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Building Financial Institutions in Developing Countries

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Building Financial Institutions in Developing Countries

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Abstract

Financial development and financial institution building are important prerequisites for economic growth. However, both the potential and the problems of institution building are still vastly underestimated by those who design and fund institution building projects. The paper first underlines the importance of financial development for economic growth, then describes the main elements of "serious" institution building: the lending technology, the methodological approaches, and the question of internal structure and corporate governance. Finally, it discusses three problems which institution building efforts have to cope with: inappropriate expectations on the part of donor and partner institutions regarding the problems and effects of institution building efforts, the lack of awareness of the importance of governance and ownership issues, and financial regulation that is too restrictive for microfinance operations. All three problems together explain why there are so few successful micro and small business institutions operating worldwide.

Keywords: Financial Institution Building, Economic Development, Corporate Governance

1. Introduction

For many years, development policy has paid little attention to the importance of the financial sector in economic and social development and to the importance of creating economically sound and stable financial institutions as a means of improving the economic and social situation of large parts of the economically active population in developing countries. Older approaches to development co-operation tended to consider institution building a mere by-product of some other, seemingly more important, objective. Almost inevitably, the relative neglect of the institution building aspect has led to economic and developmental failures.

This situation has changed in recent years. Now, there are at least some attempts underway at "serious" institution building, i.e. projects whose primary and overriding aim is to create a new, financially viable institution or to transform an existing institution into one which is able and willing to provide its services to a "disadvantaged" target population on a permanent basis and at moderate costs. Nevertheless, both the potential and the problems of institution building are still vastly underestimated by those who make the relevant decisions, i.e. the decisions to design and to fund institution building projects.

Our paper is structured around the discussion of three questions:

1. Why are financial sector development and financial institution building indeed important? This section draws on econometric studies inspired by a combination of the new theory of endogenous economic growth and on the theory of financial intermediation.
2. What can recent experience teach us about the potential of a serious approach to financial institution building? We first indicate what we consider to be the main elements of "serious" institution building: the lending technology, the methodological approaches to institution building, and the question of internal structure and corporate governance. If the necessary conditions are met, it is possible to create a viable microfinance institution in not more than two to three years and at moderate costs. This compares favourably to the time, investment and costs needed for building up a microfinance institution ten years ago.
3. If this is the state of the art today, why are not many more successful microfinance institutions created in many countries? One reason is the serious conceptual and practical difficulties of matching the internal structure and the governance and ownership structure to the lending

technology. These difficulties are responsible for the limited success of most upgrading projects in existence so far. A second reason is that in a growing number of countries financial regulation has recently become too restrictive for microfinance operations. Due to such regulation, many promising microfinance projects never get beyond the planning stage. The final, and possibly most important, reason is that the creation of successful microfinance institutions is inconsistent with the entrenched interests and established routines of partner institutions in the host countries (the reason why many so-called downscaling projects fail), of local bureaucracies in the host countries, and of donor institutions in the industrialised countries. All three seem to shy away from the far-reaching commitments which "serious" institution building requires.

2. Economic Growth and Financial Development

2.1 Theoretical aspects

In the early 1990s, macroeconomic theory was dominated by a new wave of research aimed at discovering the origins of economic growth. Building on the work of Romer (1986, 1990), Lucas (1988), Grossman/Helpman (1991) and Aghion/Howitt (1992), new growth theory succeeded in eliminating two implications of the old, neo-classical growth theory (Solow 1956) which seemed to be extremely unsatisfactory from both a theoretical and an empirical point of view:

a) a change in the saving and investment rate, i.e. in capital accumulation, has an effect only on the long-run equilibrium of the *level* of real per capita income, not on its rate of growth.

b) the most important variable which, over the long term, determines the growth rate of real per capita income, namely the rate of technical progress, is assumed to be exogenous, i.e. it is not explained as the result of rational economic actions taken by agents.

The new growth theory formulates models which demonstrate a positive influence of the savings and investment rate on the long-term real per capita growth rate. It also describes the process by which technological progress is created endogenously, either as a by-product of physical or human capital accumulation, or as targeted investment undertaken by rationally calculating firms in a model of monopolistic competition. In addition, the new theory seemed to offer economic policy many new avenues by which it can influence growth processes: education and research policy, trade policy, policy in the area of patents and industrial policy.

However, by the mid-1990s, some disillusionment was already beginning to be felt. In terms of theory, neo-classical growth theory was able to counter most of the attacks new growth theory had been making on it (Solow 1994, Barro 1996, Mankiw 1995). In addition, the new theory did not seem to offer as much guidance for empirical research as had been hoped (Pack 1994) and in terms of policy the new theory was criticised on the grounds that "too many things can happen. There is now a folk theorem ... to the effect that a clever graduate student can produce a model to justify any policy." (Krugman 1995, p. 360).

Since the focus of the new growth theory is on processes in the real economy, little room is left for a theoretical analysis of the correlation between financial development and economic growth. In addition, the models were built from the perspective of a single, representative agent, comprising all private households as well as firms. This means that they provide a precise analysis of the optimality conditions of the intertemporal resource transfer, but they forego - by definition - an analysis of the interpersonal resource transfer. However, the main function of a financial system is to organise the intertemporal *and* interpersonal resource transfer (Merton/Bodie 1995). Accordingly, models which focus on the growth-enhancing effects of the financial system (Bencivenga/Smith 1991, Greenwood/Jovanovic 1992, King/ Levine 1993) derive their insights with regard to the importance of the financial system and financial institutions for growth from the theory of finance, and then transplant these insights into a model of growth. However, the links between the two types of models are rather weak, since they "basically assume that financial development leads to economic growth, without showing the mechanics behind this supply-leading relationship" (Hermes 1994, p. 15f.). Thus, it is not surprising that not theoretical, but rather empirical investigations have established the financial sector as a credible determinant of growth.

2.2 Empirical evidence

The first comprehensive empirical investigation of the connection between the development of the financial system and economic growth on the basis of the outstanding financial assets in the financial sector was presented by Goldsmith (1969). The focus is on the "financial interrelations ratio", which measures the ratio of the value of all outstanding financial assets in the financial sector of a given economy to the value of all outstanding real capital. The analysis leads to the conclusion that there is a "positive though irregular association between the level of real national product per head and FIR"

(Goldsmith 1969, p. 377). In 1989, Gelb published a major study establishing a link between financial development and economic growth. Since the study is in the tradition of McKinnon (1973) and Shaw (1973), the major financial indicator is not the FIR, but the relation between the monetary aggregate M2 and GDP.

The latest work by De Gregorio/Guidotti (1992), King/Levine (1993) and Levine/Zervos (1996) is already based on the insights of the growth models which try to incorporate the financial sector. Via cross-country regressions the authors link the real per capita GDP growth rate, the growth in capital stock, the investment share of GDP and a variable calculated to capture productivity growth to variables which capture the level of financial asset formation in an economy, i.e. to

- the ratio of liquid liabilities, equalling currency held outside of the banking system plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries, to GDP (DEPTH);
- the ratio of credit issued by the banking system to private enterprises to GDP (PRIV/Y);
- the ratio of domestic credit issued by deposit banks to domestic credit issued by deposit banks and the central bank (BANK);
- the ratio of claims on the non-financial private sector to domestic credit (PRIVATE).

Table 1 gives a brief overview of the most basic statistical evidence on financial development and economic growth, the coefficients on the four financial indicators in a standard cross-country growth-regressions for 77 countries over the period 1960 - 1989.

Table 1: **Growth and Contemporaneous Financial Indicators Cross Country: 1960 – 1989 (77 observations)**

Dependent Variable	DEPTH	PRIV/Y	BANK	PRIVATE
Real per capita growth rate	0,024* (0,009) R^2 = 0,50	0,032* (0,010) R^2 = 0,52	0,032* (0,010) R^2 = 0,50	0,034* (0,010) R^2 = 0,52

* significant at the 0.01 level, standard errors in parantheses

Source: King/Levine (1993, p. 727)

All variables capturing the formation of financial assets show a positive and significant correlation with all indicators in the real economy. Countries where the banking system exhibits a larger volume of liquid liabilities and a larger volume of credit issued to the private sector in relation to GDP, also

have higher rates of growth in per capita income. Additional evidence shows that countries with a more developed financial system form more real capital and show greater technical progress.

In comparison to the other macroeconomic policy variables, the link between variables on financial asset formation and growth is relatively robust: The positive correlation between the financial asset formation variables and the rate of growth in per capita income is always significant, regardless of what combination of other macroeconomic policy variables are applied as further regressors. The variables capturing financial asset formation also make a significant contribution to explaining growth variables when the values for financial asset formation at the beginning of a given decade are used as regressors to explain the average rate of growth in per capita income over the decade that followed. This can be taken as an indication that high levels of financial asset formation stimulate growth, or rather stimulate real capital and technological advances, which are factors determining growth; and not, conversely, that it is high levels of economic growth, real capital formation, and/or technological innovation which stimulate high levels of financial asset formation.

De Gregorio/Guidotti (1992) explore the question of whether the effects on growth of higher levels of financial asset formation are accounted for primarily by a higher volume of investment, or by greater productivity of the investments made. Their answer is that the positive correlation between economic growth and the development of the financial system can essentially be attributed to the fact that the development of the financial system goes hand-in-hand with higher marginal productivity of the capital invested. De Gregorio/Guidotti also find that higher levels of financial asset formation correlate with a higher rate of economic growth first and foremost in countries where there is a low or medium per capita income. It is precisely in the underdeveloped countries, therefore, that successful development of the financial system could be expected to lead to higher rates of economic growth.

Finally, Levine/Zervos (1996) show that the positive correlation between financial system development and economic growth can also be found by using indicators of stock market development, like size, liquidity and risk diversification, as financial variables.

2.3 Why are the financial sectors of most developing countries so underdeveloped?

The empirical evidence suggests a clear positive correlation between selected financial indicators and economic growth. It thus underscores the relevance of the theoretical models which link financial

development to economic growth. But since "the degree of financial development is assumed to be exogenous" (Pagano 1993, p. 619) neither the neo-classical nor the new growth theory models are able to provide an answer to the question of why the financial sectors of most developing countries are so underdeveloped.

Applying the modern theory of finance as it relates to the question of the basic conditions required for financial development offers a way out of this dilemma (Winkler 1998, 1998a). The modern theory of finance shows that with asymmetric information among potential borrowers and lenders, it is rather difficult to organise an interpersonal and intertemporal resource transfer due to the incentive and information problems inherent in any financial transaction. Accordingly, the institutions which organise the bulk of this resource transfer and therefore constitute the core of any financial system, the commercial banks, have to implement mechanisms to overcome these problems: screening/monitoring, self-selection and signalling (Leland/Pyle 1977, Diamond/Dybvig 1983, Diamond 1984, Breuer 1995). This leads to the hypothesis that the underdevelopment of financial systems in most development countries is due to the fact that the financial institutions in these countries are *unable* and/or *unwilling* to overcome the incentive-related problems which are associated with external financing. Empirical studies of the causes of bank failures and banking crises in developing countries support this hypothesis, noting that "poor risk diversification, inadequate loan evaluation and plain fraud were the main factors leading to financial institutions' liquidation..." (Sundarajan/Balino 1991, p. 16; see also Caprio/Klingebiel 1996, and Caprio 1997).

This reasoning applies all the more so to financial institutions which are supposed to make a contribution to supporting micro, small and medium-sized enterprises by providing financial services, in particular loans (Schmidt/Zeitinger 1996). Accordingly, institution building has to be a key element in any strategy to extend the "frontier of finance" (Von Pischke 1991).

3. Key Elements of Financial Institution Building

3.1 Approaches to financial institution building

Any improvement in the supply of financial services to target groups which so far have had no access, or only limited access, to good, reliable and reasonably priced financial services presupposes that institutions which offer such services are created, reoriented or strengthened. There are several approaches to financial institution building. They differ in their response to the question of which type

of partner institution and which type of development project offers the best prospects for ensuring that stable and target group-oriented institutions are established. These are the two most important approaches:

The downscaling approach argues that commercial banks are the best partners to implement the target group-oriented credit technology. This approach is based on the assumption that (selected) commercial banks in a given country are, at least in principle, interested in catering to the target group but refrain from doing so because they do not have the capability to serve this clientele, and it consists in helping them to acquire these skills. Their reluctance may be due to an inadequate credit technology which entails risk and transaction costs that are too high to make MSE lending a profitable business, or simply an erroneous perception of these risks and costs. Experience confirms that capability constraints do exist to a greater or lesser extent and that they can be dealt with successfully (Schor 1997), usually by means of an intensive and well-designed technical assistance input.

However, experience also shows that more often than not, owners and managers of commercial banks are not prepared to accept an institutional transformation which would involve taking the target group seriously and adapting the way the bank organises its lending operations in order to accommodate the new lending technology (Boven 1999). This applies in particular to partner banks which are quite successful in their current business, and to state-owned institutions. The problem of unwillingness is the main reason why the downscaling approach can be much more laborious and time-consuming than the simple transfer of know-how in regard to the credit technology, which usually does not take more than two years, would seem to imply. It is also the reason why downscaling projects may fail or have to be aborted.

The upgrading approach entails establishing a new financial institution which is part of the formal, regulated financial sector and which focuses its activities primarily, if not exclusively, on serving small and micro-scale businesses. Upgrading can mean transforming an existing target group-oriented NGO into a formal financial institution; or starting a greenfield operation by setting up a credit institution in the legal form of a foundation or association which will then be converted into a commercial bank later on; or founding a commercial bank right from the start. The upgrading approach is based on the assumption that it is easier to implement the appropriate lending technology and the necessary organisational structure in an existing informal institution which is already

committed to serving the target group, or in a new institution, built from scratch, which will be designed from the start to serve the target group. There are several examples which justify the assumption that this is a promising approach, among them Banco Sol and Caja Los Andes in Bolivia, Financiera Calpiá in El Salvador and MEB in Bosnia and Herzegovina.

Taken together these examples can teach several encouraging lessons. They show that small and micro lending can be an attractive undertaking: It requires less than one might think in terms of time and investment to set up a stable and socially relevant microfinance institution which provides large numbers of small loans to a relatively poor target population at acceptable costs, which covers its cost after two to three years, and whose operating costs are moderate. The learning curve in financial institution building is indeed steep. As a rule of thumb, one can say that *today* experienced institution builders can set up such an institution with an investment of around USD 10 million in almost any country. Of this amount, USD 4 million are truly "costs", while the remaining USD 6 million serves as the initial funds for the lending operations. This is good news for the people who demand the services offered by these institutions, and for the international donor community, which has a keen interest in funding their creation as an instrument of development policy.

However, the upgrading approach can run into problems as well. These problems are basically related to the difficulties of introducing a commercial approach and a clear market orientation into an established NGO which typically has been shaped by a more socially-oriented attitude and which by definition is not profit-oriented. Experience shows that the clash of mentalities in this case can be as difficult to resolve as the one described above in the downscaling approach. This means that whenever financial institution building relies on existing institution to start with, whether the upgrading or the downgrading approach is used, the choice of project partner(s) in itself is a key factor, potentially making all the difference between success and failure. Accordingly, great care should be exercised when selecting partner institutions, using both criteria: market and target group orientation (Schmidt 1997).

The bottom line of the experience on which this paper is based is that neither the institutional form of the original local partner institution, if there is one, nor the specific type of development assistance project, are the main determinants of the success of an institution building project. Rather, the keys factors determining the success of such a project are whether an appropriate lending technology is

implemented, and whether an appropriate ownership and governance structure is established at the institution.

3.2 The lending technology

An individual financial institution can only contribute to the development of the financial system and serve its clients on a lasting basis if it employs a lending technology which is able to overcome the information and incentive problems inherent in any financing relationship. Over the last two hundred years western commercial banks have developed lending technologies according to changing needs and circumstances. It is therefore not surprising that there is a huge difference between the best practice of 1999 and the best practice of 1850. While today loans tend to be medium or long-term, based on collateral and often granted on the basis of an income statement, in the 19th century they were very short-term, based on certain non-pecuniary costs of non-performance and often granted on the basis of an intimate knowledge of the borrowers' personality and socio-economic environment (Tilly 1967, Bagehot 1873, Lamoraux 1986).

Successful institutions providing loans to micro-, small and medium-sized enterprises mimic the lending technology employed by the commercial banks, the *Privatbankiers*, in Western Europe and the USA more than a hundred years ago:

- Loan analysis focuses primarily on the prospective client's ability to pay (cash flow); less emphasis is placed on collateral.
- The graduation principle is applied to repeat borrowers. By initially granting relatively small, short-term credits, but then gradually increasing the volume and the maturity of the loans, the institution builds up a relationship of trust with its borrowers, acquires more information about its clients and their business, and establishes a strong incentive on the part of the borrowers to ensure their continued, long-term access to credit by meeting all of their obligations.
- Loan officers are fully responsible for "their" borrowers over the entire life of the loan and are paid performance-based salaries.

Since modern financial institutions cannot rely on large interest spreads to cover costs, modern technology is added to reduce transaction costs. Accordingly, the analysis is highly standardised, and loan processing times are minimal, while appropriate decision-making and control mechanisms are in

place, supported by powerful MIS/IT systems which assist in the management and administration of the loan portfolio.

Experience shows that microfinance institutions using this technology are able to keep risk costs below 5% and push operating costs below 20% of their outstanding small and micro loan portfolio within three years (see Schmidt/Zeitinger 1994). Table 2 shows the respective results taking Financiera Calpia, El Salvador, and Caja Los Andes, Bolivia, as examples.

Depending on the characteristics of the target group and the general lending environment in a given country, in the same period these institutions can build up portfolios with a volume of up to USD 10 million and serve up to 15,000 clients. This kind of empirical evidence is the basis of the conviction shared by an increasing number of experts in this field that lending to poor people can be an undertaking which is both socially valuable and economically attractive.

Table 2: **Selected Indicators for Financiera Calpia and Caja Los Andes, 1994 - 1998**

Month/Year	Average Outstanding Loan Amount (in USD)		Gross Loan Portfolio in USD '000		Loan Loss Provisions/ Average Gross Portfolio		Total Administrative Costs/Average Gross Portfolio	
	FC	CLA	FC	CLA	FC	CLA	FC	CLA
Dec. 1994	548	315	3,453	2,974	2,0 %	0,7 %	34 %	33 %
Dec. 1995	528	379	6,371	6,048	3,6 %	0,9 %	29 %	27 %
Dec. 1996	637	497	11,514	11,881	3,9 %	1,5 %	22 %	20 %
Dec. 1997	745	691	18,346	20,431	4,6 %	1,9 %	18 %	14 %
Dec. 1998	738	819	22,075	28,614	4,8%	3,5 %	17 %	13 %

Source: IPC webside (www.ipcgmbh.de), own calculations

3.3 The governance and ownership structure of the partner institution

The search for a promising partner institution is a difficult task because the ideal candidate will not exist. Whatever happens to a financial institution, whether good or bad, is the consequence of actions based on decisions taken by those who run its affairs. Thus, how a given institution develops over time is determined to a large extent by the incentives which key decision makers face and the constraints to which they are subject. Corporate governance is about allocating decision and control rights in an organisation. One can define it as "the totality of the institutional and organisational

mechanism, and the corresponding decision-making, intervention and control rights, which serve to resolve conflicts of interests between the various groups which have a stake in the firm" (Schmidt/Tyrell 1997). Ownership refers both to the legal aspect of who owns shares in the equity of the institution, and to the economic aspect of who has a great deal to lose should the institution fail to live up to expectations and fulfil its potential, and thus has the strongest motive to make the institution succeed. Ownership is the basis of the power to make fundamental decisions, which includes shaping the governance system (Hart 1995).

Over the past years, experience has demonstrated more and more clearly that a good governance structure and a strong ownership position are decisive factors in the success of any microfinance institution. In the case of an institution building project they are particularly important. Accordingly, one focus of the analysis of potential partner institutions, and of the project itself, must be their governance and ownership structure. Two aspects are involved here: First of all, the governance and ownership structures must be examined to determine whether the past lack of a market orientation (in the case of an NGO) or of a target group orientation (in the case of a commercial bank) appears to be due more to *inability* or to *unwillingness*, and to what extent the governance and ownership structure itself is responsible for the inability and/or unwillingness to combine a market orientation and a target group orientation. Secondly, as any institution building effort, by definition, leads to far-reaching change and transformation, and thus almost always entails considerable conflict with entrenched interests within the institution, it must be determined whether the governance and ownership structures are conducive to change, or tend to impede it. These questions are related; the second point in particular, however, determines whether and to what extent it will be possible to influence the governance and ownership structure so as to prevent it from interfering with the implementation of a target group-oriented, commercially oriented business policy.

A good governance structure ensures that management has the power to initiate and to implement a consistent policy, and that a strong board of directors or supervisory board guides the management and carefully monitors its policy measures. Acting not in isolation, but rather in a carefully designed interplay, these two core elements of the governance system must ensure that the institution stays on track. It is very important that the ownership rights are distributed in such a way that owners – both legal owners and economic stakeholders – have are able to ensure that this interplay functions well and also have an incentive to do so. Clearly, this implies that not everyone is suitable as an owner.

The importance of the governance and ownership becomes clearer when one looks at the consequences of deficient governance and ownership. As is the case in many real-life institutions, management may have too much freedom and become more inclined to pursue its own objectives, which may be financial or social in nature, or simply consist in having a quiet life and a secure position, than to pursue the goals of the institution, its owners and the target population; or the board may be too strong and stifle the initiative of the management; or the division of roles may not be sufficiently clear. Deficient governance and ownership can result in uncontrolled and misguided activity, which undermines stability, or in immobility and stagnation, which is plainly inconsistent with the underlying rationale of an institution building programme. Unfortunately, one of the above descriptions can accurately be applied to most would-be institution building projects. (Holtmann/Rühle/Winkler 1999). Since the corporate governance issue is often not considered relevant, no attempts are made to change the internal procedures and governance structure of partner institutions. e.g. by using the leverage inherent in the position of the donor as a provider of technical and/or financial assistance to acquire a seat on the supervisory board or on the board of directors, or by acquiring an equity stake. Therefore, institution building efforts often continue to lack a solid foundation, and thus almost inevitably fail.

4. Key Problems in Financial Institution Building

Given the unquestionable importance of viable and stable target group-oriented financial institutions and the empirical evidence that banking for the poor can be economically viable and that successful financial institutions can be built with moderate financial investment and in a short time, one might wonder why many more successful institution building projects are not started and implemented. In fact, the vast majority of would-be institution building projects are unqualified failures. In this section, we will discuss the three main reasons why institution building projects fail, or – to put it another way – the three most important challenges which institution building projects must face.

4.1 Expecting too much and too little at the same time

All too often, the difficulties involved in building or transforming an institution are vastly underestimated by those who manage and advise the institutions and even more so by those who provide the funds on which the institutions have to rely for a certain time, i.e. by the international donor community. The underestimation of the problems of starting or expanding and transforming a

microfinance institution shows up most clearly in the tendency of donor institutions to expect institution building projects to achieve many things at the same time: In addition to creating a viable institution, project partners and implementers are expected to distribute certain quantities of loans to specific segments of the target population, such as self-employed women in a remote region of a country; to provide various kinds of financial, and in many cases even non-financial services irrespective of what strains providing these services puts on the emerging institution; to train not only the people working in the institution, but also the target group; and last but not least, to meet excessive reporting requirements. These burdens are put on the institutions as if the creation of a viable institution working in a difficult environment and with a difficult clientele were not enough of a challenge on its own.

But this is not all; in many cases emerging microfinance institutions are also expected, tempted and sometimes even put under a certain pressure to "absorb" donations and cheap funds from some donors who follow a "soft" policy approach, or, as the case may be, to pay "market rates" for external funds from "tough" donors – and this again largely irrespective of the situation in which the institution finds itself (Schmidt/Zeitinger 1994). All too often, the kind of support which is provided is mainly a reflection of the policies and the internal needs of various donor agencies. The tendency to overburden an institution and to provide support of a kind which is inappropriate at the given stage of the institution's development is fostered by the fact that in many cases a promising institution is "supported" by many donor institutions which have to follow their own, often quite different, policies; which fail to co-ordinate their efforts sufficiently; or which sometimes simply compete to be involved in a possible success story. Most partner institutions do not have the experience or the strength to refuse requests when the supply of funding is made contingent on their fulfilment, or to reject ostensible "favours", even if they might feel that the measures to be adopted are not good for them.

There is also the opposite tendency of the donor community as a whole, and even of certain individual donor institutions, to ask and expect too little from a partner in an institution building project, or to be too "understanding" if a local partner institution fails to meet certain targets which have been agreed beforehand and which are essential for the envisioned process of institutional transformation and development.

It seems to be difficult for donors to make the continuation of their support conditional on progress at the level of the partner institution. There are several reasons for this: One of them is that many people

in the donor administration simply do not care enough about genuine success in terms of institution building; having achieved a certain amount of success and possibly also some positive economic and social impact is enough for them, and they may be content with a limited improvement at an institution which they support, even if this falls short of the envisioned objective of creating a strong institution. Another reason is that pushing for the kind of change and development which institution building necessarily requires invariably meets with resistance from important decision makers within the partner institution as there are always individuals who lose influence, privileges or status when the transformation proceeds along the planned path. This resistance is almost a natural consequence of success at early stages of an institution building project, as such success improves the institution and thus makes the positions of such individuals more valuable and strengthens the bargaining power of these individuals, who now have a strong motive to slow the process down. Finally, discontinuing a project "merely" because the partner institution does not change as much and as fast as it could suggests that the relevant decision makers might have bet on the wrong horse in the first place. In technical terms, a strategy of institution building is very hard to make renegotiation-proof.

Experience confirms that both mistakes, i.e. demanding too much and demanding too little, often go hand in hand: Having demanded too much at one stage is a perfect excuse for not demanding enough at a later stage when demanding more would involve serious conflicts. In addition, all of these problems are exacerbated when a local microfinance institution interacts with several donors and investors at the same time, which is typically the case. In order to make an institution building project a success, and to create a vibrant and dynamic target group-oriented financial institution, it is imperative to avoid both mistakes. This requires that donors – possibly several of them at the same time – and local partners find ways of committing themselves to the institution building objective, i.e. that they voluntarily establish mechanisms that will effectively prevent them from changing their strategies over time even though their current interests are most likely to change. A prerequisite for the establishment of such mechanisms is a detailed and explicit strategy or development plan which is formally agreed between the parties involved. But this is not enough. What is also needed is the awareness in the donor community that institution building is a worthwhile endeavour in its own right and that a long-term perspective is required in order to make it succeed.

4.2 Neglect of corporate governance and ownership

A key problem is how to allocate decision-making and control rights and, ultimately, ownership so as to ensure that everyone who has a say in important decisions is guided by both incentives and constraints to act in such a way as to help the institution to grow, become stronger, more profitable and also more socially relevant. Unfortunately, there is no easy solution as to how to best allocate these rights. There is no one optimal legal form and no ownership structure which covers all cases, or even all cases of a given type. Too strong a role for profit-oriented owners might jeopardise the target group-orientation, while too little influence for owners who really have their own capital at risk might undermine financial soundness and limit the growth of the institution and its longer-term impact.

Designing and implementing an appropriate governance and ownership structure is difficult even under stable conditions. In the case of an institution building project, it is even more difficult, and even more important. It is more important because if change and development are to take place, there must be someone with the power to drive change. It is more difficult because the governance system must enable and encourage change. In this case, the ideal owners, directors and senior managers – from an economic standpoint, not necessarily in legal terms – would be those who have a strong interest in *not* maintaining the status quo which is achieved at any given time, and who also can provide leadership and monitor other members of the institution. But people who have no particular incentive to maintain the status quo at any given time often also have no real stake in the institution at all, and therefore do not add value.

Even though all of this may appear to be fairly obvious, experience suggests that these points are often not given due consideration in practice: Even though it seems impossible to define the best governance and ownership structures, when one looks at a specific institution one can easily see whether certain weaknesses exist in this area. Indeed, many institutions and many projects have suffered greatly, and are still suffering, from inattention to the problems of aligning incentives, restricting the scope of decisions and actions and of ensuring accountability. Disregarding governance and ownership issues is a deadly sin in the case of institution building projects. In practice, it is often quite obvious where the deficiencies lie. What is then needed is a concept to bring about improvement, and the determination and the willingness to push for its implementation; all too often, these are lacking. What may appear to be respect for the autonomy of the key players in the partner institution typically turns out to be a clear violation of the interests of the other people at the partner

institution and, most of all, of the members of the target population, who will not benefit from the supply of financial services if the institution does not continue to grow and improve.

Institution building projects thus face many hazards: fruitless internal conflicts or inappropriate actions; inaction on the part of management where action is needed; a lack of commitment on the part of the board and the donors. The practical problem for those who want to make the institution building project a success is to make sure that none of these potential problems are allowed to frustrate the institution building effort.

4.3 Lack of a conducive regulatory framework for MFIs

The third main reason why institution building projects fail or are not even initiated is the lack of appropriate regulation for microfinance institutions. In general, it is important that financial institutions are subject to regulation and supervision, as, at least in principle, appropriate regulation and supervision tend to contribute to financial and institutional stability. However, in many cases regulation for microfinance institutions is not in place or is not appropriate. One kind of deficient regulation is overly lenient regulation, which is often combined with a total lack of supervision. Another kind is one which fails to take into account the peculiarities of microfinance, e.g. by forcing financial institutions to request forms of collateral which the target group typically does not have, or by preventing financial institutions from charging interest rates which are high enough to cover the considerable administrative costs incurred in making very small loans.

A specific problem in this area is that, under the guidance of, and even under pressure from, the World Bank and the IMF, many countries have recently raised capital requirements for microfinance institutions considerably. It is important to distinguish between capital requirements in the form of solvency ratios, which should in fact be high in the case of microfinance institutions, and minimum capital requirements. The latter should not be high, because high minimum equity requirements make it very difficult to create and later on to formalise such an institution. The reason is that it is typically very difficult to find professional investors who are willing and able to put up a sum of, say, USD 5 million – to take a minimum equity requirement which is now in effect in many countries – and who are also committed to the goal of building up a commercially viable target group-oriented financial institution.

The set of potential investors who can be called upon these days to invest in emerging microfinance institutions is very limited, and each of them individually is rarely willing to invest more than USD 1 million. In addition, these investors have recently come to require that a consulting firm or other private institution which implements an institution building project also contribute equity. This requirement is indeed quite reasonable, as it strengthens the commitment to succeed. However, for tax reasons, the share of the implementing organisation has to be at least 10 percent to be economically feasible, and the number of eligible organisations which have the staff and the know-how necessary for "serious" institution building in the area of small and micro finance is even more limited than that of potential investors. There are at present not even a handful of candidates, and none of them is a large and wealthy corporation which could put up the required equity easily. In addition, given such high capital requirements, a microfinance institution would have to attain quite a large size in order to be financially viable, and thus would have to develop a correspondingly large market; this might not even be possible for an institution operating in a small country.

All of this has a clear implication: Raising minimum equity requirements to the high levels they are currently reaching worldwide is stifling promising efforts to build up the target group-oriented institutions which are so urgently needed to improve the economic and social situation of a target population which is still grossly underprivileged and lacks access to credit. High minimum equity requirements tend to prevent microfinance from breaking out of the confines of informality and the NGO world, leaving it in the hands of those players in the national and international donor community who are still not interested in serious financial institution building.

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