INSTITUTIONAL TRANSFORMATION OF POVERTY-FOCUSED MICROFINANCE INSTITUTIONS IN BANGLADESH, NEPAL AND MALAYSIA

by

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Dedication

This dissertation is dedicated to my beloved parents, Md. Musleh Uddin and Musammat Aziza Khatun

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
ADBN	Agricultural Development Bank of Nepal
AIM	Amanah Ikhtiar Malaysia
APDC	Asia and Pacific Development Centre
ASA	Association for Social Advancement
BancoSol	Bank Solidarity, Bolivia
BRAC	Bangladesh Rural Advancement Committee
BRDB	Bangladesh Rural Development Board
BCIC	Bumiputra Commercial and Industrial Community
CASHPOR	Credit and Savings for Hard-core Poor in Asia and Pacific
ChBB	Chimek Bikas Bank
CDF	Credit Development Forum
CFTC	CASHPOR Finance and Technical Centre
CGAP	Consultative Group to Assist the Poorest
CMF	Centre for Microfinance
CPI	Consumer Price Index
CSD	Centre for Self-help Development
CWDEC	Community Women Development Centre
CWFD	Community Women for Development
CYC	Chatare Yuba Club
DCRDC	Dhaulagiri Community Resource Development Centre
DSK	Dustha Shahajya Kendra
EGBB	Eastern Grammeen Bikas Bank
FELDA	Federal Land Development Authority
FSS	Financial Self-Sufficiency
FWGBB	Far-Western Grammeen Bikas Bank
GB	Grameen Bank
GDP	Gross Domestic Product
GO	Governmental Organisation
GT	Grameen Trust
HRD	Human Resource Development
IADP	Integrated Agriculture Development Programme
IDB	Islamic Development Bank
IDF	Integrated Development Forum
IHI	Ikhtiar House Index
ILS	Ikhtiar Loan Scheme
IRDP	Integrated Rural Development Programme
IT	Information Technology
KSUS	Krishi Samajik Unnayan Sangstha
MCDC	Mahuli Community Development Centre
MRGBB	Mid-Region Grammeen Bikas Bank
MWGBB	Mid-Western Grammeen Bikas Bank
MFIs	Microfinance Institutions
MP	Malaysia Plan
MSS	Manabik Sahajya Sangstha
NDP	National Development Plan
NEP	National Economic Policy
NESDO	Nepal Educational and Social Development Organization
NGO	Non-governmental Organisations
NRB	Nepal Rastra Bank

NRDSC	Nepal Rural Development and Social Cooperation
NUBL	Nirdhan Utthan Bank Limited
NVP	National Vision Policy
PERDA	Penang Regional Development Authority
PLI	Poverty Line Income
PFP	Poverty Focussed Programme
PPRT	Program Pembangunan Rakyat Termiskin
OPP 1	The First Outline Perspective Plan
OPP 2	The Second Outline Perspective Plan
OPP 3	The Third Outline Perspective Plan
OSS	Operational Self-Sufficiency
PSDP 1	The First Penang Strategic Development Plan
PSDP 2	The Second Penang Strategic Development Plan
RAF	Rural Awareness Forum
RCS	Royal Co-operative Society
RDA	Regional Development Authority
RD-12	Rural Development Project 12
RM	Ringgit Malaysia
RMDC	Rural Microfinance Development Corporation Limited
SBB	Swabalamban Bikas Bank
SCC	Savings and Credit Co-operatives
SCO	Savings and Credit Organization
SEP-BD	Society for Elimination of Poverty- Bangladesh
SERU	Socio-Economic Research Unit
SOIVE	Society for Local Volunteers Effects
UNDP	United Nations Development Programme
WEAN	Women Enterprise Association of Nepal
WB	World Bank
WGBB	Western Grammeen Bikas Bank
VDSC	Village Development and Security Committee
YUM	Yayasan Usaha Maju

PENGUBAHAN INSTITUSI DALAM INSTITUSI KEWANGAN MIKRO BERFOKUSKAN KEMISKINAN DI BANGLADESH, NEPAL DAN MALAYSIA

ABSTRAK

Satu penemuan penyelidikan pada 1976 yang berkaitan dengan peranan kewangan mikro dalam mengurangkan kemiskinan di Jobra, Bangladesh telah mengembangkan satu gerakan kewangan mikro berfokuskan kemiskinan yang dipacu oleh pihak pertubuhan bukan kerajaan (NGO). Akan tetapi, institusi-institusi kewangan mikro ini menghadapi beberapa cabaran yang hanya dapat diatasi menerusi laluan pengubahan yang bersesuaian.

Objektif utama kajian ini adalah untuk menyelidiki hubungan antara ciri-ciri kepimpinan (kelayakan profesional, pengalaman dan kesirambungan pemimpin) dengan proses pengubahan institusi di kalangan institusi kewangan mikro dalam usaha mereka untuk menangani kekangan dalam menyampaikan perkhidmatan kewangan kepada golongan miskin secara lestari. Untuk memenuhi objektif ini, 33 institusi kewangan mikro di Bangladesh, Nepal, Malaysia dikaji secara empirik.

Dengan berpandukan kepada kerangka teori North (1990) dan Eckel *et al.* (1998), satu analisis ke atas 33 institusi kewangan mikro yang matang dan daripada pelbagai bentuk asal telah menghasilkan beberapa dimensi penemuan penting. Kajian ini mendapati bahawa, walaupun dengan persekitaran ekonomi, sosial dan politik yang berbeza di antara Bangladesh, Nepal dan Malaysia di sebelah pihak, serta status atau identiti asal institusi di sebelah lain, kebarangkalian untuk menjangkau sebilangan besar golongan miskin, dan pada waktu yang sama, menyenggara tahap pencapaian keberdikarian kewangan yang tinggi adalah lebih besar di kalangan institusi kewangan mikro yang berasaskan kepada latarbelakang ekonomi dan perbankan pengasasnya serta kesinambungan kepimpinan profesional dalam pengurusannya, serta keupayaan

mereka memperoleh efisiensi kewangan dan pengurusan. Pengalaman Grameen Bank dan Association for Social Advancement di Bangladesh serta Nirdhan Uttan Bank di Nepal membuktikan hubungan penting ini.

Di hujung spektrum lain, terdapat institusi kewangan mikro berfokuskan kemiskinan yang dipacu NGO, diasaskan oleh golongan bukan profesional serta mengalami keadaan tidak berkesinambungan dalam kepimpinan professional seperti Women Entrepreneurs Association of Nepal dan Nepal Educational Society Development Organisation di Nepal, Krishi Samajik Unnayan Sangstha di Bangladesh, serta Yayasan Usaha Maju di Malaysia yang kekal kecil, kurang berkesan dan mahal dari segi kos operasi. Pengalaman institusi kewangan mikro berfokuskan kemiskinan yang diasaskan oleh pihak kerajaan seperti di Nepal dan pengalaman Amanah Ikhtiar di Malaysia yang mendapat peruntukan kewangan yang begitu menggalakkan dan liberal juga tidak mendatangkan pencapaian yang sewajarnya.

Perdebatan isu “trade-off” juga telah diputuskan oleh kajian ini yang mendapati bahawa matlamat menjangkau lebih ramai isirumah serta mencapai keberdikarian kewangan dapat dicapai melalui kesinambungan kepimpinan professional yang berteraskan inovasi ke arah memaksimumkan, efisiensi pengurusan dan kewangan perlu ditekankan.

Tanpa mengira persekitaran operasi serta status institusi pada masa permulaan, kajian ini mendapati bahawa institusi kewangan mikro berfokuskan kemiskinan harus mendapatkan status pengubahan yang wajar yang akan memperkasakan serta melandaskan dwimisi institusi kewangan mikro, iaitu memberi manfaat kepada golongan miskin serta mencapai keberdikarian kewangan.

INSTITUTIONAL TRANSFORMATION OF POVERTY-FOCUSED MICROFINANCE INSTITUTIONS IN BANGLADESH, NEPAL AND MALAYSIA

ABSTRACT

A research discovery in 1976 on the role of microfinance in reducing poverty in Jobra, Bangladesh facilitated the growth of an NGO-driven poverty-focused microfinance movement. However, these NGO-driven microfinance institutions (MFIs) face a number of challenges that can be overcome through the appropriate transformation route.

The main objective of this study is to examine the link of leadership characteristics (Professional Qualifications, Experience and Continuity of leader in the management) with process of institutional transformation of MFIs in their efforts to overcome constraints of rendering financial services to the poor in a sustainable manner. To meet this objective, 33 MFIs in Bangladesh, Nepal and Malaysia were studied empirically.

With the theoretical framework of North (1990) and Eckel *et al.* (1998), an analysis of 33 matured MFIs of different original status, have uncovered important dimensions. This study notes that irrespective of the diversity in the economic, social and political environments of Bangladesh, Nepal and Malaysia on the one hand, and the initial institutional status or identity on the other, the probability of reaching out to huge numbers of poor clients while maintaining a high degree of financial self-sufficiency is greater among microfinance institutions that are entrenched with the economic and banking knowledge of their founding members, their continuity in the management, and their ability to pursue financial and management efficiency. The

experience of Grameen Bank and ASA of Bangladesh and Nirdhan Uttan Bank Limited of Nepal demonstrates the vital link.

At the other end of the spectrum, those NGO-driven poverty-focused microfinance institutions founded by non-professionals and experiencing discontinuity of professional leadership such as Women Entrepreneurs Association of Nepal and Nepal Educational and Social Development Organisation of Nepal, KSUS of Bangladesh and Yayasan Usaha Maju of Malaysia remain ineffectively small and costly.

Nepal's experience with a government-driven poverty-focused microfinance institution and the Malaysian Amanah Ikhtiar Malaysia experience with favourable and liberal funding did not bring about respectable achievements either.

The debate over the issue of trade-off has been put to rest by this study as reaching out to a large number of poor households can be undertaken in a financially sustainable manner through the continuity of professional leadership armed with innovations towards maximising financial and management efficiency.

Irrespective of their operating environments and despite the variety of forms at the point of start-up, this study demonstrates that poverty-focused microfinance institutions have to secure appropriate transformation status that will strengthen and entrench their dual mission of benefiting the poor and achieving financial self-sufficiency.

CHAPTER ONE
INTRODUCTION

1.0 Emergence of Microfinance

Since the Second World War, the world has experienced quick successions of development strategies ranging from reconstruction and rehabilitation to import substitution (Askwith, 1994; Yunus, 1994; Remenyi, 1991; Singer, 1989; Remenyi, 1991; Singer, 1989; Adelman & Morris, 1997). A diversity of development strategies ranging from growth through industrialisation, redistribution with growth, rural development through green revolution (Details in Appendix 1) were adopted by numerous national governments during the post world war period. As these strategies were designed for macro-economic growth, they did contribute to substantial increase in national income, production (Remenyi, 1991) and reduction in poverty rate. By the late sixties, a new set of strategies namely structural adjustment, human resource development and infrastructure development were designed to overcome the shortfalls of the earlier models. However, these policies of institution-building and infrastructure development too were ineffective to tackle the structural economic problems of developing nations. Those strategies left out a huge proportion of population, the unemployable human resources and especially poor women, from those benefits. The promise of the benefits of economic growth to 'trickle down' that dominated the development strategies of the fifties through sixties had limited impact on the poor (Askwith, 1994; Remenyi, 1991; Singer, 1989; Haines, 2001).

However, it has to be acknowledged that those households or population that could benefit from the above strategies of growth and development have benefited and managed to get out of poverty leaving behind a huge residue that require a fundamentally new and different approach. As such a large number of the poor in the developing countries remain poor (ABD, 1999; Ariffin, 1994; Askwith, 1994; Sharif, 2000; Khan, 2000).

By the seventies, national development priorities again shifted to poverty-focused relief strategies in the form of vulnerable group development through relief goods, food for works and provision of basic needs. These programmes were highly expensive for the developing nations to sustain. The beneficiaries reverted to poverty as soon as the goods and services diminished. The vulnerable group could not capitalise from the one-time temporary relief goods and basic needs. Such strategies too did little to the residue left behind by the earlier models (Yunus, 1994). A brief on poverty, causes and measurements of poverty is given in Appendix 2.

Microfinance have emerged in the late seventies as a new strategy to overcome the structural shortfalls of the earlier development strategies in tackling the large residues through the provision of financial and other productive resources to the poor as their basic thrust (Yunus, 1994 & 1998; Seibel, 1998; Getubig, 2000). The residues that were unable to capitalise on the strategies of growth and development were basically human resources both male and female with varying ages with limited educational achievements and are poorly resource-based. However, their demographic existence in the face of harsh economic, social and political adversaries accompanying those phases of development model had been due to their cumulative survival skills facilitating their subsistence income. A small loan amounting to less than US$2.00 or Taka 120.00 to 42 poor women in a remote village of Jobra, Chittagong in Bangladesh, brought about impressive impact towards increasing household income by utilising their survival skills to make bamboo stools, revolutionised the philosophy of development especially on poverty reduction (Yunus, 1998).

Financing scaling up of income generating survival skills with banking on economic empowerment of poor women have become the latest strategy, a model that effectively tackles the residues of the national development. The poor have limited access to the job market due to limitation of job specific technical and educational requirements and skills. With the poor lacking in collateral assets, they could not benefit from banks and financial institutions for access to capital to scale-up their income-generating survival skills and acquire other productive resources (Gibbons, 1994; Yunus, 1994; Yunus, 1998; Khan, 2000). Therefore, the poor have very limited opportunities that could be capitalized from the macro-economic growth strategies. The benefits of the increase in national income and production usually go to the upper echelon of the society (Remenyi, 1991) who possess the means of production and know-how (Aliyev, 2003) and has relatively easier access to productive resources (Remenyi, 1991). The institutional and financial systems in developing countries do not support the poor to have productive and financial resources to participate in economic activities (Remenyi, 1991).

By the early nineties, microfinance had emerged as a viable strategy in both developed and developing countries. A decade later, more than 57 million poor households are being served by different microfinance institutions all over the world (Micro-credit Summit, March 2006). It began as a movement and has emerged as an industry, as it is both financially viable and it is a means to the economic ends of the poor (Yunus, 1998). Financing scaling-up outreach and income generating survival skills have emerged as viable alternatives to eradicate poverty. A discussion on microfinance theory and practice is given in Appendix 3.

1.1 Impact of Microfinance

Access to microfinance enables the poor to utilise their survival skills, create self-employment, increase household income, improve their quality of life and overcome their poverty (Bhatt & Tang, 2001; Gibbons & Meehan 1999; Hulme and Mosley, 1996a; Khandker *et al.,* 1995; Khandker, 1996 & 1998; Kabir, 1989; Nelson, 1999; Newaz, 2003; Paradis, 1998; Seibel, 1998; Silau, 1998; Salma, 2006).

i. **Self-employment:** Microfinance creates self-employment opportunities for the rural poor especially women and other 'unemployable' human resource i.e. those who are inaccessible to job market, basically lacking the educational and lack of job specific skills and qualifications (Khandker *et al.,* 1995; Khandker, 1996 & 1998; Khandker *et al.,* 1998; Kabir, 1989; Nelson, 1999; Newaz, 2003; Silau, 1998; Salma, 2006). These unemployable human resources are now engaged in micro-business activities with the use of small loans from microfinance institutions.

ii. **Income Generation:** The borrowers who were underemployed or un-employed then become self-employed and able to generate additional income (Khandker *et al.,* 1995 and 1998; Salma, 2006) more so among those who are engaged in non-farm activities (Khandker *et al.,* 1998). Not only that the borrowers do benefit but microfinance facilitate trickling-down impact to the other household members (Gibbons & Meehan, 1999; Khandker, 1996; Khandker *et al.,* 1998; Seibel, 1998b & 1999; Salma, 2006)

iii. **Accumulation of Savings:** Participation in microfinance programme facilitated the borrowers to save at a higher rate than the non-borrowers (Khandker *et al.,* 1998; Salma, 2006). The additional income helps the borrower to repay their weekly instalments and weekly savings.

iv. **Quality of Expenditure:** Microfinance has positive influence in changing the expenditure pattern of the participating households. Due to the increase in income and social orientation, the borrower spend more on health and children's education, allocate resources for savings and other investment purposes at higher rate than before joining microfinance programme, thus improving the quality of expenditure (Todd, 1996; Osmani, 1998). The investment expenditure has overtaken the consumption expenditure i.e. the higher rate of income now goes to the investment basket.

v. **Accumulation of Assets:** Due to the change in the expenditure patterns with increase in savings and investment, the borrowers can gradually build-up a productive asset-base that prevented them from falling back into poverty (Salma, 2006).

vi. **Quality of Life:** The quality of life of the poor who participated in microfinance had improved due to the increase in the household income. The average life expectancy, business skills and productivity have increased due to awareness about health and increase in expenditure on quality items such as expense on health, medical training, participation in workshops and regular socialisation through centre meeting and the role of continuous motivation (Osmani, 1998; Newaz, 2003).

vii. **Social Awareness:** Due to the socialisation of microfinance programme, the borrowers become more conscious about their rights and responsibilities towards family and the society as a whole (Fleischer, 1999; Schuler *et al.*, 1997; Yunus, 1998; Latifee, 2003, thus controlling family size and priority in their children's education (Todd, 1996).

viii. **Role of Women:** Poor rural women are usually neglected. The women who participated in the microfinance programme have empowered themselves with their participation in business and other income generating activities with some control over the investment capital. This control on the capital enabled them to take participate in the decision-making process within the household (Kabir, 1999) as well as social affairs (Todd, 1996; Osmani, 1998), thus enhancing the role of women in general.

ix. **National Economic Growth:** Microfinance is effective not only in creating self-employment and increasing household income but also contributes to national economic growth (Yunus, 1998). For example, 720 microfinance-NGOs (MF-NGO) have more than 139, 000 employees CDF, 2003), which is more than 1/10 of total employees of the government of Bangladesh. 720 Microfinance-NGO institutions in Bangladesh serve more than 14.00 million members, creating more than 14 million full time and part time jobs for the borrowers and their family members. Micro-credit made above 10 percent of the total domestic credit in Bangladesh in December 2003. Of this, MF-NGO as source credit alone constituted 5.8 percent of total domestic credit (CDF, 2003). The amount delivered to these borrowers exceeded US$100, billion that is more than the total investment capital of the commercial bank in Bangladesh (CDF, 2003). These employment opportunities and investments have contributed to national economic growth.

Thus poverty-focused micro-finance programme has proven to be effective and equally efficient not only in raising household income, savings, productive assets, thus reducing poverty but also in sustaining poverty reduction in a financially self-sustaining manner (Yunus, 1998; Gibbons & Meehan, 1999; Seibel & Perhusip, 1998; Otero, 1999, Hulme & Mosley, 1996a). This has been a major breakthrough in the evolution of a development model in reducing poverty.

The Micro-credit Summit of 1997 comprising representatives of national governments, parliamentarians, microfinance practitioners etc with due recognition to the effectiveness of microfinance declared a goal of reaching 100 million of the world's poorest households, especially women of those households with credit for self-employment and other financial services by 2005. The United Nations, with due recognition of the role and effectiveness of microfinance followed suit in proclaiming 2005 as the International Year of Micro-credit.

The momentum generated by microfinance worldwide resulted in the world leaders at the general assembly of the United Nations in 2004 in setting the millennium development goal to halve the world's poverty by 2015 with a major thrust being placed on microfinance. The economic empowerment of women, sustainable increase in household income, creation of self-employment opportunities, increase in savings, investment and productive assets shown by microfinance institutions facilitated the United Nations to adopt microfinance as one of their major thrust in halving world poverty by 2015 as millennium development goal.

The Grameen Bank is widely considered as one of the world's successful microfinance institution in banking with the poor (Gibbons & Meehan, 1999; Seibel & Torres, 1999; Seibel, 2001) because of its rapid expansion of outreach to a large number of the poor with a positive impact on income, employment, consumption, savings and assets of its participants (Khandker, 1996, Khandker *et al.,* 1998, Sinha, 1996), high recovery rates of 98% and program sustainability (Khandker, 1998; Khandker *et al.,* 1998; Hulme & Mosley, 1996; Getubig, 2000). A large number of microfinance institutions have replicated this approach in different parts of the world (Getubig, 2000; Grameen Dialogue, Vol. 59, 2004).

The current global microfinance industry has been inspired not only for the Grameen Bank's efficient physical performance and sustainability but also for its impact on social awareness and utilisation of human resources. Intellectuals, academics, professionals, governments, international development agencies, non-government organisations and trusts around the world now share not only a common concern about the importance of access to institutional credit in helping the poor overcome their poverty but also common vision 'how better' to deliver it to those of more than one billion people living below $1 a day, currently overlooked by the formal banking sector.

Despite their impressive impact, the number of poor households reached and benefiting from microfinance institutions remains small. To reach the millennium development goal targets of reducing global poverty by half by 2015 would require microfinance institutions reaching out to very large number of very poor households. Basically the limited outreach has been due to the fact that microfinance industry is NGO-driven. The growth of outreach by NGO-driven microfinance institutions is impeded by structural constraints. Non-government organisations are not legally allowed to mobilise resources from non-members and from formal financial sources because of the banking and financial institution act. Thus the transformation of NGO-driven microfinance institutions is critical to maximise outreach in a financially sustainable manner.

Some non-government organisations were initially engaged in multi-dimensional non-profit oriented development activities like human resource development, empowerment, and gender issues or in sector programmes like literacy movement, health and sanitation. Overtime they realised that those programmes are not only unsustainable but left developmental residues relatively untouched. Access to financial and productive resources enables the poor to create self-employment and generate income thus reducing poverty in a sustainable manner. Thus those multi-purpose non-government organisations have moved into poverty-focused microfinance.

It is clear that NGO-driven microfinance institutions can reach out to more poor households and benefit them with self-employment, economic empowerment and sustainable increase in income, savings and investment. But they need more funds to expand their operating capacity and overcome structural constraints associated with their non-government organisation status.

1.2 Constraints of NGO-driven Microfinance institutions

Most of the microfinance institutions in the Asia-pacific region are NGO-driven (Gibbons, 1994; Ledgerwood, 1999; Otero, 2001; Latifee, 2003). Non-government organisations or microfinance institutions serving their participants face a number of constraints in their efforts to transform into a viable financial institution while maintaining outreach to a large number of poor households.

i. **Resource Constraint:** Gibbons, 1994; Bank Poor '96; Micro-credit Summit '97; Micro-credit Summit Councils 1999, 2003, 2004; Hulme & Mosley, 1996a; Ledgerwood, 1999; Paradis, 1998; all identified that microfinance institutions have resource constraints (both funds and skilled working force). Projects or NGO-based microfinance institutions cannot generate funds from private and public sources because of their project / non-government organisations status. Projects or non-government organisations are not allowed to take deposits from non-members and cannot borrow from commercial banks or any other conventional financial source due to lack of collateral assets and legal constraints.

Wholesaler institutions such as Grameen Trust (GT) and Palli Karma Shahayak Foundation (PKSF) in Bangladesh, Rural Microfinance Development Centre (RMDC) in Nepal, CASHPOR Finance and Technical Services (CFTS) in India, Foundation for International Credit Association (FINCA) in Latin America and Grameen Foundation of the USA (GFUSA) have emerged to channel loan funds to microfinance institutions for on-lending to poor households. Even wholesalers require certain level of operational and financial efficiency prior to financing microfinance institutions. Even then, the amounts channelled through these organisations are inadequate to meet the ever increasing demand.

Deposits are among major sources of funds for conventional banks. Microfinance institutions have no access to such deposits from non-members. Most of the microfinance institutions are allowed to take deposits from their members but due to their small capacity, such source of funding has limited impact. Deposits require costly security with regards to inflation, liquidity and bankruptcy.

Commercial banks are not willing to sanction funds unless the borrowing microfinance institutions demonstrate financial viability of the loan operation. Private investment is another big source of fund. Profitability is the driving force for private investment. Private investment will not be attracted unless banking with the poor is profitable.

In addition to fund constraints, microfinance institutions have severe human resource constraints. Microfinance institutions have a high turnover rate as bright, energetic, committed young are not attracted because of their non-government organisation status. Staff quit their non-government organisation posts for better and more secured opportunities.

The microfinance institutions have to maintain sound management practices to ensure financial viability. A number of factors are responsible for sound management practices in microfinance operations such as maintenance of higher performing asset ratio, productivity and cost efficiency. The most critical challenge is to design a professional loan operation to maintain sound financial practices. Most of the microfinance institutions lack professional and skilled field staff to design suitable demand-driven financial products.

Thus microfinance institution must transform into appropriate institutional identity to overcome their resource constraints.

ii. Regulatory Constraint: There is no single uniform regulatory framework for microfinance operations across the world. As microfinance institutions have different institutional identities ranging from foundation, trust, non-bank finance company (NBFC), rural bank (RB), microfinance development bank (MFDB), financial NGOs (FNGOs) and Co-operatives, their financial operations too are limited by their legal status. No microfinance institution under any of the above institutional identity is allowed to function like a formal conventional bank. Public deposits, being an important source of capital accumulation, cannot be mobilized by microfinance institutions as these institutions are not allowed to take deposits from non-members because of their non-bank status imposed by central bank restriction. Borrower's deposits are not protected under any legal framework in case of inflation, fraud and bankruptcy. Lack of regulation for the protection of deposits discourages the public interest in savings with microfinance institutions.

Only a few countries have supportive legal provisions for the microfinance industry. For example, the Nepal Central Bank has made provisions under priority sector programme in providing funds to microfinance institutions. Under this provision, all commercial banks are bound to offer at least 12% of their total disposable funds to microfinance institutions for on-lending to the poor (ADB TA No 3580 NEP, 2003) with a maximum limit of NR30.000.00 (US$400.00) in a single loan thus ensuring funds for the poor.

iii. Operational Constraint: Microfinance operations in the rural areas is constraint by limited accessibility such as lack of communication network, inferior infrastructure facilities, unfavourable geographical conditions, isolated settlements with a diversity of social and political environments.

The delivery of collateral-free small loans with high recovery frequency and other microfinance services at the doorsteps of the poor involves higher operational costs compared to conventional banks or other financial institutions. Since non-government organisations are welfare-oriented, they tend to charge lower interest rate considering the capability of the poor. Either microfinance institutions have to charge higher interest rates or rely on subsidy and grants to cover operational costs. But microfinance institutions cannot sustain with subsidy or grant money for long. The interest rate charged by microfinance institutions to cover operational costs varies from as low as 6% to as high as 51% across the world (Hulme & Mosley, 1996a; Gibbons & Meehan, 1999). However microfinance institutions can reduce operational costs by designing credit products and loan operation professionally. The operational costs depend largely on management efficiency.

iv. Trade-off: The debate in the poverty-focused microfinance industry especially for those NGO-driven outfits is providing sustainable microfinance services in a cost effective manner to a large number of poor households within the context of achieving financial self-sufficiency or go for clients that facilitate faster route to financial viability, i.e. the not so poor and the non-poor. Since micro loans incur higher operational costs, should microfinance institutions go for larger loans then they are doing that at the expense of their outreach to the poor. Hulme & Mosley (1996a) uncovered the 'trade-off' dilemma that if microfinance institutions go for the very poor, their route to sustainability is unlikely to be achieved as the delivery of small loans at the doorsteps of the poor is highly expensive. On the other hand, Gibbons & Meehan (1999) found that there was no 'trade-off' between outreach to the poor and achieving financial self-sufficiency of microfinance institutions in the long term. But the issue in the short run i.e. at the initial stage of expansion incurred high administrative costs for setting up new offices, enrolment of new participants and motivating them. This debate has to be resolved as the mission of microfinance institution is poverty reduction.

v. Lack of a Suitable legal Identity for Microfinance Institutions: Another factor constraining the outreach of microfinance institutions working with the poor is their lack of a suitable legal identity (Gibbons, 1994). NGO-driven microfinance institutions have no access to funds from commercial banks and cannot mobilise resources from non-members. Most microfinance institutions operate without any protection for their depositors. This discourages the poor from participating in the microfinance programme. Thus transformation is critical towards overcoming the dilemma of NGO-driven microfinance institutions.

Microfinance institutions have taken various institutional identities; ranging from research projects or NGOs to foundations or formal financial institutions such as Rural Bank, Non-Bank Financial Company, Development Bank (Ledgerwood, 1999; Seibel, 2001; Zeller, 2001; Latifee, 2003). For example, CARD in the Philippines has transformed from a non-government outfit into a rural bank; SHARE of Hyderabad, Andhra Pradesh in India has transformed from a society into a Non-Bank Finance Company (Grameen Dialogue, 49, 2002). ASA in Bangladesh remains as a financial NGO while some others e.g. AIM, YUM in Malaysia have transformed from research projects into Registered Private Trust or Foundation (Official records of ASA, AIM and YUM). In this context, the institutional alternatives in transformation are:

a. From non-government organisation to formal financial institution like rural bank, development bank, non-bank finance company, foundation or trust;
b. From a project to a foundation or a trust or any other formal financial institution mentioned above;
c. From non-government organisation to financial non-government organisation;
d. From co-operative to financial co-operative.

Each institutional identity has its operational constraints. The microfinance operation of co-operatives is limited to location and membership while non-government organisations are not legally allowed to take deposits from non-members and inaccessible to loan funds from banks and finance companies to scale up their outreach. Thus the lack of a suitable legal identity for microfinance institution is a major obstacle to substantially increase their outreach.

The most appropriate institutional identity is likely that has sufficient financial resources at their disposal to undertake poverty-focused microfinance programmes in reaching out to a large number of poor households and benefiting them out of poverty in a financially sustainable manner. This is the central theme of this thesis; the transformation of NGO-driven poverty-focused microfinance institution into meeting the poverty reduction targets while fulfilling the goal of financial self-sufficiency.

1.3 Problem Statement and Research Questions

Despite impressive effectiveness in raising household income, savings, creation of self-employment opportunities from among massive residues of the traditional development strategies and models, poverty-focused microfinance institutions have limited success in scaling-up their outreach to large number of poor households in a financially self-sufficient manner hence practitioners, donors and governments have become more concerned about how to render viable microfinance services to the poor.

Being involved in providing loans and recovering them, microfinance institutions had to comply to certain standards not just in lending and recovery of loans alone but achieving financial self-sufficiency, profitability and asset quality etc. Overcoming the problems that are constraining the NGO-driven microfinance institutions is critical in their mission towards sustaining poverty reduction in a financially sustainable manner.

In theory, the underlying philosophy of the transformation of NGO-driven microfinance institutions into a more appropriate legal entity is to meet a number of challenges. These are:

a. Limited loan funds and legal restriction to fund mobilisation from public sources,

b. Maintaining financial viability through cost effective loan operations,

c. Limited human resource investments toward fulfilling institutional standards

d. Sustaining their microfinance operations.

(See Getubig *et al.,* 1997; Gibbons & Meehan, 1999; Ledgerwood, 1999; Hulme & Mosley, 1996a).

However, in meeting those challenges, the transforming microfinance institutions have traversed in various ways with diversified identity and performance levels. Based on the above observations, the following research problem is identified:

“Reaching to a large number of very poor households in a financially sustainable manner is the most important role of microfinance institutions in reducing poverty. But this mission cannot be achieved as most poverty-focused microfinance institutions are NGO-driven. Thus the transformation of NGO-driven microfinance institution into an appropriate institutional identity is critical towards achieving millennium development goal in a financially sustainable manner”.

The subsequent research questions pertaining to the research issues are:

1) Despite having similar institutional mission of poverty reduction by providing financial services to the poor, why have microfinance institutions taken various transformation routes to institutional change and various institutional forms?

2) Which institutional form in the transformation of microfinance institution is most appropriate in collectively increasing outreach to a large number of poor households while attaining financial self-sufficiency?

3) Do professional qualifications, experience and continuity of the key change agents influence the outreach of the microfinance institutions?

4) Do professional qualifications, experience and continuity of the key change agents affect the financial self-sufficiency of the microfinance institutions?

5) Do professional qualifications, experience and continuity of the key change agents affect the management efficiency of the microfinance institutions?

6) Is there any link of professional qualifications, experience and continuity of the key change agents with 'trade-off' between reaching the poorest households especially women and achieving financial self-sufficiency within microfinance institutions?

This study attempts to systematically analyse the most critical problems facing microfinance institutions and to present an analytical framework in addressing key issues in their transformation as viable alternative identities. This study is also designed to analyse the comparative impact of transformation on the institutional goals of greater outreach to the poorest and financial self-sufficiency in a diversity of institutional forms of microfinance institutions.

1.4 Research Objectives

As noted by the previous section, the NGO-driven poverty-focused microfinance institutions face a number of constraints both at macro and micro level in delivering vital financial services to their clients especially women. The main purpose of this study is to examine how professional qualifications; experience and continuity of key change agents in the management affect the transformation process and outreach coverage, financial self-sufficiency, management efficiency and trade-off of microfinance institutions. The specific objectives are:

1) To examine the link between professional qualifications, experience and continuity of key change agent with the institutional change and the choice of institutional form of microfinance institutions.

2) To assess and compare the outreach and the financial self-sufficiency level of MFIs by focusing on the forms of microfinance institutions.

3) To examine the link between professional qualifications, experience and continuity of the key change agents and the outreach of microfinance institutions;

4) To examine the link between professional qualifications, experience and continuity of the key change agents and the financial self-sufficiency of microfinance institutions;

5) To examine the link between professional qualifications, experience and continuity of the key change agents and the management efficiency of microfinance institutions.

6) To examine the link between professional qualifications, experience and continuity of the key change agents and trade-off' between greater outreach to the poor and fulfilment of financial self-sufficiency of microfinance institutions.

1.5 Significance of the Study

Since the eighties, the poverty-focused microfinance strategy has emerged as alternative model to overcome the shortfalls of the traditional development strategies in addressing the residual poor and further reduction of poverty. Poverty-focused microfinance program has proven in a number of developing countries and over different economic, social and political environments to overcome the residues left behind from the various development strategies. In reaching out to the poor through targeting and financing capitalisation of their survival skills with economic and financial empowerment, a new development philosophy of banking on the poor has emerged and is capable of meeting the millennium development goal of reducing global poverty by half by 2015. To facilitate such mission, MFIs have to transform into financially viable identities.

NGO-driven microfinance institutions have to overcome numerous constraints. As such, the issue of transformation of a microfinance institution into a self-sufficient institutional identity in delivering microfinance services to a considerably large number of poor households is critical. This study is designed to address the issues pertaining to transformation. The study is important not only for transforming microfinance institutions studied but also for the microfinance industry as a whole. Thus the outcome of this study is vital to the management of microfinance institutions, policy makers, banks and financial institutions, development economists and other stakeholders in the following aspects:

This study is designed to look into transformation in order to address the structural constraints facing NGO-driven poverty-focused microfinance institutions, as such, is expected to provide policy alternatives to overcoming those obstacles. It is expected that the study would enable the leaders of the microfinance institutions, policy makers and stakeholders to stake-out appropriate measures towards a more successful transformation. This study is designed to examine the influence of professional knowledge, experience and the impact of changes of professional leaders on outreach and financial self-sufficiency of microfinance institutions, thus enriching the knowledge and tradition on the poverty-focused microfinance industry.

1.6 Definitions and Terminologies

1) **Average Outstanding Loan Amount (AOLA) -** (Opening Balance + Closing Balance)/2.

2) **Average Net Fixed Assets (ANFA) -** (NFA balance at the end of the previous year + NFA balance at the current year)/2.

3) **Borrowers -** Number of members having loans from microfinance institutions during the study period.

4) **Dropout -** Number of members who withdrew from the microfinance programme.

5) **Financial Assets -** Financial Assets include all types of deposits and investments.

6) **Fixed Assets -** Fixed Assets includes land, buildings, equipment and all other intangibles (Golin, 2001).

7) **Financial self-sufficiency –** Financial Self-sufficiency (FSS) refers to the capability of microfinance institutions (MFI) to cover their operational costs (OC), financial costs (FC) and imputed costs (IC) from internally generated income from loan operations. FSS= (Financial Income)/ (FC+OC+LLP+IC) where Financial Income includes fees, interest on loan and interest on investment (The SEEP Network, 1995). In calculating financial income of MFI, this study considers fees and interest on loan only. FSS is required for sustainability of microfinance institutions.

8) **Imputed Costs of Capital -** (Net Worth – Net Fixed Assets) * Inflation Rate + (Average Loan Losses) (The SEEP Network, 1995).

10) **Microfinance Institution (MFI) -** Any organisation such as NGO, Research Project, Foundation, Trust or Co-operative that provide microfinance services to the poor.

10) **Microfinance Services -** Microfinance services include micro-loans for the poor, savings, insurance, and organisation of groups, transfer of money, linkage with the bank, training and other services related to microfinance operations.

11) **Net-worth -** (Equity/Share/Grants) - (Accumulated losses in the previous year + net deficit for the current year) + General Reserve + Net Surplus in the current year.

12) Operating Efficiency - Costs of the inputs and or/the price of output (Micro Rate, 2002)

13) Operational Costs - Operational costs include salaries and allowances, administrative expenses (rent, transport costs, vehicles, and costs for office maintenance), depreciation and overhead costs but not financial costs and loan losses. The operational cost is the most influencing indicator of management efficiency. It compares the institution's operating expenses (monthly or annual) with its average outstanding loan portfolio for the same period (CGAP, 1998; The SEEP Network, 1995; The MicroBanking Bulletin, 2001; MicroRate International, 2002; M-CRIL, 2003).

14) Operational Self-sufficiency (OSS) - (Financial Income) / (Financial Costs + Operating Costs + Loan loss Provision) (The SEEP Network, 1995).

15) Outreach - Number of targeted households enrolled under the programme.

16) Outstanding Loan - The amount in the hand of the borrowers during the period.

17) Performing Assets - Performing assets includes only cash, interest-bearing deposits, and net loans outstanding and long-term investments. The funds that do not earn should not be included in the performing assets (MicroRate International, 2002). Only the average outstanding loan amount will be used in this study to measure management efficiency of microfinance institutions to reflect the efficiency of utilising scarce resources.

18) Poverty Density - Number of poor households available in one square kilometre area.

19) Productivity - Productivity is one of the important measures for management efficiency. Productivity refers to average number of members per field staff, amount of average disbursement in a year per staff and average amount of savings mobilised by a staff in a year (CGAP, 1998; The SEEP Network, 1995; The MicroBanking Bulletin, 2001; MicroRate International, 2002; M-CRIL, 2003). In calculating productivity of microfinance institutions, this study considers total staff i.e. field staff and support staff and total number of borrowers.

20) Trade-off - The vocabulary meaning of “trade-off’ is an act of balancing two things that we need or want but which are opposed to each other i.e. an act of giving something away for getting something in return. ‘Trade-off’ is a process of giving some goods or objectives for gaining something. This move towards non-poor and wealthier participants raises the issue of ‘trade-off’.

1.7 Summary

The economic philosophy and growth strategies of most of the development models followed by national governments and donors during the post Second World War period was based on the assumption that the benefits of economic growth and development will trickle down to the poor in the form of employment opportunities and higher wages thus contributing to poverty reduction. This idea of 'trickling down' has limited impact on the unemployable human resources especially on poor women that lack educational qualification thus are out of the conventional employment market. At the same time, the poor are not endowed with financial and productive resources to access fund from the banks and financial institutions. Even with considerable drop in the poverty incidence in most of the developing countries, the number of people remaining under poverty remains substantial.

Poverty-focused microfinance programme has emerged among the most effective strategies in raising household income and accumulation of savings through the generation of self-employment opportunities in different social, economic and political environments. NGO-driven microfinance institutions rendering financial services to the poor, however, lack appropriate legal or institutional form that have been responsible in constraining their growth, development and transformation into viable financial institutions capable of reaching out to large number of very poor households. A critical question of the transformation of MFIs into viable financial institutions while maintaining greater outreach to the poor is the debate over trade-off; "Is there "trade-off" between outreach to the poor and financial self-sufficiency?"

The main objective of this study is to examine the link of professional knowledge, experience and continuity of professional leader with the transformation of MFIs from a research project or subsidy dependent NGO-driven MFIs into a financially self-sufficient MFIs while maintain greater outreach to the poorest.

CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

The NGO-driven microfinance institutions face a number of constraints in delivering financial services to the poor that through institutional transformation, those constraints are likely to be overcome. However, microfinance institutions follow different transformation routes in overcoming those constraints. Transformation is a change process requiring key change agent. The mental construct, that is, the perception of the key change agent determines the transformation route. Professional knowledge, experience and continued involvement of key change agent influence the mental construct. This chapter reviews literature on the microfinance institutions, the institutional transformation in general and the transformation of microfinance institutions in particular.

2.1 Institutional Transformation

Institutional transformation refers to a systematic and desired change process towards the attainment of specified institutional mission (Bekke, 1997; Eckel *et al.,* 1998; Lin, 1989; Klooster, 2000; Clemens, 1997 and 2003; Meske, 1998; Marquis, 2005; Egeberge, 2005) and the needs of the people that the institution serves (Hollis & Sweetman, 1998). It answers the questions: what, why and how (Eckel *et al.,* 1998; Astin *et al.,* 2001; Pickel, 2004). It involves processes, actors and interventions (North, 1990; Sjöstrand, 1995; Lin, 1989). Johnson *et al.* (1999) defines 'Transformation' in a broader perspective as a 'deeply rooted change in belief, values, attitudes, actions, relationships and structures manifested in a sustained higher level of existence of an individual or community'. Eckel *et al.* (1998) proposed the following definition of institutional transformation:

"Transformation alters the culture of the institution by changing selected underlying assumptions and institutional behaviour, processes and products; it is deep and pervasive, affecting the whole institution; it is intentional; and occurs over time, it enhances capacity of institutions".

The main ingredients of this definition are: it is a process of change, it is intentional, it occurs over time and it requires agent(s) to change. At this juncture, a fifth element is included: that transformation enhances the capacity of an institution to perform its fundamental mission, research and service.

Transformation can occur in two ways namely evolutionary and revolutionary. Evolutionary transformation occurs gradually over time within the same organisational structure. Evolutionary changes are incremental, convergent and include adjustment in systems, processes or structures, moderate pressure and continuous persuasion (Newman, 2000) while revolutionary transformation is a radical change in institutional mission, belief, organisational structure and operational design (Myer *et al.,* 1993). The former is known as 'induced change' while the latter that might be due to a new law enacted by the State, is termed as 'imposed change' (Lin, 1989).

Institutional theory literature have focused for several decades on understanding the process of organisational change and transformation from various contextual perspectives (Worren *et al.,* 1999) while efforts are being made to analyse the transformation process from a common generalised theoretical framework. North (1990) developed the Theory of Institutional Change from simplistic concepts of costs and benefits based on profit maximising rationality assumptions of the classical economics where the entrepreneur analyses the costs and benefits within the imperfect information framework and applies such knowledge and experience in the change process.