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Microfinance Commercialisation, Challenges and Issues in Developing Countries: A Critical Literature Review

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Abstract

This paper aims at reviewing empirical literature on the performance and issues associated with commercialisation of microfinance institutions (MFIs). The popular approach believes that commercial-based operation can lead to financial self-sustainability without reducing the role to assist the poor. Although the growth in financial intermediation is evident, many commercialised MFIs remain dependence on subsidy and fail to achieve a greater outreach. Hence, this approach highly undermines the social mission of microfinance to reach the poorest of the poor.

Keywords : *Microfinance, Commercialisation, Developing Country*
JEL Classification : *G00, L14, O50*

1. INTRODUCTION

Over the last decade, the progress towards self-financing of some microfinance institutions has renewed interest in the study of MFIs assisting the world's poor. While the ultimate goal of MFIs is clearly to improve the welfare of the poor, the extent to which microfinance should aid the poor is uncertain among financial practitioners. According to the 'pro-profit' approach, MFIs should be seen as an ordinary financial business in which their capability to mobilize funds from and to the poor should coincide with maintaining a self-financing capacity and being independent of subsidies (Pischke, 2002). In contrast, the 'pro-poor' approach on the MFIs relies on how well they can reach out to the 'poorest of the poor' (Schreiner, 2002). In this approach, profitability should not be the main concern and, therefore, funding donations remain an essential component to succeed in the holy mission of non-profit orientation. However, the pro-profit approach seems to be favourable in terms of theoretical and empirical standpoints. Many of these standpoints are based on the fact that subsidized credits have low repayment rates and most are channelled to inappropriate recipients (Morduch, 1999; Gonzales-Vega *et al.*, 1997).

Recently, the superior performance of BancoSol in Bolivia, BRI-unit in Indonesia and the Grameen Bank in Bangladesh has triggered the world-wide transformation of microfinance NGOs into regulated MFIs in many developing countries. In the last decade about 39 microfinance NGOs had been transformed into regulated MFIs, covering Latin American countries (e.g., Colombia, Dominican Republic, Mexico, El Salvador, Peru), to Asia (e.g., Cambodia, India, Mongolia, Nepal, Pakistan, and the Philippines), and Africa (e.g., Kenya and South Africa). Optimistic views indicate that the self-sustainability objectives of MFIs can be achieved in parallel to the role in assisting the poor. With technical supports available to the transformed MFIs, the implementation of market-based operations will contribute to both outreach and self-finance in the long-run (Dhonaghue, 2004; Charitonenko *et al.*, 2004; and Christen, 2001). In contrast, pessimistic views suggest that the performance of regulated programs remains discouraging. Many of the transformed MFIs are still experiencing high default rates and are seemingly incapable of operating without subsidies. Most importantly, the fear exists that focusing on self-sustainability will lead MFIs away from their original mission. It is very likely as the targeted customers have become 'better-off' poor that 'very poor' households are excluded (Schreiner, 2001; Bhat and Shu-Yan, 2001; Bhatt, 1997 and Coleman, 2002, 1999).

This paper seeks to review the performance and issues associated with the transformation of MFIs into regulated financial institutions. It is structured as follows. Section 2 outlines the phases of development from the microcredit activities to regulated microfinance institutions. Section 3 reviews the performance and issues of microfinance. The transformation into regulated MFIs and its implications for governance, sustainability and outreach is discussed in section 4. Section 5 concludes this paper.

2. THE PHASES OF MICROFINANCE DEVELOPMENT

In the past international donations for poor people were relatively small because they assumed that poverty is due to a personal failing. Poverty traps are believed to be inherent in the development process in that it has reduced the access of the poor to credit sources. Credit availability should be seen, according Elahi and Danopulus (2004) among many others, as basic human right for the poor. As a result, funding supports for microcredit activities has increased dramatically. The Microcredit Summit in 1997, for instance, has called for $20 billion of funds to be available during 1997-2006 to scale-up microfinance activities around the globe (Coleman, 2002).

The inadequate access of the poor to formal financial services is the central reason for the introduction of microcredit activities. Formal financial institutions become risk averse to serve poor households because of two main reasons. Firstly, economic activities of the poor are characterised by mini-scale economies of production, consumption, saving, borrowing and income. Under this circumstance, there are substantial transaction costs in financing such a small scale of economic activities. Secondly, the economic activities of the poor have high risks and insecurity caused by unpredictable changes in income and expenditure (e.g., harvest failure, funeral, wedding and sickness) and moral hazard (e.g., contract enforcement difficulty and insecurity) (Matin *et al.*, 2002).

Elsewhere, Hulme and Mosley (1996) state that formal lenders face high risks due to the lack of viable information on the loan repayment capability of the poor. They term this as a 'screening' problem from which the lenders are incapable of distinguishing good from bad borrowers. In this case, high transaction costs as well as the cost of screening are the core issues for selecting creditworthy applicants. As the poor cannot insure their loan with collaterals, the prospective lenders highly face the 'enforcement' problem. This is akin to an adverse selection problem which is theoretically well proven by Akerlof (1970) and Stiglitz and Weiss (1981). Consequently, the screening and enforcement problems deter credit supply for the poor. If so, such markets would be occupied by informal moneylenders who impose high interest rates on lending to the poor (Robinson, 1997).

Given the debatable issue of whether moneylenders are good or malicious, there is a disparity between supply of and demand for credits for the poor. To narrow the gap, since the 1950s the government and international funding agencies began to develop directed credit programs for the poor. Credit programs were subsidised and had specific sectoral and regional purposes, such as small credits for agriculture activities and micro enterprises of the poor in rural areas. However, the result of subsidised credits was disappointing in terms of loan collection and repayment. The World Bank study in 1975 brought to light that most microcredit programs in developing countries lost almost half of their capital every year (Morduch, 1999). This futile development then motivated the theoretical and empirical works of microfinance scholars from Ohio State University in the early 1980s, popularly known as the 'Ohio School'. The centre point of their ideas is that any state influence on microfinance markets is likely to fail because it creates 'rent seeking' behaviour within public sector institutions. This then leads to higher cost and relatively inefficient credit programs, compared to traditional moneylenders. Secondly, most credit programs cannot reach the targeted recipients due to such a moral hazard. Thirdly, saving mobilisation is important to encourage market discipline of the MFIs (Hulme and Mosley, 1996).

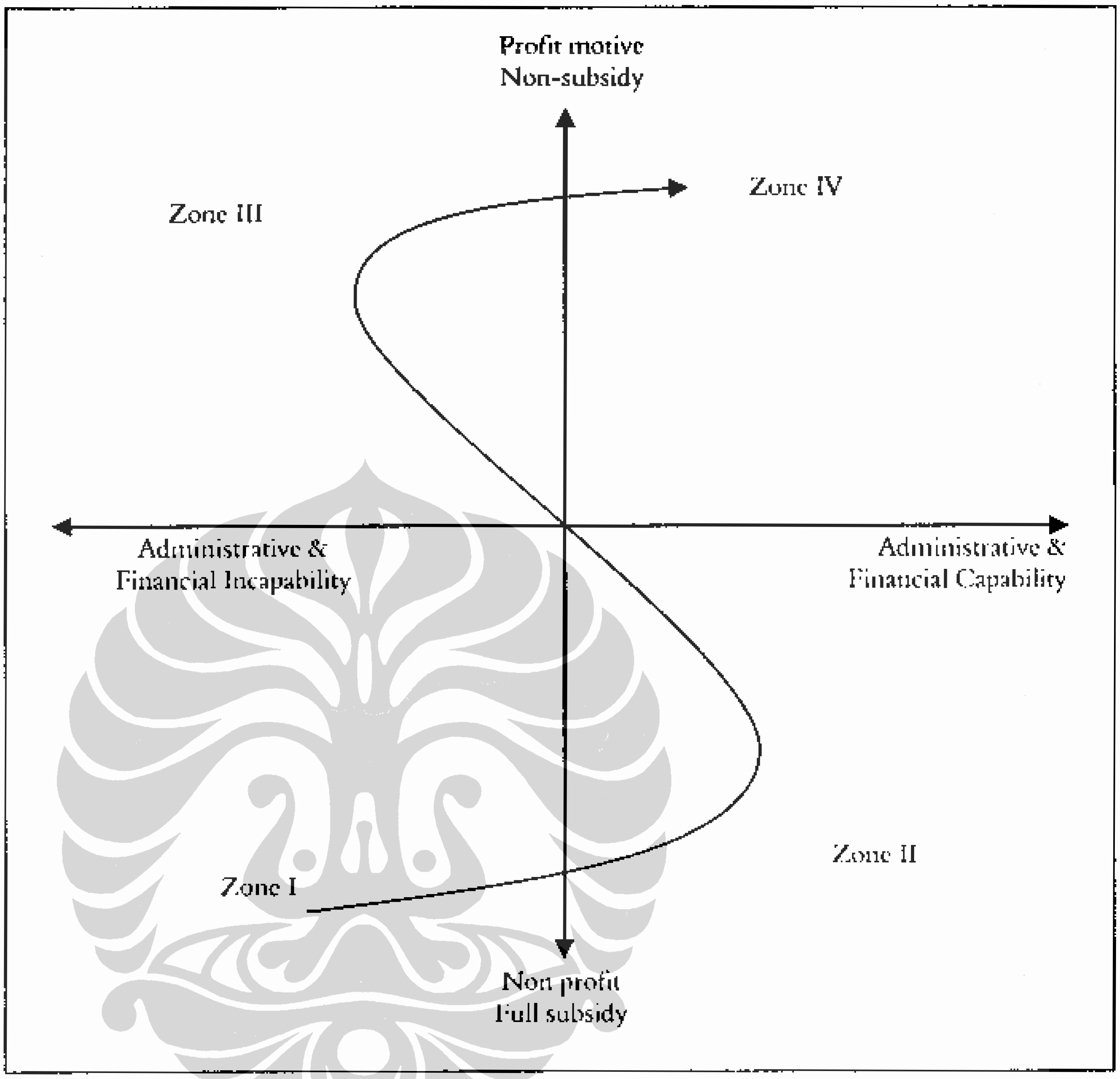
Since the late 1980s microfinance has become a global concept necessary to develop financial markets for the poor in developing countries. A widely-cited example includes the Grameen Bank in Bangladesh, BRI in Indonesia and BancoSol in Bolivia. Unlike credit-directed programs, such MFIs do not necessarily depend on external financing from donors. They have grown into self-financing and significantly reduce the dependence on financial subsidies. As their financial performance relies more on profit and saving mobilisation for the poor, this then boosts the popularity of regulated microfinance. This is stimulated by the successful transformation of the microfinance NGO, PRODEM into BancoSol in 1992. The ultimate target is to promote financial intermediaries of the poor for profit, so as to gradually relax funding subsidies in the long-run.

The evolution from credit-directed programs to the existence of regulated microfinance institutions can be outlined as in **Figure 1**. Here, suppose that the vertical axis describes two extreme conditions of non-profit orientation with fully subsidised funds from donors and the profit-oriented motive without subsidy. The horizontal axis indicates another extreme of administratively and financially incapable or capable. Then, the intersection of these two extreme lines sketches four sequential stages of MFI development. The first level, *Zone I*, indicates the early stage of MFI development where the microfinance NGOs are the main vehicle for the directed credit programs with no profit motive. As a non-profit organisation, they will persistently depend on financial supports from donor bodies. With perceived weaknesses in administrative and financial capabilities, a termination of funding subsidy from donors will lead to organisational failure in the short-run.

There has been evidence that some microfinance NGOs have achieved better organisational management after some years of establishment. Such NGOs have moved into *Zone II*. The only difference between Zone I and II is that in Zone II the microfinance NGOs have experienced relatively better performance in administrative and financial capabilities. Although financial supports remain an important part of their operations, administrative and financial skills have increased their business efficiency. BRAC in Bangladesh and PRODEM in Bolivia are often cited as examples of successful microfinance NGOs with strong business acumen, although they financially remain dependent on the donors.

In order to reach more of the poor, there is an increased pressure from donation bodies on microfinance NGOs to raise business efficiency. Many aid donors have required microfinance NGOs to have obvious plans in attaining self-financing capability. They believe that the goal to reduce poverty may not be achievable in the absence of self-financing sustainability. With technical supports for financial and managerial skill advancement, some microfinance NGOs have been transformed into banking-type institutions. This effort is particularly to achieve profitability and better access to commercial funds (e.g. voluntary savings and commercial borrowings), so as to gradually escape from financing subsidies in the long-run. However, the inadequate business skills and (less) unprofitable operation characterise the MFIs entering into the transitional process towards the market based operation. They enter *Zone III*. In this stage, therefore, funding support may still be necessary to overcome immature business capacities, inefficiency and unprofitable operations.

Figure 1
The Life Cycle of Microfinance Institutions



Through continuous improvement of business skills, MFIs have developed into financially viable organisation without subsidy by generating sufficient profits. The significant increase in saving mobilisation and accessibility to commercial funds celebrates the MFIs moving into *Zone IV*. In this final stage, the mature business capacity to compete against other financial companies indicates that their operations can be subject to prudent (market-based) regulation and supervision.

The movement from Zone I to Zone IV in Figure 1 can be traced to the case of BRI in Indonesia. The government-directed credit programs have been successfully transformed into mature microfinance institution of the village bank *(BRI-unit)*. Originally, the BRI-unit was set up to channel credit programs for villagers under the BIMAS or *Bimbingan Masal* (Mass Guidance) program in the 1970s to achieve self-sufficiency in rice production. With regard to the unsuccessful BIMAS, in terms of loan collection and repayment, the government reformed the BRI-unit into the market-based operation within BRI in 1983. With financial innovation and profitability, the BRI-unit has become the main player in Indonesia's microfinance system. In 2001 with 4,063 branches, BRI-unit contributed about 43.5 percent of total microfinance loans and of 74.2 percent of total deposits (Charitonenko and Afwan, 2003). BRI unit has also been relatively financially solid in response to the financial shock in 1997/98 (Matin *et al.*, 2002).

3. MICROFINANCE PERFORMANCE AND ISSUES

Not coincidentally, non-governmental organisation (NGOs) has long been the main player on microfinance delivery for the poor. The historical 'success' of their mission has been through bottom-up approach to governance in the community. The long experience in providing non-financial assistance to the poor has also made NGOs favourable for delivering microfinance services. This is mostly the case in areas, such as adult education and training, entrepreneurships, women empowerment and the like. This then raises an expectation that the microfinance NGOs would be able to implement a more innovative management system with a strong participatory approach, than government bodies or profit-motive organisations (Bhat and Shu-Yan 2001).

Some NGO-type financial providers have documented remarkable performances in some developing countries in terms of outreach –'social benefits of microfinance for the poor'– (Schreiner, 2002). The NGO, Promoción Desarolla de la Micro Empresa (PRODEM), established in 1987 is an example of a well-cited successful microfinance NGO (Mosley, 2001). Data in 1999 indicated that PRODEM had covered about 59,000 borrowers, mostly in rural areas with the average amount of lending of US$450 each. Comparably, this figure was much larger than that of 1987 when the number of borrowers stood at about 1,737 with the average loan about US$92. About 70-80 percent of the customers were women (Mosley, 1996, 2001).

Moving to the Asian context, a similar story occurs in Bangladesh. The NGO, Bangladesh Rural Advancement Committee (BRAC) was set up in 1972 to help to rebuild the socio-economy of the poor, landless women in particular, after the war of independence. By 2002 BRAC had successfully organized about 3.5 million poor households, mostly women participants, with total lending of about US$ 1.4 billion. About one-third of the loans have been mobilised from deposit of participation programs. In the educational sector, BRAC has run about 34,000 primary schools with 66 percent of student enrolment are girls. For adult literacy, it has covered vocational training on human rights, legal education, property law as well as income generating activities. BRAC is unsurprisingly well-known as the largest NGO in developing countries, in terms of scope and program diversity (Chowdhury and Bhuya, 2004). The development of BRAC has significantly contributed to the increase in income, health, nutrition, and education of the poor in Bangladesh (Bhat and Shu-Yan, 2001 and Chowdhury and Bhuiya, 2004).

Recently, there has been a significant diversification of financial services to the poor. These include various saving and credit facilities, and loan repayment systems perceived important to ensure loan collection. Hence, the assumption that the 'poor are too poor to save', has been found to be unrealistic. Martin *et al.* (2002) provide an argument on this through so-called 'life-cycle needs', 'emergency' and 'opportunities' hypotheses of which the poor is highly required to save money. The life-cycle-needs hypothesis states that the poor face many life-cycle expenditures, such as childbirth, child education, and marriage. Such expenses should be anticipated by the poor through saving money. The emergency hypothesis proposes that the poor are consistently pushed to save money for any personal emergency, such as sickness, death, and lost of employment opportunities. The opportunity hypothesis points out that there is always also a chance for poor people to have additional incomes, through new investment, job opportunities or expanding their ongoing business. Therefore, it is worth saying that saving facilities is as equally important as delivering micro credit services for the poor.

Apart from flourishing NGOs as the microfinance delivery conduit, they are mostly dependent upon funding subsidy. According to Bhatt and Shio-Yan (2001), about 85 percent of BRAC's operation required financial support from external donors (e.g., the Ford Foundation, the Canadian International Development Agency and the British Overseas Development Agency). In the case of PRODEM, the study of Mosley (1996) calculates the subsidy index which is derived from setting up interest rates below market rates, non-repayment dividends for stockholders prior to profitable operation, and the provision of free services. In exception of BRI in Indonesia, the subsidy index of all sampled MFIs in his study has a positive value, meaning that they remain dependent on subsidy. For example, the subsidy index of PRODEM stood at about 74 percent in 1987 in which this then sharply increased to about 195 percent in 1990. Although, the subsidy index falls significantly to 12 percent in 1993, following the transformation of PRODEM into BancoSol in 1992 (Mosley, 1996).

Since the 1990s the transformation of microfinance NGOs into regulated MFIs has become a role model for the microfinance development in many developing countries. The ultimate goal of this is to achieve self-financing sustainability and reducing subsidy. The establishment of BancoSol in Bolivia is a well-known metamorphosis from the microfinance NGO into a profit-oriented institution. Its role is similar to commercial banks which enable them to tap funds from non-donor sources and then channelling to prospective borrowers for profit. However, a critical difference is that while commercial banks focus mainly on wealthier clients in urban areas, the regulated MFIs provide financial services especially for poor households and micro enterprises in rural areas.

The transformation into profit-oriented MFIs has also created a substantial increase in funding mobilisation with profitability, high loan repayments and self-financial sustainability. Following its establishment in 1992, BancoSol has remarkably expanded the scope of its operation and financial performance. Mosley (2001) notices that with total borrowers of about 80,000, BancoSol's coverage is much larger than any other microfinance institution in Latin America, Africa and Eastern Europe. With high loan repayment rates of its over 100,000 borrowers, for instance, in 1996, it was the first time BancoSol has generated dividends for the shareholders (Gonzales-Vega *et al.*, 1997). The Grameen Bank provides a different success story, providing small loan designed for rural poor households, women in particular and collateral-free loans. The Grameen Bank in recent years has raised a microfinance promise for the poor with mostly having no collateral in hand and lacked access to traditional banking institutions (Murdoch, 1999). In comparison with the rural areas without the Grameen Bank, the absolute poverty level of rural areas covered by the Grameen Bank indicates two-thirds lower than the villages without the existence of the bank (Khanndker, 1996). Another remarkable success story of banking-type microfinance is BRI-unit in Indonesia. Although BRI-unit does not have a special mission for poverty alleviation, it does successfully encompass low-income households with profitable operations. It does this through designing financial products favourable for this group as well as micro enterprises in rural areas.

Some argue however, that the self-financing sustainability of the MFIs through profit-orientation may reduce its original mission of alleviating poverty. The commercialisation of microfinance services may leave the very poor households with limited access to capital, particularly for those living in remote areas which are commercially unprofitable to serve than in urban areas (Chao-Berrof, 1997 and Weis *et al.*, 2003). It is very likely that focusing on sustainability and profitability will make the MFIs to pay more attention to better-off clients in order to gain economies of scale and increasing the loan repayment probability. As Cohen and Sebstad (2000) point out, some microfinance institutions remain incapable of having deeper poverty focus on the poorest of the poor. It is also very often that many of the very poor clients drop out of the programs after only a few loan rotations. Some others eventually exit even when their loan repayment capacity actually raises (Hulme, 1999). Many factors are responsible for excluding the very poor households. According to Woller (2002), the failure of the marketing orientation of the regulated MFIs can be the main factor. He notices that such failure stems mainly from the lack of a customer-orientation strategy, in a sense that they pay too much attention to the products and services, rather than what customers need. In short, many MFIs do not have an explicit marketing target of the very poor. As a result, they are becoming risk averse to serve the very poor borrowers because of the fear of creditworthiness and unmet financial performance. The urban bias also tends to exclude the very poor because the MFIs have mostly been located in urban areas where the poverty is usually less concentrated (Woller, 2002) .

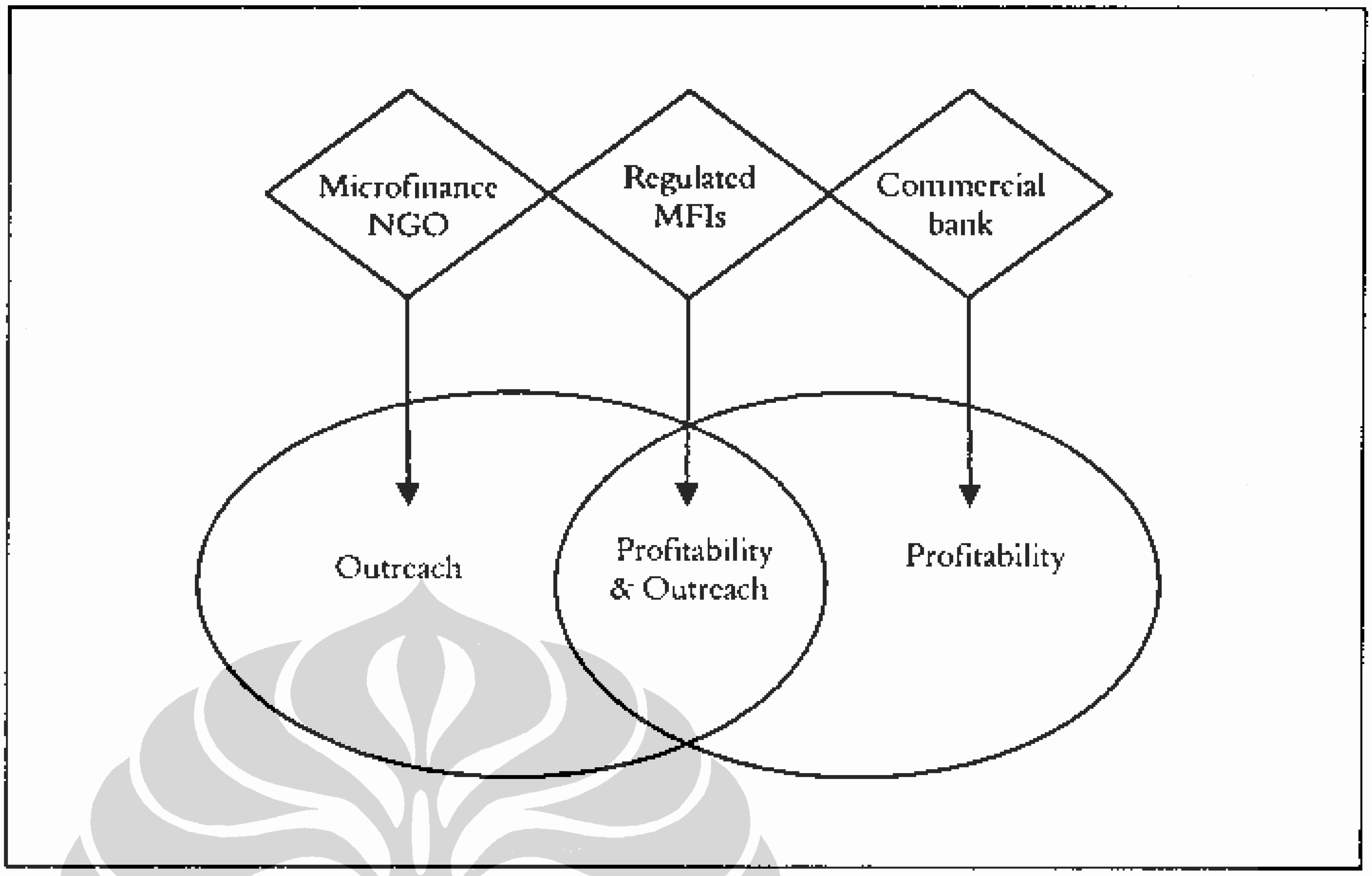
4. TRANSFORMATION INTO REGULATED INSTITUTIONS

The transformation into regulated MFIs gradually increased in many countries following the case of BancoSol in Bolivia in 1992. Latin America and Asia recorded the largest case of transformation between 1992-2003 (Fernando, 2003). Conceptually, this transformation pictures a dramatic change in the perspective toward microfinance. Originally, the favourability of microfinance NGO modality to cater financial services to the poor is because regulated financial institutions (e.g., commercial banks) have failed to take the role. The profit-driven motive of regulated institutions is argued to be incompatible to the socio-economic characteristics of the poor. Nowadays, many microfinance scholars believe that the transformation is a logic procedure to attain efficiency and financially sustainable without necessarily reducing the role to assist the poor. This commercialisation approach is particularly stimulated by at least three expectations. Firstly, the change in the ownership structure of the MFIs will strengthen governance. Secondly, the transformation is expected to increase access to commercial funds and broader financial services. Thirdly more importantly, it can further the number of poorest served (Fernando, 2003). The critical question is whether the transformation has fulfilled the expectation. The following sections are to discuss this issue.

4.1 Governance Issues

The concept of corporate governance can be referred to as a managerial process through which the board of directors navigates the resources of the organisation toward the achievement of its corporate mission. This implies the governance structure to be comprised of two levels: the governing body (the board of directors) and management team whose responsibility is to set up day-to-day decisions. The basic role of the board is to provide direction to the managers and monitoring them toward the fulfilment of the shareholders' interests (Otero, 2001; Aliriani, 2004). However, at a broader concept of governance, stakeholder approach, it should not only be assigned to realise the shareholders' interest but also to the whole economic agents in society who may be affected by and influence the productive process of the organisation (Otero, 2001; Labie, 2001 and Rock *et al.*, 1998). From microfinance perspectives, the governance issue is critically important at least for five reasons. Firstly, the stronger role of the director board is required to effectively manage the dynamic progress of the MFIs in terms of assets, the scope of financial services and the assignment to increase outreach. Secondly, the transformation into regulated MFIs has changed the ownership structure of the transformed MFIs. Shareholders are becoming important element within the board of directors with diverse interests in place. Thirdly, in the view of financial authority, the regulated MFIs entail sound financial oversight as they become deposit-taking institutions (Otero, 2001).

Figure 2
The Dual Mission of the Regulated Microfinance



Source: Adapted from Otero (2001 p.7)

Figure 2 above presents the corporate mission of MFIs which can be put in three different specialities. The first is those who have a focus mainly on the number of clients served. Microfinance NGOs mostly dedicate their mission to cater financial services to as many of the poorest as possible. Secondly, some microfinance NGOs have been metamorphosed into regulated MFIs who incorporate profitability into their missions, implying a dual mission of profitability and outreach. Thirdly, potential profitability has attracted commercial banks to get involved in microfinance. For this entity, the number of poor clients is put into consideration, only if they can contribute to the improvement in profitability.

Strengthening governance is basically to increase efficient control mechanism and transparency of the regulated MFIs. From shareholder perspectives, the core issue is the extent that incentives and internal control mechanism can be made available to the organisational growth with interest balance between each party involved in the MFIs (Otero, 2001). Considering the dual mission of MFIs, it can be a serious dilemma as one party within the board of directors can be interested in maximising profit, but the others are more on social accomplishment. The incapability to reduce this trade-off can generate incoherent priority and conflicts which can end up with and organisational failure (Otero, 2001 and Labie, 2001).

4.2 Ownership Structure

The corporate governance is strongly related to ownership. The ownership structures of microfinance NGOs considerably differ with the regulated MFIs, particularly in relation to the risk sharing capitals. Microfinance NGOs mostly obtain start-up capital from donation bodies as a grant or concessionary loans. As a result, to whom the founder or the directors board of the microfinance NGO should be accountable to is unclear. This is probably why the accountability structure of microfinance NGO tends to be relatively inadequate and distant. In this case the loyalty and personal commitments to the institutional mission play the role to strengthening accountability (Rock *et al.*, 1998). Another way is by transforming the microfinance NGO into regulated MFIs (Rhyne, 2001). The conversion into shareholder ownerships of the transformed MFIs will generate incentives to improve accountability. This can be achieved basically through the clear direction of accountability and governance. In general, the ownership structure of the transformed MFIs is composed of the private and social investors. The first is usually concerned to capital returns (profitability) and the second is more on social returns. The combination between these two objectives brings the light on setting up institutional missions and that is to whom the accountability and governance should be addressed for. The important role of social/non-profit investors is to maximise an adequate level of profit with social returns of investments (Rock *et al.*, 1998; Otero, 2001; and Fernando, 2003).

A study of Fernando (2003) shows that the transformation of microfinance NGO into regulated MFIs has not changed much of the ownership structure. Table 1 reveals that the NGO founders remain the majority of stockholders in most samples of regulated MFIs (45 percent or more). In some cases the transformation has successfully attracted commercial and non-profit investors with small amount of ownership. In Latin America for instance, although, the transformation of Financciera Compartamos in Mexico has raised significantly the ownership of commercial investors to about 30 percent, in most cases, the ownership of commercial investors in the transformed MFIs are less than 15 percent (**Table 1**). From a positive side, the increase in commercial ownership can likely improve governance and sustainability of the transformed MFIs. This can be the case through transferring the advanced governance mechanism as well as managerial skills from private financial companies to the regulated MFIs. The private investors can also provide a better access to additional capital in the case of illiquidity problems. Although, the side effect should be considered, as the profit-driven motive can dominate the decision making process within the regulated MFIs and therefore, deteriorating the social mission.

Social investors such as public entity, multilateral and bilateral institutions, international NGOs and specialized funds have significantly contributed to the ownership of the transformed MFIs. Mostly, the ownership of the social investors is relatively small (**Table 1**). Although in some cases, the social investors such as multilateral NGO have dominated the ownership structure of the transformed MFIs. In 2002, for instance, the ownership of social investors in BancoSol in Bolivia has accounted for about 38 percent, while in Calpia in El Salvador it is about 36 percent. In the case of Banco ADEMI in Dominican Republic, the ownership of social investor has been about 39 percent. The ownership of social investors in Asia is relatively lower than in Latin America in many cases (Fernando, 2003). As social investors are more interested in reaching more poor people, the modality of social investors in the regulated MFIs is to ensure the balance between profitability and social objectives. Yet, it will depend on the level of proficiency and commitment to poverty issues of representative individuals employed by the social investors at the director board of the transformed institutions (Rock *et al.*, 1998).

Table 1

The Ownership of Structure of Selected MFIs in Latin America and Asia

Ownership (%)	Founder	Foreign NGO	Public Entity	Specialised Equity Fund	Commercial Entity¹	Other²
< 15	3 (14.3)	1 (4.8)	5 (23.8)	1 (4.8)	6 (28.6)	9 (42.9)
15 – 24,9	4 (19.1)	3 (14.3)	4 (19.1)	1 (4.8)	1 (4.8)	6 (28.6)
25 – 34,9	-	1 (4.8)	-	3 (14.3)	2 (9.5)	2 (9.5)
35 – 44,9	3 (14.3)	-	2 (9.5)	-	-	1 (4.8)
45 – 54,9	5 (23.8)	-	-	1 (4.8)	-	-
55 <	6 (28.5)	-	-	1 (4.8)	-	1 (4.8)

Source: Calculated from Fernando, 2003

Notes:
The regulated MFIs in Latin America include BancoSol, Calpia, BancoADEMI Confia, Financiera Compartamos, FPP Caja Los Andes, FFP-FIE, Mibanco, EDYFICAR, Confianza and in Asia include XAC Bank, Nirdham, Share, SB Bank, CARD, ACLEDA, OMB, First MF Bank, Hatta Kaksekar, Vision, and EMT.

¹) Including private individual and

²) Including employee and the board of directors.

Moving to the stakeholder concept, the good governance of the transformed MFIs is crucial as they have been legally eligible to mobilize voluntary saving for the poor. From policy perspective, the regulated MFIs should then be subject to prudent regulation and supervision. This is in particular to protect precious savings of the poor against unsound financial practices that can lead to bankruptcy and collapse of the MFIs. Hence, good governance and accountability are needed, in order to meet prudent regulation and maintaining adequacy capital. However, whether or not, financial authorities should apply the universal principle of sound *banking* regulation and supervision (e.g. Basle Accord) to the regulated MFIs is a big question. In dealing with risks, for instance, the MFIs may act differently to that of commercial banks. Commercial banks can react more quickly in the case of insolvency through recapitalizations. This can be possible because they usually have better access to capital market than that of the regulated MFIs. Whereas, the owner of the MFIs may not be interested to add more capital because they may have nothing to lose in the case of bankruptcy. If the MFIs call the donors for capital rescue, their capacity to do so would be too late because the approval and disbursement of additional capital could take quite long time. Indeed, financial companies facing illiquidity problems require quick capital defence. According to Vogel *et al.* (2000), however, it should be acknowledged that the capacity of the regulated MFIs to sustain capital adequacy requirement is limited because of their social missions to serve a number of poor clients. This should also be a concern for financial authorities in dealing with MFIs.

4.3 Accessibility to Commercial Sources of Funds

The transformation of the microfinance NGO to the regulated MFIs is to provide more access to commercial funds. Among other reasons, this will depend on their financial performance, investment risks and regulations attached to the investment and business climate favourable to the MFIs. Apart from the accessibility of the MFIs to commercial funds, this success is not mainly based on their financial performance, rather than the guarantee from influential managers and or multilateral funding agencies. For instance, in the Philippines, the CARD bank has obtained substantially commercial credits from banks because a personal link exists between the members of the directors board and the senior executive of the creditors (Goodwin-Groen, 1998). In 1997 Banco Sol successfully issued $3.0 million bonds only with a guarantee from USAID. Similarly, the success of Mibanco to borrow $5.0 million from IFC is due to the assurance from the Accion International's Latin America

Bridge Funds (Fernando, 2003). This reflects that most commercial sources of funds are seemingly reluctant to provide loanable funds to the regulated MFIs. Similarly, only few regulated MFIs in the Asia and Pacific region received credits from commercial banks to support their mission. Two factors are responsible for this: the lack of transparency and comparable risk assessments to the creditworthiness of the MFIs (Charitonenko *et al.*, 2004).

The weakness in transparency is partly because the existence of funding subsidies masks market risks of the MFIs, so that their profitability does not clearly indicate market-based profit. This then discourages external financing for the MFIs. Unsound monetary policies leading to financial instability puts another problem as it can increase the risks of commercial investments on the regulated MFIs. Pouliot (2002) points out that high risks, coupled with the lack of standardised measurement on risks imply that the financial transparency in the MFI is substandard. As a result, credit worthiness of the regulated MFIs could not be assessed comparably. For this reason, prudent regulation of the MFIs is an important element to increase transparency, providing a conducive investment climate for the MFIs (Pouliot, 2002). For instance, the increase in disclosure and transparency of rural banks in Indonesia (BPR) has improved their accessibility to commercial credits from the banking sector. Charitonenko *et al.*, (2004) estimate that about one-third of existing rural banks in Indonesia have enjoyed credits from commercial banks.

Despite the difficulty of the transformed MFIs to access commercial loans, they have successfully mobilized funds from the clients. The passbook savings have been introduced to tap funds from poor clients, while deposit-type services are addressed to mobilize funds from wealthier clients. For instance, following the transformation of CARD, bank in the Philippines has been capable to mobilize voluntary savings of about 61.2 million pesos in 2002, compared to just about 4.9 million pesos before the transformation (Alip, 2003). Similarly, in Peru following the transformation of Mibanco in 1998 and the introduction of voluntary saving in 2001, saving mobilization increased about US$10.4 million by 2002. The mobilisation of funding deposits also indicates a remarkable result. The saving deposits of Mibanco increased from $1.4 million in 2000 to about $12 million in 2003. In Africa, the deposit mobilization of K-Rep in Tanzania increased from $US3.48 million in 2000 to about $11.35 million in 2003. The introduction of deposits of the transformed MFI in Pakistan (FMB), Nirdhan Bank in Nepal, EMT in Cambodia also recorded a significant progress (Fernando, 2003).

4.4 Transformation and Outreach

The central issue of the transformation into regulated MFIs is whether or not; it can increase the outreach of the transformed institutions. In the other words, the question is whether the transformation has drifted the FMIs away from their social mission. The term "outreach" refers to four aspects. The first is the depth of outreach referring to the number of poor covered by the MFIs. The second, the breadth of outreach, indicates the number of clients served. The third is the scope of outreach that refers to the range of financial services for the clients and the last is the sustainability of financial services provided by the MFIs (Charitonenko *et al*.. 2004, Meyer, 2002 and Schreiner, 2002).

Although, the transformation into the regulated MFIs has significantly resulted in various financial services to the poor, it depends on what type of institutions they were transformed into. The transformation into non-bank financial institutions has a lower capability to provide financial services than that of bank-type institutions. This can be the case because financial regulations in some countries do not allow non-bank institutions to provide certain services such as public deposits, check accounts and international money transfers. The transformation of Compartamos into SOFOL in Mexico, for instance, is not permitted to mobilize funds through deposit services. In Peru, the regulated nonbank MFIs are allowed to issue deposit only if they can achieve higher minimum capital requirement. By contrast, the transformation into bank-type MFIs, such as Mibanco in Peru, BancoSol in Bilivia and K-Rep in Kenya, ACLEDA bank in Cambodia have no legal restriction to provide such services (Fernando, 2003). This indicates that financial regulation has an important role on determining the breadth of outreach of the transformed institutions.

The depth of outreach is more concerned as it can link the capability of the transformed MFIs to provide the microfinance services with the income level of their clients. The depth of outreach is usually measured by the average loan size. The larger loan size reduce the capability of the poorest to serve the loan and therefore, decreasing the depth of outreach. At macro level, comparing the average loan size between regulated and nonregulated MFIs in Latin America shows that the average loans of regulated MFIs is significantly larger than that of non-regulated MFIs. This reflects that the transformation has drifted the MFIs away from their social mission. However, the larger size of loans does not necessarily lead to the mission drift of the MFIs. The larger loan size can be a response of the regulated MFIs to meet the demand on the various ranges of financial services resulted from the increase in economic activities of their clients (Christen, 2001). From a different perspective, Charitonenko *et al.* (2004) state that the inability of the MFIs to cover the 'hardcore' poor, the bottom 50 percent of the poor below poverty line may be acceptable because this poorest of the poor often have no sufficient debt capacity even for microcredits. Providing credits for the poorest with no income generating activities will deprive financial soundness of the MFIs due to an increase in the possibility of loan defaults. Hence, the precious role of the transformed MFI in this case is not to provide microcredits but saving facilities.

A micro-level study by Schreiner (2002) on BancoSol argues that the efforts to achieve profitability do not decrease in the depth of outreach. Similarly, the transformation of Mibanco in 1998 could maintain about half of their loan portfolios below $500, indicating the capability to achieve the deeper outreach. Considering geographic coverage, ACCION survey on Mibanco client has found that almost half of its clients are living in poverty areas covering those working as pot-makers, market vendors and others. In the Philippines the transformation of an NGO, Centre for Agriculture and Rural Development (CARD), into CARD bank doubled the poor clients from 10,868 in 1997 to about 26,369 in 1999 (Carpio 2004). While, the transformation of ACLEDA bank in Cambodia increased its micro business loans by about 44 percent (Fernando, 2003). By contrast, a study of Senanayake and Ho (2002) on the six provinces of the Delta Mekong in Vietnam found that the poorest has a lower access to the cheap credits provided by both formal and informal MFIs than that of the better-off poor. Although, according to the author, this finding may be unnecessarily as a result of the commercialization of the MFI in Vietnam. Therefore, they suggest that to provide the poorest with credit, the government should design special institutions to address this issue.

The depth of outreach can also be measured by the number of women served by the MFIs. Study on the Khula Enterprise Finance in the Republic of South Africa, Makina and Malobola (2004) reveals that in a credit guarantee scheme, women participation is relatively less than their men counterparts. This can be the case because the women participation is not considered to be the targeted recipient of such a loan program. Similarly, a study by Siwar and Talib (2001) in Malaysia on three different types of the MFIs *(Amanah Ikhtiar Malaysia, Yayasan Usaha Maju and Koperasi Kredit Rakyat)* show that the implementation of the Grameen Bank-type operation does not change much the outreach of those MFIs. The numbers of poor women served by the MFIs remains constantly lower than that suggested by a standard guideline of deeper outreach.

Geographical difficulty is the main constraint to reach the hardcore poor (Siwar and Talib, 2001).

A part from a geographical dispute, Mosley and Hulme (1998) conclude a negative impact of sustainability to the income of the hardcore poor. This can be the case because the poorest tends to be risks averse to take higher loans. The loans are often used to protect (smooth) their consumption against unpredictable changes in incomes or expenditures. For prospective lenders, the poorest having less saving capacity and often fail to secure the loan with collaterals means the higher possibility of loan defaults. As a consequence, the lenders tend to collect the loan instalment frequently, discouraging the poorest to borrow. In contrast, the better-off poor have access to higher loans for 'promotional' activities such as hiring more labour and the purchase of fixed capitals that can lead to the possibility of higher incomes perceived important to secure the loans (Mosley and Hume, 1998).

5. CONCLUSION

Microfinance industry has moved into a revolutionary stage of development. Initially, microfinance NGOs were seen as being a convenient vehicle for delivering pro-poor credits, previously ignored by most commercial financial institutions. Recently, most microfinance scholars and practitioners conclude that commercial approach to microfinance lead the way to become financially viable and less subsidy without reducing the role to assist the poor. However, this conclusion is seemingly premature as many empirical works have failed to conclude that the commercialisation of the MFIs leads to the deeper outreach. Therefore, a part from the significant progress of the transformed MFIs, this change highly undermines the social mission of MFIs. To refine the view on the benefits of the transformation, the future empirical works should be addressed particularly to emphasize the depth of outreach of the various types of the transformed microfinance institutions in different countries with numerous socio-economic backgrounds.

Regarding the dual mission of profitability and outreach, some efforts should be considered at institutional and regulatory levels. At institutional level, the core issue is to attain the good governance that allows interest balance between social and private investors of the transformed MFIs. This is crucial as the failure to offset the dual mission can generate incoherent priority of the institution. Focusing more on profitability reduce the outreach which can disadvantage the interest of social investors. Hence the failure to narrow the trade-off can end up with an organisational breakdown in the long-run.

While the growth of saving mobilization of the poor is evident, the good governance and transparency of the transformed MFIs is a central issue. In this respect, the implementation of prudent regulation and maintaining adequacy capital is required to protect the precious savings of the poor. Considering the dual missions of the regulated institutions, a particular dispute is whether or not financial authority should attach the universal principles of prudent regulation and supervision to MFIs. Moreover, the lack of access to commercial borrowing reflects that the transparency in the transformed MFIs remains relatively substandard. Coupled with the financial instability, the weak transparency and the absence of comparable measurement on risks cause higher risks of investments on the MFIs. Therefore, the investment policies and regulation that provide business circumstance conducive to microfinance investment is vital. In this case the precursor condition is to achieve prudent macroeconomic policy as monetary instability creates high risks and lowering returns of investments on the microfinance industry.

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