



NGO/RSPS/Cooperatives- TRANSFORMATION GUIDELINES

Introduction

The NGO-MFIs & RSPS have been the major players in Pakistan's Microfinance Sector since 1980s. Though their outreach levels remained modest over the years, they played an important role in development of whatever form of microfinance sector the country had before enactment of MF framework in 2001. The framework acknowledges their contribution in the sector and encourages the NGO-MFIs/RSPs/Cooperatives having requisite capacity to transform into formal Microfinance Banks. The licensing criteria for establishing Microfinance Banks/Institutions allows NGOs/RSPs/Cooperatives/other programs having potential and capacity to contribute up to 50% of the required capital in the form of credit and other assets portfolio subject to review by a Chartered Accountancy Firm from amongst the SBP panel. Considering the peculiar nature of MFIs' credit portfolio, State Bank issued guidelines for reviewing credit portfolios of NGO-MFIs interested in transformation, to ensure a reliable assessment of the portfolio quality based on pre-defined parameters.

The Portfolio Review Guidelines however, focus on just one aspect of the NGO transformation and do not cover the whole transformation process. To cover this gap SBP has now developed detailed guidelines to help & facilitate the NGOs/RSPs/Cooperatives/other programs in their transformation process. The guidelines define and discuss various aspects of the transformation and prescribe minimum requirements to be completed for the transformation. The NGO-MFIs/RSPs/Cooperatives may apply additional processes to assess their capacity to transform and ensure a smooth transition from informal, non-profit and unregulated to a formal, for profit and regulated financial institution for the poor.

Why to Transform

Transformation from NGO-MFI/RSPs/Cooperatives/other programs to a formal MFI is a major shift from a non-profit, socially motivated and donor dependent institution to for-profit, self-reliant and regulated financial institution, which involves cultural, organizational, operational and financial transformation. Normally one or all of the following objectives leads to the transformation decision:

- **Access to commercial capital:** As NGO-MFIs/RSPs/Cooperatives/other programs grow and attain maturities the expectations and demand to expand outreach increase substantially, this requires greater and rapid access to different sources of loan able capital. Being in the informal & unregulated sector, NGOs/RSPs/Cooperatives/other programs across the world are not eligible to mobilize public savings to finance their operations, nor do they have adequate



collaterals to obtain credit lines/wholesale funds from commercial banks, whereas the donors' support remain uncertain and not forthcoming in all the circumstances. Transformation into formal & regulated MFI enables them to raise commercial funds through deposit mobilization, borrowings from financial sector, issuance of bonds or other commercial papers and stock issues to finance their businesses and appropriately leverage their equity.

- **Expand outreach and grow portfolio:** - Access to limited and uncertain sources of funds inhibits NGOs/RSPs/Cooperatives/other programs to increase their capacity and outreach levels. The transformation into formal MFBs lends credibility to the MFIs and provides sustained access to multiple sources of capital giving them necessary comfort to plan and go for network expansion as well as increase outreach and scope of microfinance services. This will however be contingent on effectiveness and responsiveness of the policy, legal and regulatory framework under which the MFI would transform.
- **Product Diversification:** Microfinance experience from across the world shows that the poor do not need just credit but a package of financial services including savings, credit, payment transfer etc. The NGOs/RSPs/Cooperatives/other programs being in the informal sector can only offer micro credit leaving a huge unmet demand for other financial products. Transformation enables the MFIs to fill this gap and offer variety of financial products and services to the poor, which not only increase the access of the poor to a range of financial services and enhance their satisfaction and commitment with the institution but also helps the MFIs to diversify and increase their revenue streams besides creating a stable source of loan able funds.

The NGO-MFIs/RSPs/Cooperatives/other programs interested in transformation should carefully review its transformation objectives and make an objective assessment that whether under the given policy and regulatory environment, it has the capacity to achieve the desired objectives.

Transformation Cost & Transformation Continuum

Notwithstanding the benefits and attraction of the transformation, it involves substantial cost including pre-transformation cost, regulatory requirements, taxation cost, vulnerability to external shocks etc. and should be carefully and consciously evaluated viz. a viz. expected benefits while planning for transformation. Further successful transformations are normally a gradual progress along a continuum¹, major milestones of which include:

¹ Charitonenko, Stephhanie, "Commercialization of Microfinance Philippines", ADB, Manila, 2003



- Adequate experience as NGO-MFI/RSPs/Cooperatives/other programs & achieving reasonable operational size & scale in terms of credit portfolio and service delivery network, reliable accounting & information system, establishment of internal audit function, review of books of accounts by external auditors etc;
- Adoption of professional, business like approach to manage the NGO-MFI operations and offering demand driven products/services at cost recovery interest rates;
- Achieved full operational sustainability and satisfactory progress towards achieving financial self-sufficiency through increased cost recovery, efficiency and expanded outreach of services;
- Accessing market based and non-subsidized commercial funds and impact thereof on outreach, revenue streams and future outlook of the NGO-MFI/RSPs/Cooperatives.
- Prepare to operate as for-profit, formal financial institution subject to prudential regulation/supervision and able to attract private risk capital.
- Have acquired /developed critical minimum software to support the existing operations.
- Preferably have got itself rated from a reputed credit rating agency.

The NGO-MFIs/RSPs/Cooperatives/other programs willing/planning to transform into Microfinance Banks should assess their respective positions in the transformation continuum and accordingly decide to proceed further.

Independent Institutional Assessment

The NGO-MFIs/RSPs/Cooperatives/other programs satisfied with their progress along the transformation continuum and willing to go for transformation, shall arrange an independent institutional assessment of their capacity and advisability to transform in the given economic, political, cultural, legal and regulatory environment. The institutional assessment shall include assessment of NGO-MFIs'/RSPs/Cooperatives/other programs financial position, governance structure, human resources, control systems and accounting and information systems. The assessment shall be made by a team comprising a Chartered Accountancy Firm from amongst the panel maintained by State Bank of Pakistan for banks & financial institutions and Microfinance Specialist(s), domestic or



foreign having adequate understanding of Pakistan Microfinance Sector and policy & regulatory environment.

Financial Position & Capacity

To assess the financial position, the consultants shall make a detailed review of assets and liabilities of the NGO-MFIs/RSPs/Cooperatives/other programs and make an objective assessment of their quality and real value. The credit portfolio like commercial banks and other financial institutions, is a major component of MFIs'/RSPs/Cooperatives/other programs assets portfolio, however its characteristics and nature is different from that of commercial banks and as such needs to be reviewed with a different approach and methodology. Keeping this in view, State Bank of Pakistan has issued detailed guidelines for reviewing credit portfolios of NGO-MFIs interested in the transformation. The guidelines are [enclosed as Annexure-I](#) and shall be used to assess the credit portfolio quality. The quality and value of investments and fixed other assets could however, be reviewed and assessed using the normal audit tests and procedures.

While reviewing the liability side, the auditors/consultants shall assess the real value of the obligations of the NGO-MFI/RSPs/Cooperatives/other programs, their respective maturities, possibility of transferring to the new entity and their impact, if any, on the transformation. The nature of capital & reserves of NGO-MFIs/RSPs/Cooperatives/other programs is also different from normal commercial entities having no ownership structure and mostly buildup through donations, grants and earnings of the MFI. The auditors/consultants shall assess the quality of the capital and opine that whether the capital is free from encumbrances or restrictions of any kind and that the NGO-MFI/RSPs/Cooperatives/other programs can contribute the same to the capital of the transformed entity.

Governance Structure

The auditors/consultants shall review the governance structure of the NGO-MFI/RSPs/Cooperatives/other programs, the composition of its Board of Directors/Governing Body/Council, the criteria & eligibility for election/selection as member BOD etc, the capacity and understanding of the Board about MF dynamics, the members' commitment with the mission and objectives of the NGO-MFI/RSPs/Cooperatives/other programs and their willingness as well as capacity to contribute personal resources/funds to the new entity's capital. They shall also review the decision making process in NGO-MFI/RSPs/cooperatives/other programs and the role and effectiveness of the Board in developing professional and business like environment and culture in the MFI. Further keeping in view the nature of operations and mandate of the MFI after transformation, as well as the regulatory requirements, the auditors/consultants shall recommend changes, if any, required in the composition and skill mix of the Board.



Human Resources

The quality of human resources is critical for success of any organization and due to highly decentralized and personalized nature of operations of MFIs, its importance increases manifold. The auditors/consultants shall make an objective assessment of the qualification, experience, skill level, capacity to learn new and innovative techniques etc. of the senior management team and the field force and their commitment to the cause of the institution. They shall identify the skill gaps and developmental needs of the HR, if any required, in case of conversion into formal Microfinance Bank.

Control Systems & Environment

The quality of control environment in an MFI is reflective of the level of professionalism and business mindedness of the management. Normally the successful and prospering institutions have strong control systems and a control conscious environment. The auditors/consultants shall review the control systems keeping in view the peculiar nature of operations of MFIs and identify the specific control areas in which improvements would be required in case of transformation into MFB. The presence of Microfinance Specialist(s) in the review team should facilitate a realistic assessment of control systems, the governance structure as well as the human resources quality of MFI.

Accounting & Management Information System

The review and assessment of Accounting & Management Information system of NGO-MFIs/RSPs/Cooperatives/other programs have been covered in detail in the annexed portfolio review guidelines; the auditors/consultants shall review the systems using the tests & procedures given in the guidelines.

Recommendation to Transforms

The auditors/consultants shall, based on the findings of institutional assessment exercise an objective analysis of political & economic conditions in the country and policy, legal and regulatory environment for the Microfinance Sector and its future outlook, recommend that whether the NGO-MFI/RSPs/Cooperatives should go for transformation. They shall also recommend the future course of action in case of recommendation in favor of transformation. It is advisable that the same consulting team would undertake the feasibility study for conversion of the MFI into MFB as a number of areas like organizational background & capacity, review of policy environment etc of the study would already be covered in the institutional capacity assessment exercise.



Transformation Decision

The NGO-MFI/ RSPs/Cooperatives/other program's Board on receipt of the institutional assessment report by audit/consulting team, shall review the report and its recommendations and make a decision to go for transformation or otherwise. In case of decision in favor of transformation the Board shall authorize preparation of proposal and application for submission to State Bank of Pakistan for grant of license to operate as Microfinance Bank under MFIs ordinance 2001. The resolution of the Board shall also be submitted to SBP along with other documents. The criteria for grant of license for establishing Microfinance Banks specify the terms & conditions to be completed for grant of license and may be carefully reviewed along with these guidelines while preparing the proposal and application for grant of license. [The criteria are annexed for ease of reference as Annexure- II.](#)

Information/Documents to be submitted to SBP for Grant of License

The NGO-MFI/ RSPs/Cooperatives/other programs shall submit application for grant of license to SBP on prescribed forms, duly filled in and signed by NGO-MFI/ RSPs/Cooperatives Board's authorized person along with following documents, the forms are annexed as [Annexure III:](#)

- Institutional Assessment Report prepared and completed as per the guidelines discussed in above paragraphs;
- Board Resolution to go for transformation along with its objectives;
- Feasibility Report containing business plan & financial projections for 5 years specifying what the MFB plans to achieve and how to achieve these in the medium term
- Detailed CVs of the Proposed Board Members of the MFB and commitment letters to serve as the Board member and subscribe capital, if any.
- Draft Memorandum and Articles of Association & proposed name of the MFB;
- Detail of assets & liabilities to be transferred to the MFB- the transfer shall be admissible at value assessed/determined by the audit/consulting team during institutional assessment phase
- A pay order/bank draft valuing Rs.500, 000/- in favor of State Bank of Pakistan as application processing fee



Relationship between NGO & MFB

The NGO-MFI/RSPs/Cooperatives/other programs shall, in its proposal for transformation, describe in detail the nature of its relationship with the Microfinance Bank other than owner/major shareholder and the nature of activities/functions the NGO/RSPs/Cooperatives will continue to perform after transformation into/sponsoring the MFB and linkages if any, with the operations and functions of the MFB.

Approval in Principle

State Bank of Pakistan on receipt of application complete in all respect shall process the application and if satisfied with the overall quality of the proposal, shall grant approval in principle for establishing the Microfinance Bank under MFIs ordinance 2001 within one month of receipt of the application. The State Bank shall also grant NOC for incorporation of the Microfinance Bank with Securities & Exchange Commission of Pakistan (SECP) as a public limited company.

Grant of License

The NGO-MFI/RSPs/Cooperatives/other programs granted approval in principle and NOC for incorporation, shall, after incorporation of the proposed microfinance bank, submit the incorporation certificate to SBP. The State Bank shall grant the license subject to receipt of clearance from security agencies and CBR etc.

Commencement of Business

The NGO-MFI/RSPs/Cooperatives/other programs after grant of license to establish the MFB shall complete the assets & liabilities transfer process, arrange subscription of capital, if any to be subscribed by persons other than the NGO/ RSPs/Cooperatives and obtain certificate of commencement of business from SECP. The licensed MFIs shall open branches/places of business under MFIs branch licensing policy. The process shall however be completed within six months of grant of license by the SBP.

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