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From NGOs to Banks: Does Institutional Transformation Alter the Business Model of Microfinance Institutions?

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Summary. — In the microfinance industry an increasing number of providers are undergoing an institutional transformation from NGO to a shareholder-owned and typically regulated financial entity. Little is known about the extent to which this transformation affects the way microfinance institutions (MFIs) conduct their business. Our results obtained by applying an event study methodology to 66 transformed MFIs suggest that portfolio yield is driven down by 3.9 percentage points due to transformation, indicating that clients get more favorable interest rates. MFIs are able to significantly cut down their operational expenses, of which 1.1 percentage points can be attributed to transformation. Other findings include a steep increase in commercial debt leverage and deposits, a significant decrease in the fluctuation of funding costs and a sharp rise in average loan size, often taken as an indicator for mission drift. Profitability in terms of ROA drops in the short term, while ROE is driven up in the medium to long run, suggesting a more shareholder-oriented attitude.
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1. INTRODUCTION

Microfinance pledges to provide financial services to people without any access to banking. At the peak of public attention, roughly a decade ago, the microfinance movement was enthusiastically embraced by policymakers around the world, whereas in the aftermath of crises in oversaturated markets, concerns arose that profit-seeking behavior among microfinance institutions (MFIs) might harm their clients rather than benefit them (Dichter & Harper, 2007; Guérin, Labie, & Servet, 2015). Today it is acknowledged that microfinance *can* have a positive impact on poor people's incomes, albeit to a lesser extent than previously hoped by many. [1]

The global microfinance sector has continued its growth regardless, though it has undergone structural changes. Initially a purely philanthropic idea, modern microfinance started out in the 1970s as a not-for-profit activity sponsored by donors. However, since PRODEM in Bolivia was transformed into the regulated bank BancoSol in 1992, the received wisdom is that MFIs will follow a natural evolutionary process and transform from non-governmental organizations (NGOs) into financial institutions (von Pischke, 1996). While the bulk of MFIs today are still NGOs and heavily depend on subsidies (D'Espallier, Hudon, & Szafarz, 2013), several NGO-MFIs have already transformed into banks or other kinds of regulated non-bank financial institutions (NBFIs). Transformed NGO-MFIs include regional leaders such as Banco Compartamos in Mexico, Banco FIE in Brazil or Bandhan and SKS in India, which are among the largest MFIs in the world.

The transformation process implies moving to a shareholder ownership structure; and most often it also includes becoming subject to prudential regulation by national banking authorities. In this paper we investigate how transformation affects an MFI's business model by focusing on its main cost and income components, funding structure, services offered and average loan sizes.

The arguments for transformation are manifold, including: the importance of becoming independent from donors, better access to commercial funding, an improved governance structure and the possibility to provide clients with savings accounts (Frank, 2008; Mersland, 2009). However, some argue that commercialization and transformation tend to push MFIs away from their mission of serving the poor (Dichter & Harper, 2007). For example, studies such as Chahine and Tannir (2010) and Wagenaar (2014) suggest that transformed MFIs increase the size of their loans and tend to serve a lower percentage of women.

Our paper aims to make a threefold contribution to the existing empirical literature on MFI transformation. First, while the impact on social performance has frequently been studied, we look at the impact of transformation on the overall business model of MFIs. This comprises all the cost and income components (the MFIs' profit function), the decision whether to offer savings products, the funding structure of MFIs and the scale of their operations. By investigating the business impact of transformation we seek to shed light on the question whether transformation is indeed a useful option for MFIs to increase their financial viability, as is often proclaimed. This is a persistently relevant concern for an industry that does not regard itself as a "charity", yet is still largely financed by donations.

Second, the few empirical papers on transformation that are available have mainly exploited *between-MFI* information and compared transformed with untransformed organizations. The drawback of such an approach is the difficulty in

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controlling for unobserved differences between transformed and untransformed counterparts, especially since transformed MFIs typically make up only a very small part of the overall investigated sample. In order to better isolate the effects of transformation, we employ an event study methodology relying mainly on *within-MFI* information. Arguably, this methodology is better suited to documenting the changes caused by transformation; it is frequently used both in the finance literature (MacKinlay, 1997) and in the development literature (McIntosh, Villaran, & Wydick, 2011).

Third, we go beyond investigating effects at the mean, by looking at trends in variables before and after transformation along their distribution. More precisely, we assess whether different segments of the distribution (such as well-performing *vs.* low-performing MFIs prior to transformation) are affected differently after transformation.

Three main results stand out of our analyses. Firstly, nominal portfolio yield, a proxy for interest rates charged, falls by 5.9 percentage points (from 39.5% to 33.6%) on average after transformation. Correcting for the overall declining trend, we attribute 3.9 percentage points in the decrease of interest rate to transformation. This suggests that clients are offered more favorable interest rates after transformation.

Secondly, MFIs achieve substantial efficiency gains after transformation through an average reduction in operational costs of 9 percentage points, of which we estimate at least 1.1 percentage points are due to transformation.

Thirdly, transformation is followed by reduced volatility in funding costs as well as in overall profits, indicating that MFIs seek to decrease their operational risks, in part to comply with regulations imposing stricter risk management. We note a boost in debt leverage, which is associated with decreasing returns on assets and less operational self-sufficiency, and a rise in return on equity in the medium run, which is the most relevant profitability measure from an investor's point of view. Besides, MFIs at the lower end of the self-sustainability scale during their NGO period are able to increase their operational self-sufficiency after transformation.

Further results reveal a continued growth in the loan portfolio, largely financed by a strong increase in commercial funds whereas donations and subsidized debt dwindle. The expanding loan portfolio is a result of both reaching out to more customers and of issuing larger loans on average.

We conjecture that MFIs transform in order to take advantage of economies of scope and scale, and to tap into debt and deposit markets. Lower interest rates for clients are achieved by cutting operational costs but also by offering larger loans, which may entail a potential shift toward wealthier clients, such that mission drift cannot be ruled out.

The remainder of the article is structured as follows: Section 2 reviews the literature on institutional transformation in microfinance and the reasons why MFIs transform; Section 3 presents the methodology and describes the MFI dataset employed; Section 4 reviews the empirical results, and Section 5 provides conclusions.

2. INSTITUTIONAL TRANSFORMATION IN MICROFINANCE

(a) *Transformation as a profound, country-specific process*

Following Fernando (2004) we define MFI transformation as a shift from NGO to shareholder firm. It should be noted that this does not bar the NGO from being a shareholder of the transformed MFI. In most cases a transformed MFI will also become regulated by national banking authorities. The shareholder-owned financial institution may be a regular bank, but also one of several types of NBFIs, which are similar to banks but have different limitations to their operations and services.

This definition seems to be clear-cut; it emphasizes the date on which the NGO status of an MFI legally ends and it starts operating as a formal financial institution, typically licensed by national banking authorities. In reality, however, transformation is a long and complex process heavily dependent on country-specific regulations. Thus, while many studies including ours consider the moment of transformation as a fixed point in time t, it actually requires extensive preparation. Moreover it causes tensions and changes within the organization, both before and after legal transformation takes place (Battilana & Dorado, 2010). For example, Rosengard, Rai, and Oketch (2000) document the transition of the formerly largest MFI in Kenya, K-Rep, from an NGO to a regulated financial institution. The authors report that the process took five years, from the initial decision in 1994 to obtaining a banking license in 1999. They describe the transformation as an "*extremely challenging process*" involving major strategic, operational and regulatory choices.

Frank (2008) notes that the transformation process impacts upon almost all organizational aspects of an MFI, including governance, capital structure, product design, and regulatory environment. Hudon and Louche (2014), in their study of organizational changes induced by transformation in Kenya and Vietnam, observe that transforming MFIs struggle with redefinition of identity, redrawing the boundaries of the firm and issues of legitimacy. These challenges arise because MFIs are by nature hybrid institutions floating between two institutional logics, namely the social logic of poverty alleviation and the commercial logic of becoming self-sustainable (Randøy, Strøm, & Mersland, 2015). Although this double bottom-line principle lies at the very heart of microfinance (Armendàriz & Morduch, 2010), many researchers doubt whether it is possible to achieve in the long run, and observe a potential tradeoff between social and financial objectives (Dehejia, Montgomery, & Morduch, 2012; Hermes, Lensink, & Meesters, 2011). Other scholars believe that it is possible for MFIs to pursue this double logic and achieve success on both fronts (Cull, Demirguç-Kunt, & Morduch, 2007; Mersland & Strøm, 2010; Morduch, 2000). What is certain, however, is that transformation is a profound process which forces MFIs to rethink their position with respect to both the financial and social logics and to strike a new balance between these possibly opposing goals.

The transformation process depends very much upon the local regulatory context in which it takes place. For instance, in Bangladesh, where transformation is subject to the Microfinance Regulatory Authority Act of 2006, the licensing statute imposes requirements on all licensed MFIs concerning the total loan portfolio, the number of borrowers and loan applications (Khalily, Khaleque, & Badruddoza, 2014). Further, it caps annual interest rates and demands strict monitoring procedures. In most countries (but not Bangladesh), national banking authorities demand that regulated institutions be either member-based (credit unions, savings and credit cooperatives) or shareholder-owned. Since NGOs by definition have no owners (Mersland, 2009), most regulators consider them unsuited as banks since neither the authorities nor the depositors have any recourse if the bank gets into distress. Mersland (2009) points out that a change in ownership type, from NGO to shareholder-owned, will in itself alter the MFI's governance system substantially, and is

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