

# Conditions for the transformation of the MFIs from informal to formal types

## *Podmínky transformace neformálních mikrofinančních institucí na formální typy*

K. SRNEC

*Institute of Tropics and Subtropics, Czech University of Life Sciences, Prague, Czech Republic*

**Abstract:** The article supplies the information concerning the transformation of informal MFIs to formal ones (Srnc, Havrland 2006). It underlines some risks of finance investors to the microfinancial segment of money market. Financial investors influence the possible development of MFIs and reverse. In contrary, MFIs can farcify or weaken the economic development in local areas and thus to decrease the financial effect and farm sustainable development.

**Key words:** microfinance, MFIs, life-cycle, critical triangle, transformation

**Abstrakt:** Článek doplňuje informace týkající se transformace neformálních mikrofinančních institucí na formální typy (Srnc, Havrland 2006). Zvýrazňuje některá možná rizika pro finanční investory do mikrofinančního segmentu peněžního trhu. Finanční investoři ovlivňují možný vývoj mikrofinančních institucí a naopak. Mikrofinanční instituce mohou tedy posílit, nebo oslabit hospodářský vývoj v dané oblasti, snížit, ovlivnit finanční efekt pro investory i udržitelný rozvoj chudého venkova rozvojových oblastí světa.

**Klíčová slova:** mikrofinance, mikrofinanční instituce, životní cyklus, kritický trojúhelník, transformace

### INTRODUCTION – MFIs AND THE PRESENT TIME

Microfinance in LDCs started in the 70's of the last century when prof. Muhammad Yunnus was awarded the 2006 Nobel Peace Prize, and established a microfinancial system known as Grameen banks in Bangladesh. The history of Microfinance is rather short in in LDCs. It can be divided into four developmental periods:

- Early 80's – many MFIs (microfinance institutions) have a better repayment policy than banks
- Early 90's – a few MFIs began covering all their costs
- Mid 90's – top MFIs began to attract a significant commercial funding
- Today – MFIs are striving to reach these twin objectives

MFIs can be classified into three fundamental groups for the purpose of this article – basic regulations:

- Formal MFIs – regulated by the financial authorities of a country (commercial banks, development banks, rural banks, credit unions etc.)
- Semiformal MFIs – regulated by non-financing authorities (savings and credit cooperatives, unregulated village banking etc.)
- Informal MFIs – controlled by the customary law and/or peer pressure (ROSCA – Rotation Savings and Credit Ass., ASCRA – Accumulation Savings and Credit Ass., SFGA – Small Farming Groups Ass., SHG – Self Helping Groups, PG – Peering Groups, door step collectors etc.)

The fourth developmental period has been characteristic by a fast development of the formal MFIs and by the transformation of some informal MFIs to formal ones.

Many significant organizations are intensively engaged in the acceleration of transformations, such as the UNITUS (Unite-Us).

The Unitus's mission is to alleviate global poverty by increasing the access to microfinance.

Only a few microfinance institutions (MFIs) have grown to a size in which they make a significant impact in the communities and regions in which they operate. We must do better, for we believe that everyone deserves the opportunity to improve their lives through microfinance. With this goal in mind, we call the Unitus a Global Microfinance Accelerator. The term "transformation", or commercialization, of a microfinance institution (MFI) refers to a change in the legal status from an unregulated nonprofit or non-governmental organization (NGO) into a regulated, profit institution (UNITUS 2006).

## MFIs – DIVISION ACCORDING TO FINANCIAL RESOURCES

There are many other international organizations which are engaged in this problem. The transformation acceleration of MFIs from informal to formal institutions is a very sensitive matter. Informal MFIs grant their clients very cheap and accessible microcredits with minimal risk. On the other hand, formal MFIs offer more expensive microcredits with higher risks, because their aim is not only the decrease of the grave poverty and hunger, but profit and capital increase of their own. Anyway, they are translucent, more professional and fully integrated into the financial systems of the country. Therefore, they own a substantially wider access to external financial

resources. Differences in MFIs manners are evident from the outlay of the financial resources controlled by them (Figure 1).

### Group I

Formal MFIs – the prevalence of foreign financial resources

- possibility of losses due to the changes in rates (majority in \$)
- risks are regular, not incidental (rates)
- diversification of the accepted currencies can be anticipated

If MFIs in a region offer only this type of service then the petty and very poor entrepreneurs have no chance to use financial resources and so most of the local inhabitants become impoverished. The given financial credits are not accessible and relatively expensive. The accesses to financial resources starts to be functional at the entrepreneurial subjects, fully or partially producing for the market.

### Group II

Informal MFIs – the prevalence of financial resources coming from financial middlemen (users)

- financial resources are given in the local currency
- risks are not identifiable (the interest of mediators may be secretive – for example winning debtors' property)
- risks are unacceptable for any economic conditions – nor for MFIs
- risks are not incidental but regular
- risks are solvable by the limited income of these financial resources. Can be substituted by other resources.

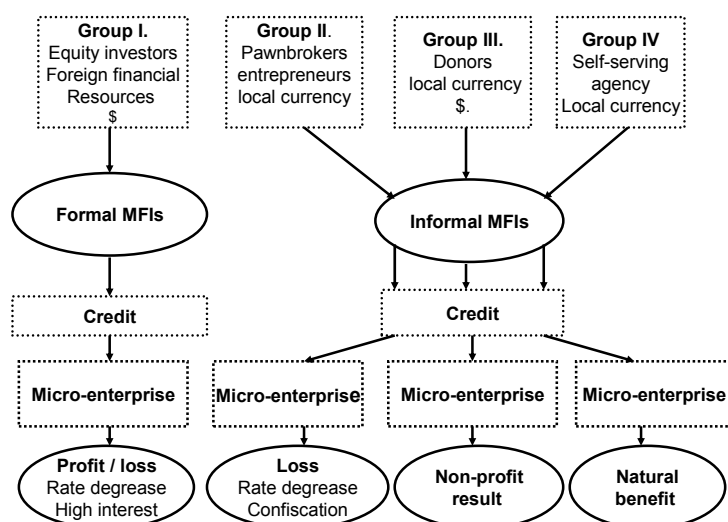


Figure 1. Financial risk – MFIs, division according to financial resources

Source: UNITUS (2006)

This is the worst variant. Even if it very often ends by the property centralization into large agricultural enterprises, it can, at the same time, increase the total rural poverty. Productivity and rentability of agricultural production increase but unemployment and property is increasing too. Special conditions have to be created for this process nation-wide, a transparent financial system (tax system, insurance system, social network, pension system etc.). No special conditions have arisen from the above mentioned trend for the states heavily indebted, mainly for the Sub-Saharan Africa.

At the present time, this type of development impairs economic stability and living conditions. It restrains the historical bases and tradition of the given states. The traditional principles and modern technologies need to communicate, not one side in their development.

### Group III

Informal MFIs – prevalence of financial resources from charity organizations, humanitarian organizations and donors:

- risk is difficult to identify (resources are constant in their character, donors are inconstant),
- risk is not acceptable for economic conditions,
- risk can be decreased by the means of increasing these financial resources from the transparent medium or higher financial institutions and by increasing the volume of people's savings.

Many organizations and people realize the necessity of helping very poor people all over the world. Their enthusiasm has resulted in financial donations, mainly by informal MFIs.

Their enthusiasm and contribution to the struggle against poverty are indisputable. Unfortunately, in general, they have no understanding for the transfer of these organizations to formal financial institutions (Johnson 1998)

Together with the suggested economic development of very insolvent countries, this process is necessary. From the long-term view, there is no other way of solving the problem than creating a transparent financial system.

The mentioned MFIs type is valuable for the struggle against poverty and especially against hunger. It supports the self-sufficiency of the inhabitants. The development supports the changes for informal MFIs. The MFIs significance in this group will be strengthened wherever the MFIs first groups are functional. They not only complete financial markets, but above all decrease the credit accessories given by the formal MFIs (reduce credits granted by themselves).

### Group IV

Informal MFIs – mostly total resources of Self Helping Groups

- risk is only partially acceptable by economic conditions
- self helping activities are frequently necessary for the community survival

This model consists in the voluntaristic tendencies directed to self-helping. It is a contemporary way of financing in extremely poor regions. It is necessary to support these forms.

More persistent structures, such as the Village Bankings (The Foundation for International Community Assistance – FINCA) or Credit Cooperatives (Huppi, Feder 1990) can emerge from these institutions.

Another contribution is the reality that they are the unique financial institutions which are able to support small farming or artisans in their living conditions. For very poor rural populations, their products are accessible (total resources of groups' members). If these financial activities did not exist, the number of starving people would not decrease. Another migration wave to the cities would result, the rural poverty could be transformed into an urban one. There are questions – where and how could the government of a country obtain suitable financial funds for solving the new situation. Informal MFIs of the group IV offer their services outside the government financial system and their activities work out of their financial control.

It is a matter of a necessary transient state, until their speedy infiltration into local financial markets and formal MFIs. In the following phase of development, a part of informal institutions has to be transformed into formal institutions.

MFIs distribution according to the prevailing financial input makes clear the investor's philosophy, behavior and function of participants to financial markets in the poor and remote rural areas in developing countries. Understanding for the relationship among the individual financial or entrepreneurial groups enables a better understanding for financial losses and their forecasts (eventually their decrease). It is another advantage of the microfinancial systems in comparison with the often published views (institutions – client relationship).

Individual groups have been usually studied as the points of a system from the position of their services. Analyses of financial inputs and relations represented by financial flows and philosophy of their bearers have not been very common. Distribution according to the financial resources opens a relation problem. It also refers to many questions concerning the fu-

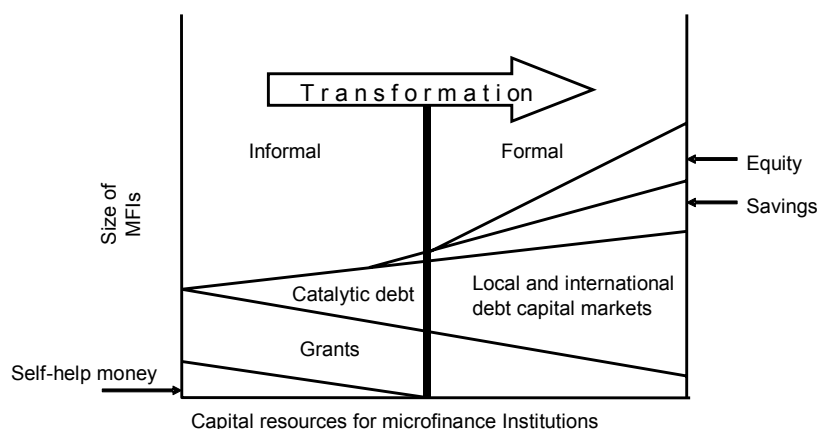


Figure 2. Life-cycle for financing MFIs growth

Source: USC (2006)

ture MFIs development and ensures the necessity of transformation in a suitable part of informal MFIs – to formal forms (Srncic, Ajiwa 2006).

**BASIC QUESTION: “When and under what conditions is the possibility to accelerate the transformation of informal MFIs to formal institutions?”**

The question needs to be divided into three parts

1. Influence upon the MFIs area – Critical Triangle of environment
2. MFIs contribution to clients – Critical Triangle of microfinance
3. Insurance of MFIs own development – Critical Triangle of MFI

**Critical triangle of environment (poverty – agriculture – environment)**

According to the United Nations Development Programme (UNDP) experts and the European Union Commission on Poverty and Environment, a model of mutual relationship called the Critical Triangle exists. This is the relationship between poverty, agricultural production and the environment. The decision making aims at:

- Investing into scientific research, implementation of new technologies etc. It should only be directed into the selected localities, or across the board, regardless of the impact on the environment.
- Supporting small scale farmers including those in areas with water shortage.
- Building infrastructure and by so doing changing the character of the local environment, or not; by so doing changing the demographic distribution, or not...

Such types of specific questions are many, but the immediate need to help the impoverished dying masses is a necessity. There is a need to draw a line between environmental protection and ecological catastrophe in the near future; and the current loss of life arising from starvation.

*Relationship: agriculture – environment*

It is necessary to state in advance that this relationship is controversial in the poverty stricken conditions of the Sub-Saharan Africa. The primordial success of the so called Green Revolution era which saw the rise in agricultural production even in developing countries has been downgraded by the negative impact on the environment. In many cases the application of new technology, intensification and concentration of agricultural production led to underrating the negative impact on the environment. The need to increase the volume of agricultural production persists. A new concept was born – “Double-Green Revolution”. Intensification is ongoing with considerations for ecological requirements, protection and sustainability of natural resources. This is to ensure that the current environmental standards do not deteriorate. This new concept is also called the sustainable rural development. From the economic point of view, the costs per unit of production have increased. Where the environment is concerned the trend can be said to be positive due to cost savings in the environmental control (Sherr 1997).

*Relationship: agriculture – poverty*

A very close monitoring implemented by international institutions to observe and evaluate the effectiveness of development aid established that the growth in agricultural production had a significantly less impact on the poverty eradication than it had been thought. Differences in the benefits surfaced according to the individual groups of population. The rich have become

richer and the poor have remained more or less at the same level of poverty, this was due to the preference given to the monoculture of export commodities. The resulting effect of exports has not helped in the reduction of poverty, but has been utilized into the non-productive sector of the national economy. The monoculture economy has had a negative effect on the environment. Studies were mainly carried out in India and the Sub-Saharan Africa. The informal shadow economy had a very strong influence in Africa. A qualified estimate was made for statistics concerning production and local consumption. According to these estimates, for example every dollar invested into the intensification of agriculture in Nigeria and Burkina Faso netted two dollars. Visibly, poverty has not decreased thanks to the increase in population and the unfavorable distribution of proceeds from foreign trade.

#### *Relationship: poverty – environment*

This is a very critical relationship. Liquidation of poverty and hunger is by the law of nature in conflict with the need to protect the environment and to ensure sustainability of natural resources and the environment. The undernourished and hungry poor are mounting the pressure to force immediate solutions. This leads to reckless efforts to exploit natural resources exploitation and the rapid increase of agricultural production. Devastation of nature leads to a downward spiral – hunger, plunder, food, negative irreversible changes to the environment, hunger, etc. From the economic point of view, the need for financial resources to patch up these sudden problems increases. This is usually followed by civil instability, dissatisfaction, migration, the shift of poverty to urban areas or other states, breaking up of bonds with tradition, increase in diseases, drugs, etc. This results in the growth of chauvinism and the commencement of demagogic and populist dictatorship.

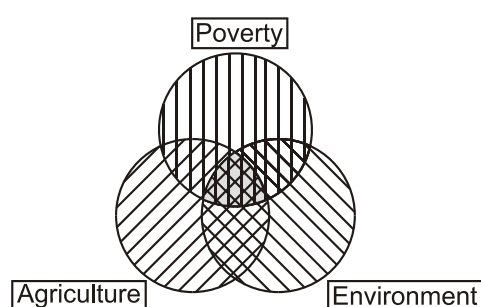


Figure 3. Critical triangle – environmental of the activity MFIs

Source: Srnec, Havrland (2006)

Individual relations are briefly explained and can be analyzed more deeply. But they are satisfactory for the needs of this contribution. Microfinancial activities must be in the harmony with contemporary needs for solving poverty problems, living conditions, and agriculture (nourishment). MFIs activities should not depart from the critical triangle (the term has been commonly used in the UNDP materials) (Figure 3).

The formal MFIs can lead to an expressive effort to gain a ceiling profit and fully increase foundation capital and so disturb the harmony expressed by the critical triangle (typical for standard economics). The mentioned presumption is not only connected with formal MFIs decisions but also with the regional and state economic politics (economic and financial management).

#### **Critical triangle of microfinance (financial sustainability – outreach – welfare impact)**

A microfinance institution (MFI) is an organization that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, methodology, and sustainability. However, all share the common characteristic of providing financial services to a clientele poorer and more vulnerable than the traditional bank clients (FAQs).

The clients of microfinance-female heads of households, pensioners, displaced persons, retrenched workers, small farmers, and micro-entrepreneurs-fall into poverty levels: destitute, extreme poor, moderate poor and vulnerable non-poor. While the repayment capacity, the collateral availability, and data availability vary across these categories, methodologies and operational structures have been developed that meet the financial needs of these client groups in a sustainable manner.

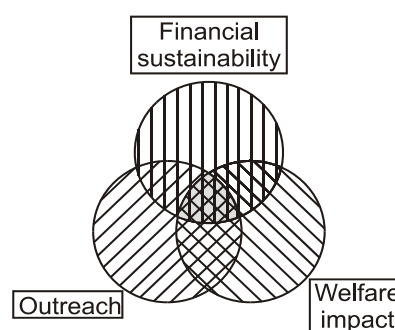


Figure 4. Critical triangle (Zeller) – outer effectiveness MFIs

Source: Srnec, Havrland (2006)

The client group for the given financial service provider is primarily determined by its mission, institutional form, and methodology. Banks that scale down to serve the poor tend to reach only the *moderately* poor. Credit Union clients range from the *moderately* poor to the vulnerable non-poor, although this varies by region and type of the credit union. NGOs, informal savings and loan groups, and community savings and credit associations have a wide range of client profiles (FAQs).

Microfinancial activities in a given region take place between MFIs and their clients. Very important is also the preservation of all circumstances truthfully characterized by prof. Manfred Zeller and some other respected personalities, engaged in these problems. Prof. Zeller announces in his research papers (Zeller 2006; Zeller, Mayer 2002) (Figure 4).

“The research led to the concept of the Critical Triangle of Microfinance – the need for MFI to manage simultaneously the problems of outreach (reaching the poor both in terms of numbers and depth of poverty), financial sustainability (meeting operating and financial costs over the long term), and welfare impact (having discernible effect upon clients’ quality of life)” (Zeller, Mayer 2002).

#### Critical triangle of MFI (profitability – liquidity – solvency)

The prices of bank products and services are very important to ensure their profitability, solvency and liquidity to MFIs and to other finance intermediates. A sound proportion between profitability and solvency and liquidity is very important for managing MFIs and the ability to create competitive advantage. If MFIs are not able to comply to the requests of triangle, then it is better to remain in the form of self-help groups (Srnc, Havrland 2006).

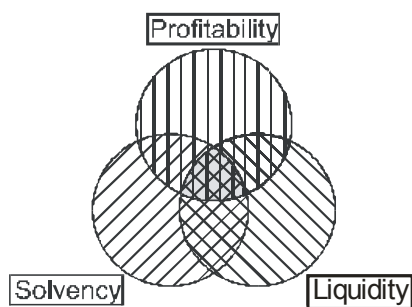


Figure 5. PLS triangle – intra sound MFIs’ proportion  
Source: Srnc, Havrland (2006)

- *Profitability* – realized desired profit; ‘Return on assets’ is the key ratio of profitability, indicating how efficiently financial institutions are employed. ‘Return of equity’ is the net income divided by total equity – it is a profitability ratio measuring how well the equity capital is used. Both ratios are basic indicators of the management of the money and resources;
- *Solvency* is the ability to pay, the capacity to meet future obligations from earnings or income. It is the ability to meet due debt service payments;
- *Liquidity* is the ability of an organization to meet its current financial obligations. In banking, adequate liquidity means being able to meet the needs of depositors wanting to withdraw funds (Figure 5).

#### CONCLUSION

Conditions and suitability for the transformation from informal financial institutions to formal types are comprehended by the scheme of three triangles – the institutions must accomplish the following three tasks (Figure 6).

1. Stability of region condition where MFIs act (Critical Triangle of Environment)
  - Sustainability of regional living conditions
  - decrease of hunger level in regional conditions
  - poverty decrease in the region
2. Outer sustainability of microfinancial institutional institution development (outer institutional stability of microfinancial stability – Critical Triangle of Microfinance)
  - financial sustainability
  - outreach
  - welfare impact
3. Internal economic sustainability of microfinancial institution (internal institutional stability – Critical Triangle of MFI)
  - profitability
  - liquidity
  - solvency

In the improvement of financial system of the given countries, it is necessary to comprehend self-help activities and informal MFIs as not only very significant (decrease of poverty and hunger) but complementary institutions of the transparent financial system. It is therefore necessary to transform informal institutions to formal ones, if possible. This sort of microfinancial institutions (their maturity) is presumably suitable for the transformation if they fulfill conditions of all the triangles.

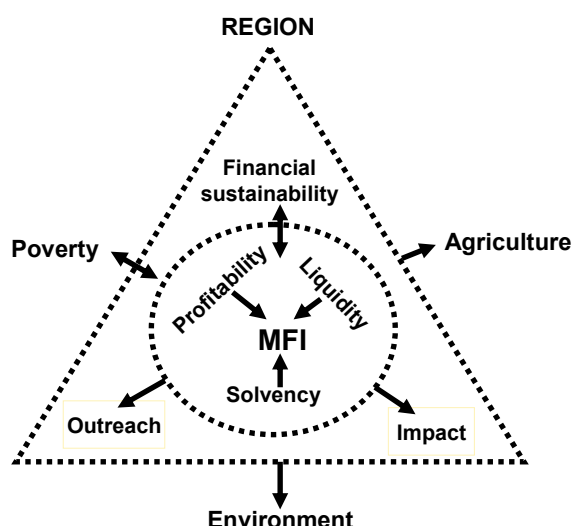


Figure 6. Connection among triangles (Figurs 3, 5, 6)

Their activity must influence the region according to the character of the Critical Triangle of Environment. The financial service is necessary for fulfilling the character of the Critical Triangle of Microfinance and simultaneously the internal balance common at bank organizations (Critical Triangle of MFI).

Informal institutions are not unlimited in their activities (for example self-help groups, the ROSCA, the ASCRA etc.), sometimes it is one year shorter. Their activity is mostly directed to their self-help character and is also oriented to the problem of hunger – self-sufficient way of agricultural activities. External stability is based on mutual confidence. Internal stability is not firmly rooted in foreign financial resources because it mostly works with its own ones. If some of these institutions reinforces, usually by the means of an external assistance, then it comes closer to the point of the possible transformation. These financial institutions should be engaged in some transformation models such as acceleration transformation program of the UNITUS organization. The additional transformation stage of formal MFIs to commercial banks active in microfinances, seems to be a question of a future and is connected with the total economic development of given state.

Banks coming into existence specialized in microfinance (for example in Zambia, Bolivia etc.) are more prospective.

## REFERENCES

- Huppi M., Feder J. (1990): The role of groups and credit cooperatives in rural lending. *The World Bank Research Observer*, 5 (2): 187–204.
- Johnson S. (1998): Programme impact assessment in micro-finance: the need for an analysis of real markets. *IDS Bulletin*, 29 (4): 21–31.
- Sherr S.J. (1997): Poverty-Environment Interactions in Agriculture: Key Factors and Policy Implications [online]. Available at [www.undp.org/seed/pei/publication/agriculture.htm](http://www.undp.org/seed/pei/publication/agriculture.htm)
- Srnec K., Eiša E. (2006): Microfinancial institutions and financial resources. *Agricultura Tropica et Subtropica*, 39 (1–2): 34–38; ISSN 0231-5742.
- Srnec K., Havrland B. (2006): Microfinancing: challenges and prospects – conditions when appropriate changes from informal to formal microfinancing institutions. *Agricultural Economics – Czech*, 52 (10): 489–496.
- UNITUS (2006): 25 entrepreneurs, who are changing the world. Available at [www.fastcompany.com/social/2006/statements/unitus.html](http://www.fastcompany.com/social/2006/statements/unitus.html)
- USC (2006): Microfinance and Beyond. Microfinance's Contribution to Local and Global Economic Development. USC Marshall School of Business, Los Angeles, April 19–20.
- Zeller M., Mayer R. (2002): Food Policy Statement. IFPRI, No. 40, November, Washington, D.C.
- Zeller M. (2006): Model of Rural Financial Institutions, Agreement No. LAG-A-00-96-90016-00. Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program (BASIS-CRSP) and World Council of Credit Unions, Inc. (WOCCU)

Arrived on 18<sup>th</sup> March 2008

---

### Contact address:

Karel Srnec, Czech University of Life Sciences Prague, Institute of Tropics and Subtropics, Kamýcká 129, 165 21 Prague 6-Suchbát, Czech Republic  
e-mail: [srnec@its.czu.cz](mailto:srnec@its.czu.cz)

---