this money transfer service is shown by the fact that the bank carried out 1,863 transfer transactions amounting to $3.3 million between May 2003 and April 2004. The bank also offers a housing improvement loan product in its rural branches and plans to extend its core business to microinsurance, and health- and education-related products. Currently, all borrowers have access to microinsurance through an external insurance company at 0.31% of the loan amount. It is extending the geographical coverage of its services: at the end of May 2004, it had 21 branches/units, and 14 of these are in rural areas.

Pakistan has an estimated population of about 146 million. The incidence of poverty is high: 33 % of the population, or 47 million people in 6.6 million households. About two thirds of the population and 70% of the poor live in rural areas (Khushhali Bank, p. 2). There is increasing poverty in urban areas as well. Most of the poor households in both rural and urban areas suffer from financial exclusion because they do not have access to formal or semi-formal financial services. Self-finance and informal finance do not allow them to actively participate in and benefit from the economic opportunities around them. Also, lack of access to financial services at reasonable costs makes it virtually impossible to manage many risks and vulnerabilities to which they are generally exposed. Hence, financial exclusion contributes to persistent poverty in the country. In this context, FMFBL and other banks that focused on the low-income and poor households have a major challenge ahead of them: to substantially reduce, if not eliminate, financial exclusion and thereby make a contribution to creating a nation free of poverty.

ADB welcomes FMFBL's entry into the challenging area of providing financial services for the low-income and poor households and their microenterprises. We hope that FMFBL will live up to its expectations to serve millions of such clients and grow to become another flagship financial institution in the region.

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[*This profile was prepared by Nimal A. Fernando mainly on the basis of the information provided by FMFBL.*]

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