TRANSFORMATION OF NON-GOVERNMENTAL MICRO FINANCE INSTITUTIONS (MFIS) IN TANZANIA

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ABSTRACT

Transformation of NGO micro finance institutions (MFIs) is one of the solutions for increasing the supply of financial services to micro and small enterprises and the rural poor. The findings revealed that there are a number of challenges affecting the transformation of MFIs, including the lack of human resource capacity; inadequate technical skills in banking and finance; the lack of demand-driven financial products; limited capital and loanable funds; weak ownership and governance structures; and poor information technology systems including poor loan tracking. The legal and regulatory framework and high donor dependence also affects MFIs' operations as commercial enterprises as well as future sustainability. The paper concludes that, while commercialization and transformation of MFIs is beneficial, many MFIs in Tanzania are not ready. Transformation of MFIs will lead to a mission drift, resulting in a widening of the financial service gap, especially for micro and small enterprises, low income earners and the rural poor.

Key Words: *Tanzania, Transformation, Commercialization, Micro finance, Sustainability, Micro and Small Enterprises*

INTRODUCTION

In recent years the challenges facing the commercialization and transformation of micro finance institutions (MFIs) has been a major concern in relation to increasing the supply of financial services to micro and small enterprises, low income earners and the rural poor. The literature shows that transformation of non-governmental MFIs into regulated financial institutions is one of the solutions to increasing access to financial services. From the literature there are two schools of thought. One argues that the up-scaling and hence commercialization of MFIs into commercial initiatives is a solution to improving access to financial services. The other school of thought is in favour of the down-scaling of commercial banks, hence allowing banks to offer micro credit

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similar to what is currently being offered by MFIs. Whatever route is taken, there are systemic challenges (both external and internal), which inhibit MFIs from commercializing and/or transforming themselves. Following the closure of a number of branches of publicly owned banks and the reluctance of private banks to extend their services to low income earners, the Bank of Tanzania (BoT), 1997 & 2002 study showed that the provision of financial services to rural areas had contracted. Despite the different initiatives taken in subsequent years, the gap in the supply of financial services for the rural poor and low income earners in Tanzania is still large (FSDT, 2009).

The provision of credit to micro and small enterprises (MSEs), rural people and low income earners in developing countries can be traced back to the 1960's and it has evolved over the years to what is now known as micro finance (Okulo, 2001). The Consultative Group to Assist the Poor (CGAP) define MFIs as organizations that provide financial services to the poor. They include a wide range of providers that vary in their legal structure, mission and methodology. In principle all share the characteristic of providing financial services to clients who are poorer and more vulnerable than traditional bank clients. Unfortunately, most MFIs provide only a limited range of financial services (Chijoriga and Cassimon, 1999), rendering them unable to fill the gap left by commercial banks. The existence of second generation micro credit schemes and the introduction of micro finance services have been considered a feasible solution for increasing access to financial services by the rural poor and low-income earners and improving market imperfections. For many MSEs, whose incomes are very low, access to micro finance services by low income earners and the rural poor offers the possibility of managing scarce household and enterprise resources more efficiently. It also gives protection against risks and offers future investment opportunities for economic returns. Households' participation in micro finance services leads to a higher standard of living and facilitates income growth. When households save with MFIs it creates a culture of saving, while allowing enterprises to accumulate profits and use the savings for reinvesting in order to earn higher economic returns. The services provided by MFIs contribute to the growth of the financial sector, rural financial deepening and poverty alleviation.

In Tanzania, parallel to the growth of MFIs, in 1991 the Government introduced financial sector reforms, leading to reforms in the banking industry, including the closure of unprofitable branches in rural areas, which widened the supply gap and access to finance by MSEs and the rural poor. As a result of limited access to financial services, the government of Tanzania came up with a number of measures to improve the efficiency and outreach of the micro finance system, including putting in place the micro finance policy. The 2006-2009 FSDT survey showed that MFIs' access to finance is still very limited (about 4% of all those with access). The study showed that many rural people still use non-monetary means of financing, such as livestock and crops, and other assets such as bicycles. This meant that there was a need to improve micro finance services at the lower level. This paper comes at a time when there are various micro finance schemes in Tanzania and other developing countries. The paper presents the research findings on the challenges faced by non-governmental MFIs in commercializing and transforming themselves. It also tries to assess whether the transformation of MFIs will lead to mission drift.

RESEARCH OBJECTIVES AND METHODOLOGY

A field survey was conducted between 2005 and 2007 and updated in 2009. **T**he overall objective of the study was to analyze the potential and challenges of the commercialization and transformation of MFIs in Tanzania and to assess the implications of providing access to financial services to MSEs. Specifically, the study intended to (i) assess the legal, regulatory and operational challenges that MFIs are likely to face in the process of transformation; (ii) assess whether there is a potential market for MFIs to operate in commercially; (iii) analyze whether MFIs in Tanzania have the capacity and are ready to commercialize their operations; and (iv) reveal the implications of MFIs transforming themselves.

The research covered formal MFIs operating in Tanzania which offer financial services to the low-income population and rural areas. According to the Tanzania Association of Micro Finance Institutions (TAMFI) and Chijoriga 2000, by 2000 there were more than 120 registered MFIs offering micro finance services or micro credit. However, many of these MFIs were informal, had limited outreach in rural areas and served a limited clientele. Field assessment showed that only five MFIs had branches in more than two regions and many clients. These were Promotion of Rural Initiatives Development Enterprises Tanzania (PRIDE (T)), Tanzania Gatsby Trust (TGT), Presidential Trust Fund (PTF), Small Enterprise Development Agency (SEDA), and FINCA (T). For the purpose of this study only the five abovementioned MFIs were selected for detailed analysis. The criteria for selection were**:** (i) outreach - a number of branches and a large number of clients, up to 2008, meaning that the MFI should have at least 2 branches that serve more than 10,000 rural customers in Tanzania; (ii) operational – the MFI should have been in operation for more than five years, which is a condition for assessing its operational sustainability; (ii) loan portfolio **-** up to 2008 the MFI should have had a loan portfolio of at least 1 million USD; (iii) default rate **-** by 2008 the MFI should have had a default rate of not more than 5%; (iv) clientele **-** MFI clients should be micro and small businesses and should have mixed economic/business activities); (v) mission and objective - the MFI should have a developmental and/or commercial mission. Table 1 below shows the basic data for the five selected MFIs, while Appendix 1 provides their detailed profiles.

Primary data were collected from the clients, managers and staff of the selected MFIs and the Directorate of Micro Finance, BoT, using structured and unstructured questionnaires, face-to-face interviews and physical observation. In total, 60 randomly selected MFI clients (customers) were interviewed on the demand for financial services. Most of the secondary data were obtained from BoT publications, recent primary surveys such as the FSDT 2007 and 2009 studies, various Acts and regulations including BFIA 1991 & 2004, Licensing Regulation of 1997, Cooperatives Societies Act 1991 and the proposed MFIs and Micro credit Activity Regulation and Micro Finance Policy 2000. Data were analyzed using the Statistical Package for Social Sciences (SPSS) using structured analysis of the expected results.

LITERATURE REVIEW

Commercialization and Transformation of MFIs

Commercialization has been defined in this study to mean simply an MFI operating commercially by charging commercial interest rates and being sustainable. An MFI could operate its business commercially without being regulated. Transformation is defined as an MFI which is a non-governmental organization (NGO) operating as an institution lending to MSEs, low income earners and the poor that is regulated by a regulatory agency and in this case the Central/Reserve Bank. Micro finance operations may be restructured through mergers and acquisitions, franchising, linking with or down-scaling of mainstream financial institutions or transforming themselves from an NGO into a regulated MFI. Commercialization does not lead to mission drift, although regulating MFIs could do so. Empirical evidence on transformation has shown how MFIs can contribute to poverty alleviation and the improved economic development of a nation. Studies and the experience of Bangladesh, South Africa and elsewhere show that the benefits of transformation include: access to additional/commercial sources of funds to meet increasing and unmet demands for micro loans; increased range of financial services including savings; improved self-sustainability and profitability due to increased growth and outreach; improved internal governance structures and internal controls due to wider ownership and sense of stewardship; greater efficiency and improved financial performance; improved customer services with a greater range of products and services for different clientele; and improved governance in terms of financial transparency and accountability. In this paper commercialization is considered a necessary step in the transformation into a regulated MFI.

In Tanzania, while all the above benefits are important, the main concern regarding commercialization is the dependence on subsidies by these NGOs and the sustainability of their services. Recent developments have shown that most donors have moved away from subsidized lending and are focusing more on the provision of loan capital. Few non-governmental MFIs borrow money at the commercial rate and repay it. No MFI has been able to attract private equity. Like other market segments, micro finance customers require a diverse menu of financial services and products, such as access to credit and a means of saving, paying bills and other related financial services (Christen, 2001). Evidence shows that many MFIs offer limited products and services. Many offer credit and compulsory saving. Few are innovative, but offer the same services and products. The regulatory requirements limit MFIs from making saving voluntary and operating as full financial intermediaries, while the limited number of products and services inhibits low income earners from accessing financial services. Low income earners and micro enterprises require specific products and services, such as small sized loans, a small amount of savings, and non-traditional collateral, etc. None of these products and services is offered by the majority of commercial financial institutions or MFIs.

Micro finance organizations can acquire their start-up and working capital from various sources, which include international donors, the government, commercial banks, the public through the issue of shares and other financial instruments. However, due to the structural and institutional constraints of most MFIs, commercial sources of funds are not accessible (Okulo, 2001). Sustainability is usually understood as a process involving different stages (Chijoriga, 2000 & BoT, 2002). Stage one is operational sustainability, whereby the MFI covers its administrative costs and loan loss expenses from internally generated funds. The second stage is financial sustainability, whereby an MFI is operationally sustainable and able to cover the cost of funding including inflation. The last stage is institutional and financial sustainability, whereby an MFI covers all its operational and financial costs and is also able to generate enough surplus to enable it to develop. At this stage, an MFI is financed more by equity and less by grants or donations. The Subsidy Dependence Index (SDI) is used as the test for financial sustainability. Evidence from Chijoriga's research in 2000 on the "Performance and sustainability of MFIs in Tanzania" revealed that, among 28 MFIs visited, 11 were donor funded, 6 were both donor and government funded and 11 were SACCOs. The high dependence on donors meant that the sustainability of the MFIs was questionable. Sustainability of MFIs can also be enhanced by them broadening their client base, and diversifying their products, services and delivery systems using combined group lending and individual lending (Christen, 2001, BOT, 2002).

Robert 2000 argues that commercialization and transformation of MFIs is inevitable, but not all MFIs may be affected. Nowhere has the transformation of micro finance proceeded more rapidly than in Latin America. A few years ago, micro finance was the exclusive domain of non-profit organizations and cooperative societies. In 2000, only 29% of approved commercial bank funds went to micro enterprises. NGOs that have transformed themselves into licensed financial institutions, together with other special licensed financial intermediaries, were provided with 45%. Okulo (2001) referred to Latin America as the champion of commercialization and transformation. This shift signaled the entry of micro finance into a new stage in the provision of financial services to the poor on a massive scale by commercial enterprises.

Robert (2000) shows that financial NGOs have transformed themselves into licensed MFIs under general banking law. This model was followed in Bolivia, where micro credit originated in the NGO community. As financial NGOs gradually grew, they saw a future in becoming part of the formal financial sector. The first to follow this route was Prodem, which sought and was granted a full banking licence as Bancosol in 1993. Subsequently, in Colombia, Finansol was formed by Corposol, and Financiera Calpia was formed by AMPES in El Salvador. In Peru, MiBanco was also formed by Acción Comunitario del Perú. Robert, 2000, further argues that some NGOs have transformed themselves into specially licensed MFIs and municipally owned local non-bank intermediaries called “cajas”. Non-governmental MFIs in this category have became licensed MFIs under a special law for micro finance (credit unions or *cajas*), rather than under the general banking law.

A review of Latin American micro finance published by CGAP, 2001 showed that regulated banking institutions served over 53 percent of all clients and provided 74% of funds for micro credit. This is a dramatic shift from a decade ago, when micro credit in the region was totally dominated by unregulated micro finance NGOs. Transformation in Latin America has changed the state of the micro finance market, and has shown that MFIs can be profitable. Some of them have become financially sustainable and in addition they are showing returns that exceed those of traditional commercial banks in the region. The trend shows that, as a result of the transformation, even MFIs that cater for poorer clients are generally improving their financial performance.

While transformation is taking place in other parts of the world, Africa has not been left behind. Kenya Rural Enterprise (K–Rep), established in Kenya in 1984, is one of the most innovative and successful micro finance transformation schemes in Africa (Rosengard et al, 2000). Up to 1987, it operated as an NGO providing financial services to the poor. In 1994, K–Rep decided to transform its micro enterprise credit programme into a commercial bank in order to achieve institutional and financial sustainability, gain access to additional sources of capital in order to reduce dependence on donor funding, expand its market outreach, and recycle clients' savings and to offer additional financial services. Rosengard et al (2000) argue that K-Rep's dependence on grant income declined as the result of transformation. In 1993, grants comprised 87% of K-Rep's income. Because of transformation, grants fell to 32% of income by 1998. Financial independence gives the institution the mandate and independence to make decisions on a number of issues, for example, where to operate, the type of clientele to focus on and the type of investments. Donor-driven MFIs may sometimes face the problem of being supply driven, where a donor may dictate where the MFIs should operate and what clientele to focus on, etc. Most donor-supported MFIs have a developmental focus with limited commercial orientation and lacking the profit maximization motive. Financial independence allows MFIs to operate with both commercial and developmental objectives with a major focus on demand and supply principles.

Some people perceive that commercialization and transformation is incompatible with the social mission of NGOs (Stephanie and Rahman 2002). Nonetheless, there is a general consensus that commercialization is a stage in the development of MFIs and a new framework of thought from the micro finance movement (Okulo, 2001). Both commercialization and transformation entail the application of market-based principles to micro finance operations (Poyo and Young 1999; Christen 2000). According to Stephanie and Rahman (2002), the transformation micro finance is considered to be process along a continuum. Transforming MFIs is neither a one-time job nor an instant act, but rather a process which needs both institutional factors and attributes of the environment within which micro finance operates. In the transformation process, an MFI goes through the following stages**:** adoption of for-profit orientation in administration and operations; increased cost recovery; progression towards operational self-sufficiency; progression toward financial self-sufficiency; utilization of market-based sources of funds; operating as a for-profit MFI as part of the formal financial system regulating it.

Stephanie and Rahman (2002) argue that, at the macro level, transformation means that the MFIs are operationally and financially self-sufficient and are operating in a regulated environment. They further argue that the extent of transformation of the micro finance industry reflects the degree to which the operating environment is conducive to the establishment and growth of commercial MFIs. Robert (2000) mentioned that the three key elements of the commercial approach to transforming an MFI are profitability, competition and regulation.

Progress toward micro finance transformation is usually hastened by a strategic decision of MFI owners and managers to adopt a for-profit orientation, accompanied by a business plan to operationalize the strategy in order to achieve full financial self-sufficiency. An MFI with operational cost efficiency can easily attain financial self-sufficiency since the interest gained and its revenue covers first its operating costs and then the cost of its loanable funds. Operating as a for-profit formal financial institution will be the main hallmark of micro finance transformation. The change will lead to an MFI being subjected to prudential regulations and supervision and it becoming fully integrated into the formal financial system.

The transformation process is usually driven by micro finance pioneers who desire to reduce the MFI's dependence on donor funding. The main role of the government is to create and maintain an enabling macro and sectoral economic policy environment and an adequate legal, regulatory and supervisory framework for micro finance operations (Stephanie and Rahman 2002). The funding agencies have a role in building the capacity of MFIs. They also need to assist the government in developing an effective policy, as well as a conducive legal and regulatory environment. MFIs also need support in the development of market linkages and partnerships with other NGOs and financial institutions. The MFIs themselves also have a role to play during the commercialization process. This includes balancing their commercial and social objectives, increasing cost efficiency and improving institutional capacity.

The Balance between Sustainability and Mission Drift

All in all, the whole process of transforming a non-governmental MFI requires a good balance between sustainability and mission drift. Pushing MFIs towards sustainability sometimes means deflecting these institutions from their original objective of serving MSEs and the low income population. Generally, transformation of a non-governmental MFI results in mission drift and has a negative social impact that results in shifting its focus from the poor to relatively higher income groups. This shift may result in increased loan sizes, raised interest rates, a change in the target market from women to men and a reduced emphasis on reaching the hardcore poor (Stephanie and Rahman, 2000). Thus, when MFIs decide to transform themselves they have to be careful not to move away completely from their original target market. The shift could be interpreted as a conflict between MFI growth and poverty alleviation (Mosley and Hulmen, 1998). Other than the mission shift, globally a number of challenges inhibit MFIs from transforming themselves, which can be divided into macro and micro challenges**.**

Micro level challenges include institutional capacity, organizational structure, management and staff, weak ownership and governance, low level of technical understanding of banking and finance and stiff competition. The macro challenges relate to the lack of a supportive legal and regulatory framework for micro finance, the negative perception of commercialization and less dependence on grants and soft loans. The micro finance market has been self-regulated and is considered to operate outside the formal market. Compliance with regulations such as BFIA, (1991) in Tanzania is a costly process, requiring the training of staff, investing in management information systems (MIS) and supervision fees and the formation of Assets and Liabilities Committee (ALCOs). In the absence of a legal and regulatory framework, the monitoring and supervision of MFIs is difficult. Grants and soft loans have allowed many MFIs to achieve economies of scale, and their continued availability removes the incentive for MFIs to access commercial funds or become sustainable. Grants and soft loans have allowed MFIs to charge subsidized interest rates. The growth of commercialized MFIs may result in the need to establish credit reference bureaux to mitigate the problem of overlap and loan default.

Poyo and Young (1999) conducted a study on the commercialization of micro finance in Latin America. The study aimed at evaluating market forces, financial sector policy, institutional incentives, and the financial technology and organizational structure that would facilitate or hinder the transformation of MFIs. The study revealed diversity of ownership among micro credit service providers, the inability to mobilize deposits from the public and the lack of a defined ownership structure. Another study by Christen, (2000) showed that, up 2000, regulated financial institutions channeled 74% of the funds provided to Latin American micro enterprises, reaching 53% of the clients being served. Five years before, no micro finance clients had been reached by regulated entities. The study also showed that regulated MFIs' profitability was higher than that of commercial banks operating in the same area. Christen (2000) noted that, as a result of competition in Latin America's micro finance market, in some countries, especially Bolivia, the micro finance market may have reached saturation point since there was evidence from micro finance programmes that they were competing for clients, many of whom had loans from more than one MFI. As a result, some clients became over-indebted and were financing the repayments of one loan with another. Christen, 2000 therefore argues that increasing loan size as a result of an MFI transforming itself does not necessarily indicate mission drift, but rather a natural evolution of the targeted group in the form of loan graduation.

Few studies in Africa have looked into the commercialization of MFIs. As mentioned earlier, in 1998, Chijoriga conducted a study on the "performance and sustainability of MFIs in Tanzania". The study revealed that MFIs' financial performance was poor and their operational and financial sustainability was questionable. Given that the previous study was done five years ago, there was a need to conduct another study to assess whether MFIs in Tanzania can be transformed. In Tanzania, considering the large gap in the supply of financial services, the discussion on MFIs' commercialization and transformation should also include what type of micro finance services and products can be offered using the best credit delivery models, and sustainability of micro finance. In addition, the question of mission drift should be considered. The mission drift question centres on assessing whether a transformed MFI will still have the same mission, will focus on the same clientele with the same delivery approach, reach MSEs and the rural poor and charge affordable interest rates for low income earners and the rural poor. All these will have some cost implications and require the right institutional structure and framework to support the change. These questions and others are important for assessing whether commercialization and transformation will lead to an MFI drifting from its core mission and objectives. Overall, it should be remembered that a micro dollar loan offered to a poor man is worth more than million dollars offered to someone who has access to large corporate loans. The utility levels differ between the poor and those who are not. Hence accessibility of financial services becomes a core issue.

RESEARCH FINDINGS

This section presents the research results of the five MFIs assessed to see whether they could commercialize and transform themselves.

General Profile of MFIs

The field results showed that key players in the MFI industry in Tanzania include formal, semi-formal and informal financial institutions. Formal banks and micro credit institutions offering micro credit include Akiba Commercial Bank, National Micro Finance Bank (NMB), CRDB Bank, Kilimanjaro Cooperative Bank, Mufindi and Mwanga Community Banks and Tanzania Postal Bank, Bay Port, Easy Finance, and Blue Finance. Semi-formal institutions include financial NGOs and SACCOs. Examples are FINCA, SEDA, PTF, POVERTY AFRICA, SELFINA, AMKA, PLAN INTERNATIONAL, FAIDA, PRIDE, Tanzania Gatsby Trust (TGT) and Equal Opportunities Trust Fund (EOTF). Most organized and well known rural based SACCOs include Lupembe in Iringa, Kibaigwa, CAVI MKOKA in Dodoma, and Kinole and Mvomero in Morogoro (BoT, 2002). The third category are the traditional informal financial institutions such as Kibati (found in Kilimanjaro and Arusha regions), Upatu (found in Coast and Dar Es Salaam regions), Infogon'gho (found in Mwanza region) and Oluguyo (found in Ukerewe District). Most of the traditional institutions support social and cultural activities such as weddings, funerals and other cultural activities such as "unyago".

From the above list, only five institutions were assessed to see if they could be commercialized and transformed. None of the five MFIs were regulated by the BOT. All five MFIs were established before 1998 under different regulations. Except for TGT, which operates in Zanzibar and Tanzania, the rest of the MFIs had more than five branches in Tanzania mainland. All five MFIs had solidarity group products and mainly used group guarantee as loan collateral. Lending interest rates ranged between 1 to 3% per month. The descriptive results showed that 93.5% of the loans were issued to women and 78% of the respondents were spending US$ 1 to USD 2.5 per day. This proved that most of the MFI clients were low income earners. The clients indicated that the economic ability of the customer was used as a condition for being accepted by the group, which assured it that the loan would be repaid. The economic activities of the respondents were varied, with 36.7% dealing in foodstuff, 46.6% were in the service sector and 15% and 1.7% were in the agriculture and manufacturing sectors, respectively. The type of activities conducted by MFI clients have an impact on the sustainability of MFIs, because the more risky the business, the more likely the MFI will be at risk and not achieve financial sustainability. The general profile of the MFIs also showed that 87.1% of the MFI staff was young, with 74.2% having either a Bachelors Degree or Advanced Diploma in an area not related to banking or finance. The majority had been educated in social science-related studies. Among the staff, 28.9% had 2-3 years' experience and 22.6% had 4-5 years' experience. The statistics are not so different from those of many developing countries. The issue of staff who work in MFIs not having banking knowledge or experience has worked positively in the delivery of micro credit to the rural poor. This is because the staffs do not use rigid banking procedures and are more flexible. However, this could be a major challenge if MFIs decide to commercialize and transform themselves. With commercialization, MFIs will need to apply some banking procedural regulations, hence requiring staff with banking competence. All five MFIs had acceptable default rates ranging between 2 to 5%.

Assessment of Demand and Supply of Micro Finance Services

The results confirmed that demand for micro credit and savings is higher in rural areas than in urban areas where there is a high concentration of MFIs. A previous RNE (2002) study showed that about 80,000[*] households in Tanzania are supplied with micro credit. The BoT 2002 study revealed that 82% of the households kept money in their homes, 79% were willing and able to save if appropriate products and savings mechanisms were there and 94% were willing to borrow more if resources were

[*] RNE study[*] Source DFID Financial Sector Deepening, NORAD Private Sector Development in Tanzania 2002

available and appropriate methodologies were put in place or instituted. The Financial Sector Deepening Trust, (FSDT), 2006 and 2009 studies showed that only 8.3% of rural dwellers have bank accounts or are otherwise formally included, compared with 22.1% in urban areas. The results also showed that the micro and small business sector is substantially under-served by banks, with only 20% of those running their own business and about 18% of people in informal employment having bank accounts. Financial access for this economic segment is provided primarily by informal organizations, followed by semi-formal organizations. This implies that, while most MFIs provide micro credit, the level of service is still very low, hence questioning the justification for their transformation.

MFIs Commercialization and Transformation Challenges

The field results showed that all five assessed MFIs are charging commercial interest rates as opposed to subsidized interest rates. It was further established that the demand for financial products and the need to expand are the factors considered before a new branch is established. Calculations of sustainability based on the CGAP index showed that, by the end of December 2009, PRIDE (T) had attained 107% operational sustainability, PTF 148 % and SEDA 74%. The data also showed that by the end of 2009, PRIDE (T) had attained 7.15% financial sustainability, adjusted for the real cost of capital. According to the literature, a sustainability rate of below 100% indicates low dependence of an MFI. Based on the results, only PRIDE (T) and PTF showed a reduced sustainability rate. The results also revealed that many MFIs in Tanzania are not in a position to transform themselves. In 2009, PRIDE (T) was preparing to transform itself into a Micro Finance Company (MFC). Some of the challenges inhibiting transformation in Tanzania are similar to the findings of Poyo and Young (1999). As narrated by PRIDE (T) CEO":

> ***"Specific challenges that hinder PRIDE from being licensd and abiding by BOT regulations as a fully fledged MFI are lack of equity ownership and the transformation of PRIDE into a shareholding Company. Identification of local/foreign investors has been a challenge due to the initial ownership of PRIDE-Tanzania. In addition, the supervisory regulations provided by BOT do not support micro finance organizations such as PRIDE in their desire to become regulated MFIs. For instance, with the current 41 branches operated by PRID –Tanzania, the regulatory requirement for a minimum capital requirement of 500 million for each branch is beyond the current financial capacity of our organization. BoT regulations should allow for step-by-step growth of financial NGOs, credit companies and MFIs into fully fledged banks"***

Overall, the study revealed the following key challenges to the commercialization and transformation of MFIs: legal and regulatory requirements; ownership and equity structure; capital adequacy; operational gaps including poor governance; management competence and skills gaps; the need for an MIS, poor networks and stiff competition. The issue of mission drift was also considered a challenge to commercialization and transformation.

Legal and Regulatory Challenge

By 2009, the majority of MFIs in Tanzania were not regulated by the BoT regulations. Some operate as NGOs, others as associations, trusts, or even cooperatives. The field results revealed that PTF was incorporated in 1988 under the Trustees Incorporation Ordinance as an NGO, and PRIDE (T) and FINCA (T) were established in 1998 and 1993, respectively, and registered as companies limited by guarantee. One of the critical legal requirements is the registration and capital structure of MFIs, which many MFIs do not meet due to high donor dependence. The MFIs will also be unable to meet the collateral and savings requirements. In general the supervisory regulations are not supportive of MFI transformation, hence preventing them from evolving. The transformation of MFIs will lead to them shifting from the unregulated to the regulated market. If MFIs transform themselves, they will be subject to the Banking and Financial Institutions Regulations of 1991 and 1997 (BFIR, 1991 & 1997). BFIA 1991, part II and the new BFIR, 1997 regulation allows MFIs to be transformed and registered as a bank or Micro Finance Company (MFC).

Section 3 of the amended BFIA 1991 and the subsequent BFIA, 2004, defines an MFC as a bank or financial institution incorporated as a company limited by shares to undertake banking business, primarily with households, smallholder farmers and micro enterprises. This is equivalent to Section 33 of the Licensing Regulation of 1997, which states that “a licensed bank shall be organized in the form of a stock incorporated under the laws of Tanzania”. Section 5 (2) of the Licensing Regulation also states that shares of a licensed bank should not be purchased with borrowed money, but shall be purchased from the personal net worth of promoters and subscribers. The promoters and subscribers of shares of MFIs wanting to transform themselves into a bank will have to indicate and declare their source of funds for forming the bank, and the funds must not be from a borrowed source and should be free from any encumbrance, including grants. This raises the challenge of soliciting private capital for the MFI.

Ownership and Equity Structure Challenge

The study revealed that MFIs have no clear ownership structure. All of the visited MFIs have some donor funding and none have private (equity) funding. The results showed that none of the five MFIs have true owners, questioning their whole governance structure. Under commercial operations, MFIs are required to clearly define their ownership structure and stop being dependent on individual donors.

Limited capital for many MFIs will be an inhibition, which will also limit them from increasing their outreach and even providing the current clientele with additional loans.

Capital Adequacy Challenge

The results showed that many MFIs are able to service the first and second loan, but subsequent and repeat loans take too long to process and deliver, due to the lack of loanable funds. The delay in processing a loan also indicates that there is more demand for than supply of loanable funds. The long waiting time has forced clients to drop out of MFIs. The results also show that a good number of MFIs depend too much on grants for running their operations, including the provision of loanable funds. Except for PTF, none of the studied MFIs were borrowing from banks for onward lending. The lack of good collateral to pledge to the banks and poor networks with banks and financial institutions also limits MFIs from accessing more funds for onward lending. Many banks have excess funds, but are unable to lend to MFIs due to stiff collateral requirements. As an alternative, banks could also consider down-scaling in order to reduce the supply gap, because they have the financial and human resource capability. Current regulations allow MFIs only to receive savings, thereby hindering them from using savings for onward lending. To provide financial services effectively and expand in a more sustainable way, MFIs need to access more funds and change their capital structure from being donor dependent. They also need to be innovative and diversify their products to meet clients' needs, plus improving their network and delivery capacity.

Operational Challenges

There are a number of operational challenges, which include offering the right products and services, stiff competition, poor MIS, lack of competent skills and qualified staff, poor governance and management and poor networking. Questioned on the operational challenges of commercializing MFIs in Tanzania, the MFI staff indicated the following: clarity of MFIs' missions (59.1%); weak ownership and governance structure (54.5%); low level of technical understanding of banking and finance (68.2%); lack of transparency in operations (50%); shortage of qualified staff (54.5%); stiff competition in the micro finance market (77.3%); shortage of funds to modernize operations (21.7%); and lack of access to commercial sources of funds (9%). Most of the MFI staff has a social science background and very few have a banking or financial intermediary background. MFIs have poor governance in terms of poor financial disclosure, especially of financial statements.

Products and Service

Transformation of MFIs is meaningless if there is no potential market for the financial products that will be offered by transformed MFIs. Demand for financial products entails not only willingness to buy, but also ability to buy. Demand for financial products is the principal determinant of the commercialization of MFIs. The field results showed that, other than PRIDE (T) which offers insurance, the other four visited MFIs offer micro credit and business training as the only additional financial products. Responses from MFI clients indicated that 68.3% would need savings accounts, 85% individual loans, 51.7% the leasing of equipment and 28.3% the transfer of money to be introduced as a new product. The results also revealed that 63.3% of all respondents keep their business money in savings accounts offered by banks and the remaining 36.7% keep their business money at home. Of those who use savings accounts with banks, 73.3% use the savings service of the National Microfinance Bank (NMB), 7.7% the Tanzania Postal Bank, 3.4% Akiba Commercial Bank, 3.3% the National Bank of Commerce (NBC), 7% CRDB Bank, and the rest keep their money in SACCOs. The results showed that there is a vacuum in the provision of financial services to those on low incomes beyond offering credit and the saving of money; MFI clients need other financial products. The study showed that micro finance customers get other financial services from commercial banks to supplement the services provided by MFIs. However, for rural clients access to such services is limited or many MFI clients do not qualify. By the end of 2009, PTF and PRIDE (T) had started offering other products and services, such as student loans, housing loans and insurance.

The current study and other previous studies show that low income earners and those in rural areas demand other non-conventional financial services. To meet this demand would require MFIs to be innovative and design appropriate financial products suitable for low income earners. Christen (2000) argued that the low income population needs financial services just like the mainstream (high income) population, except that appropriate products have not been developed to meet their financial needs. Given MFIs' lack of operational capacity, including low amount of capital, innovation by MFIs is limited and will take time. Lack of the right skills and funds will limit them from obtaining the right staff and being innovative. The results have therefore shown that while transformation is imperative, there is an untapped market in the current market segments due to low MFI outreach. This means that before MFIs decide to transform themselves they should consolidate and focus more on their existing clientele, while improving their products and services.

Stiff Competition among MFIs

Competition in the MFI market is not a phenomenon of excess supply, but rather over-subscription/overcrowding of micro loans in certain areas, especially in cities and towns, where there is a proliferation of MFIs servicing the same clientele. This has resulted in increased poverty of clients due to multiple borrowing, leading to late loan repayment and over-indebtedness. Many clients, after taking out several loans, fail to repay some of the subsequent loans, making them more indebted than before. This means the competition is not real, because there is more demand for financial services than the available supply. With transformation MFIs will have to compete in terms of offering lower interest rates, which could be harmful to them if these are not cost effective. All in all, competition forces MFIs to lower delivery costs and change their delivery models.

Lack of Appropriate Technology and Management Information System (MIS)

All five MFIs used some kind of information technology and had an MIS for loan management, tracking and monitoring. However, only PRIDE (T) had a robust and efficient system. The lack of a good MIS prevents an MFI from being efficient and effective in processing, storing and managing data. The transformation of MFIs also involves them procuring a good MIS, which many MFIs cannot afford due to limited capital.

Mission and Objectives Drift Challenge

A mission statement makes clear the direction in which an organization is heading and is the road map for its operations. When the mission statement is narrowly defined, it prevents an institution from expanding and exploring available market opportunities. The mission statements of the visited MFIs are summarized in **Table 2 below.**

As shown above, all mission statements of the visited MFIs and other MFIs in Tanzania have a social and developmental focus instead of a commercial focus. A social and developmental focus limits an MFI from operating on a commercial basis. From the mission statements, only PRIDE (T)'s mission statement is broader, allowing it to transform itself into a commercial enterprise. PRIDE (T)'s new mission statement for transformation reads "*To provide quality inclusive financial services to contribute to the economic growth of Tanzania"*. If FINCA (T), PTF, and SEDA want to transform themselves they will need to review their mission statements to reflect a developmental and commercial focus. TGT has revised its mission statement, which now focuses more on wholesale lending, working in partnership with established MFIs. The results showed that only PRIDE (T)'s mission statement is not restrictive in terms of its operations in respect of certain financial products and group of clients. FINCA

(T) restricts its operations to servicing only poor families, while PTF restricts its operations to servicing disadvantaged groups, particularly women and youth. In relation to financial products, PTF's mission statement restricts the provision of financial products to the provision of credit, savings mobilization and business skills training. An MFI which needs to commercialize and transform itself should have a broad mission statement and allow diversification of clients and products portfolio.

While the results show that transformation will broaden MFI mission objectives and attract more clients, they also show that there will be a shift from the current clientele, leaving some customers under/not served. The most affected will be MSEs and the rural poor. This could therefore create a negative impact in terms of poverty alleviation and people's improved living standards. A solution to this is to require MFIs to balance their commercial and developmental objectives.

CONCLUSION

Overall, the study has revealed that, worldwide, the micro finance landscape is changing rapidly. Commercialization and transformation of MFIs is now a worldwide movement and Tanzania cannot isolate itself from this movement. It has also shown that there is still a huge potential and unmet demand for micro finance products, including savings accounts, individual loans, leasing of equipment, money transfer and long-term loans. It further revealed that there is no legal and regulatory framework supportive of transformation. Internally, many MFIs lack human resource capacity, have poor governance in terms of transparency and disclosure, face stiff competition, have weak ownership and governance structure, have a poor or lack an MIS, lack of capital/loanable funds and poor networks. The results also showed that most MFIs utilize donor funds and none of the MFIs are financially sustainable. While PRIDE (T) is more likely to commercialize and transform itself into a Micro Finance Company/bank, the other four MFIs will need more time. With the establishment of an MFI regulatory framework most of the macro challenges would soon be resolved. Nonetheless due to other internal challenges, not all MFIs will be able to commercialize or transform themselves.

Generally, MFIs wishing to commercialize or transform themselves will also need to deal with their internal operational challenges, including reviewing their mission and objectives. Such a transformation will be required to balance their social and commercial objectives and improve their cost efficiency in order to provide their clients with more affordable demand-driven products and services. Given the huge financial services gap, especially for the rural poor, transformation will widen this gap. Transformation will also require MFIs to change their delivery models to meet the regulatory requirements, hence excluding more clients. Individual loans will have to be introduced and the majority of the low income clients and MSEs currently served by MFIs will not be served by the transformed MFIs. They will require alternative collateral instead of the current lending pressure groups. The size of loans will also need to be reviewed upwards to make them more economical to monitor. Few low income earners and rural poor will be able to apply for large loans. Interest rates will need to be commercial interest rates, which will not affordable for many MSEs. Few MFIs will operate in the rural areas making rural financial deepening a major challenge. This means that transformation could force MFIs not to operate in the rural areas, leading to a reduced number of branches. The majority of MFIs will need to recruit or train staff who can cope with commercially oriented MFIs. Some institutions which have transformed themselves have created two institutions; an NGO which continues offering services with a developmental and social focus; and a new MFI, regulated for limited clientele. Running both institutions is an expensive business.

For MFIs operating in Tanzania and many developing countries, successful commercialization and transformation will require MFIs to do the following: (i) develop a clear integrative strategy and plan for commercialization and transformation; (ii) build human and financial resources capacity; (iii) introduce demand-driven products; (iv) improve board and management governance structures and systems; (v) build and institute a strong MIS to track loans and manage debts, (vi) develop good networks, partnership and linkages with banks and financial institutions; (vii) solicit private funding from new shareholders or investors and other funding sources, and (viii) prepare themselves to meet BoT’s regulatory requirements. The monitoring and delivery costs will also need to be reduced.

In addition, regulatory authorities and the government will need to create a conducive environment for MFIs by developing a legal and regulatory framework, formulating policies and improving regional and rural infrastructure to encourage MFIs to operate in rural areas and reach low income earners. All in all, the transformation of MFIs into commercial enterprises is inevitable, but it will have to be done step by step. Operating in the traditional way could lead to the dysfunction of micro lending since donor grants are drying up and MFIs will have to depend on commercial and other sources of funding.

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Table 1

Selection Criteria for each MFI as at June 2008.

Selection Criteria		**PRIDE**	**TGT**	**PTF**	**SEDA**	**FINCA**
Establishment	Year	1993	1992	1998	1996	1994
Number of Outreach	Branches (regions)	41	2	6	10	24
	Customers	90.000	38,000	27,000	10,000	22,000
Default rate	Percentage	2%	5%	5%	2%	1%
Loan portfolio	US Dollars	23.1 million	1.8 million	3.0 million	2.1 million	2.2 million
Mission and objectives	Developme-ntal and/or commercial	Developme-ntal and Commercial	Developme-ntal	Developme-ntal	Developme-ntal	Developme-ntal

Source: TAMFI and web: http://www.mixmarket.org

Table 2

Mission Statements of the Visited MFIs

Institution	**Mission Statement**
PRIDE (T)	Create a sustainable financial and information services network for Micro and Small–Scale entrepreneurs to increase incomes and employment and stimulate business growth.
TGT	Harness, channel and unleash human energy to build social, financial and physical capital through entrepreneurship development.
PTF	Create employment on a self basis and increase the incomes of disadvantaged groups of people, women and youth in particular that constitute the largest proportion of active population in Tanzania. This is facilitated through provision of credit, savings mobilization and business skills training.
SEDA	Being a microfinance provider of choice through the provision of quality products and services to families and communities to foster sustainable livelihoods.
FINCA (T)	Provide financial services to poor families so that they can create their own jobs, raise household incomes and improve their standard of living.

APPENDIX 1
GENERAL PROFILES OF FIVE SELECTED MFIs

Assessment Variables	**PRIDE**	**TGT**	**PTF**	**SEDA**	**FINCA**
Year of Establishment	1993	1992	1988 August 2nd	1996	1998
Mission and Objectives	Developmental and commercial	Developmental	Developmental	Developmental	Developmental
Outreach	41 Branches	2 Branches (Tanzania mainland and Zanzibar)	19 Branches	10 Branches	6
	90,661 customers	38,000 customers as at December 2008	27,085	10,728 customers	23,533
Major Types of Clients	*Women*	*Women*	*Women*	*Mixed*	*Mixed*
Products Offered	*6 Products* • **MEC Loans-** loans offered to micro and small and medium enterprises based on solidarity group guarantee • **FAHARI Loans-** solidarity group guarantee blended with collateral pledges • **AJIRA Loans-** salary guaranteed loans for salaried employees. • **MATAJI Loans-** individual loans for high-end borrowers, with necessary collateral. Loan evaluation assesses the borrower's character, assets and business cash flow. • **ASASI Loans -** wholesale loans issued to SACCOS for on lending to its members. • **MKULIMA Loans-** solidarity group guarantees loans targeting small scale commerce al farmers	*4 Products* • **UPATU Loans -** Women Group Guarantee product. • **WHOLESALE Loans-** offered to micro finance organizations and SACCOS • INDIVIDUAL Loans- individual loans for micro and small business entrepreneurs/ borrowers, with limited collateral requirement mainly group solidarity. • FOOD PROCESSORS loans- loans offered to micro and small business entrepreneurs/ borrowers operating food processing businesses. • HOUSING loans	*6 Products* • **SOLIDARITY Group** - Loans- loans offered to micro and small and medium enterprises based on solidarity group guarantee • **LOW Income Earners-** Salaried Loans offered -salary guaranteed loans for low income salaried employees. • **Empowerment SACOSS Loans-** (also known as **JK funds**)- wholesale loans issued to SACCOS for on lending to its members guaranteed by the SACCOS • **SCHOOL FEES Loans** – offered to existing clients as a bonus/ incentive for client retention and reduce misuse of loans • **LOW COST HOUSING loans -** offered to existing clients as a bonus/ incentive for client retention and reduce misuse of loans. • **SPECIAL POLICE FORCE LOW INCOME loans-** offered to low income earners in the police force. • **AGRICULTURAL loans** - (in the pipe line) - solidarity group guarantees loans targeting small scale commercial	*2 Products:* • **GROUP Loans-** loans offered to micro and small and medium enterprises based on solidarity group guarantee • **INDIVIDUAL Loans** – offered to individual borrowers, with necessary collateral.	*3 Products:* • **GROUP Loans-** loans offered to micro and small and medium enterprises based on solidarity group guarantee • **INDIVIDUAL Loans** – offered to individual borrowers, with necessary collateral • **Village Group Loans-** *Offered to villages based on village guaranteed loans.*

			farmers		
Services	*2 types of services micro credits* - Micro credit insurance with some social benefit riders - Health Insurance-Pilot program to provide access to essential health services through insurance.	*3 types of services* - Entrepreneurship tailor-made training - Access to Markets Support - Incubators, workspace and low cost housing	*4 types of services* - Micro credit Loans - Business skills trainings only for client uptake and during client meetings - Savings culture training during client meetings - Insurance services to its clients a pilot service	*2 types of services* - Micro credit Loans - Insurance Fund in progress	*3 types of services* - Micro credit Loans - Village guaranteed loans - Business skills trainings
Type of economic activities engaged	- Trade and commerce business, Shops, Restaurants, Agriculture, livestock and food vendor	- Small and Medium traders, food processing, housing builders.	- Trade and commerce business, Food vendors, Clothes (batik), agriculture/livestock business	- Commerce/Trade business, Service businesses, Agriculture/live stock business	- Trade and commerce business, agriculture/livestock business
Interest Rates	Between 2- 3% per month	2% per month	2.5% per month normal loans, 1 % for housing and school fees loans	3% per month	3% per month
Default Rates	2%	5%	5%	2%	5%
Delivery Mode	- Group Mechanism (Grameen Model) - Individual loans - Wholesale lending	- Group Mechanism - Individual loans - Wholesale lending	- Group Mechanism - Individual loans - Wholesale lending	- Group Mechanism - Individual loans	- Group Mechanism - Individual loans - Village loans
Loan Portfolio	23. 2 million US$	1.8 Million US $	4.4 Billion TZS.	2.1 Million US $	Not provided
Portfolio at Risk	4.6%	-	3%	2% (>30 days)	Not provided
Institution Subsidy index	0%	-	0%	0%	Not provided
Institutional Operational Sustainability Index	107%	-	148%	74%	Not provided
Institutional Financial Sustainability Index	7.15%	-	148%	66%	Not provided
Data date	As at March 2010	As at December 2008	As at June 2010	As at June 2010	As at June 2010
Number of Staff	435	30	80	107	Not provided
Staff Qualifications	Diploma and Degrees, most have degrees, CPA(T)	Diploma and Degrees, most have degrees	Lowest –Form 4 Highest –Masters Degree, CPA (T)	Lowest – Form 4 for clerical jobs Highest – Masters Degree, CPA (T) for management	As at June 2010

Key: PRIDE(T) : Promotion of Rural Initiatives Development Enterprises Tanzania, TGT: Tanzania Gatsby Trust, PTF: Presidential Trust Fund, SEDA: Small Enterprise Development Agenc