Microfinance Institutions in Transition

Fonkoze in Haiti Moves toward Regulated Banking Status

Michael Tucker and Winston Tellis

Abstract: Microfinance institutions (MFIs) established to provide the poor with access to capital have typically operated outside of their countries’ regulated banking environments. Many have relied on donor grants and low-interest funds to support loan portfolios and social programs. As MFIs mature they aspire to become more efficient and attain economic sustainability because they understand that greater numbers of the poor can be serviced by economically sustainable institutions. Many MFIs collect savings deposits but are often barred from using them for loans by their countries’ laws. Fonkoze, an MFI in Haiti, has sought regulated status, which would provide access to deposit assets and enable Fonkoze to better compete with other MFIs, some of which are regulated subsidiaries of commercial banks. In the midst of political and economic turmoil, Haiti’s Central Bank has delayed Fonkoze’s transformation. A different solution is now moving forward, with Fonkoze becoming two entities, Fonkoze Financial Services and Fonkoze Foundation.

Most microfinance institutions (MFIs) have been outside of or at least partially removed from the banking regulatory system of their respective countries. The poor also lack access to traditional forms of banking capitalization and are frequently reliant on donor organizations, typically nongovern-
mental organizations (NGOs). One such NGO is Fonkoze, which started in Haiti as an organization to help the poor and grew into an MFI. Fonkoze started with an office in Port-au-Prince, the capital of Haiti, and quickly expanded into an organization with 18 branches throughout the country to meet rising demand from the poor. From its inception in Haiti, Fonkoze has been financed by a combination of outright donations and loans at below market interest rates. As with many MFIs, adhering to the mission of providing capital to the poor was more important than profits for Fonkoze. Financing continuing and growing operations without access to depositor funds limited operations to whatever could be raised or borrowed from donors, necessitating continuous rounds of fund-raising. Like a growing number of MFIs, Fonkoze is in the process of making the transition from an MFI to a regulated banking institution legally able to mobilize deposit capital for its loan portfolio. While transformations have been successfully negotiated in other developing countries, Fonkoze is the first applicant for transformation in Haiti. Each MFI contemplating transformation is in a unique situation, but there are similarities as well as country-specific differences that illustrate the promise and pitfalls of becoming a regulated financial institution.

Larger MFIs with operating assets in place may not be able to realize economies of scale without becoming regulated institutions. Expansion of loan portfolios that could be accommodated by MFI infrastructure already in place may not be possible, due to funding constraints. Such constraints can be overcome with the establishment of or access to already existing savings deposits. Becoming a regulated bank would also mean focusing on profits. Since profits are not the focus of all MFIs, some may not be candidates for transformation to regulated institutions. MFIs with missions heavily tilted toward servicing the poor incur expenses far beyond those of banking operations that would make transformation to an operationally profitable entity difficult if not impossible. In Bangladesh

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there was concern that a focus on profit-making could reduce service to the existing clientele, 90% of whom were women (Charitonenko & Rahman, 2002). Programs focusing on serving the poorest can at best cover 70% of operating costs (Morduch, 2000). Donors believe that as few as 5% of MFIs with a social welfare orientation may be able to attain financial sustainability. Fonkoze, with its mix of social and educational services as well as lending to the poor, has been a social-welfare-oriented MFI. Fonkoze plans to address mission drift, a preeminent issue in MFI transformation, by splitting its organization into a profitable bank with plans for becoming regulated and a foundation that would continue as a separate organization for social services. Splitting the functions and the funding sources will set up a synergistic relationship. The poor can receive rudimentary education and instruction in running small businesses, making them more creditworthy borrowers from Fonkoze the foundation and eventually move on to doing business with Fonkoze the bank.

Competition can also be a motivating factor behind seeking regulated status. In Haiti, regulated banks have created spin-offs or have directly entered microfinance. While their services differ considerably from those offered by Fonkoze, over time and with perhaps government intervention, they could become dominant players in an altered lending environment.

Regulation means stepped up reporting requirements and audited financial statements. For most MFIs receiving support from multiple donors, financial reporting is nothing new. They often need to satisfy multiple and time consuming reporting demands. Some NGOs funding MFIs have also insisted on audited statements. Transformation to a regulated institution streamlines these reporting requirements while simultaneously making those loose requirements more stringent. Regulated institutions are subject to far more scrutiny than unregulated MFIs. Regulation means higher standards, and the necessity of profitability translates into focusing on greater operational efficiencies. Regulated unprofitable banks cannot continue to function while losing money, unlike unprofitable MFIs. Improving operational efficiency can be a good
thing for clients but may move regulated institutions away from serving the more expensive clientele, the poorest of the poor. As Fonkoze moves steadily towards transformation, it has much to learn from the experiences of similar organizations around the world.

The first two sections of this paper trace the origins of Fonkoze and place it in the context of recent Haitian history. The next sections discuss and review microfinance institutions and banking in other countries and how some of these MFIs have transformed into regulated banks. The paper proceeds to examine the banking regulatory body in Haiti, the National Bank of Haiti (BRH), followed by an overview of MFI competition in Haiti. The final section and conclusion of the paper describe the impediments to Fonkoze’s transition toward transformation into a regulated bank and how these impediments were overcome, allowing the formation of a new entity, Fonkoze Financial Services (FFS), a transitional entity that is partway to achieving that transformation.

Origins of Fonkoze in Haiti
Fr. Joseph Phillipe founded Fonkoze in 1994. One year later it became a foundation under Haitian law. Since it is a membership organization, only other organizations, with the exception of political parties, can be members of Fonkoze. Organizations with membership in Fonkoze represent the organized poor. Governance is through a democratic General Assembly, with organizations having memberships greater than twenty-five sending two delegates and those with fewer than twenty-five sending one. The delegates elect nine members to a Board of Directors.

It was not until 1996 that funding levels began to rise and Fonkoze began making loans to the poor. In 1996 an organization of Haitians living in Canada donated $10,000, which was matched by the Canadian government as seed capital for a loan portfolio. Soon after that an organization of women in Louisiana, USA, donated funds. In 1997, the Doen Foundation of the Netherlands provided a combination grant and loan of $100,000, allowing Fonkoze to have a major impact on loans to the poor. To assist
Fonkoze in Haiti, Fonkoze USA was formed in 1997 as an independent 501(c)3 charitable organization incorporated in the United States with a separate board of directors. Sixty-eight percent of Fonkoze’s loan portfolio is financed through Fonkoze USA. Funds raised in the United States have come from three sources:

- Progressive Donors: those making tax deductible donations.
- Solidarity Investors: those who loan $1,000 or more for a period of one year at little or no interest.
- Dedicated Partners: individuals or organizations donating expertise (Fonkoze, 2004).

Fonkoze requires that borrowers maintain savings deposit accounts, but because of Haitian banking regulations, it cannot mobilize those savings for any purposes. The savings are effectively segregated from Fonkoze’s other accounts by being held in separate commercial bank accounts.

Meeting rising demand for loans had been possible with the participation of Fonkoze USA, international donors, and lenders. Political instability in Haiti in recent years, however, has increased the difficulty of maintaining donor funding. Satisfying different reporting requirement of the various NGOs has also become increasingly burdensome particularly since there is no standardization. Gaining legal access to deposits in order to minimize and possibly even eliminate the need to continue to seek outside funding, which is a time consuming and costly pursuit for management, would set Fonkoze as a bank firmly on the road to self-sufficiency.

Deposits on hand were much greater than the loan portfolio in both 2001 and 2002, reaching over 270% of the loan portfolio. Interest paid on deposits held by commercial banks in 2002 was 5% per annum. Fonkoze charged borrowers upwards of 3% interest per month. The spread between rates charged and rates Fonkoze would need to pay depositors leaves considerable room to cover operating expenses. Not all deposits would be available for loans. BRH set reserve requirements at 31%, well above the 8% standard set by the Basle Capital Accord of 1988 (Basle Committee, 1988).
Even at this level, considerable deposit funds would be available to fund a loan portfolio larger than current levels.

In 2001 and 2002 Fonkoze had net operating losses and sustainability ratios of 40% and 54% respectively. These numbers in isolation would seem to be poor indicators of the ability to survive without subsidies in the form of donations. Low sustainability margins, however, reflect both expenditures serving the poor, such as literacy and business practices classes, and a strategy of purchasing assets in preparation for the transformation into a larger regulated entity. Transformation would enable Fonkoze to utilize economies of scale by tapping deposits. With fully staffed branches throughout the country and considerable fixed assets ready to be utilized, Fonkoze in 2002 was poised for regulated status and expansion.

**Recent Historical Background**

Fonkoze was founded at one of the many turning points in Haitian history. A military coup had taken over the country from Bertrand Aristide, the first democratically elected president in Haiti’s history, forcing him into exile. By September 15, 1994, having exhausted diplomatic negotiations to reinstate the elected president, the United States along with twenty other countries decided to intervene in Haiti (Ambassade d’Haïti, 2004). Four days later troops landed, and coup leaders stepped down and left the country. On October 15, Aristide returned from exile and resumed what had become an abbreviated presidency. In June 1995, former Prime Minister René Préval was elected president to succeed Aristide, who could not succeed himself.

Parliamentary elections were held on May 21, 2000. Results were delayed and then in June Haiti’s top election monitor fled the country, casting doubt on the election’s legitimacy (Associated Press, 2000). Even with this hasty departure, local and international observers expressed a willingness to accept the election results as marred but legitimate. Opposition parties were less sanguine, continuing to express outrage. They accused former President Aristide’s Lavalas Family Party of fixing the election to
ensure an overwhelming victory prior to Aristide’s own run for the presidency later in the year. Led by the United States, the international community rejected the May 2000 elections and subsequently embargoed all aid to Haiti (CIA, 2004). The Haitian economy has been shrinking since, with approximately $500 million in aid suspended only worsening the plight of 80% of the population already mired in extreme poverty (Janet Matthews, 2004).

In early 2004, unrest fomented by extremists, some of whom were convicted murderers, participants in the prior military coup, and retreads from the Baby Doc Duvalier dictatorial regime of the 1980s, led to the late-night February 29 departure of President Aristide under questionable circumstances. Chief Justice Boniface Alexandre was sworn in as caretaker president (Janet Matthews, 2004). New elections were scheduled for late 2005. The US military returned with a multinational force to restore order at least in some portions of the country. The Haitian government functions were reconstituted without Aristide and the possibility of a resumption in aid with the promise of stability seemed imminent in mid-2004.

Corruption and lack of security were rampant before Aristide’s departure. In June 2003, Police Chief Jean-Robert Faveur resigned after only a short time on the job. His predecessor had lasted only three months before he resigned after being accused of a 1991 murder. With law enforcement minimal, Haiti has become a transshipment point for cocaine to Europe and the US, with 15% of all US cocaine consumption passing through the country (Janet Matthews, 2004). In 2002 GDP was down 1.5% following a 1.7% decline in 2001. Inflation was down to 8.7% in 2002 from the 2001 level of 14.2%. There was a run on bank deposits after a rumor was spread that BRH would require forced conversion of all US denominated deposits to Haitian gourdes. While exports in 2002 held to 2001 levels, coffee exports, a mainstay of the rural economy, continued to decline from the 1995 level of $25 million to just $2.6 million. Manufacturing exports fell from $100 million to $85.9 million, although this was still considerably above 1995’s $30 million. Imports were off by $77 million to $980.2
million, seven times the level of exports. US currency reserves dropped to $45 million, barely sufficient to cover two weeks of imports. Foreign investment undaunted by political instability rose slightly in 2002 to $99.1 million, more than double the 1995–1998 annual averages (Janet Matthews, 2004).

The budget deficit rose to 3% of GDP as taxes fell to just 5.3% of GDP, covering only 50% of government expenditures. The IMF in 2003 called for privatization of telecommunications and energy along with substantial infrastructure improvements. It would be difficult to imagine where the funds to accomplish any rebuilding would come from other than foreign aid, which in 2001 had fallen to $20.40 per capita from $43.40 in 1997, significant sums in a country where average wages are $1.20 per day (CIA, 2004).

MFIs and Banking in Other Countries

Microfinance institutions’ ability to attract capital is in part dependent on the stability of the country’s political climate (Campion & White, 2001). Sri Lanka’s experience of political unrest impinging on commercial development (Charitonenko & de Silva, 2002) could be instructive to countries like Haiti undergoing similar disruption. Indonesia also endured sectarian violence, but the government introduced enabling measures to assist in microfinance development (Afwan & Charitonenko, 2003). In Bangladesh, creating an MFI enabling environment is not the highest priority of a government that has been faced with occasional instability. Even so, government subsidies do contribute to enhancing the 41% of loanable funds that come from donations to MFIs (Charitonenko & Rahman, 2002).

Some countries, recognizing the lack of capital and banking services available to the poor, often encouraged and assisted the establishment of institutions. In the Philippines the Rural Banking Act of 1952 promoted the establishment of rural banks. The Central Bank of the Philippines (Bangko Sentral ng Pilipinas, BSP) provided free technical assistance and access to loans at preferential rates (Charitonenko, 2003). The way was open to entrepreneurs or cooperatives to own rural banks. That is not to say that Philippine
rural banking was always successful or that government assistance was not without a price. In the 1970s, BSP forced rural banks to act as a conduit for unsecured loans to rice farmers by threatening to fund new competitors if they did not cooperate. The loan program was a disaster, creating economic hardship and even bankruptcy for some rural banks. Similarly, Indonesia began deregulating the financial sector in the 1980s by liberalizing interest rates. The government has tried to strengthen the Central Bank since 1998 (Afwan & Charitonenko, 2003). Sri Lanka addressed the issues across several areas: the policy environment, the legal framework, regulation and supervision, money and capital markets, and support institutions. Sri Lankan government support was not always beneficial. Government subsidization and debt forgiveness significantly compromised movement toward best business practices and sustainable viability of the microfinance industry (Charitonenko & de Silva, 2002).

The governments of Bangladesh, Chile, Sri Lanka, and Indonesia directly subsidized microfinance lending for selected institutions, sometimes causing serious harm to those outside the orbit of such aid (Charitonenko & de Silva, 2002). In Chile, the focus of the subsidies was the country’s largest banks. MFIs were bypassed even though they had built a base of 81,000 loan clients over ten years. Quickly, the three largest banks attracted 70,000 microcredit clients (CGAP, 2001). NGO-established MFIs, locked out of the subsidization program because it was open only to regulated banks, eventually closed down. Many MFI employees ended up working for banks in their microcredit departments. While profitability was not up to the standards of other sectors of Chilean banks, efficiencies achieved by economies of scale aided by government subsidies made loans more available. More of the poor may have been assisted by the government subsidized expansion of microfinance lending in the end, but the process destroyed existing MFIs.

Since MFIs are costly to operate, the ability to set interest rates high enough to cover operating expenses is crucial to survival. Government laws capping usury rates can be restricted to regulated
institutions or in some cases extend to all lending institutions in the economy. In Nicaragua, where the microfinance industry has grown rapidly in both rural and urban areas, the legislature capped all loan interest rates at such low levels, reportedly at the behest of the commercial banks in the country, that the survival of microfinance organizations was threatened. Since the cost of administering small loans is higher for MFIs than the cost of administering larger sized bank loans, MFI profit margins are particularly susceptible to the imposition of interest rate caps. In 1986, ACP Group in Peru had become the largest MFI lender in Latin America with over $5.8 million in loans and better than nine thousand borrowers (Campion, Dunn & Arbuckle, 2001). To fight inflation, the government capped interest rates at 32% in 1987, an extremely unrealistic figure, as inflation rates climbed to over 7,000%. By the following year ACP’s loan portfolio was below $100,000 and two of its four branches had closed. Fujimori’s election led to reforms that lifted the usury cap in 1990. ACP expanded its loan portfolio to $6.8 million and 19,100 clients. Though inflation was also down, ACP still had to charge an effective annual interest rate of 125%. Without the ability to adjust interest rates, ACP would certainly not have been able to expand or possibly even survive.

**Progress and Challenges to MFI Transformation**

Ideally a country’s political and economic climate should nurture new financial institutions. Some specific legal and economic conditions that are seen as favorable to the growth and prosperity of financial institutions include the following:

- The elimination of policies that inhibit transformation, such as rate caps on commercial institutions.
- The elimination of government sponsored loan programs that undercut private and NGO sector loans.
- A legal system that allows for the creation, registration, and repossession of claims against borrowers.
- Banking supervision that both regulates and assists in the mobilization of savings.
The existence of both money markets for short-term credit and capital markets for longer term funds.

The existence of institutions or the ability to create institutions that compile credit information, credit rating, and collections agencies.

MFI trade organizations that provide training and technical support (Campion & White, 2001).

Favorable conditions did exist in Sri Lanka, so much so that microcredit saturation is reported to be around 80%. Some of these MFIs are at a fairly early stage of transformation. A few NGO-sponsored MFIs were attempting to transform, but most were economically unsustainable. There is limited involvement in microfinance by commercial banks. Government policies and interventions now discourage new entrants into microfinance and hinder the transformation of existing MFIs (Charitonenko & de Silva, 2002). Saturation of the microcredit market “Has led to many cases of over-indebtedness and appears to be undermining the primary incentive to repay . . . increasingly, clients appear willing to default . . . safe in the knowledge they can access the financial services from one of its competitors if follow on loans are not made available” (Wright, Christen & Matin, 2001). In Bangladesh, the government estimates that 45% of the population, or 12.2 million families, are poor. If this estimate is correct, the microcredit market is largely saturated, with MFIs reaching more than 70% of the poor households (Charitonenko & Rahman, 2002).

Bolivia was also fertile ground for MFIs. The number of microfinance lenders reached such high levels in the 1990s that borrowers began to obtain loans from one MFI to repay another (Rhyne, 2001). By 2002 as much as 34% of all Bolivian MFI loan portfolios were for borrowers with obligations at more than one MFI. Insolvency at some institutions and excessive debt burdens forced the government to intercede.

The tendency to subsidize interest rates to borrowers and to forgive loans during adverse weather conditions was perhaps the most inhibiting factor faced by MFIs in Indonesia as they moved
towards transformation (Afwan & Charitonenko, 2003). Sri Lanka was also hampered by government intervention, which had a chilling effect on organizations considering transformation to regulated status (Charitonenko & de Silva, 2002).

Many MFI boards and NGO sponsors are reluctant to consider transformation to regulated status, fearing that the founding mission of serving the poor will be lost in the pursuit of profits. Focusing on profits can raise the size of the average loan, effectively locking out the poorest of the poor. By contrast, mission drift may be low in semi-formal MFIs that are content with serving a localized market on a competitive basis (Charitonenko & de Silva, 2002).

Indonesia had a sound regulatory framework, but with lax enforcement MFIs circumvented regulations banning the use of savings deposits to finance loans. Indonesia lacks deposit insurance—there is no deposit insurance institution—and public savings have reached 70% of total bank assets, which makes the lending of deposits even more dangerous without appropriate supervision and control. Indonesia also lacks a Credit Information Bureau and like Sri Lanka lacks microfinance training centers (Afwan & Charitonenko, 2003).

MFIs in Sri Lanka overemphasized the social mission, which in turn curtailed progress towards transformation. In Sri Lanka there is a legacy of ad hoc debt forgiveness that damages the repayment culture. Sri Lankan cooperatives mobilized over 1 billion Sri Lankan Rupees (US$11.2 million), but an inadequate legal and regulatory framework places customers’ funds at risk. Most MFIs in Sri Lanka consider transformation to a regulated bank as the best survival option, but the high minimum capital requirement—500 Million Sri Lankan Rupees (US$5.6 million)—is likely to be difficult to meet (Charitonenko & de Silva, 2002).

In Indonesia, transformation has allowed large scale, sustainable microfinance outreach. Indonesian MFIs are averse to the term transformation and instead invoke the phrase greater business orientation. The more “business oriented” MFIs have a good record in reaching the poor and have not experienced significant mission
drift. However, MFI s have not had to deal with competition from new entrants.

Indonesia’s Bank Rakyat (BRI) is the largest microcredit institution in the world. It is also 100% state owned. Such market dominance can inhibit other MFI s from making the transition to regulated institutions that would entail greater scrutiny and reporting requirements. Only a few Indonesian NGOs have made efforts to formalize their microfinance activities. Prohibited from mobilizing savings deposits for use in loan portfolios, they set up credit unions to circumvent the law. Moslem religious prohibitions against usury are another impediment to lending practices in Indonesia. Here government-sponsored changes in the late 1990s to banking laws have paved the way to creative lending that accommodated the ban on charging interest (Afwan & Charitonenko, 2003). In the Philippines, restrictions on MFI access to mobilizing savings are more flagrantly violated. Many MFI s regularly loan savings, effectively challenging regulatory authorities to intervene (Campion & White, 2001).

In Peru, APC faced two choices when it considered transformation to regulated status in 1994. One choice, Financieras, required capitalization of $3 million, less than the second choice of the traditional full-service bank, but Financieras was restricted from offering savings accounts and other banking services (Campion, Dunn & Arbuckle, 2001). Later in 1994 legislation created a third alternative specifically designed for MFI s, the EDPYME, with an even lower capital requirement of $256,000. EDPYME organizations were to be a first step in a transformation process eventually leading to becoming a full service bank. Mobilizing savings deposits, however, was barred until the transformation was complete. The cautious step-by-step approach appealed to ACP until Fujimori, after attending a Microfinance Summit in 1997, proposed establishing a full-fledged microfinance bank in Peru. Rather than create a new MFI institution, Fujimori saw ACP, the largest MFI, with capitalization exceeding the $5.6 million minimum, as the logical choice. The new entity would also be permitted to collect passbook savings.
The Haitian Banking Sector

The National Bank of Haiti (BRH) was founded in 1880 but did not assume the role of a national bank until 1934 (U.S. Department of the Army, 1989). Since then it has had multiple roles, including the issuance of Haitian currency, the gourde. Under 1979 legislation, BRH gained authority to control credit, and to set interest rates and reserve requirements. It exercised that authority in the 1980s to implement conservative monetary policy requiring high reserves and low interest rates on loans made by the country’s commercial banks. This policy effectively limited credit availability, slowing the economy and curtailing inflation.

The bulk of banking profits were made on the spread between the interest rates banks could earn on their investments and what they paid out to depositors. With rates on deposits low, commercial banking was a money machine. In the 1980s imposed caps on loan rates made commercial bank lending unprofitable and undesirable, particularly when money could be made on the spread between rates paid and investment returns. Private-sector lending beyond the purview of banking regulation supplied loans at very high rates. The poor had access to loans only from loan sharks, who were often brutal in collecting overdue debts. It was not until the 1990s that NGO-sponsored microfinance institutions began making loans available to the poor. MFIs were unregulated and outside the imposed BRH rate caps, though not beyond a prohibition barring access to deposits for their loan portfolios.

MFI Players in Haiti

There are many microfinance institutions in Haiti (see Table 1) but none offers the type of services and geographical reach of Fonkoze. With branches in outlying rural areas, where 95% of its clients are located, Fonkoze serves the rural poor as a lender and as a deposit institution, though those deposits are eventually transferred and held by commercial institutions. Fonkoze’s average loan size is well below average loans provided by other Haitian MFIs (Table 1) because of its dedication to serving the poor. Remittance services,
i.e., money transfers from outside Haiti done affordably, as well as foreign exchange services are not found at other MFIs.

In the early 1990s Haitian bank regulators removed interest rate caps, motivating three commercial banks to offer microfinance loans (Gonzalez, 2001). As in Chile, commercial banks were building on the success of NGO-backed MFIs, but unlike in Chile, the only help from the government was the lifting of interest rate caps to create a level playing field. With 80% of Haiti’s workforce self-employed (CIA, 2004), the market for small loans is large. The sophistication of borrowers, however, is limited, as it is in Sri Lanka or Indonesia.

Legislation that removed interest rate caps from commercial banks and lowered equity requirements opened the way for large scale commercial lending as well as the expansion of commercial banks into microfinance (Accion International, 2000). In 2000, following these reforms, Sogebank, a major commercial bank, created Sogesol as a joint stock company to be its entrant in the microfinance market. Sogesol planned to rely on Accion International for advice. Profits were to be the focus of Sogesol business—not an unusual focus for a commercial bank but somewhat different from the typical orientation of NGO-supported MFIs that emphasized social benefits (Gonzalez, 2001). Another departure from NGO-run MFIs was Sogesol’s collateral requirement. Loans would only be made to borrowers able to pledge

<table>
<thead>
<tr>
<th>Institution</th>
<th>Outstanding portfolio</th>
<th>No. of active loans</th>
<th>Average outstanding balance</th>
<th>Interest rate (monthly)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACME</td>
<td>US$1,432 mil.</td>
<td>4283</td>
<td>US$334</td>
<td>3% flat + application fee</td>
</tr>
<tr>
<td>FHAF</td>
<td>US$1,431 mil.</td>
<td>2951</td>
<td>US$484</td>
<td>N/A</td>
</tr>
<tr>
<td>FONDESPOIR</td>
<td>US$1,126 mil.</td>
<td>3645</td>
<td>US$308</td>
<td>N/A</td>
</tr>
<tr>
<td>FONKOZE</td>
<td>US$1,128 mil.</td>
<td>10000</td>
<td>US$113</td>
<td>3% + application fee</td>
</tr>
<tr>
<td>BUH</td>
<td>US$2,349 mil.</td>
<td>3000</td>
<td>US$783 (US$1500 in Port-au-Prince)</td>
<td>3% flat + application fee</td>
</tr>
<tr>
<td>SOGESOL</td>
<td>US$2,197 mil.</td>
<td>5522</td>
<td>US$366</td>
<td>3%, 5% flat + application fee</td>
</tr>
<tr>
<td>MCN</td>
<td>US$3,152 mil</td>
<td>2500</td>
<td>US$1260</td>
<td>5% declining balance + application fee</td>
</tr>
</tbody>
</table>

Source: Microfinanza Ltd. 2002 and Fonkoze
collateral, which could include appliances, beds, or other household goods. Collateral requirements have locked the poor out of capital markets in the past, i.e., commercial bank loans. Borrowers with collateral are not the poorest of the poor, making Sogesol’s clientele only slightly down market from Sogebank’s clients but unlike many of Fonkoze’s clients who lacked collateral, particularly first-time borrowers. In its first year, Sogesol had 700 clients. Sogesol’s client base rapidly expanded to over 5500 clients, with a loan portfolio just under $2.2 million. While Sogesol was effectively a regulated MFI, the fact that it attained this status because it was a joint stock company owned by an already regulated commercial bank, Sogebank, did not offer any guidance or procedures that BRH could follow in reviewing Fonkoze’s application for regulated status.

Established in 1999 as a joint stock company, Micro Credit National (MCN) is 50% owned by Haiti’s number two bank, Unibank S.A., and the remainder is held by three NGOs (IMI, 2003). Loan sizes are large by MFI measures, averaging $1,000, though MCN also has low end loans and high end loans up to $20,000. Operations are in Port-au-Prince and ten other cities, with 36 loan officers. As of 2002, MCN’s loan portfolio was over $3.5 million and its clients numbered 2500.

In 1997 with assistance of loan guarantees from USAID, Banque de l’Union Haitienne, a commercial bank, established a microfinance subsidary BUH to provide microcredit to the poor (USAID, 2003). By 1999 BUH had 14 branches, including 8 outside of Port-au-Prince. BUH’s loan portfolio in 2002 was over $2.3 million, with 3,000 active loans. Forty percent of BUH’s loans are in the Port-au-Prince market and the average loan is also at the higher end: $1500 in Port-au-Prince and $783 elsewhere.

Association pour la Cooperacion avec la Micro (ACME) is an NGO-operated MFI founded by a Belgian professional in 1997 (Microfinanza, 2002). Like Fonkoze, ACME is registered as an association in Port-au-Prince. Since it is not a regulated financial institution and is not owned by a commercial bank, it has limits on its sources of funds. It has managed to borrow from commercial
banks, which insist on 100% equity to back loans to ACME. With such loans composing the bulk of its funding, leverage to grow the loan portfolio is limited. Bank loans also charge interest rates of 18–24%. To make up for these high rates and the high cost of doing business, effective annual rates on ACME loans were 74–83% in 2002 (Microfinanza, 2002). Rates consisted of a flat 3% monthly rate plus fees. Borrowers seeking loans do not have to pledge collateral but they do need a fixed residence, a business that has been in operation for six to nine months, and a loan guarantor who is not an ACME client and who has an annual income at least triple the loan amount requested. Nearly all loans are for six month periods, averaging just over $500 in 2002. ACME puts a $2,000 cap on loans. Twenty-four loan officers administer loans. Loans are made on a commercial bank account from which borrowers withdraw money by ACME-issued check and to which borrowers make deposits as payments. Clients perceive ACME as being friendlier than banks and its staff as motivated and qualified. ACME provides no other services, such as training in business practices or literacy, both provided by Fonkoze. Incentives paid to loan officers succeeded in lowering an 18.7% PAR (portfolio at risk) in 2000 to just 4.48% in 2002. But the tilt of the incentives toward larger loans also resulted in 50% of the PAR being concentrated in smaller loans. Collecting on bad loans is a slow and tedious process due to inefficiencies within the Haitian court system, but ACME has managed to collect on over 20% of the loans it writes off. In 2002 ACME had a loan portfolio of $1.4 million and over 4300 active loans (Microfinanza, 2002). It has also managed to attain sustainability; revenues exceeded costs in both 2001 and 2002. ACME recognizes the advantages of becoming either a cooperative or a commercial bank but does not have plans to pursue regulated status in the immediate future.

Interest rates on loans may be stated on a rate per month basis but a hidden aspect of these loans that makes them less comparable is the principal to which the interest rate is applied. Sogesol’s 3% monthly rate appears comparable to Fonkoze’s loan rate (Table 1) but it is considerably higher. Sogesol borrowers repay principal
over the course of the loan installments but the interest they continue to pay is on the initial amount borrowed. It is not interest on the declining balance, typical of installment loans. Fonkoze borrowers pay interest only on the declining balance. For example, assuming both Sogesol and Fonkoze charge the same application fee and the total loan is $500 for six months at 3% per month, the effect of Sogesol applying interest to the initial amount borrowed for the entire six-month period and collecting equal installments results in monthly payments of $98.33 versus $92.30 for Fonkoze’s loan. Sogesol’s actual monthly rate is 4.94%, which approximates the 5% rate charged by MCN on declining balances.

The launching of a new MFI trade organization in Haiti, DAI/FINNET, is a positive development. DAI/FINNET has begun to keep track of borrower credit information. One difficulty in compiling such information is that the poor often lack proper addresses. Note that one of ACME’s requirements is that borrowers have a residence with a fixed address.

**Fonkoze: Planning a Commercial Transformation**

Making the transformation in Haiti is more of a challenge than in many other developing countries. Haitian capital markets are nonexistent, the legal system is in tatters, and BRH is largely without the means to properly supervise and regulate. In Haiti, the lack of infrastructure makes normal business decisions risky. If the judicial and supervisory agencies were functional, the governor of the Central Bank would provide a list of instructions to the applicant MFI, which would guide the process through transformation.

MFIs seeking other avenues to access savings could have considered becoming cooperative banks. In 2000, *Caisses Populaires* (CP) or savings cooperatives began expanding in Haiti. Government regulation created a boom in this banking segment with a 2001 anti-money-laundering law that forced drug money from commercial banks into less regulated CPs (Microfinanza, 2002). Competition for deposits heated up, with promised interest rate of 10–12% per month, much higher than annual rates offered by commercial banks. CP deposits reached $200 million. The pyramid
scheme imploded when the volume of savings inflow slowed after the rush to move drug money into CPs. Soon interest rate payments halted and CPs limited withdrawals. Rioting and even burning of CPs followed. The government was forced to pay off some of the deposits but the reputation of cooperatives was tarnished. This black mark against savings cooperatives effectively eliminated such a transformation alternative for Fonkoze.

With Haiti under siege internationally in 2001 and aid cut off following the parliamentary elections of 2000, just when Fonkoze began pursuing transformation, it was unlikely that Aristide could have undertaken an MFI transformation initiative. Transformation to become a regulated bank would have to be proposed and managed by Fonkoze and BRH. On May 28, 2001, Fonkoze wrote to Gustave Flaubert, Haitian Minister of Finance and Economy; Fritz Jean, Governor of the Bank of the Republic of Haiti; and Staley Theard, Haitian Minister of Commerce and Industry, proposing a transformation to a commercial bank. The new entity would be a stock company, with 40–49% owned by the foundation currently managing Fonkoze. A minimum of 51% of the stock would be owned by Haitians. Dismissing the idea of becoming a cooperative in the letter, Fonkoze proposed a gradual process. First it would become a provisional commercial bank, with $500,000 deposited in escrow. Fonkoze would seek further funding to achieve full status as a commercial bank, with $3 million in equity.

Fonkoze reorganized itself into the Fonkoze Foundation and Bank Fonkoze. There would be two distinct boards. The funds that Fonkoze USA raised for the bank were turned over to a new entity, Fonkoze LLC. Through a private offering memorandum, Fonkoze LLC would in turn invest in Fonkoze SA, a holding company that would control the regulated Bank Fonkoze. With $2.5 million in funds raised, more than any prior Haitian bank had raised at startup, Bank Fonkoze was well financed.

Fonkoze’s 2003 application for transformation to regulated status languished in the waning months of the Aristide regime. In 2004 Fonkoze management discovered that the application was dismissed in an August 2003 BRH report which questioned the
capitalization of the proposed bank. The report was never delivered to Fonkoze. The negative report revealed a basic misunderstanding of the complex structure of Fonkoze. Although Fonkoze was well capitalized, the main objection voiced in the report to moving forward with regulated status was doubt about Fonkoze’s ability to honor its obligations in the event of financial failure.

Fonkoze’s board of directors, frustrated with the lack of progress, considered an alternative strategy that would provide legal access to savings deposits. MFIs in the Dominican Republic similarly barred from using savings deposits in their loan portfolios had found a way to circumvent banking regulation. They accessed savings by creating a new debt instrument to “sell” to the public. MFIs issued notes instead of deposit slips as a form of acknowledgement of the receipt of funds. Would-be depositors became creditors loaning money to the MFIs at fixed interest rates. The MFIs could then legally use these “borrowed” funds to finance their loan portfolios.

With the departure of Aristide and the installation of Acting Prime Minister Latortue, the possibility of moving forward with regulated status was reopened. Latortue was known to be favorably disposed to MFIs—his daughter was an official with the Consultative Group to Assist the Poor (CGAP). In May of 2004 Latortue assured Fonkoze that bureaucratic stumbling blocks would be removed. However, it soon became apparent that the new administration and BRH had many other pressing issues to address, relegating Fonkoze’s application to further delay.

The board pursued the option of using a credit instrument with which to turn deposits into loans. A new entity, Fonkoze Financial Services (FFS), was created to supercede Fonkoze Bank as an interim step toward becoming a regulated bank. It was to handle the new credit instruments. There would need to be training sessions for Fonkoze employees and new forms and procedures would need to be designed. Following legal advice, Fonkoze conferred with BRH and explained their intention of using credit instruments instead of deposit slips. BRH was amenable to the change but went further with a simpler solution. Each existing depositor
was simply to sign an agreement granting permission to Fonkoze to manage their savings. The process of gaining access to deposits would not only be streamlined, it would effectively be approved by BRH.

Prior to transferring funds from Fonkoze LLC to FFS, LLC investors asked that a pilot project be run at two rural branches and at a branch in Port-au-Prince. The change would be explained to depositors and they would be asked for written approval. Rural depositors were unanimous in their approval, while 85% approved in Port-au-Prince. The lower approval rating in Port-au-Prince was mainly because some depositors were unable to consider the proposed change, due to time constraints. Fonkoze LLC authorized conversion of the MFI to FFS, which would serve as a transitional entity. The $2.5 million raised and currently in escrow in the US would be released to Fonkoze LLC and eventually to FFS. Fonkoze would effectively obviate the urgent need to transform into a regulated bank.

FFS was not required to adhere to banking regulations since it would not be a regulated bank. Fonkoze’s board, however, continued to focus on the need for best practices. Planning for a future transformation, the board mandated that the new entity act as if it were regulated and meet BRH standards as well as international standards under the Basle accords. BRH standards required 31% of deposits be held as reserves. The only exception to strict adherence to BRH regulations would be that FFS would keep the 31% reserves in dollars and deposits in US banks rather than in Haitian currency on deposit with BRH.

Fonkoze has been reconstituted into two separate entities. The first entity is a continuation of the original foundation, which will continue to provide educational programs for new borrowers and serve as an incubator for new branches by financing and operating them. A subset of the first entity will manage cooperative agricultural loans. Cooperative agricultural loans are a relatively new product in Haiti. Haitian farmers have been encouraged and given help to grow crops for export, but there was no existing entity to purchase those crops and aggregate shipments. The agricultural
cooperatives lacked funding to carry-over the several month period between buying crops from farmers and receiving payments from outside the country. Fonkoze entered into the business of providing loans to agricultural cooperatives, initially with a loan guarantee program sponsored by USAID. That guarantee program expired without any guarantees being invoked. The foundation will continue to provide cooperative loans. The second entity, FFS, will operate the established bank branches and manage savings deposits, foreign remittances, and foreign exchange. Small business loans, which are typically longer-term, for larger amounts, and with men being the predominant clientele, will be managed by FFS.

Fonkoze has used the Grameen model (Grameen, 2004) in organizing its borrowers into solidarity groups of four or five clients. Under the Grameen model between 1996 and 2001 there were 601 NGOs operating as MFIs in Bangladesh. The loan recovery rate had reached over 95% in 2001. There were over 8 million borrowers and over 11 million active members in Bangladesh (Charitonenko & Rahman, 2002). Fonkoze clientele lack collateral; relying on solidarity groups for social collateral, as Grameen does, creates incentives to make payments. Solidarity groups centralize contact between credit officers and clients. The ability of loan officers to meet with large groups of clients makes for greater efficiency. Currently loan officers service 320 clients. Postregulatory projections anticipate that experienced credit officers could oversee thirteen centers consisting of a maximum of 520 clients. Fonkoze’s fully operational small branches typically include a manager, two credit officers, two cashiers, two security guards, and one custodian. Managers are expected to handle up to 200 clients in addition to other tasks.

Banco Solidario in Bolivia was an MFI that employed group-based lending exclusively prior to becoming the first MFI to make the transition to a regulated institution. Bolivian MFI lending quickly evolved toward individual loans, which in 2000 composed 78% of loans, up from just 41% in 1997 (Rhyne, 2001). Fonkoze began with group loans and until recently they composed 90% of lending activity, mainly to groups of entrepreneurial women.
Solidarity groups went through education and literacy programs together and borrowed together, albeit for different individual needs. Graduates from solidarity groups were eligible for individual loans. Graduates have successfully completed the second phase of Fonkoze's business training program and have previously repaid all their loans on time. It is likely that individual loans will make up an increasingly greater portion of Fonkoze's portfolio.

Becoming a regulated bank can often mean larger, more profitable loans and mission creep away from an emphasis on serving the poor. Fonkoze's strategy to avoid this is to leave the more charitable, not-for-profit operations to the Foundation. The poor will continue to be served and perhaps served even better. One new Foundation-based program will provide loans to poorer women not currently served by Fonkoze. The requirement for a savings account will be postponed and dues will be paid over the course of time. Loans will be made to solidarity groups in smaller sums and the women will receive basic literacy and educational services.

**Conclusion**

The following continuum describes typical MFI progress toward transformation:

- Adoption of a professional, businesslike approach to MFI administration and operation.
- Progression towards operational and financial self-sufficiency.
- Use of commercial sources of funds.
- Operation as a for-profit formal financial institution subject to regulation and supervision (Afwan & Charitonenko, 2003).

Fonkoze has attained a professional and businesslike approach. It has been hampered from moving toward the second phase of transition, sustainability, because of a lack of access to savings deposits and the need, defined by its mission, to provide social welfare programs. To continue to provide social welfare programs and attain profitability, Fonkoze's board came up with a plan to divide Fonkoze into two entities: the original foundation that would
focus on welfare programs and seek funding through donations and a bank that would eventually attain regulated status.

Turmoil in Haiti and a lack of understanding of the complexity of Fonkoze’s tiered structure resulted in delay and denial of the initial plan to become a fully regulated institution, even though funding requirements were met. Fonkoze devised another plan that would create a transitional entity, Fonkoze Financial Services (FFS), which would circumvent the government ban against non-regulated institutions loaning savings. FFS was approved by BRH. Savings would be considered “loans” to Fonkoze by depositors and as such would then be legally available for its loan portfolio. Not only did BRH approve of the plan, it suggested speeding up the process by simply obtaining approval from current depositors to allow FFS to manage their money.

FFS is a transitional vehicle which will conduct business as if it were already a regulated institution while preparing for the final transformation into a commercial bank. That final transformation will be delayed until a more stable political situation develops in Haiti. While this is not a predictable and smooth progression toward attaining transformation, as has been accomplished in other countries, Fonkoze has taken the first step to move through the transformation continuum as quickly as the political situation allows. FFS will for all intents and purposes function as if it were a regulated bank.

References


