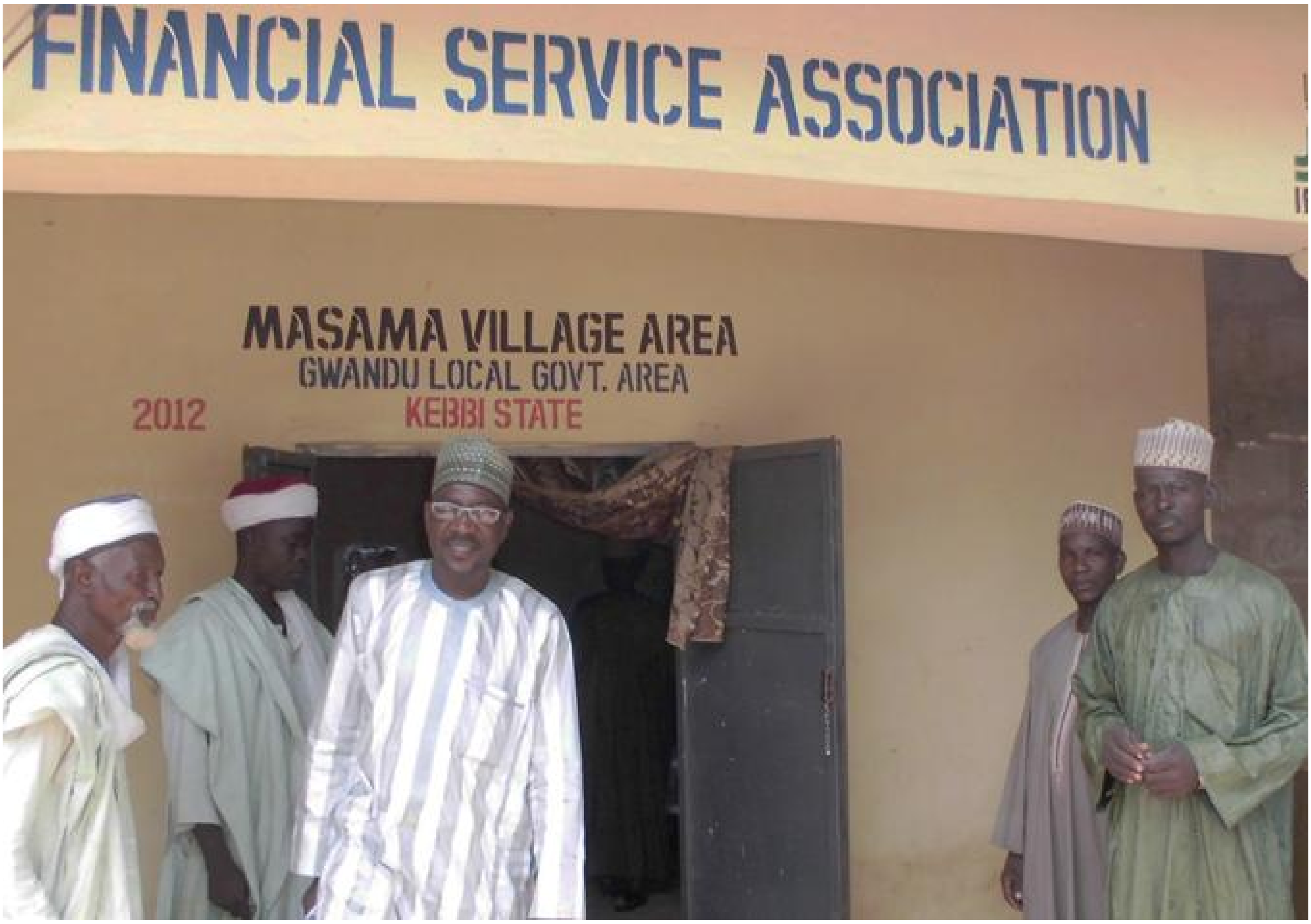
TEASER

Formalising community-based microfinance institutions

IFAD
Investing in rural people

Inclusive rural financial services



Photografer: M.Hamp
Kebbi State, Nth Nigeria

Introduction

Microfinance institutions (MFI) take various forms these days, among them: projects, credit union or village banking networks, savings and credit cooperatives and mutual institutions, associations, capital companies, etc.

For some time now, large MFIs with the status of NGO/association have been opting for transformation to include shareholders, ensure their medium- and long-term financing, and develop and diversify their products.

MFI regrouping operations are a more recent phenomenon, dictated essentially by regulatory constraints.

MFI transformation or regrouping operations may have several objectives, but their feasibility or success depends on the existing legal and regulatory framework.[1]

These operations are well suited to the current approach of the International Fund for Agricultural Development (IFAD) to rural finance, which favors increasing the viability of financial service providers to sustainably contribute to poverty reduction in rural populations.

Transformations or regrouping of rural microfinance institutions are often an effective way to: (i) tailor their legal status to their growth imperatives; (ii) diversify their sources of financing; (iii) professionalize their operations; (iv) gain their independence from donors; (v) clarify their ownership; (vi) improve institutional governance; and (vii) ensure their institutional and financial viability. Failing transformation or regrouping operations, some MFIs could disappear, and the cost of their disappearance could prove higher for the community than the cost of financing these changes.

Protographer: M. Hamp
Mongolia Hentii Aimag: Savings and Credit Cooperative

[1] The contexts used as the basis for the design of these toolkits are African. More specifically, the legal and regulatory framework is the one prevailing in the WAEMU member States. Most of the analyses and concepts, however, are applicable to other legal and regulatory contexts and frameworks.

DEFINITIONS

Microfinance regroups all activities offering proximate financial services to people excluded from the banking system who are able to pay for the services.

In microfinance, **proximate financial services** consist of savings, microcredit, signature loan, microinsurance, and money transfer services.

Proximity in microfinance consists of geographic, cultural, and behavioural proximity and straightforward procedures.

A **microfinance institution** is a financial institution authorized to offer its clientele some of the proximate financial services listed above. Microfinance institutions authorized to offer all the proximate financial services are rare. Microfinance institutions generally obtain authorization to offer savings, microcredit, and signature loan services directly, strategically partnering with other financial institutions to act as their agent in offering microinsurance and money transfer services.

Institutionalization is an operation whereby an organization lacking legal personality (project or group) comes to acquire it. The institutionalization of an MFI, therefore, consists of the transformation of an experimental model into an autonomous institution with legal personality (that is, one that is legally autonomous).[2]

Article 181, paragraph 1 of the Uniform Act of the Organization for the Harmonization of Business Law in Africa (OHADA)[3] states, "**The transformation** of a company shall be an operation whereby the company changes its legal form by decision of its partners". Thus, the ordinary transformation of one type of company into another, in accordance with the prescribed procedures, does not involve the creation of a new legal personality. When a company acts, the rights and obligations it contracted under its earlier form continue under the new form.

It should be noted, however, that once transformed, a company with a corporate form that is no longer one of those authorized in the aforementioned Uniform Act loses its legal personality. This is the case when a company decides to become an association, cooperative, or mutual society.[4]

In microfinance, **institutional transformation** is modeled on the concept of institutional transformation in business law. For a microfinance institution with legal personality, it consists of changing its legal status.[5]

A **regrouping of microfinance institutions** is an operation whereby two or more microfinance institutions join together to become or create a larger microfinance institution or network of microfinance institutions.

Background and context

Microfinance developed in Africa during an initial "experimental" phase, without a great deal of State intervention but with the support of donors from the North. Subsequently, once the innovations of microfinance institutions were put to the test in the fight against poverty and the promotion of private initiative, many donors became interested in the sector and encouraged the creation and development of microfinance projects and NGOs/associations in virtually every African country.

The development of the microfinance sector initially occurred in a context marked by a nearly complete absence of State regulation and oversight, leading to crises that resulted in the bankruptcy and closure of certain MFIs in the early 1990s.

[2] Guide de transformation institutionnelle des SFD de la zone UEMOA, René AZOKLY and Ibrahima Fane CAMARA, December 2009.
[3] Organization for the Harmonization of Business Law in Africa.
[4] Guide de transformation institutionnelle des SFD de la zone UEMOA, René AZOKLY and Ibrahima Fane CAMARA, December 2009.
[5] Idem

These crises raised awareness among regulatory authorities and development partners about the need for professionalization, regulation, and supervision of the sector. The result was legal and regulatory frameworks specifically for the microfinance sector in the mid-1990s that were strengthened over time.

Today, regulations in the microfinance sector in most African countries are increasingly favorable to MFI institutional transformation or regrouping operations. Moreover, the microfinance sector has entered a phase of maturity characterized by: (i) fiercer competition; (ii) greater diversification of client needs; (iii) sophisticated client demand; (iv) increasingly demanding clients aware of their rights; and (v) an increase in the number and seriousness of the risks associated with MFI activities.

This was the context in which several MFI institutional transformation or regrouping operations were launched in Africa. These operations took different forms:

- The transformation of a microfinance project into a savings and credit cooperative, as in the case of the Credit and Savings Alliance for Production of Senegal (ACEP of Senegal).
- Transformation of a microfinance project into a corporation, as in the case of the Agency for Private Enterprise Credit of Cameroon (ACEP of Cameroon).
- Transformation of a microfinance NGO into a commercial bank (as in the case of K-REP in Kenya).
- Transformation of a microfinance NGO into a commercial microfinance institution authorized to accept savings (as in the case of the Kenya Women Finance Trust (KWFT) of Kenya).
- Creation by a commercial bank of a microfinance branch office with the legal status of a corporation (as in the case of FINADEV of Benin).
- Regrouping of two regional networks of self-managed village savings and credit institutions (CVECA) into a centralized microfinance institution with in-house technical support service and agencies, pursuant to the new law (as in the case of the Association for the Promotion of Inclusive Finance of Burkina Faso] (APFI-Burkina).
- Restructuring of a network of self-managed village savings and credit institutions (CVECA) by creating an in-house technical support service and regrouping community-based credit unions (as in the case of the network of the Association of CVECAs and CECAs of the Centre Region (A3C) in Cameroon).

The majority of these operations involved MFIs that served rural areas.

Rationale

In practice, institutional transformation basically involves MFIs that are NGOs/associations that have reached the maturity phase. Experience has shown that when this type of MFI reaches maturity, absent its transformation to begin a new growth phase, it will inevitably decline and eventually disappear. In fact, once they reach a certain age and size, MFIs that have the legal status of NGOs/associations confront a series of challenges (governance issues, difficulty securing financial resources, lack of owners, etc.) that only institutional transformation can overcome.

Regrouping is an external growth strategy embraced by certain small MFIs to reach a critical size that will enable them to meet the demands of the legal and regulatory framework.

MFI institutional transformation or regrouping operations require a great deal of technical assistance and donor support. For more details on how to conduct MFI institutional transformation or regrouping operations, see IFAD’s “How to do” series: Institutional transformation and regrouping of rural MFIs.

Summary of past experience

Experience has shown that MFI institutional transformation or regrouping processes are difficult, complex, expensive, and very time-consuming. These processes are not linear and have several strengths:

- They improve MFI governance;
- They bring in shareholders;
- They increase the ability of MFIs to secure commercial financing;
- They expand the range of financial services offered to clients;
- They ensure financial and institutional viability;
- They increase transparency and financial accountability.

However, they also entail weaknesses and risks:

- The MFI shifts from a tax-exempt institution to one subject to all taxes;
- The process is very expensive;
- The process is very lengthy;
- There is a risk of mission drift.

Challenges, opportunities and benefits

Institutional transformation or regrouping of microfinance institutions often requires preauthorization from the regulatory authorities at the start of the process and approval of the new entity resulting from the operation at the end. These authorization processes can be particularly lengthy and onerous.

The other challenges are:

- Resistance to change on the part of certain salaried employees and elected officers;
- Selection of the new entity's shareholders;
- Selection of the members of the new entity's governing bodies;
- The magnitude of the project costs;
- Mobilization of the human resources needed to implement the project;
- Coordination among the different stakeholders, especially technical and financial partners;
- Appointment of the Director and redeployment of senior management in the new entity.

To overcome the challenges and manage the risks mentioned above, it will be necessary:

- To entrust the operations to a qualified technical assistance institution;
- To draw lessons from past experience;
- To collaborate with regulatory authorities from the outset;
- To prepare and implement a good communication plan;
- Not to rush into things.

The success of MFI institutional transformation and regrouping operations will make it possible to:

- Professionalize the microfinance sector;
- Consolidate the microfinance sector by reducing the number of small and poorly managed MFIs;
- Make supervision and control of the microfinance sector by the regulatory authorities less onerous and more effective;
- Improve the quality of service to clients.

Summary of key issues

Preconditions for IFAD's engagement

Prerequisites for IFAD support for MFI institutional transformation and regrouping operations

To benefit from IFAD support, the institutional transformation or regrouping operations must be those of MFIs working in rural areas, and the operations must result in viable and sustainable rural financing institutions. These institutions must be well-managed and have good prospects of financial viability.

Recommendations for the design and execution of projects

IFAD should help convince governments and donors that supporting the financial and institutional viability of rural MFIs through institutional transformation or regrouping operations can contribute to poverty reduction in rural populations.

Insofar as possible, IFAD projects should support rural MFIs that are planning to begin transformation or regrouping operations. This support should be provided at both the micro level (support for rural financial institutions seeking transformation or regrouping) and the macro level (support for improving and implementing the legal and regulatory framework).

Before supporting an institutional transformation or regrouping operation, however, IFAD must a priori ensure the sound financial health of the institutions involved.

Second-tier organizations

To ensure the success of the MFI institutional transformation or regrouping operations that will receive IFAD support, collaboration with a technical partner with extensive experience in this domain is imperative. The intervention of this technical partner will enable both IFAD and the institutions to benefit from a good methodology, optimize the process, gain time, lower project costs, and reduce the likelihood of failure. Experience has shown that at the conclusion of transformation or regrouping processes, the new entities resulting from these processes still need a great deal of technical assistance, which the technical partner can continue to provide.

Brief description of the institutional transformation and regrouping of rural MFIs toolkit[6]

⇨**Teaser**: Sets out the scope (you are here).

How To Do Note: Describes the principal stages and offers advice on design and implementation.

Lessons Learned: Analyses past experiences and offers recommendations for the future.

[6] All toolkits can be found at https://www.ifad.org/topic/overview/tags/knowledge_notes

©IFAD/Fulvio Zanetti
Nepal – Second Small Farrmer Development Project

Originators

Michael Hamp
Lead Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: m.hamp@ifad.org

Jonathan Agwe
Senior Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: j.agwe@ifad.org

Francesco Rispoli
Senior Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: f.rispoli@ifad.org

Acknowledgements

The writing of this toolkit has been a highly collaborative effort and we, the originators, would like to thank René Azokly, the main author, co-author Renée Chao-Béroff and the team from the Participatory Microfinance Group for Africa (PAMIGA) for their support and contributions. IFAD's grant to PAMIGA supporting the grant-funded programme "Responsible and Sustainable Growth for Rural Microfinance" enabled us to capitalise on PAMIGA's extensive experience in Merger and Transformation of small community based Financial Institutions. Our thanks also goes to the internal peer reviewers of the Policy and Technical Advisory Division of IFAD for their insightful feedback.

Contact

Maria-Elena Mangiafico
Knowledge Management and Grants Officer
Policy and Technical Advisory Division
E-mail: PTAKMmailbox@ifad.org

September 2016

IFAD

International Fund for Agricultural Development
Via Paolo di Dono, 44 - 00142 Rome, Italy
Tel: +39 06 54591 - Fax: +39 06 5043463
E-mail: ifad@ifad.org
www.ifad.org
www.ruralpovertyportal.org
ifad-un.blogspot.com
www.facebook.com/ifad
instagram.com/ifadnews
www.twitter.com/ifadnews
www.youtube.com/user/ifadTV