# How to do

## Formalising community-based microfinance institutions

Inclusive rural financial services

**How To Do Notes** are prepared by the IFAD **Policy and Technical Advisory Division** and provide practical suggestions and guidelines for country programme managers, project design teams and implementing partners to help them design and implement programmes and projects.

They present technical and practical aspects of specific approaches, methodologies, models and project components that have been tested and can be recommended for implementation and scaling up. The notes include best practices and case studies that can be used as models in their particular thematic areas.

**How To Do Notes** provide tools for project design based on best practices collected at the field level. They guide teams on how to implement specific recommendations of IFAD's operational policies, standard project requirements and financing tools.

The **How To Do Notes** are "living" documents and will be updated periodically based on new experiences and feedback. If you have any comments or suggestions, please contact the originators.

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# Contents

## List of acronyms

| | |
|---|---|
| BD | Board of Directors |
| CBD | Chair of the Board of Directors |
| CPMT | Country Program Management Team |
| CPO | Country Program Officers |
| GA | General Assembly |
| IFAD | International Fund for Agricultural Development |
| IR | Internal regulations |
| LLC | Limited liability company |
| M&E | Monitoring and evaluation |
| IMCEC | Mutual or Cooperative Savings and Credit Institution |
| MFI | Microfinance institution |
| NGO | Nongovernmental organization |
| OHADA | Organization for the Harmonization of Business Law in Africa |
| PV | Procès-Verbale |
| RGA | Regular Session of the General Assembly |
| SGA | Special Session of the General Assembly |
| SUPGA | Supplementary General Assembly |
| TSP | Technical service providers |
| WAEMU | West African Economic and Monetary Union |

# Introduction

During the period 1980-1990, many rural microfinance institutions (MFIs) were created by international donors as experiments in new or alternative financing to combat financial exclusion. The development of these MFIs, as well as the extent of their contribution to other initiatives, has led to efforts to sustain their operations.

In fact, rural MFIs have tackled the challenge of offering financial services to rural populations that up to now have been ignored by classical credit institutions. MFIs have facilitated rural households' access to formal financing, introducing and offering customized loans that beneficiaries have come to depend on. Thus, access to proximate financial services (credit, savings, money transfers, insurance) has become an enduring need for rural populations, and any interruption in these services could have dire consequences for the beneficiaries. Thus, the International Fund for Agricultural Development (IFAD) is concerned about ensuring the institutional and financial viability of rural MFIs.

The new regulations established for microfinance institutions in most of the African countries are what have driven the profound changes currently seen in the sector. After an initial experimental phase in which objectives were measured in terms of growth in the volume of loans and the number of disadvantaged populations reached, the priority has gradually shifted to the search for the financial and institutional sustainability of MFIs. The search for sustainability has pushed MFIs in three directions:

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

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

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

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

Institutional transformation is an internal growth strategy adopted by certain large MFIs, especially those that are associations, to ensure their financial and institutional viability.

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

Regrouping is an external growth strategy adopted by certain small MFIs to reach a critical size that will enable them to comply with the legal and regulatory framework.

[a] Guide de transformation institutionnelle des SFD de la zone WAEMU, René AZOKLY and Ibrahima Fane CAMARA, December 2009.
[b] Organization for the Harmonization of Business Law in Africa.
[c] Guide de transformation institutionnelle des SFD de la zone UEMOA, René AZOKLY and Ibrahima Fane CAMARA, December 2009.
[d] *Idem.*

- Institutionalization of microfinance institutions as NGOs/associations, cooperatives/mutual savings and credit institutions, or capital companies
- The institutional transformation of large microfinance NGOs/associations into capital companies
- The regrouping of MFIs whose small size prevented them from complying with all the regulatory provisions governing organization and management

IFAD support for MFIs does not favor any particular legal status. So diverse is the demand for proximate financial services that IFAD considers that a durable response to the issue of financial inclusion must also be diverse. Thus, IFAD supports the institutional transformation or regrouping of rural MFIs.

The purpose of this publication is to provide IFAD CPMs, MFIs, and all technical and financial partners with a methodological tool that will facilitate efficient implementation of the institutional transformation or regrouping processes of microfinance institutions, especially those that serve rural populations – processes that *a priori* are highly complex.

# Key issues

The microfinance sector is very dynamic. Constantly changing, it includes many types of activities, such as the downscaling operations[1] of certain banks, the upscaling operations[2] of certain MFIs, the direct creation of MFIs as capital companies (greenfield investments), the institutionalization of microfinance projects, the creation and transformation of microfinance NGOs/associations, operations for the development and consolidation of networks of savings and credit cooperatives, and regroupings of small microfinance institutions.

Today, international investors and the microfinance regulatory authorities consider the governance of MFIs that are capital companies superior to that of other types of MFIs, thanks to the activities of their shareholders.

MFIs that are NGOs/associations are considered institutions without a beneficial owner against whom one could take action in the event of a problem. The senior management of these microfinance NGOs/associations would therefore be less concerned about the efficiency of the organization.

Likewise, MFIs that are cooperatives based on the principle of “one man, one vote,” would by nature be less well-governed.

However, the view that capital companies are the institutions with the best governance in the sector is far from unanimous. For proponents of the social approach to microfinance, the sector has been “energized” by the NGOs/associations and, if it is to remain faithful to its original mission, the transformation of NGOs/associations into capital companies should not be encouraged.

Nonetheless, for international investors, it is precisely these transformation operations that bear witness to the maturity acquired by the sector, since they allow the MFIs involved to accept savings from the public more efficiently, thus closing the financial intermediation loop by assuming the two basic functions (credit and savings) that guarantee structural development potential.

Finally, for proponents of the cooperative system, savings and credit cooperatives (COOPEC), which made their appearance more than a century before microfinance NGOs/associations, are the “real solution” to the financing problems of populations excluded from traditional banking channels.

1 Downscaling is a strategy in which a commercial bank attempts to enter the microfinance sector.

2 Upscaling is a strategy in which an unregulated microfinance institution (for example, an MFI with the legal status of NGO) becomes a regulated institution (for example, a corporation). This strategy is generally motivated by the MFI’s desire to gain access to new sources of financing (such as savings) to finance its growth.

The different possible types of institutions and the applicable transformation models depend on many parameters, such as the initial legal status of the institutions, the options offered by the regulatory framework, the vision and mission that the founders wish to pursue, the market context, etc. In order to understand the issues surrounding the institutionalization, transformation, or regrouping of MFIs, it is necessary to know the existing institutional categories for implementing the potential microfinance activities and regrouping models.

# Institutionalization and transformation of MFIs

## Rationale

Generally speaking, the acquisition of or change in legal status can be driven by many considerations: i) the need to sustain the achievements of a microfinance project; ii) regulations that demand professionalism, transparency, and good governance; iii) the need to tailor legal status to the exigencies of growth (opening of the capital to new investors, the acceptance of savings, greater access to commercial financing); iv) the desire to change the institution's initial status to one more suited to the vision of its members; v) the need for greater independence from donors; vi) the need to clarify ownership of the institution, especially in the case of microfinance NGOs/associations considered institutions without owners; vii) the need to expand the range of services offered (loans beyond a certain limit, longer loan terms, use of digital finance, access to the retail payment system, etc.).

Moreover, it is important to understand that the curve of the natural evolution of microfinance NGOs/associations is as follows.

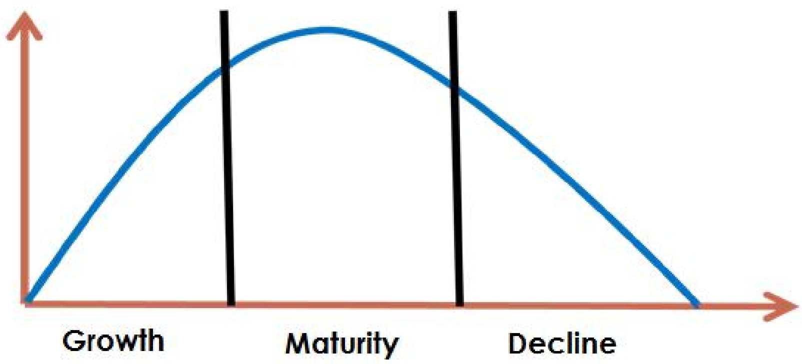


**Figure 1: Curve of the natural evolution of microfinance NGOs/associations**

Experience has shown that there are three major phases in the natural evolution of microfinance NGOs/associations:

- The growth phase, which generally covers the first 10 years of an MFI. During this phase, if an institution is well-managed, it thrives and has good performance indicators.
- Following the growth phase, the MFI enters the maturity phase, during which its growth slows, stagnates, and begins to decline. During this phase, which lasts roughly 10 years, the MFI encounters governance problems, especially in access to financing. This is when institutional transformation becomes vital.
- During the maturity phase, if the MFI does not undergo an institutional transformation, it will inevitably enter the phase of decline and eventually disappear.

Figure 2 below shows the curve of the evolution of microfinance NGOs/associations that have been transformed.

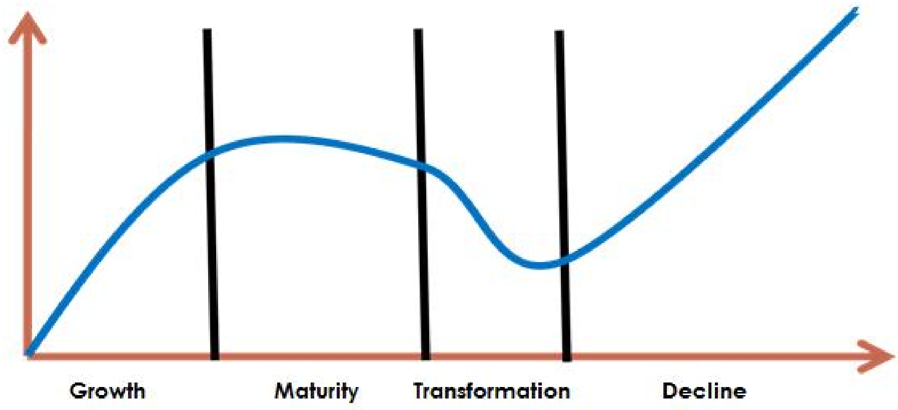


**Figure 2: Curve of the evolution of microfinance NGOs/associations that have been transformed**

Experience has shown that the evolution of microfinance NGOs/associations that undergo transformation generally includes four major phases. The first two (growth and maturity) are identical to the natural evolution depicted above. The last two (transformation and viability) have the following characteristics:

- During the institutional transformation phase, which lasts two to five years, the MFI's overall performance declines for a time, given the numerous institutional restructuring activities that consume staff time and financial resources.
- When the institutional transformation operation is successful, the MFI enters the viability phase, characterized by a net increase in growth and an improvement in its performance indicators.

## Main objectives

The main objectives of MFI institutionalization and transformation operations are a combination of the following:

- Access to commercial funds, especially equity
- The development of new products: savings, medium- and long-term credit products, money transfer services, etc.
- Improvements in policies and procedures
- Upgrading of the management information system
- Improvements in governance and the business culture
- Improvements in the institutional brand image

# Options for MFI institutionalization or transformation

## Options for institutionalization or transformation to capital companies

Table 1 below summarizes the characteristics of limited liability companies (LLC) and corporations, which are the two forms of capital company permissible under the regulations governing MFIs in the WAEMU member countries.

**Table 1: Characteristics of LLCs and corporations**

| Form | LLC | Corporations |
|---|---|---|
| **Definition** | Company in which the **members** are responsible for company debts only in proportion to their contributions, and where rights are represented by member shares. | Company in which the **shareholders** are responsible for company debts only in proportion to their contributions and where the rights of shareholders are represented by their **shares** |
| **Creation** | ▪ Minimum capital: unspecified<br>▪ All capital paid in on creation<br>▪ Instruments of incorporation (statutes, report of constitutive GA, crossed check payable to the company being established corresponding to the amount of share capital) deposited in the originals section of a notary if not drafted by the notary<br>▪ Drafting of the notarial deed recording the document of incorporation and signature and the notarized statement of subscription and payment<br>▪ Entry in the business registry<br>▪ Registration in the tax roll | ▪ Capital: 10,000,000 CFA francs<br>▪ Payment of ¼ of the capital on creation and the rest before authorization is obtained<br>▪ Instruments of incorporation (statutes, report of constitutive GA, report of first BD meeting if there is one, subscription form) deposited in the originals section of a notary if not drafted by the notary<br>▪ Drafting of the notarial deed recording the document of incorporation and signature and the notarized statement of subscription and payment<br>▪ Entry in the business registry<br>▪ Registration in the tax roll |
| **Organization and operation** | ▪ Management exercised by an administrator with executive powers and unlimited authority to represent the company<br>▪ RGA and SUPGA<br>▪ Authority to distribute member shares, according to the type of entity and rigorous formalities<br>▪ Strict formality in holding member assemblies<br>▪ Administrative control exercised by an auditor<br>▪ Inability to accept savings from the public; thus, less possibility of financing<br>▪ Distribution of dividends in the event of profits (subject to respect for legal reserves) proportional to the member shares held<br>▪ Contribution to losses and debts proportional to the member shares held | ▪ Management exercised either by the corporation with BD (administered by the CBD and a GA) or the corporation with a general administrator<br>▪ Freedom to distribute shares<br>▪ RGA, SGA and special assemblies<br>▪ Hierarchical company in which each governing body has its own powers (GA, CBD, SUPGA, etc.)<br>▪ Administrative control exercised by one or more auditors<br>▪ Ability to accept savings from the public; thus, issue of securities<br>▪ Distribution of dividends in the event of profits (subject to respect for legal reserves) proportional to the shares held<br>▪ Contribution to losses and debts proportional to the shares held |
| **Applicable taxation** | ▪ Taxation linked to the institutional development of the MFI (taxation of asset and liability divestiture; taxation of donations and loans)<br>▪ Ongoing general taxation of MFIs (tax on financial activities; annual minimum tax; tax on business profits; value added tax; miscellaneous contributions)<br>▪ Taxation not specific to microfinance institutions (tax on member and client income; tax on earned income; customs duties) | |

| Form | LLC | Corporations |
|---|---|---|
| **Advantages** | ▪ Low capital and liquidity requirements<br>▪ Appropriate business regulation<br>▪ Easy securing of investors<br>▪ Ability to distribute dividends<br>▪ Flexible regulatory requirements for governance structure, organization, ownership, and financing | |
| **Disadvantages** | ▪ Dependence on large banks<br>▪ No access to clearinghouse or payment systems<br>▪ Taxation | |
| **Other characteristics** | ▪ Can become a corporation without losing its legal personality<br>▪ Cannot become an association or cooperative without losing its legal personality | ▪ Can become an LLC without losing its legal personality<br>▪ Cannot become an association or cooperative without losing its legal personality |

Having largely abandoned the old system of credit lines for targeted and subsidized loans, IFAD has shifted to promoting rural financial institutions capable of mobilizing financial resources in the capital market to give poor rural populations better long-term access to a wide range of financial services. Rural MFIs that are capital companies are among the financial institutions of this type. In addition to their ability to accept savings from the public, these MFIs are better able to mobilize different types of financial resources (debt, quasi equity capital, equity capital) in the capital markets and can do so more easily. Thus, IFAD encourages and supports the transformation of mature microfinance NGOs/associations and the institutionalization of microfinance projects as capital companies.

## Options for institutionalization or transformation into an association or savings and credit cooperative

Table 2 below summarizes the characteristics of associations and savings and credit cooperatives, which are the two forms of nonprofit institutions permissible under the regulations governing MFIs in the WAEMU member countries.

**Table 2: Characteristics of microfinance associations and mutual or savings and credit cooperatives**

| Form | Association | Mutual or Savings and Credit Cooperative |
|---|---|---|
| **Definition** | Permanent nonprofit group of natural persons or legal entities, either national or foreign, created to meet common objectives, especially in the cultural, sports, spiritual, religious, scientific, professional, or socioeconomic domain | Nonprofit group of individuals, with legal personality and variable capital, founded on the principles of union, solidarity, and mutual aid, whose main objective is to collect savings from its members and grant them credit |
| **Creation** | ▪ Hold a meeting of the constitutive body (General Assembly, congress…)<br>▪ Submit the proposed statutes containing the objective, goals, duration, headquarters, and internal regulations of the future association to this body for adoption<br>▪ Designate the senior officers of the association<br>▪ Prepare a report (*procès-verbale*- PV) on the work of the constitutive body, with compulsory mention of the composition of the governing body and the | ▪ Hold a meeting of the constitutive GA, which should draw up a list of share capital subscribers, adopt the proposed statutes and regulations, and elect the members of the various bodies.<br>▪ Capital consisting of member shares,<br>▪ Create and submit the dossier |

| Form | Association | Mutual or Savings and Credit Cooperative |
|---|---|---|
| | identity and complete address of its members<br>▪ Report the creation of the association to the competent administrative authority,<br>▪ Obtain the certificate of creation for the organization<br>▪ Publish an excerpt from the certificate in the Official Gazette,<br>▪ Create and submit the dossier with the approval request. | with the approval request |
| **Organization and operation** | See Statutes and IR (GA, BD, Executive Committee, Director's Office) | ▪ Governing bodies: GA, BD, credit committee, and oversight body<br>▪ RGA and SGA<br>▪ Nature of member shares: nominative, individual, non-negotiable, intangible but transferrable under the conditions established in the statutes |
| **Applicable taxation** | ▪ Exempt from all taxes, levies, or duties on their **savings collection and credit distribution operations** but not on other types of services unrelated to credit and savings<br>▪ However, as an employer, the association must pay certain taxes (barring a tax exemption agreement with the State). | ▪ Exempt from all taxes, levies, or duties on their **savings collection and credit distribution operations** but not on other types of services unrelated to credit and savings<br>▪ Members are exempt from all levies and taxes on their member shares (IRVM), income from their savings (IRC), and interest payments on credit they have obtained from the institution (IRC)<br>▪ However, as an employer, the IMCEC must pay certain taxes (barring a tax exemption agreement with the State). |
| **Advantages** | ▪ Fiscal advantages<br>▪ Exercise of commercial activities to meet social objectives<br>▪ Significant capitalization from retained earnings that cannot be distributed | ▪ Easy entry<br>▪ The clients are the owners<br>▪ Internal strengthening of equity<br>▪ GA decisions reached democratically<br>▪ Fiscal advantages |
| **Disadvantages** | ▪ Dependence on donors<br>▪ Governance issues<br>▪ Lack of equity that could be used as collateral for lenders<br>▪ Risk of conflicts between founders and new members<br>▪ Lack of share capital<br>▪ Inability to distribute surplus to members and staff | ▪ Difficulty securing investors;<br>▪ Breakdown of the governance system;<br>▪ Elected officers' frequently low level of education;<br>▪ Confusion of roles between clients and members<br>▪ Divestiture of disadvantageous member shares. |
| **Other characteristics** | ▪ Cannot become a capital company or cooperative without losing its legal personality | ▪ Cannot become an association or capital company without losing its legal personality |

Although savings and credit cooperatives (COOPEC) are exposed to the risk of a breakdown in governance and have limited capacity to mobilize certain types of resources (equity capital) in the capital market, they have great capacity for mobilizing savings from the public, especially in rural areas. Thus, IFAD also supports the institutionalization of microfinance projects as savings and credit cooperatives.

### Special case in which a microfinance bank is transformed into a commercial bank

A commercial bank is a privately owned capital company authorized to engage in diverse financial operations (credit, acceptance of deposits, transfers of funds, currency exchange, operations in the interbank market, refinancing with the central bank, insurance, intervention in the national and international financial markets, etc.). In each country, the regulatory authorities (ministry of finance or central bank) authorize these operations only if they comply with certain obligations that are closely monitored.

There are cases in which MFIs are transformed into commercial banks. This type of transformation occurs in contexts where the regulation of microfinance activities is still in its infancy, in order to ensure the long-term security of the investments made. The vast majority of MFIs, however, cannot meet the conditionality imposed by the authorities to obtain a banking license. In fact, they often lack even the minimum capital required to engage in banking activities.

The regulatory authorities in some countries have issued a microfinance banking license to certain MFIs that have been transformed into capital companies. While this license, of course, does not allow them to engage in all the operations of a commercial bank, it does authorize them to accept savings. While the prudential constraints imposed by this microfinance banking license are less stringent than for commercial banks, they are nevertheless more stringent than those for other categories of MFI.

## Regrouping of MFIs

### Rationale

The decision to regroup is driven by widely diverse motives, depending on the size of the original entities, the nature of their activities, the problems confronting them, and the strategies pursued by their leaders.

The arguments in favor of regrouping are many and multifaceted. The most salient are the need to: i) reach a critical size that will permit compliance with all legal and regulatory requirements; ii) create economies of scale to reduce operating expenses; iii) increase the market share and boost competitiveness; and iv) control growth.

### Main objectives

The main objectives of MFI regrouping operations are:

- To achieve financial and institutional viability
- To ensure that the organizations involved adhere to the standards and requirements of the legal and regulatory framework governing MFIs
- To professionalize the organizations
- To create synergies by pooling the available resources (human, material, and financial)
- To improve the institution’s governance and culture
- To improve the institution’s brand image

## MFI regrouping options

### *Regrouping through union*

Union is the regrouping of two or more institutions to create a new institution to which they are subordinated. It is important to note that the entities comprising the union do not disappear; their legal personality remains distinct from that of the new entity created.

Figure 3 below presents a diagram of regrouping through union.


**Figure 3: Regrouping through union**

This type of regrouping is often found in MFIs that are mutual or cooperatives. A union can have several levels: grassroots structures, regional unions, national federations, confederations.

On an organizational plane, they have multiple administrative bodies (the administrative bodies of the union and its different member entities), which can complicate the management of the entire network.

On a regulatory plane, each level of the network is considered an institution requiring approval.

### *Regrouping through merger*

Merger is an operation whereby two or more institutions join together to form a single entity by creating a new institution. Merger entails the dissolution without liquidation of the institutions, which disappear, and the universal transfer of their assets and liabilities to the new institution in the state in which they were found on the date the operation was finalized. In a merger, the members of the institutions that disappear become members of the new institution under the conditions stipulated in the merger agreement.

Figure 2 below presents a diagram of regrouping through merger.


**Figure 4: Diagram of regrouping through merger**

This type of regrouping poses the following problems:

- The approval is INTUITU PERSONAE and cannot be transferred by the old institutions to the new entity.

- The newly created entity must request and obtain approval before it can legally operate, a process that is very lengthy. How then can the activities of the institutions that have disappeared to form a new entity continue while approval of the new entity is pending?

It is therefore legally impossible for MFIs to engage in this type of regrouping.

### *Regrouping through absorption*

Absorption is the regrouping of two or more institutions, which disappear into one of them. In other words, absorption is an operation whereby, through dissolution without liquidation, one or more enterprises transfer all their assets and liabilities to another, issuing shares or parts of the absorbing enterprise to their members.

Figure 5 below presents a diagram of regrouping through absorption.


**Figure 5: Diagram of regrouping through absorption**

This is a relatively simple operation when the enterprises absorbed are capital companies, because the operation can be considered a sale and the profit from the sale can be distributed pro rata to the shareholders or members, based on their share of the capital of the enterprise sold. However, when the enterprises absorbed are nonprofit institutions (associations, cooperatives), transfer fees make the operation becomes difficult and very onerous.

### *Regrouping through the transfer of assets and activities*

The transfer of assets and activities consists of creating a new entity to which two or more existing entities transfer all their activities and all or part of their wealth (goods, receivables). The institutions that transfer the activities and assets do not necessarily disappear. However, when they transfer all their activities and assets, they may become institutions in name only or disappear.

Figure 6 below presents a diagram of regrouping through the transfer of assets and activities.

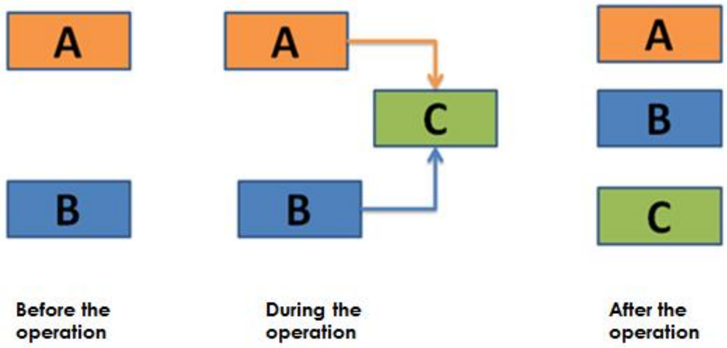


**Figure 6: Diagram of regrouping through the transfer of assets and activities**

MFIs that carry out this type of regrouping can create the new entity and submit the approval request while continuing their activities. The transfer of assets and activities will not take place until the new institution receives approval from the regulatory authorities.

After the operation, the old institutions may become institutions in name only or modify their social objective to engage in activities other than savings and credit.

## Main MFI institutional transformation or regrouping activities

The main activities for ensuring the success of an MFI institutional transformation or regrouping operation are summarized in Table 3.

**Table 3: Main MFI transformation or regrouping activities**

| No. | **Activities** | **Necessary resouces** | **Objectively verifiable indicators** |
|---|---|---|---|
| | **Before approval of the new company** | | |
| 1 | Workshop on institutional transformation or regrouping | Cost of the workshop | Workshop report |
| 2 | BD meeting to propose the first studies on transformation or regrouping to the GA | Cost of the meeting | Meeting report |
| 3 | Meeting of the GA to authorize the first studies on transformation or regrouping | Cost of the meeting | Meeting report |
| 4 | Feasibility study on transformation or regrouping | Cost of the mission | Mission report |
| 5 | Business plan for the institution that will emerge from the transformation or regrouping | Cost of the mission | Mission report |
| 6 | Business plan of the parent organization to be transformed | Cost of the mission | Mission report |
| 7 | BD meeting to validate the feasibility studies and business plans of the new entity resulting from the transformation or regrouping and, if appropriate, the parent association transformed, and to propose the composition of the steering committee (SC) for the transformation or regrouping | Cost of the meeting | Meeting report |

| No. | Activities | Necessary resouces | Objectively verifiable indicators |
|---|---|---|---|
| 8 | SGA to adopt the feasibility studies and business plans of the new entity resulting from the transformation or regrouping in order to authorize the operation and create the steering committee to oversee it. | Cost of the meeting | Meeting report |
| 9 | Designation of the institutional transformation or regrouping coordinator | Cost of the expert | Report of the selection committee |
| 10 | Submission of the preauthorization request for the transformation or regrouping to the regulatory authority | PM | Acknowledgement of receipt of dossier with documentation |
| 11 | Preparation and implementation of the communication and change management plan | Cost of the mission<br>Cost of implementing the plan | Mission report<br>Reports on implementation of the plan |
| 12 | Identification of new company's potential shareholders | PM | Copy of letters of intent |
| 13 | First meeting of new company's potential investors | Cost of the meeting | Meeting report |
| 14 | Drafting of proposed basic documents of the new entity | Cost of the mission | Copy of basic documents |
| 15 | Drafting of proposed amendments to the basic documents of the parent association to be transformed, or when appropriate, the institutions initiating the regrouping | Cost of the mission | Copy of amended basic documents |
| 16 | Drafting of the new entity's administrative documents and management tools (policy and procedural manuals) | Cost of the missions | Mission reports |
| 17 | Drafting of the administrative documents of the parent association to be transformed | Cost of the missions | Mission reports |
| 18 | Selection of the new entity's management information system | Cost of the mission | Mission report |
| 19 | Evaluation of the assets and liabilities of the parent association or institutions initiating the regrouping | Cost of the mission | Mission report |
| 20 | Evaluation of the staff of the parent association or institutions initiating the regrouping | Cost of the mission | Mission report |
| 21 | Preparation of a plan for transferring the assets and liabilities of the parent association of the institutions initiating the regrouping into a new entity. | Cost of the mission | Mission report |
| 22 | Preparation of the plan to transfer the staff of the parent association or institutions initiating the regrouping to a new entity. | Cost of the mission | Mission report |
| 23 | Preparation of a shareholder agreement | Cost of the mission | Mission report |
| 24 | Second meeting of potential shareholders | Cost of the meeting | Meeting report |
| 25 | Updating of the business plans of the new entity and the parent association to be transformed | Cost of the missions | Mission reports |
| 26 | Creation of the new entity | Cost of the notary | Documents creating the new entity |

| No. | Activities | Necessary resouces | Objectively verifiable indicators |
|---|---|---|---|
| 27 | First meeting of the new entity's BD | Cost of the meeting | Meeting report |
| 28 | Preparation of the request for approval of the new entity | PM | PM |
| 29 | Submission of the request for approval of the new entity | PM | Acknowledgment of receipt of the dossier containing the documentation |
| **AFTER APPROVAL OF THE NEW COMPANY** | | | |
| 30 | Reorientation of the transformed parent association or institutions that initiated the regrouping | PM | |
| 31 | Transfer of the assets and liabilities of the transformed parent association or institution that initiated the regrouping into the new entity | Cost of the mission | Mission report |
| 32 | Transfer of the staff of the transformed parent association or institutions that initiated the regrouping into the new entity | Cost of the mission | Mission report |
| 33 | Launch of the new entity's activities | PM | Activity start-up report |
| 34 | Launch of the new activities of the transformed parent association or institutions that initiated the regrouping | PM | Activity start-up report |
| 35 | Final evaluation of the operation | Cost of the mission | Mission report |

# Lessons learned

The MFI institutional transformation and regrouping operations in Africa in recent years have yielded many lessons, the most important of which are presented below. For more information about the lessons learned through case studies, see IFAD's "Lessons Learned" series at https://www.ifad.org/topic/overview/tags/knowledge_notes

## Need for an appropriate legal and regulatory framework

In the past, the absence of regulation had the advantage of spurring innovation and the proliferation of microfinance institutions. Today, it is clear that to guarantee the financial and institutional viability of MFIs, safeguard credit and savings operations, ensure the professionalism of the players, and enable the microfinance sector to shift from dependence on grants to autonomy, an appropriate legal and regulatory framework is necessary. This framework should establish clear rules that will facilitate the transformation of MFIs, authorizing them to accept savings from the public.

## Need to involve the regulatory authorities

MFI institutional transformation or regrouping operations often require preauthorization at the start and approval at the end. In order to secure these authorizations, documentation must be prepared and submitted to the regulatory authorities for examination. Involving the regulatory authorities in the design phase and preliminary studies is a success factor for MFI institutional transformation and regrouping operations. Their involvement will yield useful guidance for putting together the necessary dossiers (preauthorization and approval requests) and, very importantly, will reduce the time it takes for the regulatory authorities to study them.

### Need to start with an in-depth diagnostic study of the institutions involved

MFI institutional transformation or regrouping operations are highly complex and represent very precarious periods for these institutions. An independent in-depth general audit is essential before any decisions are made. The diagnostic study should identify strengths and weaknesses, as well as threats and opportunities, and propose a remedial action plan that should be in place before the operation gets off the ground. An MFI institutional transformation or regrouping operation that does not include this very little chance of obtaining preauthorization from the regulatory authorities.

### Need for good institutional governance

Good governance of an MFI generally consists of: upholding the vision, mission, and objectives; guiding the strategic orientations; maintaining financial health in the short, medium, and long term; mitigating risks; promoting transparency in management; and ensuring and encouraging accountability throughout the institution.

The success of MFI institutional transformation or regrouping operations requires the governing bodies and senior management of the institutions involved to properly exercise these functions. Any dysfunction in governance can therefore compromise the operation.

### Need to align the personal interests of senior management with the interests of the institution

MFI founders often wish to become shareholders with a seat on the governing bodies of the capital companies resulting from the institutional transformation of associations/NGOs without having the financial means to do so. Failure to take this into account can complicate the negotiations to structure the company's capital and occasionally cause the operation to fail. Thus, it is very important to create mechanisms that will enable founders to become shareholders in the capital companies resulting from institutional transformation operations.

### Need to prepare and implement a good communication and change management plan

MFI institutional transformation or regrouping processes involve many changes in the organizational and operating plan. Hence, it is important to ensure that all these changes are well-received in a context where lack of information inevitably leads to rumors.

MFI executives and salaried personnel concerned about institutional transformation or regrouping operations should therefore be duly informed about all projected changes through a communication plan that will answer their questions and address their concerns. They, in turn, should try to convince others of the need for the changes and their advantages.

The communication plan should address the concerns of the regulatory authorities, the MFI's main technical and financial partners, local authorities, and clients and their representatives, providing convincing answers to all their questions and giving them regular updates on the operation.

# Guidance on design and implementation

## Prerequisites

Preparation of an IFAD project that includes MFI institutional transformation or regrouping operations should begin with an evaluation of the financial sector to identify weaknesses or needs that should be addressed. The purpose of this evaluation is to gain a good understanding of the market so that potential IFAD interventions can be identified.

Since the success of the institutional transformation or regrouping operations of rural MFIs depends first and foremost on a country's legal and regulatory framework for MFIs, the evaluation should identify all regulatory obstacles and propose corrective measures to include in the project. It should also identify potential national, regional, and/or international technical service providers and their expertise, as they are key to MFI capacity building.

It is likewise important to conduct an independent in-depth general audit of the MFIs that should be transformed or regrouped. The audit should not only identify MFIs wishing to transform or regroup and are likely to benefit from the project, but should also propose, where necessary, remedial action plans to include in the project.

Finally, MFIs that could benefit from IFAD support in the framework of an institutional transformation or regrouping operation should have:

- an institutional vision compatible with IFAD's rural finance policy
- good financial and social performance indicators
- experience in rural finance
- good growth potential

The financial-sector evaluation and in-depth audits of MFIs should be conducted by financial consultants/consulting firms with the guidance of IFAD's Country Program Officers (CPP) and Country Program Management Teams.

The consultant/consulting firm in charge of the financial-sector assessment should have:

- a thorough knowledge of national regulations governing MFIs in the country
- good knowledge of national and international MFI transformation or regrouping experiences
- conducted at least two similar missions

The consulting firms in charge of the general audits of MFIs likely to benefit from the project should be auditing or accounting firms and have:

- a good knowledge of the microfinance sector
- conducted at least two similar operations.

Photgrapher: Michael Hamp
Savings and credit self-help groups in Rajasthan

## Guidelines for project design

The design of an IFAD project with MFI institutional transformation and/or regrouping operations should take the following factors into account:

- The use of transparent criteria (call for bids/proposals) for selecting MFI partners for the project. These criteria should include the compatibility of the candidates' institutional vision with IFAD's rural finance policy, the use of sound financial performance indicators, experience in rural finance, growth potential, etc. The project should include a project tender to gauge candidates' interest vis-à-vis the project objectives, as well as their engagement with rural finance and IFAD's target group
- Stakeholder involvement and cost-sharing, because MFIs that undertake institutional transformation or regrouping operations should be mature institutions are on a sound financial footing
- Capacity building among the staff and elected officers of the project's MFI partners so that they can effectively navigate all activities involved in the transformation or regrouping operation
- Funding for the studies necessary for the operation's success
- Funding for the services of the expert in charge of coordinating the operation
- Funding to upgrade the MIS
- Funding to create the new entity
- Lobbying of the regulatory authorities to secure approval of the new entity
- Support to the regulatory authorities of the microfinance sector to help them formulate policies and strategies consistent with good international MFI transformation and regrouping practices

- Capacity building among the regulatory authorities of the microfinance sector so that they can properly perform the vital functions of regulation, supervision, and control of the microfinance sector
- Coordination among donors whenever possible (project design, financing, implementation, and monitoring; harmonization of reporting requirements, etc.).

## Guidelines for project implementation

Efficient implementation of IFAD projects that include MFI transformation or regrouping operations depends on many factors, most importantly:

- The preparation of a detailed performance-based work plan with partner MFIs. This plan should make the disbursement of additional resources contingent on meeting specific objectives. It should include a series of activities, performance standards for each activity, the expected timetable for meeting these standards, and the project's contributions to meeting the agreed upon standards and timetable. If financing is necessary, MFIs should be encouraged to tap their own resources to supplement the financing from IFAD.
- The identification of technical service providers (TSP) that can partner with the project. Technical assistance to MFI partners can be an important part of any IFAD intervention in projects that include MFI transformation or regrouping operations.
- Preparation of a technical assistance plan. While each MFI partner requires a unique approach, some of them will often need technical assistance or similar services. It will therefore be necessary to prepare a plan for organizing and managing the technical assistance. This plan should state how the assistance will be provided (e.g., through foreign consultants coming for short missions to solve specific problems, local consultants). Nevertheless, it is important to maintain a certain flexibility with respect to the specific nature of the short- and medium-term services offered in order to accommodate the changing needs of MFIs or scheduling problems.
- The selection of TSPs through a transparent competitive tender. As a rule, national, regional, or international TSPs should be hired to carry out certain project activities. It is therefore important to guarantee a good selection process to attract the best expertise, while clearly indicating the obligation to render an accounting of the TSP's results.
- The preparation of performance-based contracts. It is important to establish performance-based relations with partner MFIs and TSPs. Specific and measurable MFI and TSP performance targets should be included in the contractual arrangements. Disbursement of project funds should be contingent on the organization's performance and its contribution to meeting project objectives.
- Flexibility. MFI institutional transformation or regrouping operations are often subject to changes in strategy during the course of the activities. Flexibility in project implementation keeps these changes from causing the operation to fail.
- The creation of a project steering committee that includes:
    - Government representatives of different agencies (ministries of finance and agriculture), who, if possible, are knowledgeable about the rural finance sector and have few political interests
    - Representatives of donors experienced in rural finance, including IFAD
    - External experts capable of mitigating potential government interference and providing supplementary expertise

### Replication

A good monitoring and evaluation system will make it possible to follow the progress of IFAD projects that include MFI institutional transformation or regrouping operations and draw lessons that will be useful for similar projects in the future.

Hence, it is important to establish a monitoring and evaluation mechanism in each project that:

- clearly states the purpose and scope of the M&E system and provides information on the expected outcomes
- provides a general description of the key stakeholders and the type of information that each of the parties expects, specifying when the information is required, in what format, and who is responsible for compiling it
- indicates the performance indicators to compile and evaluate for each type of stakeholder
- indicates the steps to take in the event of repeated failures of the project or partner to meet the established performance criteria in a given period

The IFAD publication "Lessons Learned: Institutional Transformation and Regrouping of Rural MFIs" also presents numerous lessons learned and case studies that are very useful for replicating projects.

## Additional tools

- Link to IFAD's "Teaser: Institutional Transformation and Regrouping of Rural MFIs" at https://www.ifad.org/topic/rural_finance/overview/tags/knowledge_notes ;
- Link to IFAD's "Lessons Learned: Institutional Transformation and Regrouping of Rural MFIs" at https://www.ifad.org/topic/rural_finance/overview/tags/knowledge_notes ;
- Tools for capitalizing on the experiences of PAMIGA in MFI institutional transformation and regrouping.

## Frequently asked questions

MFI institutional transformation and regrouping operations raise many questions. People who support these operations or are responsible for their implementation must have a good answer for each of these questions. Not having one for certain questions can lead stakeholders to reconsider the operation.

The following are examples of frequently asked questions:

- Why should institutions be transformed or regrouped?
- Is the operation feasible?
- Would the operation be a good idea?
- Is it a good time to implement the operation?
- Does the institution have the means to implement the operation?
- If the operation fails, will it be possible to return to the status quo with no consequences?
- What resources do we have to finance and implement this operation?
- How much time do we have to implement the process?

- Have we fully examined all the implications of the operation?
- How can the interests and strategies of the various stakeholders be aligned to maximize support for the process?
- Do all stakeholders accept the changes produced by the operation?
- How can we avoid mission drift?
- How can we reconcile operational objectives and implementation of the operation while pursuing activities without interfering with the process?
- What role will the old entity's staff play in the new one?
- What role will the old institution's senior management play?
- Will the operation have a significant impact on working conditions?

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