

Research Area:
Scaling Up Microfinance Services

FROM NGOs TO FFIs IN MICROFINANCE SERVICES: CONVERSION ROAD MAP AND ITS CHALLENGES

**Comparative study of nine Eastern
European MFIs**

(Discussion phase)

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March, 2005

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i. Executive Summary

This paper looks into the logical framework of the microfinance institutions' (MFIs) scaling up process, particularly conversion from non-governmental organization towards formal financial institution.

After introducing the subject, in the Second section the paper offers an overview of the microfinance environment worldwide, with particular emphasis on the institutional variety in providing microfinance services, trends in microfinance industry and rationale for conversion.

Third section introduces Opportunity International as a global microfinance coalition and its nine Eastern European implementing partners. Brief overview of each of the nine MFIs has been offered, altogether with their formal, institutional status and their performance in the past 6 years.

Forth section focuses on the process of conversion that has been developed for the MFIs in question. As they are belonging to different economic and legal environments, the initial road map offered is just a framework for action, while each of the partners were free to undertake (or not) their own path towards achieving their mission and vision.

Conversion implications, key issues and debates followed by the lessons learned have been part of the Section five. Although not an easy task due to the differences, initial classification of the challenges for the road map has been made.

The last section concludes the paper, comparing the theoretical and empirical findings of the research.

ii. Methodology and Terminology Challenges

Although to some extent relaxed, there is still ongoing political debate on the sense of conversion of non-governmental organizations into regulated or formal financial institutions. The perpetuation of the debate implies that there are no widely accepted, accredited or recognized methods on how to assess the rationale for conversion.

Having this understood as unquestionable, i.e. that the argumentation in favor of conversion cannot be successfully objected, the second level of methodological dilemmas draws closer: how to measure the successfulness of the conversion, so to recommend a road map? Which of the performance figures to measure: client outreach - number of clients and portfolio size, loan portfolio quality, efficiency, sustainability, loan activity? Unfortunately, it was not possible to track two crucial indicators - neither the number of active savers nor the value of client savings - and that makes the interpretation of the pre and post conversion performance more approximate than accurate.

In addition, as most of these performance figures increase with all partners, the next question is how to qualitatively and quantitatively interpret the level of increase?

And finally, if we agree on the references on which the successful conversion is to be based, the third level of dilemmas appears: is it possible to classify or standardize the challenges, conversion implications and lessons learned, bearing in mind that the nine different microfinance institutions are constituted differently and operate under nine different countries therefore being subject to different legal provisions?

Namely, it is very much possible that the social, legal and business environment influences MFI's performance much more than the (un)successfully undertaken conversion. The same applies to the human resources/management in place engaged to go through the process.

As for the terminology, that is another group of issues that deserve full attention.

The first one is whether to make a distinction between the notions *micro-credit* and *microfinance*. In many works namely, these two terms have been used simultaneously. However, this paper distinguishes one from the other: so called *development finance* approach (highly subsidised or loss-making loans) has been considered a history, while micro-credit has been viewed as too narrow concept compared to microfinance that includes savings and insurance.

Furthermore, in this paper formal and regulated financial institutions (FFI/RFI) are synonyms. In that respect, while microfinance institution (MFI) refers to any type of entity that provides microfinance services, FFI/RFI refers to some kind of entity being under supervision of the Central Bank.

Another point of clarification is needed for the term *conversion*. Many authors use the term *transformation*, while some go further and name the whole process as *commercialization*. In that respect, while *transformation* might mislead or confuse

the reader (some MFIs use this term to refer to the impact on the client's life), *commercialization* might not be very much welcome due to political reasons. So, the *conversion* as a term remain in use, as proposed in the very title of this paper.

Of course, there are many other not conceptual and linguistic, but technical dilemmas concerning the terminology. For example, one of those is whether the finance companies are considered as FFIs, being under the supervision of Central Banks? As different regulatory frameworks treat them differently, in this paper they are rather seen as *modus vivendi* for operations than as fully regulated financial institutions that are to be made over with the conversion.

Being close to the Central Bank's supervision theme, it should be noted that the membership societies - namely credit unions or cooperatives have been considered as unregulated financial institutions, even knowing that there are cases of conversion from NGO to a co-operative.

1. Introduction

For more than three decades global microfinance services have been dominantly carried out by coalitions of non-for-profit organizations dedicated to providing opportunities for people in poverty to transform their lives through small and micro business loans, training, and financial services that enable them to develop and sustain income-generating and job-creating enterprises. Most of them have been motivated by their vision and mission that include outreach - number of clients served, financial viability - measured by the sustainability of their programs and transformational impact - measurable impact on the lives of their clients.

Opportunity International (OI) is one of those global networks of microfinance institutions and funding partners dedicated to achieve a triple bottom line of outreach, financial viability and impact on their clients. In order to better achieve its goals, as many other global coalitions, several years ago OI made a strategic decision to focus on creating regulated (formal) rather than unregulated (informal) microfinance institutions, including conversion of those in existence, established through the years as non-governmental organizations (NGOs).

The primary reason for this orientation has been to overcome legal barriers and governance limitations inherent in unregulated organizations which restrict outreach and access to capital. According to what the new concept affirmed, the significant outcomes should have been increased access to capital by regulated microfinance institutions in a form of wholesale debt, deposits and investor equity, the ability to offer additional services such as savings and insurance products, and the ability to attract investors that may not have otherwise participated. Given these advantages, it is projected that regulated microfinance institutions are able to reach far greater number of poor micro-entrepreneurs while reducing dependency on donated funds.

“Microfinance in the 1990s has been marked by a major debate between two leading views: the financial systems approach and the poverty lending approach”, underlines Robinson ([2001: 16](#)). As the tendency for creating regulated financial institutions rather than historically preferred NGOs globally faces pro and contra argumentation, the project proposes the rationale for conversion to be based on the particular experiences, as well as on qualitatively and quantitatively analyzed performances of nine East European MFIs: PShM (Albania), Nachala (Bulgaria), NOA (Croatia), Moznosti (Macedonia), OBM (Montenegro), Inicjatywa Mikro (Poland), OMRO (Romania), FORA (Russia) and OIS (Serbia). Although all members of OI Network each of these microfinance entities belong to different social and legal environment, therefore being in different paths and phases of conversion.

2. Microfinance Environment Worldwide

The emergence of microfinance institutions in developing countries has significantly multiplied over the past decades. A number of these institutions have been successful in providing credit and deposit services to the poor in low-income countries, facilitating poverty reduction strategies, supporting micro and small businesses, and expanding the financial frontier to include previously excluded clienteles. Innovative lending technologies, new financial products, appropriate pricing, and a general understanding of the challenges and opportunities for the microfinance sector have contributed to their success and expansion as well as to the substantial global political and financial support they have attracted.

2.1. Global Microfinance Providers

It is estimated that the microfinance industry overall serves only 32 million out of a potential 500 million (see [Opportunity International, 2004](#)) to 1.7 billion ([Robinson, 2001: 7](#)) clients around the world. Based on these figures, there is still great unmet demand. However, this does not mean that there are not competitive environments within countries. In many large urban areas potential clients have many options of financial service providers. This is beneficial, because it forces the financial services to operate at levels of efficiency and customer service that will attract clients. The following table (see [Opportunity International, 2004](#)) shows how the microfinance networks compare on a global basis:

	Total number of clients	Total loan portfolio (USD mil.)	Average loan size (USD)	Portfolio at risk	Number of countries served	Geographical focus
ACCION	807,553 ⁱ	442	548	10.0% ⁱⁱ 8.6% ⁱⁱⁱ	22	Africa, LA
Opportunity International	455,430 ^{iv}	75.6	228	5.75%	28	Africa, Asia, EE, LA/Caribbean
Catholic Relief Services	351,080 ^v	28	153	NA	31	Africa, Asia, Europe, LA/Caribbean, the Middle East
FINCA	227,388 ^{vi}	32	255	NA	19	Africa, LA, NIS
Freedom From Hunger	217,948 ^{vii}	13	72	NA	16	Africa, Asia, LA
Women's World Banking	580,000 ^{viii}	93	234	NA	31	Africa, Asia, LA, Europe, the Middle East
World Relief	71,486 ^{ix}	6	166	NA	10	Africa, Asia, Eurasia, LA/Caribbean, US
World Vision	220,000 ^x	39.5	404	NA	42	Africa, Asia, EE, LA/Caribbean, Middle East

Interpreting the table and comparing other figures, regional distribution of microfinance providers' operations appear as follows:

- Africa – Opportunity International has been one of the strongest Networks in the region, with its main competition coming from PRIDE Africa and Freedom from Hunger. Recently ACCION entered the Africa market and is attracting a lot of donor attention;
- Latin America – In the region as a whole ACCION's affiliates serve 800,000 clients. Women's World Banking also has a wide presence in Latin America;
- Asia – The region is dominated by the million plus clients of Grameen, BRAC and ASA in Bangladesh and BRI in Indonesia. In India, Women's World Banking and SEWA reach significant number of clients;
- Eastern Europe – Opportunity International is one of the two largest and best performing networks in the region, with IPC being the other. Since IPC focuses on a larger business size, OI is the dominant player in the small to micro sector.

It is worth mentioning in this context that while MFIs are fairly common in most of the developing world, i.e. Africa, Asia, and Latin America, the transition economies of Eastern Europe and Central Asia remain a geographical frontier where microfinance appeared about a decade ago. In part, the small number of institutions in this region stems from the former political climate, which made this market impenetrable until the early 1990s. Also responsible for the limited microfinance activities in the region was the fact that many of the successes and lessons learned from the extensive history of microfinance in more traditional developing countries have proven difficult to transfer to Eastern European transitional economies. However, a recent surveys of the "microfinance sector in the ECA region reveals that it is a fast-growing industry. Institutions providing microfinance services are less than 10 years old, with a number of specialized institutions operating for only 3-5 years. Preliminary data suggests that MFI clients are growing by about 30 percent a year" ([Djankov, Lieberman, Mukherjee and Nenova, 2002: 13](#)).

2.2. Institutional Variety in Providing Microfinance Services

A multiplicity of markets requires a variety of institutional models for serving these markets. Although their systematization requires whole new chapter, the five most common microfinance institutional models, ranked by scope of impact and sustainability of operations, are as follows: full service commercial bank, restricted service bank, regulated non-bank financial institution, membership society/union/cooperative and non-governmental organization. In general, these types of entities are listed in order of decreasing levels of regulatory supervision and capital requirements.

Yet, many authors have their own approach. Rutherford's view of the microfinance institutions, for example, describes them as promoters and providers, where "promoters are those who help the poor set up their own poor-owned and poor-managed systems, while providers are those who sell financial services to the poor" ([Rutherford, 2000: 78](#)).

Another, slightly different approach ([Jansson, 2001: 6](#)) underlines more specific typology of institutions serving the micro-enterprise sector, as given below:

	Multipurpose financial institutions	Specialized financial institutions	Specialized non-governmental organizations	General non-governmental organizations
Purpose of microfinance activities	- New market - Image - Philanthropy	- Social impact - Profitability	- Social impact - Sustainability and growth	- Social impact - Sustainability
Legal form	- Banks, - Finance companies - Cooperatives	- Banks, - Finance companies	- Foundations - Associations	- Foundations - Associations
Clients	- Various, micro-enterprises are small share of portfolio	- Small and micro-enterprises	- Micro-enterprises	- Micro-enterprises
Services	- Various and targeted to the specific market segment - Individual credit - Savings	- Individual credit - Group loans, - Limited offering of leasing - Savings	- Individual credit - Solidarity loans - Village banking	- Individual credit - Solidarity loans - Village banking
Sources of funding	- Savings - Shares - Bonds - Commercial loans	- Commercial loans - Shares - Savings	- Commercial and soft loans - Guarantees, - Donations	- Donations, - Soft loan - Guarantees

Not mentioning finance companies and savings houses/banks, in a recently published research Forster, Greene and Pytkowska ([2003: 15](#)) identify “four main microfinance models in Central and Eastern Europe and the New Independent States: credit unions, nongovernmental organizations (NGOs), downscaling commercial banks, and microfinance banks”.

2.3. Trends in Microfinance Industry

About two decades after the time when “development academics, sponsored by USAID, were busy mounting an assault on the whole idea of subsidised development finance” ([Rutherford, 2003: 6](#)), it is obvious that microfinance is becoming more commercial worldwide. Not only are traditional non-governmental organizations dedicated to microfinance transforming into licensed banks and non-bank financial intermediaries in order to access public funds or small savings deposits, but some banks and finance companies are noticing the potential of micro-credit to enhance their own products.

“The early success of non-profit grassroots organizations in serving this sector has led to two important developments” says Jansson ([2001: 1](#)). “First, commercial banks, realizing that there might be a profit to be made in microfinance, are starting to pay serious attention to how they can serve this segment of the market. Second, between grassroots non-profit organizations and profit-driven commercial banks, there is an emerging breed of professional financial institutions that specialize in microfinance. These are former non-profit organizations that have requested and received a license to operate as regulated and supervised finance companies or banks”.

At the same time, credit unions are revitalizing themselves and seeking to regain their leading role as suppliers of full-range financial services to the poor. Central Bank authorities and governments are examining whether microfinance represents a feasible option for rescuing troubled state-owned development, agricultural, savings, postal, trading and commercial banks. All of these organizations regard microfinance as a potentially viable business, regardless of whether they are constituted as profit-maximizing entities. An increasing number of people in the field regard commercialization as a necessary step to provide better quality financial services to the poor. "The microfinance revolution is a commercial revolution", explains Robinson ([2001: 24](#)), simply opposing the claims that "the *win-win* rhetoric promising poverty alleviation with profits has moved far ahead of the evidence" ([Morduch, 1999: 1609](#)).

In that respect, when trying to analyse the tendencies that were preceding commercialization, two major causes can be easily recognised: declination of technical donor grants and an increased array of social investments funds, as well as bilateral and multilateral investments.

Namely, there is evidence in the past years that donors are getting tired of funding microfinance projects, for a variety of reasons. First, they feel like they have invested a lot of money in this sector over the last decade, but have not seen any appreciable change in the rates of poverty. Second, they find the risks in this field very high. While the industry has a few showcase success stories, it has many more examples of fraud and mismanagement. Third, most of the donor governments are directing their foreign aid funds to deal with world's urgent problems, leaving less money for microfinance. Unless something can be done to radically change donors' perceptions of the risks and rewards in this sector, it can be expected for this trend to continue. "Technical donor grant funding peaked in 1999/2000 at almost USD 1 billion for microfinance and small business development programs. Amounts have been declining since 2000 and will be about USD 400 million in 2005", says Vander Weele ([2005: online](#)).

While donor funds are trending down over time, funds from government and social investment funds have greatly increased. "Major bilateral and multilateral investment entities report increasing commitment to micro and small business financing, from USD 600 million in 2000 to almost USD 1 billion per year" ([ibid](#)), while CGAP reports that social investment funds will grow from about USD 100 million in 2003 to USD 200 million by 2006.

In addition, many local governments are also providing loans to microfinance organizations, often with funds that come from the World Bank. It is now much easier to borrow funds than to get a grant. The International Finance Corporation is emerging as a key gatekeeper and a leader in this investment arena for microfinance. Beyond these sources, the next huge wave of investment funds could come from commercial investors who find microfinance to be a stable investment.

In that sense, the other path in the process of commercialization of the microfinance industry is seen with more full scale banks entering into the market through downscaling of their operations. The bottom-line in microfinance is that there is money in it. It is seen in a way that there is money to be made in microfinance, that microfinance is good for the business, and what is good for the business should also be good for the community.

2.4. Rationale for Conversion

Non-governmental organizations have been working in the area of microfinance for many years. As said, they are starting to formalize because they have found out that the type of services that they provide to the poor and other marginalized groups, are insufficient. Only by formalizing can they go into a deposit-taking mode and offer other services for which the micro-entrepreneurs that have progressed to a certain level are in need of. Therefore, the primary reason for this strategy is to overcome legal barriers and governance limitations inherent in unregulated organizations which restrict outreach and access to capital, also not forgetting the “limitations of the NGO modality arising from the lack of owners” ([Fernando, 2003: 1](#)).

The significant outcomes of this approach are increased access to capital in the form of wholesale debt, deposits and investor equity, the ability to offer additional services such as savings and insurance products, and the ability to attract investors that may not have otherwise participated. Given these advantages, regulated microfinance institutions are able to reach far greater numbers of the poor while reducing dependency on donated funds.

Yet, while focused on the rationale for conversion, various authors develop their own argumentation. White and Campion ([2002: 22](#)), for example, note that “the desire to join the financial system is a reflection of many microfinance NGOs’ twin goals of reducing donor dependence and exponentially increasing the number of clients with access to microfinance”. For Rosengard ([2000: 7](#)) the main reason for an NGO to become a regulated financial institution has been to achieve long-term sustainability, via a combination of the following factors:

- Growth in the scale and scope of operations, which in turn increases the magnitude of development impact while reducing operational costs and diversifying operational risks;
- Access to funds, whether in the form of local voluntary savings, large investor deposits, inter-bank loans, or capital market debt or equity, which decreases funding dependency and uncertainty while increasing capital leverage and the scope for business expansion;
- Improved governance and operations, usually the result of regulations regarding ownership composition, management standards, prudential norms, and accounting and reporting requirements; and
- Enhanced customer service, in the form of a wider range of products and delivery systems, together with the increased likelihood of developing a long-term banking relationship for savings, credit, and other financial services.

Similar approach has been taken by Campion ([2004: online](#)). She lists, namely, five short objectives of conversion:

- Access to commercial capital;
- Expand client outreach;
- Offer savings products;
- Improve customer service;
- Improve governance and accountability through private sector ownership.

So, based on the referred classifications, one overall view might define three major elements that are backing the rationale for NGO conversion:

- Meeting demand for credit. As an NGO, MFI is unable to expand at the desired rate to meet demand for credit, even if that is part of the original NGO mandate. There is a need for additional financing to expand services, including the need for obtaining funds to increase its loan portfolio. At the same time, financing of the NGO faces decrease while the demand is increasing faster than funds are arriving;
- Capturing savings. It is known that NGOs are restricted from using client's savings, commercial debt, shareholder investments and loans from the Central Bank for the purpose of financing, which means that they are legally restricted from offering full financial services to their clients. In addition, in some countries there is a problem with inflation and saving in banks can offer security on the value of clients' funds;
- Launching market driven approach. Some NGOs want to create market-driven approach to micro-lending. By paying for its funds through interest on savings deposits, dividends, inter-bank loans and other means available to regulated financial institutions, converted NGOs could accomplish expansion, be market driven and be independent from the donated funds. NGO might be sustainable but significant expansion calls for more funds. In this way, they are solving long-term economic challenge, serving clients not beneficiaries and funding programs through investors not donors.

3. Nine East European MFIs

In the last several years Opportunity International network has worked with 14 of its partners as they have started the transition from non-governmental organization to formal financial institution. From this it has been learned that the process is longer, more arduous and more risky than originally anticipated, and not one to be entered into lightly. On the other hand, it has been seen that those organizations that do successfully make the transition to formal financial institutions have access to many times more funding than those who remain as NGOs.

3.1. Opportunity International Network

The constituents of the Opportunity International network are divided into two main types of institutions – support partners that raise money and other resources, and implementing partners that provide financial services to the poor. The clients of the support partners are government, corporate and private donors in their countries. The clients of the implementing partners are those living in poverty that borrow money, save and in some cases purchase insurance from them.

The Opportunity International network includes 41 implementing partners in 26 countries, and one pilot program in China. As of the end of December 2004 these organizations together were serving 675,588 clients with a loan portfolio of USD 130 million. Combined, they maintain the quality of this portfolio, with arrears over 30 days at 2.01%, and operate profitably, with total earned income exceeding costs by more than 7%. A little more than half of OI implementing partners (22 of 41) operate profitably. Most of these are in Eastern Europe, Latin America and the Philippines.

However, these combined numbers can mask a great deal of variation in performance among these member organizations:

- 25% of OI members serve 69% of its clients. Of these ten organizations, five are in the Philippines, two are in Africa, and one each are in Nicaragua, India and Indonesia;
- 25% of OI members manage 73% of its loan portfolio. Of these, six are in Eastern Europe, two in the Philippines and one each in Africa (Ghana) and Latin America (Nicaragua);
- Only four organizations are on both lists;

Recently, OI conducted an analysis of the clients of its implementing partners, asking them to carry out a survey with a sample group of 500 clients. OI has received and compiled the data from over 6,000 clients and then weighted it according to overall client distribution around the world. Here is what was found: Most of OI clients are very poor, but they have more resources than thought – 43% of them earn less than USD 1 per day per family member and an additional 22% earn between USD 1 and USD 2 per day, yet a majority of OI clients have access to running water, electricity and an indoor toilet. For 58% of OI clients their business is their sole source of income, while the remainder have additional

sources of household income, such as the employment of a spouse. 16% of OI clients receive money transfers from relatives living abroad.

There is a strong demand for more credit among OI clients, and a varying demand for additional financial services. Most clients would like to borrow more, showing high levels of unmet demand among the existing clients base, let alone among those currently not reached. Actually, the number of clients served by the Network has been growing at a rate of 30% per year, while funding for the Network has been growing at a rate of 15% per year.

In 1995 the OI commissioned a study of the market for funding for microfinance. That study found that support for microfinance from government institutions was growing at a rate of 40% per year. In the past few years funding from government institutions has stopped growing and started to decline. Two major factors account for this. First, in the aftermath of wars in Afghanistan and Iraq, much of the foreign aid from the US and the UK has moved to these two countries, leaving less available for microfinance work in other countries. Second, the governments of all the Western countries have signed on to a set of goals for the results they want to achieve with foreign aid. These goals cover areas like eradicating extreme poverty, providing universal education, empowering women, reducing child mortality and combating HIV/AIDS. While microfinance has an impact on all these areas, it is not the major focus of any of them.

The technical donor and investor community globally has become substantially more sophisticated over the last five years in terms of their knowledge of microfinance and have steadily raised their performance expectations and requirements for MFIs. The bar for receiving grant funding has been raised much higher while the amount of grant funding available has declined. Exacerbating this environment is the major increase in the number of MFIs and networks competing for these limited funds. In this environment it is almost impossible to market a weak performing MFI to a technical donor institution - and it is as equally impossible to hide weak performance when donors can depend on consultants and ratings firms to gain independent assessments of performance. In addition, technical donors want to see that the organizations that receive their grants have sufficient knowledge and authority to apply best practices and intervene when problems start to emerge.

On the other side, Opportunity International receives more in private donations than any other microfinance network. Most of the other networks are largely dependent on government funds for their operations, while for OI the income of support partners is almost equally split between public and private sources. Yet, the total amount of private contributions that go to microfinance in all of the countries where OI operates is a very small percentage of total donations for international aid programs.

3.2. OI's East European Implementing Partners

In 2003 Opportunity International celebrated 10 years of operation in Eastern Europe. Since 1993, Eastern European partners have adopted a range of legal formats to suit their lending environments, with a deliberate trend towards creating formal financial institutions. Opportunity Bank Montenegro became the first full-service bank in the region, while two domestic savings houses/banks

(Serbia and Macedonia) and one foundation (Russia) expect to convert to full commercial bank status during 2005.

Comparing to other regions the nine East European implementing partners led the notable milestones and achievements of Opportunity International network in the past years, among them the leading performances in terms of operational and financial sustainability. Yet, there are challenges, both conceptual and operational, to be dealt with. Serving only 6.3% of the OI network active clients with nearly 60% of the whole OI network portfolio, and still being in demand for new sources of funds, these MFIs are turning towards rapid commercialization.

As far as their institutional form is concerned, their initial and current status varies. At present (February 2005), out of nine MFIs, one is full scale bank (OBM - Montenegro), two are savings houses/banks (Moznosti - Macedonia and OIS - Serbia), three are finance companies (PShM - Albania, Inicjatywa Mikro - Poland and OMRO - Romania), two are credit cooperatives (Nachala - Bulgaria and NOA - Croatia) and one is an NGO/Foundation (FORA - Russia). As most of them underwent or undergo changes that are to meet their current needs, here is the overview ([Opportunity International, 2002](#)) of their institutional development:

PARTNER	FOUNDED AS...	YEAR OF FOUNDATION	CONVERTED TO...	YEAR OF CONVERSION
PShM	Savings and Credit Co-op.	1998	Joint Stock Co.	2001
Nachala	NGO Foundation	1993	Credit Co-op.	1997
NOA	Savings and Credit Co-op.	1996		
Moznosti	NGO Association	1996	Savings House/Bank	2000
MCM	NGO	1999	Bank - OBM	2002
IM	Ltd. Co.	1996		
IZVOR	NGO Association	1995	Ltd. Co. - OMRO	2000
OI Russia	Separate NGO entities	1993	Consolidated NGO - FORA	2000
OI Serbia	Savings House/Bank	2002		

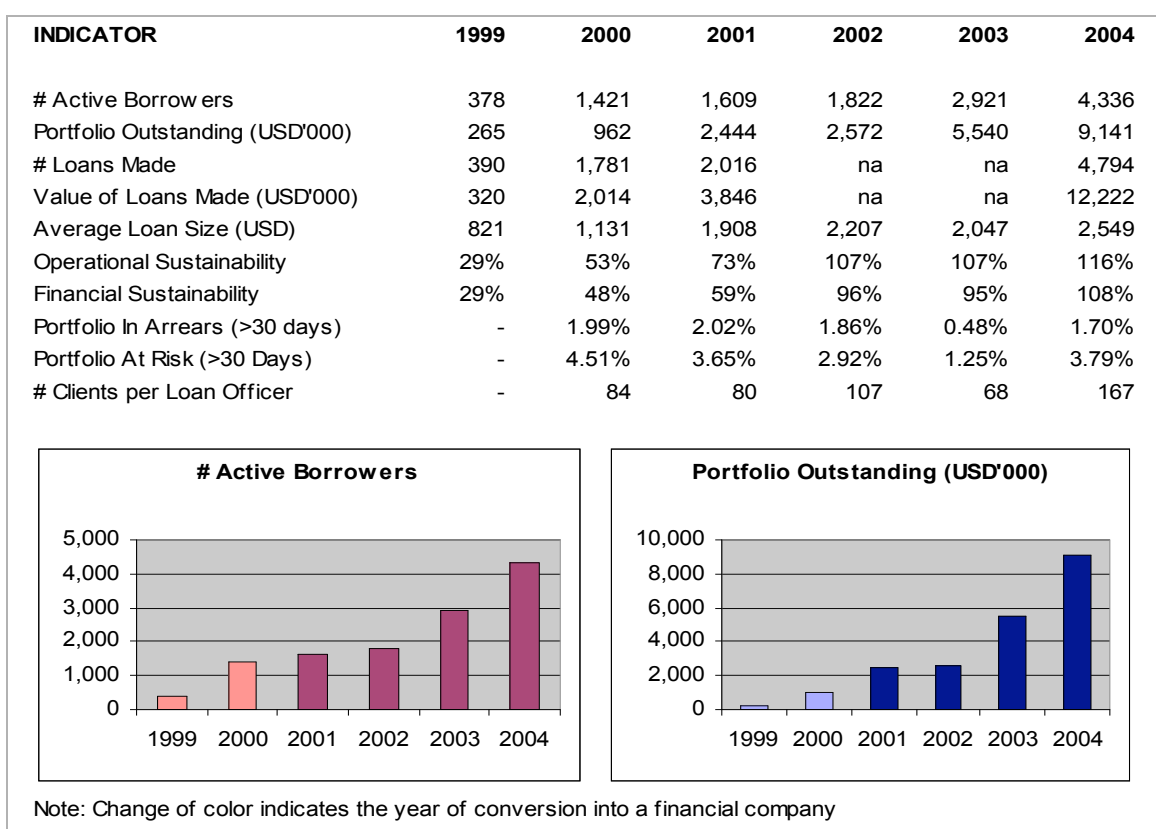
3.2.1. PSHM – Albania

PShM Sh.a. (PShM Ltd.) is OI's Albanian microfinance partner dedicated to providing credit and business support to microbusiness entrepreneurs throughout Albania. PShM began lending as a credit cooperative in August 1999, converting to a finance company in March 2001. With equity capital derived from a grant by USAID, it is licensed by the National Bank of Albania to make loans as a non-bank financial institution. Despite growing competition, PShM occupies a strong market position in Albania and is coordinating its micro-lending with the activities of several NGOs so as to target greater numbers of poor clients.

As of December 31, 2004, PShM had 4,336 active clients and loan portfolio outstanding of USD 9.14 mil. In May 2002, PShM signed a sub-grant agreement

with Chemonics International in loan funds and technical assistance costs over the next three years. This award was based on a joint proposal winning a competitive submission for USAID's integrated Small Credit and Assistance Protect in Albania. Under this contract PShM has adapted its micro-lending products and systems to the needs of small and medium enterprises (SMEs) in the production sector. During 2004 PShM succeeded to attract the interest of several important social funds (Blue Orchard, DB Microcredit Fund, Triodos Fund, Fue Vert) and to conclude loan agreements, that way increasing significantly its portfolio outstanding.

There is no present plan to convert PShM to a bank.



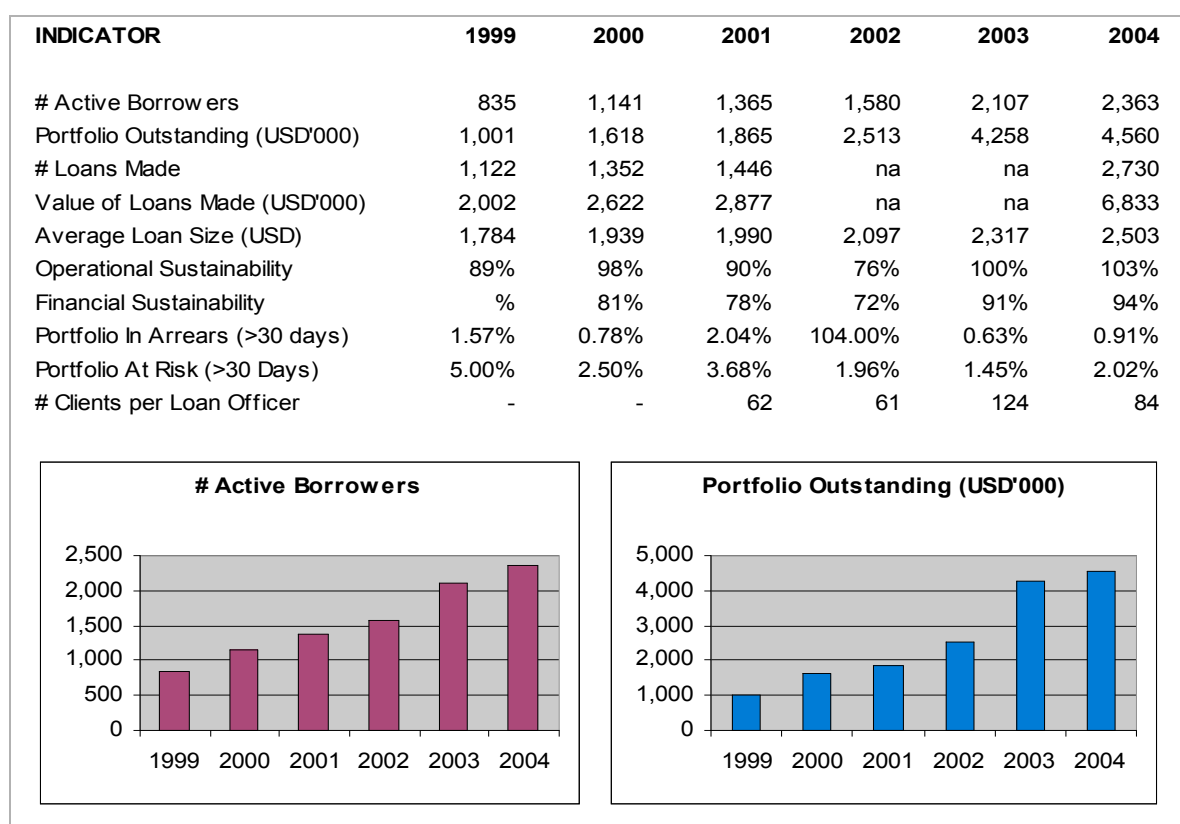
3.2.2. Nachala – Bulgaria

Nachala was OI's first partner in Eastern Europe and was incorporated in July 1993 as a Bulgarian not-for-profit foundation. Nachala's mission is to provide opportunities for the needy, poor and unemployed to transform their lives by providing small business loans and counsel. Due to changes in Bulgarian law and severe economic crisis, lending was suspended in early 1996. In July 1997 Nachala's Board decided to form a Credit Cooperative, using the credit union form of lending as the most flexible and appropriate in the context of the country's economic environment and legislative framework. Cooperatives also have long traditions in pre-communist Bulgaria as a tool for mutual assistance for successful business and social development. Nachala Cooperative started lending in December 1997.

In May 2002 Nachala entered into an agreement with USAID to increase grant funding. A grant is managed by OI-US, and the increase provided almost new funds for Nachala, increasing its equity significantly. Nachala received an initial grant from USAID in 1999, at which time it was one of three MFIs to receive grant

funding from USAID. Nachala is the only one of these MFIs to receive an expansion grant, which is the direct result of an evaluation of the micro-enterprise sector conducted by an independent consulting firm engaged by USAID. The consulting firm's review was extremely positive and complimentary about the performance of Nachala.

As of December 31, 2004, Nachala had 2,363 active clients and loan portfolio outstanding of USD 4.56 mil.



3.2.3. NOA - Croatia

NOA was founded as a Savings and Loan Co-operative (SLC) in 1996 in a region of considerable ethnic and religious division, and one which was consequently torn apart by war in 1991. From the outset, NOA's principal goals were to provide loans to small businesses in the war-torn areas of Eastern Croatia, generating new jobs and stability of employment, and seeking to encourage the return of refugees from neighboring Serbia. NOA's Board of Directors and staff reflect both the ethnic and religious diversity that is characteristic for the region.

In February 2004 NOA had to pay 700.000 USD of tax for USAID donation in 1996. In year 2004, as well as in the first four months of year 2005, while NOA is repaying the short term loan borrowed from Hypo Bank aimed to pay the tax, NOA stagnates in development until the portfolio consolidation. Thus, as of December 31, 2004 NOA had 585 active clients and outstanding loan portfolio of USD 4.16 mil.

Out of 100, NOA is still the third largest SLC in the Republic of Croatia.

INDICATOR	1999	2000	2001	2002	2003	2004
# Active Borrowers	527	594	625	598	589	585
Portfolio Outstanding (USD'000)	2,346	2,491	2,674	2,925	3,660	3,972
# Loans Made	333	384	347	na	na	168
Value of Loans Made (USD'000)	1,686	1,557	1,785	na	na	1,199
Average Loan Size (USD)	5,063	4,055	5,144	4,675	6,589	7,142
Operational Sustainability	122%	102%	110%	108%	116%	112%
Financial Sustainability	%	88%	107%	105%	94%	111%
Portfolio In Arrears (>30 days)	6.51%	6.04%	4.69%	3.84%	3.98%	3.32%
Portfolio At Risk (>30 Days)	19.80%	11.04%	11.37%	11.16%	14.59%	15.72%
# Clients per Loan Officer	-	149	78	85	98	117

Active Borrowers

Year	1999	2000	2001	2002	2003	2004
Value	527	594	625	598	589	585

Portfolio Outstanding (USD'000)

Year	1999	2000	2001	2002	2003	2004
Value	2,346	2,491	2,674	2,925	3,660	3,972

3.2.4. Moznosti – Macedonia

Moznosti was established on OI initiative as a humanitarian association in 1996 to provide help to Macedonian citizens in the development of their entrepreneurial activities through the provision of micro-credit facilities. Moznosti was the first MFI in Macedonia and has received subsequent grants from USAID, successfully consolidating its position as the country's leading microfinance provider. In May 2000, Moznosti converted to a Savings House/Bank as a step towards becoming a full service bank, having the original NGO as sole owner. However, continual changes in the banking law, coupled with economic and political instability consequential to the civil conflict in 2001, have contributed to the delayed conversion into a bank.

Later amendments to the banking law meant that Moznosti was able to press ahead with its application without previous restrictions on ownership or having to announce liquidation of the Savings House. Efforts directed to transitioning to a full service bank have resulted in refusal by the Central Bank dated early 2004, explained as simple incompatibility of the not-for-profit character of the NGO with its role as a sole owner of the profit motivated FFI. Contrary to the refusal, a full-scope examination of SH Moznosti conducted later 2004 by the Central Bank, found it to be the best-capitalized Savings House/Bank in Macedonia. The most recent loan agreement has been concluded with the German Development Bank (KfW).

As of December 31, 2004, Moznosti had 4,871 active clients and loan portfolio outstanding of USD 13.6 mil. A key challenge facing Moznosti is to maintain its

high profile and competitive advantage, while transitioning to a full service bank in 2005.

INDICATOR	1999	2000	2001	2002	2003	2004
# Active Borrowers	798	1,763	2,740	2,616	3,709	4,871
Portfolio Outstanding (USD'000)	2,608	4,444	3,096	4,298	7,559	13,600
# Loans Made	745	1,810	2,424	1,921	2,467	3,369
Value of Loans Made (USD'000)	2,898	5,276	3,922	3,200	6,315	10,398
Average Loan Size (USD)	3,890	2,915	1,618	1,666	2,757	3,086
Operational Sustainability	84%	178%	126%	145%	135%	136%
Financial Sustainability	%	113%	93%	133%	127%	131%
Portfolio In Arrears (>30 days)	0.84%	0.72%	4.81%	1.14%	1.42%	1.81%
Portfolio At Risk (>30 Days)	na	2.51%	14.36%	3.30%	3.53%	4.24%
# Clients per Loan Officer	na	160	274	138	177	187

Year	Number of Active Borrowers
1999	798
2000	1,763
2001	2,740
2002	2,616
2003	3,709
2004	4,871

Year	Portfolio Outstanding (USD'000)
1999	2,608
2000	4,444
2001	3,096
2002	4,298
2003	7,559
2004	13,600

Note: Change of color indicates the year of conversion into a savings house/bank

3.2.5. MCM/OBM – Montenegro

Opportunity Bank Montenegro (OBM) is the successor to Microcredit Montenegro (MCM), which was founded in 1999 as a non-governmental, non-profit organization offering loans to small-business entrepreneurs in Montenegro. MCM's primary target clients were entrepreneurs and farmers who lacked the financial means necessary to develop their business. MCM grew rapidly into a highly successful microfinance institution, making nearly ten thousand loans worth over USD 14.5 million to small businesses from July 1999 through to June 2002. The clients of MCM have mostly become clients of OBM, and MCM has ceased to grant new loans in 2002.

Opportunity Bank Montenegro (OBM) was founded in April 2002 to finance the growth of micro and small enterprises in Montenegro and to offer safe savings services to the Montenegrin public, as OI's first fully licensed bank in the region. OBM's equity also comprises a number of minority private shareholdings. OBM is a licensed and regulated full service bank that provides loans to both existing businesses and start-ups. As well as taking deposits, OBM is developing lending products for the SME sector. Loan sizes range from EUR 500 to EUR 10,000 for micro-entrepreneurs and generally up to EUR 100,000 (with a present average loan size of EUR 30,000) for small enterprises.

OBM opened its doors to the public in July 2002 and disbursed 140 loans in its first week of operation. During 2004 number of social and even private investors made some type of borrowings or investment, including EBRD. That led to loan

portfolio outstanding of USD 28.47 mil. - the largest in the OI Network, followed by 7,320 active clients as of December 31, 2004.

INDICATOR	1999	2000	2001	2002	2003	2004
# Active Borrowers	713	2,507	4,231	4,942	5,700	7,320
Portfolio Outstanding (USD'000)	887	2,252	3,509	8,715	16,793	28,476
# Loans Made	730	3,176	4,332	na	na	7,030
Value of Loans Made (USD'000)	1,141	4,208	6,197	na	na	31,541
Average Loan Size (USD)	1,563	1,325	1,431	2,103	3,685	4,486
Operational Sustainability	52%	117%	130%	98%	114%	117%
Financial Sustainability	52%	80%	65%	71%	95%	108%
Portfolio In Arrears (>30 days)	1.00%	1.51%	0.82%	0.63%	0.81%	0.57%
Portfolio At Risk (>30 Days)	6.44%	2.21%	1.48%	1.07%	1.79%	1.17%
# Clients per Loan Officer	-	-	201	225	238	252

Active Borrowers

Portfolio Outstanding (USD'000)

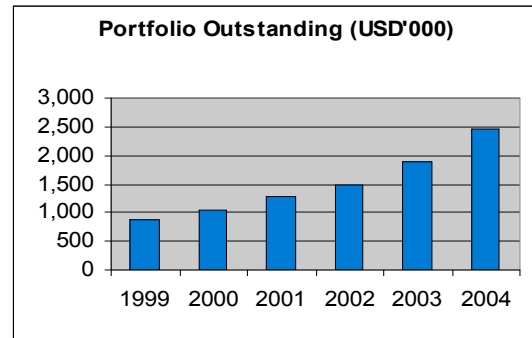
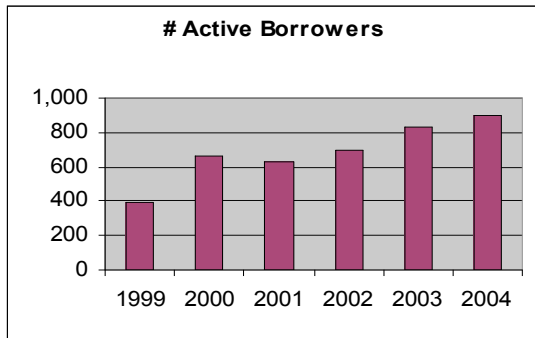
Note: Change of color indicates the year of conversion into a full service bank

3.2.6. Inicjatywa Mikro – Poland

Inicjatywa Mikro Sp. Z.o.o. (IM), established as finance company in 1996, is OI's microfinance partner operating in southern Poland, where for decades employment was concentrated in state-owned factories and mines. As many of these have closed or been downsized since 1989, IM is among the few sources of credit serving a micro-enterprise sector that has become increasingly important in generating jobs. IM is in a good position to fulfil its mission of supporting enterprise development and job creation, and intends to continue to build on its strong and sustainable performance in the region thus far.

As of December 31, 2004, IM had 902 active clients and loan portfolio outstanding of USD 2.46 mil. However, IM is in need of grant and/or borrowing facilities of in order to achieve its growth targets. Since becoming a bank is out of the question due to the high capital threshold, and borrowing funds is usually costly, one alternative for IM is to act as service deliverer for government sponsored programs supporting small enterprise.

INDICATOR	1999	2000	2001	2002	2003	2004
# Active Borrowers	389	667	634	693	831	902
Portfolio Outstanding (USD'000)	882	1,060	1,273	1,477	1,892	2,464
# Loans Made	534	552	474	na	na	582
Value of Loans Made (USD'000)	1,318	1,314	1,392	na	na	1,996
Average Loan Size (USD)	2,468	2,380	2,937	2,965	3,188	3,429
Operational Sustainability	112%	91%	106%	107%	94%	121%
Financial Sustainability	112%	74%	94%	100%	91%	109%
Portfolio In Arrears (>30 days)	3.15%	2.43%	2.33%	2.00%	1.61%	1.62%
Portfolio At Risk (>30 Days)	13.06%	13.37%	21.46%	19.10%	18.43%	11.38%
# Clients per Loan Officer	-	-	127	116	139	129



3.2.7. Izvor/OMRO – Romania

Opportunity Microcredit Romania S.R.L. (OMRO) was registered as a finance company in December 2000, following changes in Romanian law governing credit cooperatives, which obliged Izvor, OI's former microfinance partner and co-owner of OMRO, to modify its legal and organizational structure.

Izvor as a non-profit association was established in 1995. Since it was impossible for a non-profit association to disburse money as credits, it started operating as a sort of leasing company offering credit in kind - equipments and machines. In 1999 Izvor gets to know the existence of an advantageous Cooperatives law, and decided to operate as a cooperative delivering cash loans to its members. When, in 2000, the Cooperatives law changed, imposing restrictions, OI and Izvor registered Opportunity Microcredit Romania Ltd company. OMRO started its operations, as a limited liability commercial company in February 2001 when Izvor transferred its lending operations to OMRO. The National Bank of Romania has given OMRO an exemption letter providing a legal basis to operate as a non-bank finance company. This provides a better legal basis for micro-lending than an NGO. Izvor continues to operate offering training and other non-financial services to the OMRO's clients.

There is no present plan to convert OMRO to a bank.

As of December 31, 2004, OMRO had 1,109 active clients and loan portfolio outstanding of USD 3.31 mil. The challenge facing OMRO is to find new sources of funds to on-lend to this virtually untapped sector. It is expected few equity commitments and a loan agreed with Societe Generale during 2004 to be completed in the first half of 2005.

INDICATOR	1999	2000	2001	2002	2003	2004
# Active Borrowers	292	792	810	1,081	938	1,109
Portfolio Outstanding (USD'000)	226	573	899	1,338	1,751	3,312
# Loans Made	557	1,185	1,279	na	na	1,270
Value of Loans Made (USD'000)	573	1,199	1,580	na	na	3,449
Average Loan Size (USD)	1,029	1,012	1,235	1,618	2,159	2,716
Operational Sustainability	118%	103%	119%	110%	116%	189%
Financial Sustainability	%	46%	96%	88%	98%	151%
Portfolio In Arrears (>30 days)	1.99%	3.87%	1.76%	1.52%	0.54%	0.47%
Portfolio At Risk (>30 Days)	2.70%	10.81%	5.67%	5.16%	4.42%	3.07%
# Clients per Loan Officer	-	113	116	135	134	123

Note: Change of color indicates the year of conversion into a financial company

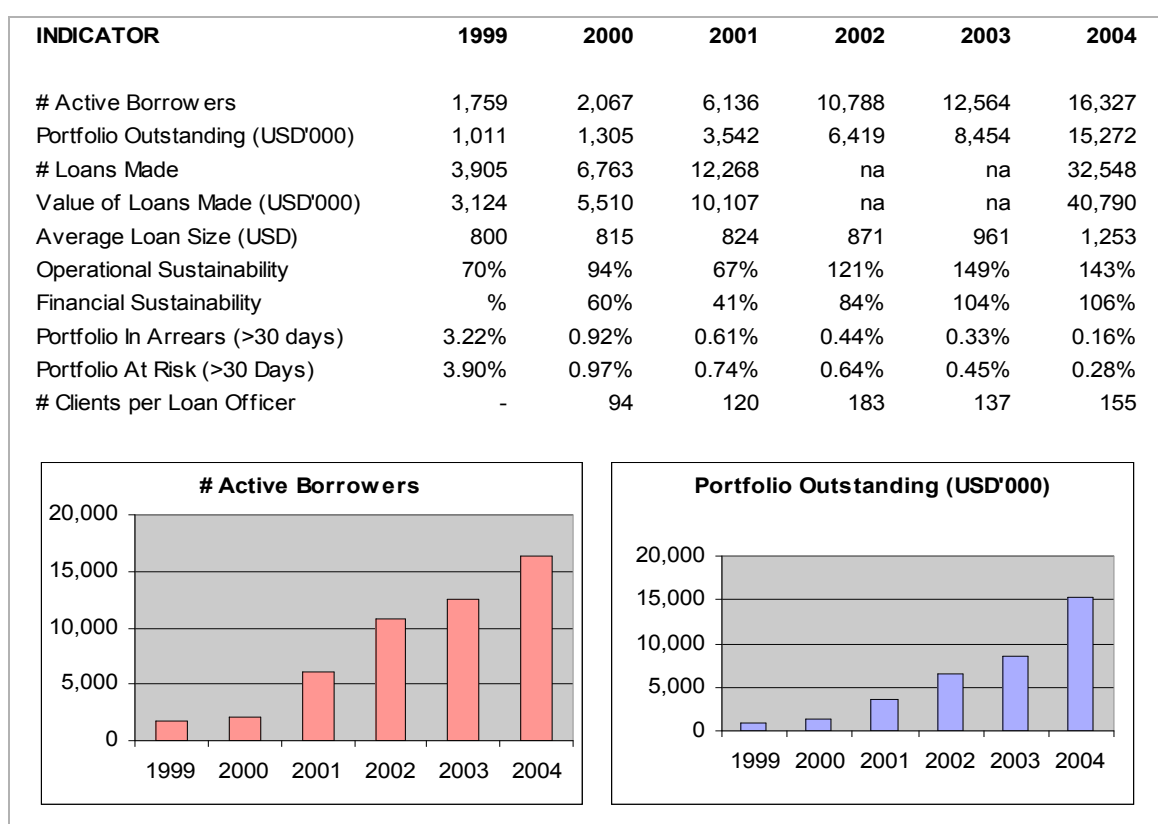
3.2.8. FORA – Russia

Fund Opportunity Russia (FORA) was created in 2000 when three OI-Russia partners (Perspectiva in Veliky Novgorod, Novy Soyuz in Voronezh, and Soprichastnost in Rostov-on-Don) and a new office Nadezhniy Partner in Saratov consolidated. The streamlining of management and operations coupled with a grant from the UK's Department for International Development (DFID) has resulted in FORA's exponential growth and demonstrable ability to reach more clients more efficiently while building a stronger organization.

As a member of the Russian Microfinance Working Group, FORA is also at the forefront of efforts to create a more positive regulatory framework for microfinance in Russia. FORA is actively developing a strategic partnership with the banking sector, mainly through the Association of Russian Bankers (ARB). FORA also continues to take a leading role in lobbying the State Duma of the Russian Federation for changes to enhance the legal environment for microfinance.

Meanwhile, on its meeting in May 2004 the Board delivered formal decision for commencement of the conversion process into bank.

During 2004 several large loan agreements have been concluded with the leading social investors and a bank such as Oikocredit, Blue Orchard and Societe Generale. That resulted in increase of FORA's loan portfolio to USD 15.2 mil. as of December 31, 2004. As of the same date, FORA had 16,327 active clients maintaining portfolio at risk (over 1 day) at less than 0.4 %, the lowest in the OI Network.



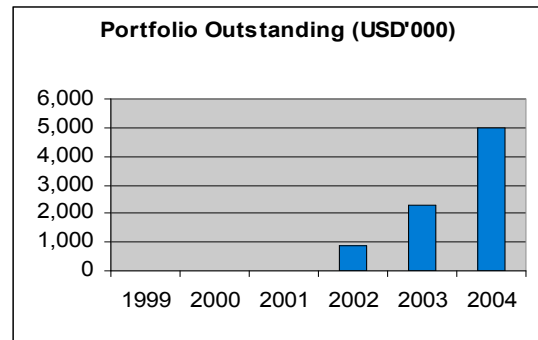
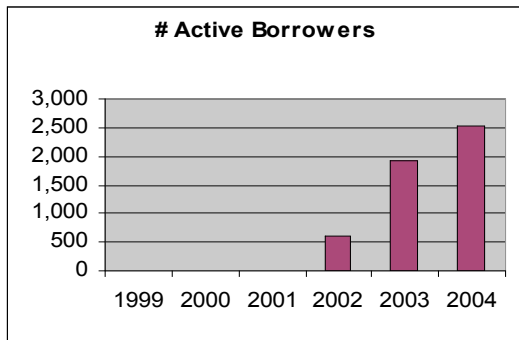
3.2.9. OIS – Serbia

Stedionica Opportunity International a.d., or OI Serbia, is OI's newest partner in Eastern Europe, based in Novi Sad, in the region of Vojvodina. While there is no law allowing NGOs to provide microfinance in Serbia, OI Serbia was licensed by the National Bank of Yugoslavia in July, 2002. Its goal is to become the primary provider of financial services to micro and small businesses within the country. With a start-up grant from USAID, the mission of OI Serbia is to create employment opportunities and improve the standard of living among its clients and their families, regardless of ethnicity, religious, or political affiliations.

OI Serbia began lending in August 2002, with loans ranging from EUR 1,000 to EUR 10,000. OI Serbia was profitable after only six months. A second grant from USAID will be used to convert to a full commercial bank, expected in 2005.

As of December 31, 2004, OI Serbia had 2,523 active clients and loan portfolio outstanding of over USD 4.99 mil. Two large equity commitments, by Oikocredit and a private investor are expected during the first months of 2005.

INDICATOR	1999	2000	2001	2002	2003	2004
# Active Borrowers	-	-	-	608	1,917	2,523
Portfolio Outstanding (USD'000)	-	-	-	894	2,317	4,998
# Loans Made	-	-	-	na	na	2,720
Value of Loans Made (USD'000)	-	-	-	na	na	6,936
Average Loan Size (USD)	-	-	-	1,691	1,857	2,550
Operational Sustainability	-	-	-	75%	125%	109%
Financial Sustainability	-	-	-	69%	93%	83%
Portfolio In Arrears (>30 days)	-	-	-	0.00%	0.45%	0.21%
Portfolio At Risk (>30 Days)	-	-	-	0.00%	0.73%	0.31%
# Clients per Loan Officer	-	-	-	68	137	93



4. Processing Conversion: Structure and Phases

There is a variety of models prescribed as necessary steps to undergo conversion. However, certain steps cannot be avoided: feasibility study of proposed FFI, promotion of the project among financial institutions and potential investors, coordination with the authorities and especially the Central Bank, legal registration, issuing of stocks and preparation of investment documents, negotiation with the existing donors to transfer funds from the NGO and coordination of the organization and design of new business plan for the bank and the remaining NGO. These steps have been structured by Campion ([2004: online](#)) in three groups of activities:

- Organizational transformation [i.e. conversion, n.a.] - licensing process;
- Financial transformation - raising equity, transferring debt;
- Operational transformation - transfer of systems, human resources, clients.

Of course, the basic precondition for conversion includes the need to ensure that the organization is sustainable. It is crucial not only for obtaining a license, but also for pursuing investors and selling the equity. Sustainability, however, is a difficult precondition because it has many meanings. Sustainability could range from highly subsidized programs to fully financially self-supporting organizations.

On their side the regulators have established minimum standards for NGO-MFI intending to undergo process of conversion. So, prior to any thought on entering the regulated world, "five issues need to be considered: minimal capital requirement, capital adequacy, liquidity requirements, asset quality and portfolio diversification" ([Ledgerwood, 1999: 23](#)).

The conversion plan involves many phases - some of which can be undertaken concurrently, while others must necessarily be sequential. While it is important that the vision of conversion can be translated into implementation in as short a period as possible, there are nonetheless inherent risks to the overall objective if any of the phases is inadequately progressed. It is important, therefore, that consideration is given to a realistic evaluation of the timescales which are required to undertake the conversion process - while this will inevitably vary between different bank conversion situations, broad development parameters must be agreed so that realistic expectations and financial contingencies can be established.

A summary of the conversion process and its timeframe as suggested for implementation within OI Network (see [Prat, 2002](#)), is shown in the table below:

Phase	Year 1 Qtr. 1	Year 1 Qtr. 2	Year 1 Qtr. 3	Year 1 Qtr. 4	Year 2 Qtr. 1	Year 2 Qtr. 2	Year 2 Qtr. 3	Year 2 Qtr. 4
Vision	xxx							
Strategy		xxx	Xxx					
Investment Proposition		xxx	Xxx					
Framework			Xxx	xxx				
Enablement				xxx	xxx	xxx	xxx	
Regulatory Authorities			Xxx				xxx	
Operations							xxx	xxx
Compliance / Audit						xxx		xxx

4.1. Vision, Long Term Objectives and Strategy

It is necessary to establish an enduring objective that will be progressed over the longer-term, with all commercial and social implications anticipated. As such, the vision will determine the values of the bank, and not the means by which they will be achieved. It provides a checkpoint against which individual short and medium term initiatives should be validated to ensure that these are consistent.

The Strategy of the bank is to progress the vision. The direction and commercial activities of the strategy should be consistent with, and contributory to, the spirit and direction of the vision.

It will be recognized that there will be a series of evolving strategies to be undertaken by the bank and that these will involve different initiatives and periodic corrections/readjustments of activities, in response to business growth, market conditions and environmental pressures.

4.2. Conversion Model and Investment Proposition

Generally, new investments are based on the individual characteristics of the entity under consideration. The most common criteria are outreach potential (determined by population size, level of poverty, and microfinance market conditions), profitability potential (competitive structure of microfinance market and legal environment), transformation potential (cultural receptivity to transformation indicators), and investment potential (largely determined by regional brand value and interested investors).

Therefore, the investment proposition must address and meet the needs of the various stakeholders in the establishment and development of the bank. As such, it requires the continuing acceptance of the vision and the on-going strategy.

The investment proposition must be acceptable to a wide range of participants – the financial investors, which must capitalize and be ready to support the development of the bank; the government, which seeks to achieve a wider social development for its people; the regulatory authorities, which must maintain the stability and confidence of the financial sector; the transitioning NGOs, which need to accept the basis of transition and their future role; the staff of both the bank and the transitioning NGO, who must address their financial and motivational needs; and, the clients, whose needs must be respected.

4.3. New Internal Standards

There is a need of internally designed framework to deal with the issues of governance, management structure, business plan, policies and products. This internal framework establishes the standards by which the bank shall operate – and thereby develops the culture and values which underpin operational activities. As such, it requires the investment proposition to have endorsed and supported the strategy so that the various stakeholders can be committed to the development of the bank and the scope of activity which can be addressed by available resources.

The internal framework must incorporate governance and business development environments which will translate the strategic objectives into a controlled business operation. The operational stability of the bank will require a framework of rules and policies, together with a capability for independent review at different levels of management.

In addition, enablement process has to be designed, so to establish the means by which the internal framework is to be implemented. As such, the standards defined can be translated into an operational structure which will be the basis of the operational stability and integrity of the bank.

4.4. Regulatory Process

The regulatory process provides the authorization and continuing approval for the activities of the banks. As such, they undertake due diligence of the strategy and the standards which have been established, together with their compliance with regulatory and legislative requirements. It provides also the objective criteria against which the future discharge of the operational activities can be measured.

It should be anticipated that there will be a continuing dialogue with the regulatory authorities during the evolving phases to ensure that such development is consistent with the requirements and expectations of the authorities.

The regulatory authority dimension establishes an essential focal point in the development of the bank and is an absolute precursor to the commencement of operational activities.

The regulatory process varies significantly by country. It is important to communicate with the appropriate regulatory authorities at all steps in the process of creating a new bank or converting an NGO into some form of bank. After initial communications and a general agreement concerning regulatory plans, the formal regulatory process in all countries starts with the submission of a license application. The form and content of the application varies significantly by country and type of bank.

It is a common policy to comply with all regulatory requirements. However, in some cases, standard bank regulations make it difficult or impossible to provide microfinance services for poor clients. Such regulatory constraints often relate to collateral requirements, reserve requirements, branch requirements, and capital or ownership requirements. The microfinance industry generally has had success in obtaining specific exemptions from certain regulatory obstacles.

4.5. Operations and Compliance

Operations reflect the commercial implementation of the activities determined by the strategy, in accordance with the standards established, and consistent with the requirements or constraints imposed by the regulatory authorities.

Compliance has been seen as an independent defence of the bank to maintain its stability through the discharge of the agreed framework standards and to maintain the support of the regulatory authorities.

5. Conversion Implications

The certain emergence of two entities and their separation affects all: board members, managers, staff and clients. The decision, process, advantages and disadvantages, implications, and actions to be taken need to be known and understood by all concerned. This will help to stop people from developing wrong perceptions which could cause undesirable resentment and damages that take long time and effort to correct. It is important to ensure that the concept of forming banks/FFIs is widely discussed and its implications widely understood. Clarity guarantees commitment and resolution whilst confusion causes a sense of exclusion and demotivation of people thereby adversely affecting present and future performance.

5.1. Key Issues and Debates

Properly prepared debate on the key issues is necessary for the future conversion process as many of the conversion elements are unknown on the beginning. "The transformation [i.e. conversion, n.a.] process is extremely difficult and time-consuming", underlines Rosengard (2000: 8). In his classification, he concentrates the main challenges around the following key issues:

- Strategic: Commercialization and corporatization of an NGO can be quite painful. Although it is essential to attain financial sustainability, it can lead to a divergence from the institution's mission and market, for example, by making larger loans to achieve economies of scale in credit operations.
- Operational: The operational requirements, both back office and front office, differ significantly for savings from those needed to administer a credit program: not only are the transactions both smaller and more numerous and the interest calculations more varied, but it is the saver and not the lender who determines the timing of these transactions;
- Regulation and Supervision: Microfinance is a new market for most regulatory agencies, and considerable dialogue is often necessary to find a way to adapt the objectives and norms of standard prudential regulation and supervision to measures and standards appropriate for microfinance. The most controversial are usually requirements for ownership and governance, loan classification and provisioning, and reporting.

In this respect, the following classification has been made based on the experience of the MFIs studied in this research.

5.1.1. Being Graduated: Picking the Right Time

In most of the cases initiation of NGO conversion cannot be seen as serious without having all possible circumstances in sight, including those at macro level. As Campion emphasizes (2004: online) there are prerequisites in the face of the "conducive external environment: political and economic stability, government recognition of micro-enterprise sector, supportive regulatory environment and the market potential". The fact is that issues such as the social environment,

macroeconomic indicators, restructuring processes of the financial sector, legal provisions, the future market positioning and many other might be never favourable all together, but at least those aspects are to be accounted for prior to taking the decision.

Having these general issues discussed, what is to be critically judged next is the so called graduation of the NGO - its capability to keep on track good and stable performance on a mid-term basis. This means that it should be able to cover all of its costs, including operational expenses, the cost of funds, and loan losses. It should also be able to generate a modest surplus for reinvestment in new products, delivery systems and technology.

All of this is needed in order to ensure the sustainability of the organization, which is an unavoidable precondition for obtaining a license from the Central Bank. Of course, in progressing through the levels of sustainability, any NGO must first show operational before accomplishing financial sustainability. The emphasis on sustainability promotes economic efficiency, decreases dependency on external resources, and creates the principal positive incentive for savers to deposit their funds - trust that their savings are secure, and for borrowers to repay their loans.

As said, no Central Bank will consider allowing a conversion until this condition is met. And this is a reasonable condition, because there is little inherent to the newly approved bank status that leads to greater sustainability in the first year after the conversion. In fact, many cases show that due to reserve requirements, higher taxes, investments in technology and higher reporting costs, initial expenses can be higher for banks than they are for NGOs. In a word, the bottom line is that the NGO must be running in a tight and sustainable manner before it should begin any process of conversion.

The additional attributes that characterize successful NGO prepared to undertake the conversion process are supposed to include increasing or at least stable number of clients, followed by decreasing or at least stable portfolio at risk indicator.

Finally, NGOs should not initiate conversion into a bank unless and until they have a proper MIS that can report daily closing information. This is a non-negotiable requirement that must be met upfront, not at some future date after the bank is already open for business. A well designed MIS will not only meet government reporting requirements, it will also assist in tracking and managing arrears, will enable loan officers to handle a larger active customer base, and will provide the right information on a timely basis for tight financial management.

However, as described in the following sections, all these prerequisites represent the necessary conditions for conversion to be launched. They are certainly not *sufficient* conditions for successfulness of the process.

5.1.2. The Role of the NGO: Initial and Remaining

The experience shows that in most of the cases the initiative for conversion comes from the NGO or, from the existing NGO donors interested for transfer of their capital into FFI. As the negotiating process with the donor of the funds operated by the NGO starts on the very beginning of the conversion process, the next issue is the structure and the sources of the foundation capital.

Knowing that many Central Banks are not accustomed with NGO as sole investor/shareholder, the issue should be double checked in advance. If bank regulations do not allow one single entity to have full ownership of a bank, NGO cannot be the sole owner of the FFIs to be established even in cases where they can raise the capital required. Therefore, the NGOs are compelled to share ownership of the entity of their own creation.

Mechanisms of the transfer of portfolio from the NGO to the bank are next. In most of the cases, the original NGOs remain as owners of the equity or become major investors. In some cases these NGOs are required by law to continue as operating entities.

Usually, for the rest of the initial bank capital, if needed, NGOs come up with a market-oriented investment strategy. In this respect its role is two fold: to ensure that investors with social and transformational orientation are invited as shareholders, and, if legally possible, to provide the best possible positioning for the NGO in the shareholders' structure. It is thought namely, that NGOs should be able to ensure that the banks will not drift from the original mission. However, the final result is to be negotiated with the prospective investors.

At this stage another issue comes up and is to be clarified - the fate of the NGO which will convert into or invest in the future FFI. In many cases that is an issue of greatest concern - for the conversion process itself, as well as for the future of the bank, especially if the idea of two entities prevails: the bank as for-profit entity performing commercial credit and savings operations, and the NGO itself as not-for-profit entity, usually supposed to do development work, training and research and development for the bank.

The initial proposal has to clear this dilemma. That way, potential investors and/or funders would have a choice: to invest in the bank, or to donate to the NGO.

In this respect, there is widespread opinion that the NGO which creates bank should not continue to provide lending services. If the parent NGO is to remain intact after the bank is launched – it needs a clear, compelling and financially sustainable mission.

However, when the NGOs surrender their micro-credit operations to the banks, they will not be able to continue generating income through interest and fees, so the next question is: how would they cover their costs?

This will have to come partly from their investment earnings (dividends) in the banks and partly from pilot projects/activities. As mentioned, the NGOs could also provide fee-based advisory services to other players and earn income to support their operations. The bulk of the money to be used by the NGOs will continue to come from grants. At certain stage, it could also be expected that the banks will have special development funds to be channelled through the NGOs for community development activities.

On the other hand, if the NGO exists only as pro forma entity (is not engaged in any other activity than being simply a shareholder/owner) the issue that arises is how to spend dividends if the bank is profitable. This is another hot debate to be dealt with.

5.1.3. Governance: Dual or Single, Professional or Street-smart?

Any conversion process from an NGO into a bank needs a group of committed leaders capable to guide and drive it. The group, usually composed of executive level people from the NGO, representatives of the partners/donors and in many cases external consultants is supposed to be knowledgeable enough to go through successfully, adding high-value in terms of specialized skills, experience and connections with investors. In addition to the executive directors, partner representatives and external consultants, in most instances one or two board members - not being experienced and qualified bankers or professionals but knowing the social and legal environment - championed the conversion efforts. In any case these key actors should be people with vision and strong management and marketing skills.

However, once the conversion process is on, it becomes clear that the flexible concept of ownership and governance in NGOs does not comply with the clear responsibilities in FFIs. The FFI in formation can readily expect raising standards through revised accreditation process and audit function, and external rating agency standards, while being in line with both original vision and mission. On the other hand, in most cases the NGOs' boards and management desire to remain as some sort of operating entities after the FFI is formed, and that might arise as a conflicting issue.

In that respect, if the NGO is not the sole owner of the FFI, newly established entity - bank or savings house/bank will have its own independent board composed of directors that represent the various investors. Their number will usually be in proportion to the size of their respective investment capital. The NGOs are to maintain their own boards but will also have representation on the banks' board. While the board of the bank might not have the privilege to directly influence or intervene with the affairs of the NGOs, the boards of the NGOs, through their representatives, will have full and direct access to the affairs of the banks. In many cases that role of the NGOs focuses exclusively on influencing the banks' board to remain on track, i.e. to operate in accordance with the original mission. That line and manner of action might differ from the highly specialized, profit-minded orientation of the board members representing other investors, and that arises as another conflicting issue. Yet, some experienced authors see no potential tension here, arguing that whatever the ownership "[it] remains intrinsically linked to effective governance, and one cannot assert that any one type of owner is more effective in governance than another. The profile of good governance is not determined by the type of owner, but rather by the adherence to the terms and requirements for all board members" ([Otero, 2001: 14](#)).

As for the management, a senior management team needs to be in place from the start of the conversion process. In some instances the management team of the NGO may not have the right set of skills and experience to successfully manage a bank. If this a case, those involved in the designing and executing of the conversion process are obliged to initiate personnel changes upfront in order to ensure the success of the bank. By recognizing this and taking the necessary steps, vision and courage to fulfil the mission will be demonstrated from the very start of the process.

When run by two different sets of boards and management, the risk that the two entities will gradually drift and distance from each other has to be well anticipated.

One standard way of preventing such outcome is through enhanced relationship at senior level. At board level, this is done through NGO board representation on the bank board. The executive teams of the banks and NGOs should also institute a good governance principles and a procedure whereby they meet regularly and interact on program and organizational issues. This will not only help them to share up to date information but also to keep their coherence and ensure that the joint mission is promoted and maintained. As with every complementary process, transparency is a must.

5.1.4. Staff and Client Transition

Staff transition and its ideological and psychological barriers might be potentially hot issue, as well. While emphasis has been put on commitment to improve social welfare of the poor for years, the new reality asks for replacement with the logic of profitability. That is not easy to be achieved and therefore, training of personnel is crucial, altogether with balanced approach in engaging both employees of the NGO and new people from the banking sector.

On the other hand, the common perception is that banks pay more than NGOs and that bank employees are more credible and better treated. The NGO personnel are likely to embrace this kind of perception and even might see it happening in the form of differences in salaries, training opportunities, uniforms, bonuses, international travels, etc. There is also the sense that the banks will be a more secure place of employment as they will be earning their own income. This scenario might motivate staff to leave the NGOs and join the banks and when such opportunities are not available to join other organizations.

It will, therefore, be important that there is a proper plan for staff movements between the banks and NGOs and for developing fair compensation packages to avoid frustrations. It is important to train the staff of the banks and prepare them to do their new duties well. It is equally important to train the staff of the NGOs to adjust to the new roles. Appreciating and treating staff in both entities equally will, most of all help to stop them from leaving both the NGOs and FFIs.

What happens with the economic, spiritual, social and personal transformation in clients' lives is the next question, since the client transition issue deserves its own attention. The normal reporting system of the FFI focuses on financial indicators only. Yet, there is still no unique formula presented on how to encourage FFIs to innovate and develop new financial products that serve their clients' needs, while maintaining quality control and making sure that they are to remain focused on serving the very poor and achieving a transformational impact.

It is important, therefore, what the clients are going to be told about the objectives of the conversion. As many of the poor are logically suspicious by even the simple mentioning of profitability, the well-thought explanation could include new client benefits such as permanent source of funds for loans, access to a variety of financial services and improvement of the quality of services.

Furthermore, although not debated very much in the literature on conversion, the interest rate policy might be of crucial importance for the successful commencement of bank operations. Expectedly, it would cover all costs and make a reasonable profit. However, the overall impact for the MFIs becoming banks is the necessity for raising their interest rates, which is not always the case.

The problem arises when it will be found out as unavoidable that the microfinance bank's interest rates are to be higher than other commercial banks. Of course, it is justified in higher costs of microfinance operations, payment of commercial rates for money borrowed as opposed to cost-free funds received by the NGO etc. However, it is not something that long term clients want to hear. On the other side, Central Bank insists on profitability and is generally suspicious about the small-amount loans, non-traditional methods of providing collateral through solidarity groups and non-conventional clientele. Beside the microfinance mantra that the access to credit is more important than interest rate, this kind of dual pressure upon the newly established FFI makes it a key issue in the debates related to the very essence of the sense for conversion.

5.1.5. Mission and Values Drift

Traditional vision, mission and values challenge versus the forthcoming commercial pressure has been among the strongest points of argumentation of those questioning the conversion. "Whether the opening of a regulatory framework leads to the development of a microfinance industry, or whether it is the visionary and competent microfinance NGOs that lead the way, operating as regulated entities will inevitably sharpen the microfinance institutions' focus on financial performance and, ultimately, make them more commercial in their outlook" says Christen ([2002: 7](#)), that way raising the dilemmas about FFIs' extent of the commitment to the original vision, mission and strategy and how much they remain strong. As said, namely, it is possible the mission to erode by commercial pressures.

However, once put in relationship, the NGOs and FFIs exist and operate as individual and independent entities under different government regulations. The real challenge is how to keep cohesion to ensure that they do not drift from each other at the cost of the original vision and mission.

This will partly depend on the roles the two come to play. It is necessary therefore, to come back with the question: what did bring the NGOs into existence and what motivates them to keep on?

It is well known that NGOs came into existence in order to fight material poverty by helping the poor through provision of microfinance services, including information, awareness raising, training and organization. So, the vision, mission, core values, activities and resources of the NGOs evolve around these core goals: empowerment, character and service. These are long-term in nature and the NGOs wish to keep on operating as long as the problems exist. Outreach, transformation and sustainability became key factors in the process.

The desire was to serve as many poor men and women as possible on a transformational and sustainable basis. Greater outreach requires more capital. The mobilization and management of large capital in turn, require a new set of organizational structure and a more complex management. Herein is the rationale for the birth of FFIs. They were brought into existence in order to promote empowerment among more poor people through the provision of more and better services, based on mobilizing more capital in a more formal way, including the savings from the public and investment from the private sector, which couldn't have been done under NGO status. Again, the management of large amounts of

capital (deposits and loans) requires a more complex set of expertise and technology.

It is essential therefore that the FFIs are seen as financial arms of the NGOs creatively innovated in response to new growth needs and requirements. If not jeopardized, their basic vision, mission and core values should remain the same as those of the NGOs. Simply, from the perspective of NGO's vision, mission and values, the FFIs are to be seen as means in transforming client's lives, not an end in themselves. In that sense, although "the combination of the term *transformation* and the term *financial institution* does not seem, at first, to be a logical one", comments Reed ([2004: online](#)), "as we shift from the more traditional NGO-style organizations to formal financial institutions, we maintain the focus on the fundamental economic, social, and spiritual wellbeing of our clients".

5.2. Lessons Learned

Debates regarding MFI conversion might be coated with optimism or scepticism, approval or denial, but once the decision is made, as Campion notes ([2004: online](#)), there is "no turning back" - the new entity is to be "permanently linked to formal financial system". It is therefore wise to consume the lessons learned by those that have already taken the step.

5.2.1. Achieve Full Sustainability

Crucial precondition to any idea of conversion into a bank is the NGO not to consider starting the process unless and until they are, as wisely called - graduated, i.e. fully financially sustainable.

As said, microfinance can attain wide outreach only outside the subsidized credit model, in self-sufficient commercial institutions. MFIs historically raise their interest rates to attain sustainable levels, but cost effectiveness must also be addressed. Therefore, in progressing through the levels of sustainability, any MFI must first show operational sustainability, then accomplishing financial sustainability, then starting to work on conversion process.

5.2.2. Double Check the Regulatory Framework

Formal financial institutions are subject to regulations and policies established by the Central Bank in their respective country. It is expected that NGOs intending to convert into FFIs should comply with all Central Bank regulations and reporting requirements in their country.

Although there is an increasing trend of harmonization of the banking legislation worldwide, there are still number of conflicting regulatory frameworks among various countries, as well as between the policies and standards of the global microfinance coalitions and regulatory requirements in a specific country. Therefore, it is essential such differences to be anticipated and addressed in advance.

5.2.3. Consider Ownership

As the most of the existing MFIs have been established with the generous grants by various charitable organizations or by the technical donations of various public entities from the developed countries, resolving the issue of FFIs' ownership becomes crucial point of conversion.

The sharing of ownership could already be perceived as both a liability and an asset. A liability, because the NGOs would have ideally liked to own the bank themselves while outside investors could have different intentions. An asset, because the risk is shared, more knowledge is made available and the NGOs could use part of their capital for other purposes.

New investors have to believe in both profitability and social merit, i.e. market driven micro-finance program that will reach the poor as declared. Therefore, it is necessary to be careful in selecting investors, so to meet their expectations. Plus, their credibility is of importance for the Central Bank.

5.2.4. Distinct Roles and Functions

As pointed out above, if the two entities - NGO and FFI remain in existence they should not do things that are competitive or undermining one entity by the other. Efforts should be done to avoid overlapping in any areas. Roles, functions and activities should be distinct and complementary at the same time. Staff, directors and clients should know who does what and where to go for what. The creation of such clarity among clients is very important, more so because they are likely to be easily confused and not always able to understand. They should have confidence in the new entity, the bank. Clarifying the various roles and functions is one way of establishing that.

However, NGOs which create banks should not continue to provide lending services. If the parent NGO is to remain intact after the bank is launched – it needs a clear, compelling and financially sustainable mission.

5.2.5. Ensure Culture Change

For decades NGOs as microfinance providers have been well known by their informal culture, including the flexible roles of the management and the staff. They have been often characterized as entities of "family" culture where everyone knows everyone else, that way building the relationships of trust rather than relationships based on clear procedures.

FFIs need clearly defined roles and responsibilities, more formal systems, more formal controls and professional expertise. Therefore, different behaviour and culture is required by all: directors, managers and the staff.

6. Conclusion

Based on what has been offered in the previous sections of this paper, both as theoretical and empirical argumentation, it is hard to deny that NGOs conversion into FFIs has positive impact on what has been drafted as general objective of the microfinance industry for the next decade. As a matter of fact, there are still views that "this development in the NGO micro-credit sub-sector is ironic because NGOs began micro-credit provision initially because of the failure of RFIs, commercial banks in particular, to serve the poor and low-income households" ([Fernando, 2003: 2](#)), but this kind of divisions, among other into *institutionists* and *welfarists* (see [Woller, Dunford and Woodworth, 1999](#)) seem to be completely outdated.

Yet, what is seen after examining the nine OI partners is some sort of competition among institutions. Generally, as everywhere else, competition is seen as good for the consumer - competition in industry has improved service quality, driven innovations, and brought about new ways of doing things.

In that sense, the performances indicated in the previous sections of this paper show that in many cases there is no compulsory relationship between MFI's success, as broadly understood notion, and its formal/informal status. Measurable by performance indicators available, within the nine MFIs examined in this paper there are examples of successful NGOs, co-operative, savings houses/banks and a full service bank. On the other side, although a very exact activity, provision of microfinance services might be never successful enough for the ultimate goal of the whole concept which is to eradicate poverty over the globe. In that respect, it is not easy to determine how much the conversion itself contributed to the level of particular success. Namely, some political and economic developments in particular countries influence the success. Specific regulator's requirements have their own influence, therefore making the skilfulness and wisdom - by which the conversion process is guided - to be important but not the decisive factor.

The number of clients served seems to be the most useful indicator for the purpose of illustration of this dilemma. Eight of nine of the examined MFIs, both regulated and unregulated, have continuous increase of this parameter. Even more, the highest rate (48%) of client growth in 2004 has been performed by a finance company (PShM - Albania), while both a full service bank (OBM - Montenegro) and the only NGO in this group of nine (FORA - Russia) in the same period accomplished similar client growth of 28-29%. These findings therefore make this indicator not very relevant to the subject of this research.

Additional indicator of the success of the MFI is the increase of the portfolio. As with the client outreach indicators, the willingness of the investors, including those with social motivation, is highly dependent not only on the institutional status of the MFI, but also on the political and economic situation in the particular country. In that sense, decrease in performance figures sometimes has been caused by wider economic or political crisis, unfair competition, organizational weakness, changes in the management etc. rather than the poor performance of the MFI caused by its regulated/unregulated status.

In the similar manner, increase in performance figures sometimes has been caused by external factors (new grant, if portfolio is concerned), rather than the

excellence in performance. Implementation of complementary step (increase of the number of clients as a consequence of downgrading the average loan size) might also lead to misleading conclusions.

In that sense, if the need for strong performance is taken as crucial reason for conversion, Russian FORA denies that stand also in another area - loan portfolio quality: with the number of clients being almost tripled in three years, portfolio in arrears more than 1 day (!) has been kept on 0.4%. As said, these results have been achieved as an NGO and are the leading ones within the whole OI Network.

Another argumentation in favour of the stand of conditional relevance of the formal status for the performance can be found in the two co-operatives' case: current difficulties and modest performance of NOA (Croatia) namely, have little to do with their institutional status, but are result of a specific problem with the Croatian tax legislation. At the same time, the other co-operative (Nachala - Bulgaria) performs very well, attracting continuous grant funding from USAID. Nachala namely, was the only one of the microfinance institutions in Bulgaria to receive an expansion grant, which is the direct result of an extremely positive and complimentary evaluation, conducted by an independent consulting firm engaged by USAID.

An interesting characterization, related not only to performance figures but also to the governance challenges, applies to Moznosti (Macedonia). Being FFI (savings house/bank since 2000) but at the same time being refused upon application for full service bank, Moznosti kept excellent performance. Even more, a year after refusal, Moznosti has been given highest possible grade for FFI in the country by the very same authority (Central Bank). All this happened with exactly the same governing board and management that were running Moznosti as NGO.

Polish and Romanian (IM and OMRO) cases, on the other hand, might be good examples in supporting the conversion logic. Both non-deposit taking finance companies, they are in relative stagnation caused mainly by the lack of funds. Although it is said that there are no present plans to convert them into banks, their current status might be a good reason to believe that as FFIs they would have done much better with the attraction of capital. Certainly, good will for conversion cannot be enough as some other open questions are to be analysed and solved first: capacity to attract the capital, unfavourable legislation (high level of capital required for bank establishment), strong competition on the market, etc.

Finally, the textbook example of the right time decision to convert (right after the new banking law has been passed, with the new Montenegrin Central Bank just established), altogether with the right method and the right people put in place, has been that of the OBM (Montenegro). It is a case that justifies all previously listed objectives of the conversion. OBM's results to date, namely, offer a dramatic example of the potential scope and scale of outreach and coverage if microfinance is done in a sustainable manner through a commercial bank. Even more, fears that a commitment to sustainability (profit) virtually guarantees that an MFI will move up market, abandoning poorer clients, in this case have appeared ungrounded. In fact, contrary to the critics of commercialization who frequently note that the average loan size of commercialized microfinance institutions is significantly higher than that of non-profit MFIs, OBM's figure raised reasonably, at the end of 2004 being at an acceptable (for European standards) level of 4,486 USD.

This does not mean again, that the success of OBM is a direct consequence of the conversion itself. As argued in various sections of this paper, conversion is doing a lot but not doing it all. In that sense, this paper does not suggest to “disregard [the] microfinance evangelists proselytizing one way of doing business” ([Rosengard, 2000: 9](#)). What this paper is advocating for is to be careful with the expectations from the conversion itself. It is not a panacea. Competition among institutions and “one size does not fit all” logic will sustain for at least some time in the future, and if regulated microfinance institutions are not going to be regarded as an end in themselves, they are now in the best position to prove their advantages.

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ⁱ Client numbers are 2002; all financials are 2002, except PAR which is 2003 Q2

ⁱⁱ Average NGO's in Latin America; does not include African partners

ⁱⁱⁱ Average ACCION Network

^{iv} Client Numbers are end of Q3, 2003

^v Client numbers are from Q2, 2002; financials are Q3 2001

^{vi} Client numbers and financials are Q2, 2002

^{vii} Client numbers and financials are Q2, 2001

^{viii} WWB has several client categories and different types of credit services. Total outreach is over 12 million people. Client numbers and financials are Q3 2002

^{ix} Client numbers and financials are Q2, 2001

^x Client and financials are from Q2, 2002