Lessons in Microfinance Downscaling: The Case of Banco de la Empresa, S.A.

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Abstract

Few commercial banks have engaged in profitable microfinance lending despite repeated attempts by donor agencies to entice their entry. The case of Banco de la Empresa, a Latin American private bank whose identity has been disguised in this publication, illustrates how penetration of the microenterprise market segment could evolve. As of December 19x11, this bank had total assets of approximately US$50 million and a microfinance loan portfolio of approximately US$4 million, which generated more than 50 percent of the bank's net earnings. Between 19x10 and x11, the bank accessed a line of credit and subsidized technical assistance provided by the Inter-American Development Bank to further build its microlending program. This paper reviews the bank's experience with microfinance, what its motivations were for starting such a program, what adjustments it made in operating procedures and what risks the program faced.

The main lessons learned from the experience are: (1) starting and sustaining a microfinance program requires committed and visionary leadership; (2) profit must be the principal motivation, not social image enhancement; (3) successful microfinance operations require a different set of operating procedures, extensive investments in appropriate information technology, training, staff incentives, a wide network of bank branch offices and a schedule of hours of operation that are convenient for low income clients; (4) careful consideration must be given to how to structure and organize a microfinance program (e.g. as a fully integrated product, a division, or a subsidiary) within a commercial bank; and (5) managers need to focus on operational efficiency and delinquency control, not solely on profits, because profits can mask problems, especially in a noncompetitive environment.

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Introduction

Banco de la Empresa S.A. (Enterprise Bank), a real but disguised, privately owned, Latin American commercial bank with total assets of approximately US$50 million as of January 19x12, was the principal participant in an Inter-American Development Bank (IDB) financed line of credit. This operation was designed to encourage private banks to attend the microenterprise sector in a country called Nueva Segovia.[1] Between 19x9 and 19x12, the Banco de la Empresa had more than tripled its micro and small loans. As of early 19x12, it had extended more than 4,000 loans valued at US$3.8 million. Moreover, the microenterprise program contributed disproportionately to the bank's net earnings though the microenterprise portfolio constituted only 12 percent of the total loan portfolio. Unfortunately, complete data were not available for a range of years and much of microenterprise's disproportionate contribution to earnings may have been due to corporate bank weaknesses.

This experience was unlike those of other IDB line of credit operations, commonly referred to as Microenterprise Global Loans, which are aimed at increasing the sustainable flow of financial resources to the microenterprise sector through involvement of formal, regulated financial institutions.[2] In the 10 other Microenterprise Global Loans executed to date, non-banks, namely finance companies, have tended to be more active participants than commercial banks, despite the stated intention of enticing private banks to build and sustain microlending programs.[3] Banco de la Empresa started to intermediate microenterprise loans without recourse to the IDB external line of credit and stopped treating microenterprise lending as an experimental product. Bank management mainstreamed microenterprise lending and came to see it as an important new market in an increasingly competitive and crowded corporate banking market. Microlending became the most profitable and fastest growing line of activity. Despite its overall positive experience with microlending, Banco de la Empresa still has to improve delinquency management, operational efficiency and

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[1] The line of credit operation called a Microenterprise Global Loan began in July 19x9. Between 19x10 and March 19x12, Banco de la Empresa S.A. has used US$2.35 million of an available US$2.5 million to rediscount micro and small loans, valued at less than US$5,000 each. Microenterprise is defined as a business entity with less than 10 employees and a microloan as being less than US$5,000. The other commercial bank participants in the Microenterprise Global Loan were Interban and Banco Sólido. Confianza and Bannexus expressed interest and received staff training but never accessed the line of credit.

[2] This particular MicroGlobal program permitted participating regulated financial entities to discount 70 percent of the total individual microloan made through a second tier bank at a cost equivalent or slightly above the marginal cost of funds in the country. The second tier bank assumed the foreign exchange (FX) risk and the individual regulated financial entities assumed all of the credit risk. The line of credit enhanced the supply available for the sector, reduced funding risk, and was coupled with training and technical assistance in how to run microfinance operations. In other MicroGlobal programs, the foreign exchange risk was either transmitted to end users or the first and second tier banks created a swap wherein MicroGlobal dollar funds were on-lent to commercial customers willing to assume the FX risk while local deposits were used to finance the microfinance portfolio.

[3] See "1996 Annual Report on the Portfolio Management: Microenterprise Global Operations," Inter-American Development Bank, July 1997.

information management before it can be deemed an unqualified microfinance success story.

A series of questions arise for supporters of microfinance. Why has this commercial bank embraced microlending while other banks in the same environment have not? How has its microenterprise lending program performed? Lastly, what lessons does this experience hold for other commercial banks?

IDB's Evolving Support for Microfinance

A handful of Latin American and Caribbean private commercial banks provide microfinancial services to micro and small business owners and the working poor.[4] Insufficient and insecure collateral give the perception of high risk. Prohibitive per-unit transaction costs using traditional technologies and lack of familiarity with a low-income client base tend to limit commercial bank microlending and small savings mobilization activities. The IDB and other donors attempted to expand commercial bank involvement in microlending, primarily through lines of credit, guarantee funds and bank staff training programs. This began in the mid-1980s, as the donors realized the potential size of the market and the implications for economic growth and equity. The IDB´s support for microfinance was implemented first through *upgrading or transforming non-governmental organizations (NGOs)* into regulated for-profit financial institutions and later through *commercial bank downscaling*.

NGO Upgrading and the IDB: Since 1978, the IDB has aggressively supported and promoted microenterprise development as a means of increasing income among marginalized groups and generating employment through a program of concessional loans, called Small Projects.[5] Several non-regulated intermediary institutions which benefitted from the program grew, matured and sought a more permanent and stable source of capital to expand lending activities. In the 1990s, several non-governmental organizations (NGOs), active in microfinance, began the process of conversion into regulated financial entities. A few notable examples of IDB-supported NGOs which transformed into regulated financial entities include Prodem to BancoSol in Bolivia, Ademi to BancoAdemi in the Dominican Republic and Ampes to Financiera Calpía in El Salvador.

The advantage of this strategy, commonly

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[4] A tentative but incomplete list for Latin America was compiled by Liza Valenzuela of USAID and distributed through the DevFinance Internet Newsgroup on September 9, 1997. Registered banks include Bolivia: BancoSol; Brazil: Banco Regional do Brasilia; Costa Rica: Banco Popular; Chile: Banco del Desarrollo, Banco del Estado; Colombia: Caja Social; Dominican Republic: Banco Ademi; El Salvador: Banco Agrícola Comercial; Guatemala: Banco Empresarial; Guyana: Bank of Nova Scotia; Haiti: Unibank, Bank de L'Union; Jamaica: Workers' Bank; Mexico: Bancomer; Panama: Multicredit Bank, Banco Mercantil; Perú: Banco Wiese, Banco de Crédito, Banco Latino; and Venezuela: Banco Real. Permission was requested and granted to cite this list. See Baydas, et. al., (1997).

[5] The Small Projects Program consists of IDB loans with a maximum size of US$500,000 with 40 year terms, 10 year grace periods, and 1 percent interest rates. Between 1978 and 1997, 429 small projects have been approved and executed, summing approximately to US$138 million. The typical recipient is either a non-governmental organization or cooperative, on-lending the funds to low income producers active in agriculture, handicrafts, commerce, services, and small- scale industry.

called “upgrading,” is that the leadership of the institutions and principal investors are very committed to the sector. These institutions retained staff familiar with the client base and the productive sectors in which they operate. The disadvantage of the approach is that it is a painstakingly slow and costly process. The investments needed in information technology, the change in “corporate culture” from one dominated by “do gooders” to one of “financiers” and the necessity of overcoming the minimum capital barriers established by law can be formidable. As a result, only a fraction of the many non-governmental organizations are successful in transforming themselves into regulated financial entities.

Commercial Bank Downscaling and the IDB In 1986, the IDB launched a pilot program in Colombia which established a rediscount line of credit through the Central Bank to commercial banks. This program on-lent to micro and small entrepreneurs to entice commercial banks to attend the target sector by proving that microlending could be profitable and sustainable. Central features of the program were: (1) a move away from collateral based lending to reputation based lending; (2) assumption of credit risk by the intermediary; and (3) technical training in appropriate microfinance technologies.

In 1990, the program was formalized and launched region-wide as the Microenterprise Global Loan Program. Its objective was an increase in the flow of financial resources to the microenterprise sector through viable and sustainable intermediaries.

The advantage of this strategy, commonly called “downscaling” because banks extend their reach to smaller scale clients, is that commercial banks have the ability to capture deposits, make investments, and attract shareholder equity. Banks also enjoy economies of scale by virtue of branching and centralized computer-based information processing. For these banks, microfinance could represent a profitable new area of activity and may offer some diversification benefits as well.

The disadvantage, however, is that commercial bankers tend to be uncomfortable with the high risk present in microlending and must be persuaded. To succeed, they need training in appropriate microcredit technologies, new products, a different type of staff and knowledge about the characteristics and demands of a new client segment.

Between 1990 and 1996, the IDB approved 13 MicroGlobal Programs totaling US$234 million. In the more successful and fully disbursed loan programs, non-banks, namely finance companies or *financieras*, have participated more actively than commercial banks.[6] Why is this so, despite the stated intention to entice commercial banks to lend more to the sector? Is it due to the to the fact that finance companies have mastered doing a high volume of small transactions, or is it due to bad pricing in donor designed downscaling programs, inadequate training, or unacceptable risk levels? By studying the

[6] Two of the more successful MicroGlobal Loans were made to Paraguay and El Salvador. In Paraguay, Financiera Familiar used more than 55% of the line of credit and in El Salvador Financiera Calpía used more than 60% of the line of credit. The latter finance company grew out of an NGO dedicated to microfinance. Successful MicroGlobal programs are marked by a combination of rapid draw down of the line, high outreach indicators, low loan average sizes, low delinquency, and institutionalization of microfinance lending as indicated by use of own deposit resources after the end of the line of credit.

example of Banco de la Empresa, a Latin American commercial bank whose identity has been disguised, an exception to the norm, we hope to offer some answers to these questions.

Objectives of the Case Study

This case study addresses the following issues related to the development and future of microfinance operations within Banco de la Empresa and the possibility of replicating the experience in other institutions:

What motivated Banco de la Empresa to participate and become convinced that microlending is an attractive business proposition?

What adjustments in regular banking operations were needed to build a successful microfinance program?

What are the future challenges to consolidating microenterprise lending within the bank?

What lessons can be gleaned from the experience that could help increase the participation of commercial banks in similar donor-initiated **"downscaling"** exercises?

Nueva Segovia, our disguised country, provided an interesting case because all the participants in the MicroGlobal Loan were commercial banks and faced the same macroeconomic shocks as well as program design and administration elements. In most other countries only a few commercial banks participated in MicroGlobal loan programs. The analysis of Banco de la Empresa may reveal and help predict the circumstances under which other commercial banks might enter the field.

The paper is organized in the following manner. An overview of Banco de la Empresa will help explain the context of the microfinance program. Subsequent sections explore the evolution of the microlending program, analyze the performance of the microfinance portfolio, and finally, the lessons drawn and recommendations about promoting and undertaking commercial bank "downscaling."

Overview of Banco de la Empresa

Banco de la Empresa was founded in the late 1970s with a mission to serve the retail and service sectors in the country. Most of its lending was for commerce (29.4%), and tourism and other services (30.3%). Industrial, housing and agricultural lending comprised smaller portions of the total portfolio, 16%, 13%, and 11%, respectively. In the 1990s, the Bank grew aggressively. As of December 31, 19x11, Banco de la Empresa was ranked twelfth out of forty-six banks in the country's financial system with US$50 million in total assets. The bank more than doubled its lending capacity from US$14 million in 19x6 to US$38.5 million in 19x11. The same is true for savings which increased from US$13.9 million to US$28.3 million.

Banco de la Empresa at a Glance

Banco de la Empresa, S.A. was founded in the late seventies by a small group of industrialists. In the mid eighties, a holding company was formed called Corporation BanEmpresa, S.A. The holding company has nine subsidiaries of which the largest and most important is Banco de la Empresa. In addition to the full service bank, other subsidiaries include a securities brokerage firm, a credit card company closely affiliated to Banco de la Empresa, an off-shore bank registered in Panama, a bonded warehouse, a real estate company, a leasing company, a factoring company, and an insurance company.

Brief History and Structure of the Bank

The bank has the typical corporate structure of governance: a seven-person board elected by the general assembly of shareholders with a General Manager responsible for day-to-day operations. The General Manager is assisted by a management team composed of seven managers: a Deputy Manager, an Operations Manager, an International Manager, a Manger for Coordination of Agencies, a Credit Manager, a Deposits Manager, and an Administrative Manager. The bank has 220 employees and nine offices: the headquarters in downtown Santo Tomás and eight other branches. Río Blanco and Bahía branches are in the greater Santo Tomás metropolitan area and the remaining six are in provincial cities.

Financial Performance of the Entire Bank

Assets and Portfolio: Over the last five years, the bank doubled its assets from US$23 million to US$50 million. The loan portfolio, on average, accounts for 68% of total assets. Cash and bank deposits plus short term investments represent almost 20% of total assets. The rest are distributed between fixed assets and long term investments. The total loan portfolio, for the last three years of available data, remained fairly constant around US$37 million. Despite the asset growth, especially in the early 1990s, the quality of the portfolio is less than desirable. The 30-day delinquency rate was 8.34% at the end of 19x11.

Table #1

Asset Structure

(Thousands of US dollars and Percentage Distribution)

	19x6	19x7	19x8	19x9	19x10	19x11
Cash	1,746	2,510	3,983	5,887	6,895	6,233
Temp.Investments	4,638	5,004	7,669	6,135	6,622	1,476
Net Loan Portfolio	14,087	23,142	32,404	38,971	36,640	38,504
Other Assets	2,664	3,276	5,218	2,308	2,722	4,065
TOTAL ASSETS	**23,135**	**33,932**	**49,274**	**53,301**	**52,879**	**50,278**
Cash	8%	7%	8%	11%	13%	12%
Temp.Investments	20%	15%	16%	12%	13%	3%
Net Loan Portfolio	60%	68%	65%	73%	69%	77%
Other Assets	12%	10%	11%	4%	5%	8%
TOTAL ASSETS	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Table # 2

Liabilities and Equity Structure

(Thousands of US dollars and Percentage Distribution)

	19x6	19x7	19x8	19x9	19x10	19x11
Deposits	13,966	22,751	30,562	33,125	28,879	28,364
Financial Borrowings	3,734	4,517	10,735	12,934	15,792	15,193
Other Obligations	746	1,411	2,052	781	348	374
TOTAL LIABILITIES	18,446	28,679	43,349	46,840	45,019	43,931
Equity	4,689	5,253	5,925	6,461	7,860	6,347
LIABILITIES AND EQUITY	**23,135**	**33,932**	**49,274**	**53,301**	**52,879**	**50,278**
Deposits	60%	67%	62%	62%	55%	56%
Financial Borrowings	16%	13%	22%	24%	30%	30%
Other Obligations	3%	4%	4%	1%	1%	1%
Equity	21%	16%	12%	11%	14%	13%
LIABILITIES AND EQUITY	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

During the study period, Banco de la Empresa had a high percentage of assets in cash and bank deposits, perhaps to maintain flexibility or cover client withdrawals. Compared to other banks within the financial system, the bank's liquidity level was high. As shown by its liquidity ratio, it was not only high, but fluctuated significantly, especially during the last three years, from 25% in 19x9 to 30% in 19x10 and to 18% in 19x11. The average liquidity ratio for the entire financial market in same period was 17%. See table of financial indicators in Annex 5 for more details.

Liabilities and Equity: During the period 19x6 to x11, liabilities increased from US$18.4 to US$43.9 millions and equity increased from US$4.6 to US$6.3 million. Equity represents on average 15% of total assets. In the last year of available data, the average ratio of liabilities over total assets was 85%, while the average for the entire commercial bank market was 81%. This suggests Banco de la Empresa had a slightly lower percentage of equity compared with other banks. However, liabilities increased as did borrowings from other financial institutions, while deposit mobilization declined slightly. Financial obligations grew from US$3.7 to US$15.1 million, while deposits for the last three years decreased from US$33.1 to US$28.3 million. The higher dependency on borrowing as opposed to deposits, tends to increase the cost of funds, implying that either higher lending rates and/or cuts in operational expenses are needed to maintain profit margins. For the study period, leverage (average total assets/average equity) trended upward.

Earnings Performance: Bank *profitability* had an upward trend before 19x11. Between 19x6 and 19x10, almost all indicators rose. Net income went from US$652,000 to US$1.3 million. The average return on equity (ROE) (net income/average equity) from 19x6 to 19x10 was 13.9%, which is higher than the average for the entire financial system (12.7%). In 19x11, Banco de la Empresa's ROE dropped to 2.8% because net income fell to US$189,000 in the same year. Significant increases in personnel and infrastructure costs, occasioned by the opening of new branches, combined with declines in interest income and other financial income, caused the drop in net income.

Total Financial Income grew significantly from 19x6 to 19x10 from US$5.3 to US$15.7 million but dropped in 19x11 to US$12.7 million. The Bank's ratio of financial income/total income was 86% which is 4% higher than the average for the market.

Total Financial Expenses grew from US$4.7 to US$12.4 million from 19x6 to 19x10 and then fell to US$10.2 million in 19x11. Financial expenses stemming from deposits increased as well from US$3.6 to US$8.8 million but dropped during 19x11 to US$7 million. Concurrently, financial expenses due to borrowing from others grew from US$1.1 in 19x6 to US$3.1 million in 19x11. The ratios measuring profitability and operational efficiency of the bank for the most part during 19x6 to 19x10 were close to the market average. All the ratios for 19x11 declined vis-a-vis market averages. The reason for the drop in 19x11 stems largely from a sharp decline in other financial income, including fees on letters of credit, wire transfers, safe deposit boxes and transfers from subsidiaries (see Table 5, page 18).

Table 3

Income Statement

(Thousands of US Dollars and Percentage Distribution)

	19x6	19x7	19x8	19x9	19x10	19x11
Interest Income	5,350	6,370	8,219	12,364	15,797	12,760
Interest Expense	4,782	4,869	6,480	9,830	12,441	10,204
Net Interest Income	*568*	*1,501*	*1,739*	*2,534*	*3,356*	*2,556*
Other Income	1,623	1,293	1,641	1,148	1,307	1,452
Administrative Expenses	1,539	2,037	2,220	2,654	3,357	3,819
Net Operational Income	*84*	*(744)*	*(579)*	*(1,506)*	*(2,050)*	*(2,367)*
Net Income	**652**	**757**	**1,160**	**1,028**	**1,306**	**189**
Interest Income	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Interest Expense	89%	76%	79%	80%	79%	80%
Net Interest Income	10%	24%	21%	20%	21%	20%
Other Income	30%	20%	20%	9%	8%	11%
Administrative Expenses	29%	32%	27%	21%	21%	30%
Net Operational Income	2%	-12%	-7%	-12%	-13%	-19%
Net Income	12%	12%	14%	8%	8%	1%
Average portfolio	**na**	**18,615**	**27,773**	**35,688**	**37,806**	**37,572**
Net Financial Income/Avg Portfolio	na	8%	6%	7%	9%	7%
Net Operational Income/Avg Portfolio	na	-4%	-2%	-4%	-5%	-6%
Net Income/Average Portfolio	na	4%	4%	3%	3%	1%

History of Microenterprise Lending in Banco de la Empresa

Origins of the Program.

The genesis of the microfinance program was the result of the following: (1) visionary leadership, (2) increased banking competition and (3) changes in the regulatory framework. This confluence led to a strategic commitment to microfinance as a profit-making proposition rather than a public relations activity.

Leadership*:* The General Manager of Banco de la Empresa from 19x2 to 11 can be credited as the visionary who implemented a new strategy which led the bank into microfinance. Between 19x5 and 19x6, he became convinced that microenterprise lending could be a successful business proposition with the right technology and proper infrastructure. He discussed his vision with senior management of Business Management Consult (BMC), an international firm with ample experience in microfinance consulting. Both BMC and the General Manager also knew the Inter-American Development Bank was designing a loan operation targeting microenterprises.

At the time, BMC was providing technical assistance to CREDIGOLFO, a rural credit-granting NGO. The operation of the program had a demonstration effect, showing that the "financial systems approach to microfinance" could work.[7] During 19x7, the IDB started discussions with the central government, microfinance NGOs and regulated financial institutions about the feasibility of a loan operation directed to the small and micro enterprise sector. During the discussions that ensued between IDB and the commercial banks after project preparation, microenterprise lending was presented by IDB as a possible diversification opportunity for domestic banks.

Increased Competition: Starting in 19x1, the country's financial system began a slow process of reform. In the early part of this decade, in anticipation of greater *financial liberalization*, many foreign banks entered the market and several new local private banks were formed. Increased competition for corporate clients resulted. In 19x11, the country had 25 private commercial banks compared to less than 11 in 19x1.

Regulatory Changes: Upper management anticipated changes in the regulatory and supervisory framework and began an active program of bank branching. In 19x10, the Banking Law was reformed, improving prudential norms, facilitating mobilization of demand deposits and making access to lines of credit more transparent for private commercial banks. At the same time, political authorities

7 The financial systems approach represents a convergence in thought about how to operate microfinance programs by the several leading researchers, practitioners, donor institutions, and consulting firms in the field. This school of thought holds that credit is a financial service, not a productive input, that interest rates must cover operating costs, and that since money is fungible, the focus in loan analysis should be on household-firm repayment capacity and not project cash flow per se.

wanted to motivate private banks to serve rural areas and small and micro businesses. These sectors were historically neglected by such banks. In September 19x11, the government granted commercial banks the right to offer personal checking accounts, a right only state banks had previously enjoyed. In return, private commercial banks were required to either open rural branches or direct 10% of the amount held in checking accounts to small and micro enterprises. The rates could be no higher than LIBOR for loans denominated in dollars. For local currency loans, the interest rate would be equivalent to the prevailing rate on time deposits, as calculated by the Central Bank. The two legal changes were contradictory. The first set of liberalizing reforms, served to promote efficiency but the latter quid pro quo regarding the right to offer checking accounts, was a return to "ill advised targeting," especially the clause establishing an interest rate ceiling that did not allow for a spread above the cost of funds. The latter ruling forced management to make a decision. Management decided to opt for rural branches as the lesser of two evils.

Another change in the regulatory framework that clearly favored microfinance was a ruling by the Superintendency in 19x9 to allow banks to classify loans under US$22,000 based on delinquency performance and not on the nature and value of real guarantees provided. Commercial bankers historically collateralize all loans with real property to avoid an E classification, Doubtful Recovery, which implies 100% provisioning. This ruling made small lending more attractive and potentially profitable for regulated financial entities.

Development of a Downscaling Strategy

In response to these changes, the management undertook a new strategy. Newly opened rural branches would focus on microenterprise lending and the headquarters, located in the capital city, would focus on both corporate and small and micro business lending. To implement the strategy, managers took three steps.

Step 1*: Increase number of bank branches.* Between 19x5 and 11, Banco de la Empresa opened bank branches in eight provincial cities to extend and diversify its client base.[8] Most of the expansion (5 of 8 branches) occurred between September 19x10 and December 19x11. Instead of competing head to head with other corporate banks in the Santo Tomás metropolitan market for a relatively limited pool of corporate clients, the new bank strategy was to *find new clients* in rural areas. To get new clients, Banco de la Empresa got *physically closer* to them. The high investment in infrastructure and the low productivity of newly hired staff, however, reduced profitability during these years.

Step 2*: Quickly achieve a critical mass of small loan operations.* In June 19x9, Banco de la Empresa purchased CREDIGOLFO, a government financed NGO program created in 19x4. This NGO had received technical assistance from BMC, which contacted Banco de la Empresa. The NGO program started alleviating the consequences of flood induced crop and infrastructure losses of 19x3. The southern part of the country was also experiencing dislocations due to the departure of Conglomerate USA, a major multinational

Those cities include Ciudad Negra, Palmar Verde, Santiago, San Diego, San Juan, Bayamon, Santa Barbara, and Bahia. Note that in 19x11, Santa Barbara was closed.

employer and commodity exporter, in 19x1. The portfolio, valued at US$600,000 represented 1,261 outstanding loans, mostly in agriculture and livestock. In order to maintain and increase the portfolio, CREDIGOLFO's original staff was carried over. Their expertise in agricultural lending was crucial. Overnight, Banco de la Empresa had a modest microcredit portfolio.

Step 3*: Modernize the bank´s management information system.* With the entrance of foreign banks came a wave of cost saving computer-based technology. To compete and lower operating costs, internal structures and information technology had to change. As of early 19x12, the bank used four different software programs, some of which were not compatible, which created inefficiencies, caused by the need to duplicate entries for consolidated reports.[9] However, efforts are underway to modify Banca 2000, a software platform, to solve compatibility problems and become the mainstay program for Banco de la Empresa by the end of 19x12.

Involvement in the MicroGlobal Loan

The MicroGlobal loan agreement specified several eligibility criteria for participant banks, all aiming to assure that only solvent and well performing commercial banks could access the line of credit administrated by the Central Bank. Banco de la Empresa signed the participant MicroGlobal loan agreement in May of 19x9 and started to rediscount microenterprise loans with the Central Bank in August of that year. Between 19x9 and 19x12, Banco de la Empresa only qualified during 2 six-month periods. The bank was ruled ineligible during the other periods because its overall delinquency of less than 30 days was higher than 5 percent.

Banco de la Empresa was eligible for technical assistance financed by the MicroGlobal program, and took advantage of this service throughout the life of the program. The MicroGlobal also provided to the Central Bank a specially designed software program that facilitated the rediscounting process. The staff of the Superintendency of Banks and participating commercial banks received training in the basic microfinance issues and methodologies. Upper management of all participating banks could also rely on the expertise of a long-term resident consultant in making the appropriate adjustments to launch and sustain a microfinance program.

9 As of early 19x12, AS-400 was the current mainstay but was considered outdated. Banca 2000 was being tested and was slated to become the mainstay by the end of 19x12. Altamira is another system in use that is considered very sophisticated but costly. A special software program developed by BMC was used only for the microlending program and not was not compatible with Banca 2000.

Structure and Performance of the Microfinance Program

Microfinance Program Structure

When Banco de la Empresa accessed the MicroGlobal loan program, its microfinance activities were considered experimental. The microenterprise credit analysts reported directly to the bank's coordinator for microenterprise. This coordinator received constant technical support from a long-term consultant paid with IDB resources from the MicroGlobal Loan and reported to the Credit Manager. In the summer of 19x11, top management ordered a study on the contribution of the microenterprise program to costs and profits.

Since September 19x11, detailed cost accounting reports have been generated on the microenterprise program. After a favorable review of the program, microenterprise lending was "mainstreamed" in February 19x12. Microenterprise credit officers now report directly to branch managers, who in turn report to a national level coordinator, who then reports to the Credit Manager. Under the new strategy adopted, most branches outside the capital's metropolitan area focused on small and micro enterprise lending.

In the charts below, the old and new organizational structures are contrasted. Note that the charts are schematic. The chart shows four, but the number of branches is irrelevant to the structure.

Figure 1

Structure Prior to January 19x12

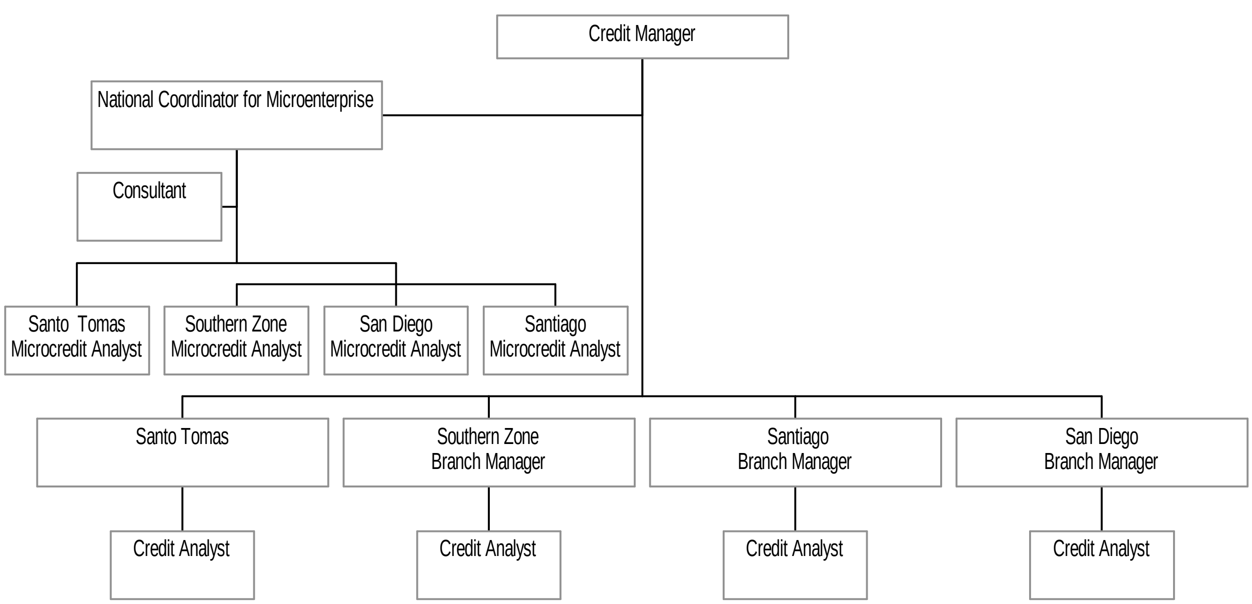
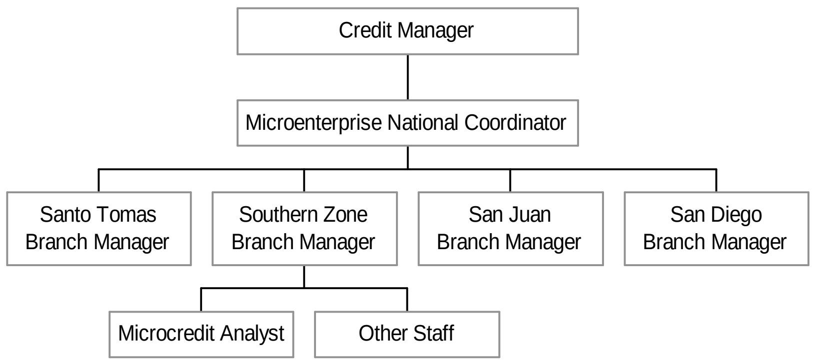


Figure 2

New Structure since January 19x12



Staffing: As of January 19x12, there were 39 branch employees, of which 17 were microenterprise credit analysts. Most of the microenterprise staff were high school graduates or college students majoring in business administration, accounting, or economics. The average microenterprise staff age was early twenties. Other branch staff were older. Though the younger staff received less pay, they were eligible for bonuses based on the performance of the entire branch. Despite the lower pay, morale was high and most interviewed staff seemed committed and motivated by their job.

Credit Methodology: The *credit delivery system* required loan officers to circulate in the community in preassigned zones and hand out fliers to attract business. Loan application processing was kept to between five and seven working days. Periodically, loan officers monitored loans by visiting clients. The loan evaluation process focuses on enterprise viability, repayment capacity of the business owner's household, solid character references, and a business site inspection. Personal guarantees back most smaller loans and property liens back the largest loans. The two most important variables were repayment capacity and character references. The bank used a microlending computer program developed by BMC to administer the microcredit program and evaluate applications. Repeat customers were usually served faster since much of the basic data were available in computer records. Only individual liability contracts were used. Moreover, the same credit officer who evaluated the loan application was also responsible for loan collection. Annual nominal interest rates in the first quarter of 19x12 ranged from 36 to 44% and terms ranged from 4 to 18 months, being essentially functions of household repayment capacity.[10]

Competition*:* The loan rates charged by Banco de la Empresa were higher than those of Banco Hogar(18%), a state-owned bank with a microlending program. Banco Hogar competed with banks specializing in consumer lending such as foreign-owned BanVayaX (41%), and the more sustainable microfinance NGOs operating in Nueva Segovia. Clients preferred to pay a higher interest rate at Banco de la Empresa than wait for their credit applications to be processed in the other banks.[11] Loan collection mechanisms rely on immediate visits when the delinquency occurs, pressure on co-signers and initiation of legal action.

Performance of the Microenterprise Portfolio

The following analysis of Banco de la Empresa's microlending was based on an evaluation of its *outreach* and *sustainability*.

Outreach: The microenterprise program has grown dramatically (Figure 3). From the start of the program, in June 19x9, to February 19x12, the number of outstanding loans tripled from 1,261 to 4,128 loans. Likewise, the outstanding loan volume surged from US$0.5 to US$3.9 million. More importantly, the program has maintained a fairly constant average loan size. The average loan size was US$745 in September, 19x10, and increased slightly to US$949 in February, 19x12. This was a strong indicator of its service to small and micro entrepreneurs.

The microenterprise portfolio increased during each of the last three years both in number of loans and volume. The monthly average growth rate was 6.1% and 7.6%, respectively.

Most loans are used for commerce, followed by agriculture, services, and livestock (Figure 4). Geographically, loans are concentrated in the southern zone. Most clients are male (78%), married and middle-aged.

Sustainability: As of early 19x12, the microenterprise portfolio represented only 12% of the total portfolio of the bank. However, its profitability was high. Net profit/revenue for the Microenterprise Program was 10 times greater than that of the bank as a whole. The microfinance portfolio contributed 65% of the bank's net profit in the year 19x11. In other months for which data were available, the ratio of microenterprise profit to total profit was also substantial. A financial margin of 51% for microenterprise loans compared with 28% for other loans,

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From March 19x9 to March 19x12, the nominal interest rates ranged from 35-54 percent. The high occurred in September 19x10 and the low in November of 19x11. As of March 19x12 the rate was 36.5 percent. The changes mirrored movements in inflation rates. At the end of 19x9, the annual rate of inflation was 13.5%, rising to 23.2 % in 19x10, a year of recovery from a financial crisis, dropping to 17.5% in 19x11, and hovering around 14% for the first quarter of 19x12. In Palmar Verde and Ciudad Negra, no commissions were charged, but in all other agencies, a commission ranging from 1.5 to 3 percent was charged.

The average processing time for a microloan from Banco de la Empresa is 5-7 working days, while it is 3-4 months at Banco Hogar.

explains the difference. The interest rate for microenterprise credit was on average 15 percentage points higher than corporate loan rates. The cost of funds for microenterprise lending was not subsidized. The IDB was one of four external lines of credit. All rates

Figure 3

Growth of the Microenterprise Portfolio

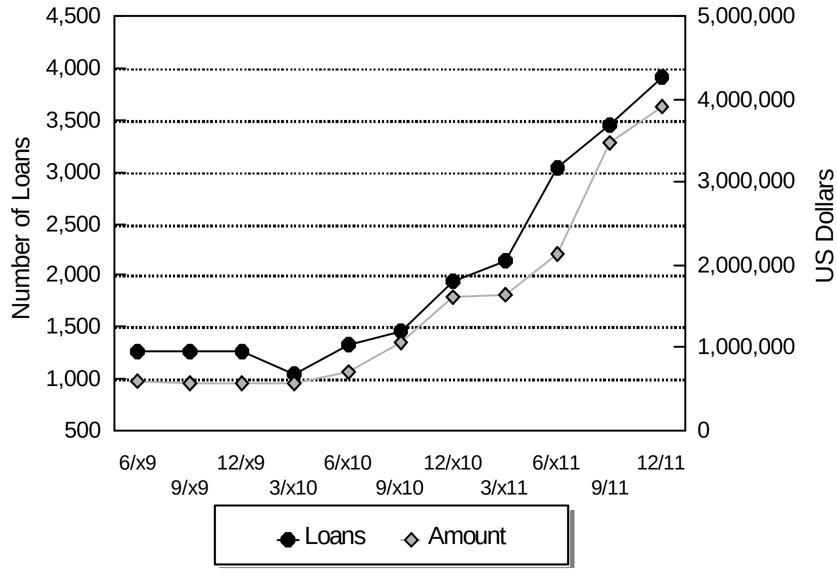
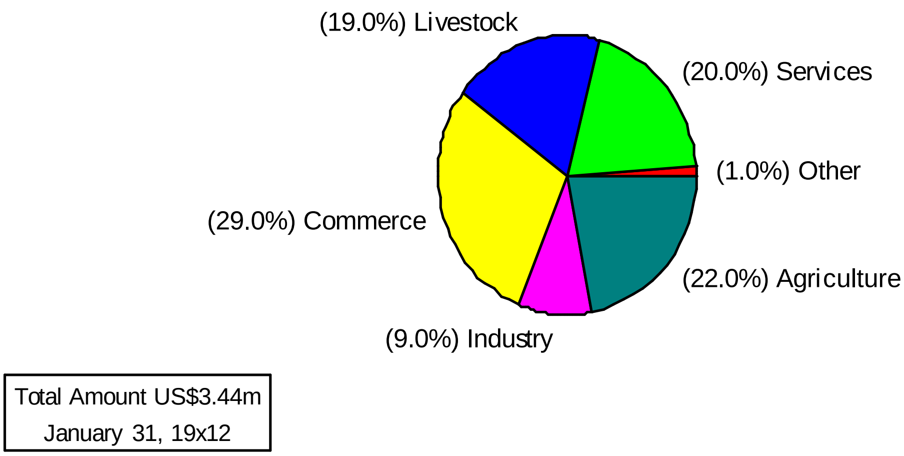


Figure 4

Sectoral Distribution of Microenterprise Lending Program



were at or above the marginal cost of funds for commercial banks.[12]

The arrears rate (loans with payments overdue more than one day) was high, averaging 20 percent during 19x11. The lowest 30 day delinquency rates (measured as outstanding loan balances for loans with payments overdue as a percentage of total loans outstanding) as of January 19x12, were reported for the Palmar Verde and San Juan branches, in the southern zone, staffed with the old CREDIGOLFO personnel. The Santo Tomás headquarters office, serving the largest urban area, was the most problematic. Another troublesome branch was Santiago. The branches in the larger urban areas, habitually showed repayment problems (Figure 5).

The high delinquency rate in the microenterprise portfolio adversely affected the net income of the microenterprise program because of increased provisioning. But corporate delinquency affected the corporate net income results to a higher degree because of the difference in arrears-aging structure. For example, as of December 31, 19x11, the 30 day delinquency rate for microenterprise was 9.2% versus 15.2% for the rest of the bank. The 90-day delinquency rate was 4.9% for microenterprise loans versus 8.5% for the rest of the bank. Since the corporate side of the bank had more aged arrears, its provisioning requirements were higher.

Small loan provisioning norms in the case of Nueva Segovia are as follows:

Arrears Structure	Loan Loss Reserve (% of Loan Outstanding)
1-30 days	.5%
31-90 days	1%
91-180 days	20%
181-360 days	60%
>360 days	100%

The microenterprise program is relatively more costly to administer than the corporate lending program, as would be expected (Table 6). However, compared to other leading microfinance institutions, Banco de la Empresa has much room to improve. For example, staff productivity (number of credits/number of credit officials), a major contributor to operational efficiency, is lower than the leaders. Banco de la Empresa reported 103, compared to leaders in the field, which report between 300 and 518 (Baydas et. al, 1997). This wide range is partly affected by the choice of lending methodology used (group vs. individual).

[12] Throughout the life of the program the cost of IDB funds was generally 2-3 percentage points above the interest rate on 6 month certificates of deposits (passive rate) adjusted upward to reflect the required legal reserves. In 19x9, the IDB rate was considerably higher. In comparison U.S. and European financed programs were either equal to the average passive rate or 1.5-2 percentage points above.

Figure 5

Delinquency Rates for the Microenterprise Program

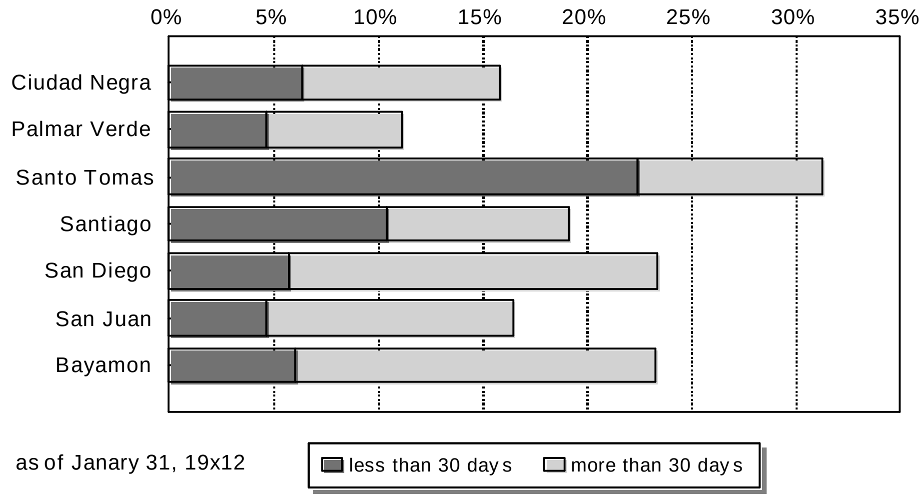


Table # 4

Microenterprise Loan Portfolio Structure

as of December 31, 19x11

Branches	Non-delinquent Loans* Total (1)	% (1/4)	Delinquent Loans** Total (2)	% (2/4)	Loan Loss Reserves Total (3)	% (3/4)	Net Portfolio Total (4=1+2-3)	% (4/4)
C.Negra	624,973	87.35	113,090	15.81	22,610	3.16	715,453	100%
Palmar Verde	1,207,970	90.22	149,261	11.15	18,389	1.37	1,338,842	100%
Santo Tomas	824,340	72.56	355,275	31.27	43,546	3.83	1,136,069	100%
Santiago	222,699	83.26	51,305	19.18	6,537	2.44	267,467	100%
San Diego	390,474	77.20	118,024	23.34	2,727	0.54	505,771	100%
San Juan	410,952	83.87	80,711	16.47	1,658	0.34	490,005	100%
Bayamon	221,628	77.08	66,767	23.22	861	0.30	287,534	100%
TOTAL	**3,903,036**	**82.32**	**934,433**	**19.71**	**96,328**	**2.03**	**4,741,141**	**100%**

* Gross Portfolio =1+2

**Past due more thatn 1 day

The most telling evidence of institutionalization of the microfinance program, however, is the Bank's use of its own intermediated funds to finance part of the program. Since 19x9, Banco de la Empresa extended 9,328 micro and small loans and discounted approximately 3,123 through the IDB-financed MicroGlobal. Another 2,030 were discounted through other donor programs. Thus, the bank extended 4,175 credits with its own funds.

Table 5 below shows the relative contribution of the microenterprise program to total bank financial income and expenses. Table 6 compares financial performance, using as a denominator interest income earned by the microenterprise and corporate programs, respectively.

Table 5

Financial Income for the Microenterprise Unit and the Rest of the Bank

as of December 31, 19x11

INDICATORS	Microenterprise total (1)	Microenterprise % (1/3)	Rest of the Bank total (2)	Rest of the Bank % (2/3)	Total Bank (3)
Interest Income	1,212,583	9.27%	11,868,417	90.73%	13,081,000
Interest Expenses	608,043	5.96%	9,595,957	94.04%	10,204,000
Net Financial Income	604,540	21.01%	2,272,460	78.99%	2,877,000
Provisions	54,478	16.97%	266,522	83.03%	321,000
Administrative Expenses	424,825	11.39%	3,306,175	88.61%	3,731,000
Other Income	19,854	1.37%	1,432,146	98.63%	1,452,000
Operational Income	145,091	52.38%	131,909	47.62%	277,000
Other expenditure	21,899	24.89%	66,101	75.11%	88,000
Net Profit	**123,192**	**65.18%**	**65,808**	**34.82%**	**189,000**

Table 6

Financial Ratios

as of December 31, 19x11

Ratio		Microenterprise	Overall Bank
Financial Income / Interest Income	(a)	98.39%	89.23%
Financial Cost / Interest Income	(b)	49.34%	72.15%
Financial Margin [1-(FinCost / Int. Inc)]		50.66%	27.85%
Provision / Interest Income	(c)	4.42%	2.00%
Adminstrative Cost / Interest Income	(d)	34.47%	24.86%
Other Income / Interest Income	(e)	1.61%	10.77%
Other Expenditure / Interest Income	(f)	1.78%	0.50%
Net Profit / Interest Income	*	10.00%	0.49%

* = (a) - (b) - (c) - (d) + (e) - (f)

Factors Contributing to Banco de la Empresa's Microenterprise Market Penetration

Certain factors explain the relative success Banco de la Empresa had in penetrating the microenterprise market segment compared to other regulated financial entities in the country. This understanding could be used to gauge the likelihood of commercial bank success in other **downscaling** exercises. Though Banco de la Empresa's experience cannot be considered a complete success due to weakness in its delinquency control, it is still quite instructive.

Banco de la Empresa is a true pioneer compared to commercial and state banks in the country. State banks most commonly attending the small and micro enterprise sector have a larger volume of outstanding loans and more clients than Banco de la Empresa. However, Banco de la Empresa has lower delinquency rates, generates a profit attending this market segment, and provides faster loan processing times. In comparison to other private banks in Nueva Segovia, Banco de la Empresa has no equal in microfinance. No private commercial bank in the country has a comparable sized microcredit portfolio. Its closest competitor has been BanVayaX, a bank specializing in consumer lending that slowly started to engage in small business lending.

BanVayaX's small business portfolio is growing but average loan size is around US$6,000, indicating that it has not yet reached many microentrepreneurs. Moreover, its 30 day delinquency rate averaged between 14-17% between 19x10 and 12, twice as high as Banco de la Empresa. Due to its recent entry into Nueva Segovia and the opening of a large number of new branches, BanVayaX's profits have been negative or negligible.

Below is a list of critical factors which explain Banco de la Empresa's success in penetrating the microenterprise market segment.

Strategic Vision, Effective Leadership, and Long-term Commitment

The former General Manager at Banco de la Empresa (19x2 to 11) believed microfinance could be profitable and this was key to Banco de la Empresa's commitment to microfinance and its persistence in developing this market niche. Other managers, such as those at Interban and Bannexus, two much stronger banks which were initially interested in the MicroGlobal program, cited social reasons as their principal motivation. Some board members at these banks were once small business people and wanted to give others an opportunity. However, when these two banks analyzed the implications of adopting microfinance technologies or faced initial setbacks, commitment wavered. They either did not sign the IDB MicroGlobal participant agreement contract or withdrew later.

Competitive Push Factor

Another important factor in explaining the development of Banco de la Empresa's microenterprise program was the bank's weak position as a competitor in the domestic marketplace, as indicated by its poor profit performance from 19x8 to 19x11. Looking for new niches, new strategy or new management were the alternatives. Faced with increased competition, some of the stronger corporate banks in Nueva Segovia competed with automation and streamlined operating procedures. Others focused on consumer credit cards. Still others decided to offer new financial products such as ATM services, direct deposit, and bill payer services. Banco de la Empresa decided to look for a new niche that was being attended largely by NGOs, cooperatives and credit unions. Banco de la Empresa's comparative advantage over NGOs and cooperatives was that is was a regulated entity. It could capture savings, which provided an additional service to its customers, and was a low cost source of funds for lending. Its strength vis-a-vis credit unions was open membership. In addition, Banco de la Empresa had nation wide geographic coverage, making co-variate risk less of a problem, compared to other nonbank intermediaries which operated in smaller geographic areas.

Rapid Portfolio Expansion

Unlike Interban, a very strong bank, which used the MicroGlobal program line of credit initially but later withdrew, Banco de la Empresa had a critical number of microcredit clients. Inherited from CREDIGOLFO, these clients could be serviced immediately with the MicroGlobal line of credit. Interban was forced to develop a microfinance portfolio from nothing. It found the proposition tedious and expensive. Prospective clients in the Santo Tomás metropolitan area were widely dispersed. Unlike the capital cities of Bolivia, Peru, Colombia or El Salvador our case study country does not boast the same density of microentrepreneurs. Thus, outreach is more costly and difficult. Banco de la Empresa exploited the more agrarian basis of the country's economy and the location of many potential small loan clients by concentrating its rapid expansion of microenterprise portfolio in rural towns.

Necessary Infrastructure and Human Resources

Its eight bank branches outside the capital gave Banco de la Empresa a significant advantage in microfinance over all private commercial banks except one. Only BanVayaX, a foreign owned bank, had an extensive rural presence, with 28 rural branches. All other branches of private commercial banks were concentrated in the greater capital metropolitan area. Notwithstanding, Banco de la Empresa still competed against a significant number of financial intermediaries in the provinces: state-owned banks (Banco Nacional, Banco de Estado, and Banco Hogar), credit unions, cooperatives, and NGOs. The main competitive advantage over these rural intermediaries was its agility in providing services and a stable source of funding. The state-owned banks offered lower rates of interest, but were notoriously slow in processing and disbursing loans. The non-banks typically were agile in processing loan requests but may or may not have experienced credit supply problems.

More important than the physical buildings was staff training in appropriate microcredit delivery, installation of specialized software to handle the high volume of microfinance lending in a cost efficient way and accepting a new way of doing business.

Microfinance analysts at Banco de la Empresa were all new hires with less academic preparation and different socio-economic profiles than the personnel in the corporate section. The microfinance analysts were expected to circulate in working class neighborhoods, looking for clients and becoming street-savvy. Their better educated and better paid counterparts in the corporate section were more adept at analyzing corporate structures, interpreting financial statements and negotiating interest rates and term structures. Expecting the typical "corporate analyst" to make the transition would be difficult. Nonetheless, other participating banks attempted it, reasoning that existing staff was known and trusted.

Technical Assistance

Lastly, Banco de la Empresa had access to and took full advantage of the technical assistance and training services provided by BMC, paid by the MicroGlobal Loan program. The long-term advisors focused most of their attention on Banco de la Empresa, providing intensive on-the-job training and maintenance of the installed computer systems to administer and monitor the microfinance portfolio. Even after the IDB-funded technical assistance program expired, BMC on its own accord, continued its support. The combination of intense, continuous, high quality consulting services generated a sense of confidence in the bank's upper management and contributed to a strong *espirit de corps* among microfinance loan officers. After more than three years of support, the bank has a core of trained staff which has not turned over. In many respects, given all the upheavals in management, the long term consultants provided constancy.

Risks to the Microfinance Program

Despite its significant achievements, Banco de la Empresa's microfinance program faces new challenges in the immediate future.

End of Technical Assistance

First, as the subsidized BMC consultant services come to an end the staff's performance will be tested. Banco de la Empresa was in an unusual and fortuitous circumstance that other commercial banks may not encounter. It received a disproportionate amount of free technical assistance. BMC, a consulting firm committed to the notion of "downscaling" and eager for a victory, was instrumental at virtually every stage of the endeavor: (1) in the design of the IDB-funded MicroGlobal program; (2) in the transfer of the NGO portfolio and staff; (3) in the provision of free services after the official end of the MicroGlobal technical assistance program in 19x10; (4) and in the installation of proprietary software.

High levels of free assistance can be double-edged. On one hand, an intense and prolonged period of technical assistance can be necessary to train personnel and help the institution weather early crises. On the other hand, free assistance can breed an unhealthy dependency. This may promote a lack of "ownership" and seriousness of purpose which results in a performance deterioration when the consultants leave. Sometimes, it may be better for institutions to pay for assistance, make a series of mistakes and find solutions on their own.

Frequent Management Changes and Restructuring

In July 19x11, the General Manager, who led the microfinance downscaling effort, resigned. The new General Manager ordered a comprehensive review of the microfinance program, was duly impressed with its performance and pledged to continue it. Nonetheless, *the bank found itself at a crossroads.* It was two banks in one, an ailing corporate bank and an emergent retail bank.[13]

Another upper management shake-up jolted the bank from late December 19x12 to early 19x13. Between 19x9 and 19x13, the institution had three General Managers and two Credit Managers. Each change in leadership generated uncertainty. Supporters of microfinance did not know if the new leadership would be as committed as the previous one. Accordingly, much time and energy was spent educating and convincing new leaders of the merits of microfinance.

During its early downscaling period, 19x9 and 19x10, the speed of changes and the high investment requirements stressed Banco de la

[13] Of the 25 private commercial banks in the country's financial system, Banco de la Empresa has ranked towards the bottom on various measures of profitability. In 19x11 , the return on assets (ROA) (net income/average total assets) for Banco de la Empresa was 1.8% . In comparison other commercial banks specializing in corporate lending (Bannexus, Interban, San Pedro, Contento, and Finlandia) all had ROA's greater than 9%. Likewise return on equity averaged only 1.4% over the last three years, while a few of its peer institutions report figures greater than 19%.

Empresa's management and staff. Some critics claimed the bank's re-orientation toward the small and microenterprise sector contributed to its further decline in the corporate market, which negatively affected performance indicators and the financial health of the entire bank. They asserted that an activity representing a growing but small percentage of the total portfolio was taking too much attention. In the meantime, the larger corporate segment of the portfolio deteriorated because of an adverse macroeconomic and business climate and the lack of a clear strategy for servicing that market segment. On the other side, supporters of downscaling claimed that the diversification strategy succeeded in finding a new market niche that is now generating a disproportionate share of net earnings.

While the microfinance portfolio has been yielding good net income results, consolidation and future growth of the microfinance program will require significant investments in new personnel training, product redesign, information technology and promotional campaigns. If this retail (microfinance) banking path was chosen, the corporate section might suffer as a result of limited investment resources to correct its weaknesses.

The corporate section of the bank needs a new strategy to protect or regain market share. Options for a competitive strategy include cost-saving innovations, personal service reputation and lower prices. Each option has implications for investments in information technology, personnel recruiment or retention, product research and marketing campaigns, operating procedures, and siting of branch offices. In early 19x12, the observed tendency was to concentrate on corporate bad debt collection and improve the quality of the portfolio without making a firm choice about future direction. If management decide to become a universal or multiservice bank, the next question will be how resources will be allocated between the retail and corporate sections.

High Delinquency

Banco de la Empresa has to refine its methodology to improve loan collection in the microfinance program. In the period under study, Banco de la Empresa charged the loan officer with both origination and collection duties. Despite internal discussions on whether to create a specialized collection unit, the bank decided to stay with the current system. Each approach has advantages and disadvantages. However, it is clear that the current system is not working. Moreover, delinquency persisted in both good and bad economic times.

The delinquency problem in Banco de la Empresa is three-fold. According to several observers, one reason is a "culture of late payment and non-payment" in the country. This stems from state-owned banks' dominance in the financial system. Three state-owned banks hold 49% of public deposits in the country and account for more than 95% of small-scale lending. With more than 300 branches, state banks reached most towns with a population of at least 5,000. Despite the impressive coverage, state banks have arrears greater than 30%. The result in this over-banked system is that many urban borrowers lack fear of exclusion for previous defaults. Limited access, less mobility, and stronger social ties between bank staff and clients keep arrears lower in rural areas.

Nueva Segovia has a cumbersome legal system that grants debtors many rights. A poorly functioning public registry also hinders collection. For example, creditors must give prior notice and ask permission to enter a debtor's property to seize moveable collateral pledged as security. Legal action is time consuming and costly, especially against debtors without fixed salaries.

Another part of the problem is product design, client screening and less-than- aggressive collection techniques employed by Banco de la Empresa. For the most part, credit is not graduated. Credit is granted to more or less meet a specific project investment request taking into account limits of household/firm repayment capacity. Thus, repayment incentives are weak and monitoring needs (industry/sector outlook and client liquidity) are high. Also, even for credits delinquent more than 60 days, the bank has no specialized collection unit. The otherwise helpful personal relationship between loan officer and debtor may prevent the loan officer from developing an aggressive collection plan, liquidating collateral or calling on personal guarantees.

Lessons in Microfinance Downscaling

The Banco de la Empresa experience provides many valuable lessons. The most far-reaching relate to design and targeting of bilateral and multilateral development agency-sponsored interventions.

Lesson I: Commitment

Committed and effective leadership is essential to downscaling successfully.

First and foremost, a few senior managers have to both believe in the commercial potential of microfinance and be committed to start such a program. This leadership must be willing to withstand setbacks and overcome opposition within and outside the institution for microfinance to succeed. Effective microfinance methodologies conflict with the existing culture and operating procedure of typical corporate banks. Microfinance supporters within commercial banks must wield enough budget and hiring authority to invest in and support the experiment. Alternatively, they should have the political acumen to influence others to make this long term commitment.

Training loan officers and middle managers, flaunting the financial success of other microfinance operators and appealing to the social conscience of senior managers or the board will not suffice. This innovative way of doing business requires different procedures and staff with a non-traditional background.

Lesson II: Profit Motive

Banco de la Empresa showed that to be successful in microfinance, the principal motivation should be profits, not social image nor access to stable, but temporary lines of credit. Other Nueva Segovia bankers that participated in the MicroGlobal program for non-profit reasons dropped out quickly. Once a number of motivated institutions are identified, technical assistance, tailored to each participant, can be an effective tool. The principal barriers to commercial banks entering the microfinance market segment are attitude and technology, not lack of funds. Attractive lines of credit, guarantee schemes and subsidized technical assistance may be insufficient. Such donor-backed initiatives promise to have the greatest impact by consolidating and expanding microfinance in countries where a few financial institutions are successfully active. In short, the "commitment" of banks to microfinance cannot be easily fabricated or bought because microfinance is difficult and risky. Donors can only assist "microfinance leaders" after they emerge.

Lesson III: Strategic Fit

Fully dedicated retail banks or banks pushed by market forces to look for new niches are more likely to participate in downscaling programs than solid, corporate banks.

If a commercial bank is doing well in its traditional market segment, the impetus to commit the necessary resources and energy to a new market may not be forthcoming. Dilatory dabbling in micro lending is not likely to result in success. The clash of "cultures" that effective microfinance implies may not be easily reconciled in a strong, traditional corporate bank. Microenterprise divisions within corporate banks experience recurrent tension with other divisions, because they need to allow for deviations in operating, remuneration, and reporting procedures, to recruit a different type of staff and to train them in a different ways, to use of computer resources more intensively. Retail banks and finance companies which have mastered handling numerous small transactions in consumer lending are more likely to migrate to small and micro businesses lending. They simply need to learn how to assess risk in these sectors. This argument, however, is double edged. Careful analysis is needed in each case. It is quite conceivable that some of the same management, technological and product weaknesses which contributed to a loss of competitiveness by locally-owned banks in traditional corporate or retail markets could also impede success in the microfinance niche.

Lesson IV: Support

Development institutions which promote microfinance through downscaling must tailor support to make it effective. Infrastructure, information technology and human resources are crucial to downscaling successfully.

First, the commercial bank must have branches or mobile services where microentrepreneurs are concentrated. The lender must be conveniently located or actively reach out to clients.

Second, the role of computer technology in lowering operational costs is obvious, but it cannot be a panacea. More important than the purchase and installation of sophisticated hardware is a well designed management information system, commitment to its consistent use and adequate staff training. Using computer technology ineffectively can raise costs instead of dramatically lower them.

Third, staff must be properly recruited, well trained, highly motivated and given appropriate incentives. Staff should be socially comfortable with and knowledgeable about small and micro business owners and their environment. They should be trained in constructing simple financial statements, using computer software for loan analysis, verifying potential clients' reputations assessing clients' managerial ability as well as the outlook for the sector in which the client operates.

Most importantly, the bank should provide attractive bonuses or commissions for high productivity and maintenance of portfolio quality. This will counter a tendency to disburse without regard to loan collection, which can occur when an employee is on a fixed salary.

Fourth, development agencies that wish to promote microfinance must be patient and willing to budget adequate resources for technical assistance as well as for effective supervision and monitoring. If the consulting firm had withdrawn at the official end of the contract in December 19x10, given all the changes in the top leadership of the bank, the results for Banco de la Empresa could have been very different. Downscaling exercises are more about institutional transformation and less about loan disbursement.

Lesson V: Appropriate Regulatory Framework

To create an enabling environment for microfinance, development agencies need to promote appropriate regulatory reform which enables profitable micro lending. If Nueva Segovia's Superintendency had not used appropriate standards for loan classification and provisioning, reputation-based microlending would not have been feasible for Banco de la Empresa and other commercial banks. Therefore, development agencies can play a key role promoting supervisory and regulatory frameworks which are not biased against microlending.

Appropriate regulatory reform should precede attempts at "downscaling." A recent study of financial regulations in 23 Latin American countries identified a number of problems which inhibit the growth and maturation of microfinance (Jansson with Wenner, 1997). The main concerns include minimum capital requirements, capital adequacy, loan risk classification, portfolio auditing techniques, usury restrictions, loan documentation and operational restrictions. The latter either impede the creation of regulated institutions dedicated to microfinance or prevent established regulated entities from engaging in profitable microfinance.

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Annex -1

Balance Sheet

Banco de Empresa S.A.	**19x6**	**19x7**	**19x8**	**19x9**	**19x10**	**19x11**
Balance Statement			*Thousands of US Dollars*			
Bank Deposits	1,746	2,510	3,983	5,887	6,895	6,233
Temporary Investments	4,638	5,004	7,669	6,135	6,622	1,476
Net Loan Portfolio	14,087	23,142	32,404	38,971	36,640	38,504
Gross Portfolio	14,413	23,414	32,991	30,057	30,812	30,484
Delinquent Loans	0	0	0	9,457	6,306	8,651
Loan Loss Reserve	(326)	(272)	(587)	(543)	(478)	(631)
Accounts Receivable	856	1,352	2,716	809	644	767
Fixed Investments	0	0	0	1,002	1,196	1,129
Equipment, Furniture and Other Assets	1,808	1,924	2,502	495	882	2,169
TOTAL ASSETS	**23,135**	**33,932**	**49,274**	**53,299**	**52,879**	**50,278**
Deposits	13,966	22,751	30,562	33,125	28,879	28,364
Obligations w ith Financial Institutions	3,734	4,517	10,735	12,934	15,792	15,193
Other Financial Obligations	442	317	630	93	284	257
Other Liabilities	304	1,094	1,422	688	64	117
TOTAL LIABILITIES	**18,446**	**28,679**	**43,349**	**46,840**	**45,019**	**43,931**
Paid in Capital	3,706	3,909	4,086	4,875	6,002	5,526
Legal Reserves	392	478	575	648	704	646
Accumulated Net Income	0	0	0	32	1	8
Net Income of the current period	591	866	1,264	906	1,153	167
TOTAL CAPITAL	**4,689**	**5,253**	**5,925**	**6,461**	**7,860**	**6,347**
TOTAL LIABILITIES AND CAPITAL	**23,135**	**33,932**	**49,274**	**53,301**	**52,879**	**50,278**

Annex -2

Income Statement

Banco de Empresa S.A.	19x6	19x7	19x8	19x9	19x10	19x11
INCOME STATEMENT			*thousands of US dollars*			
Net Loan Portfolio Income	4,262	4,909	6,634	10,016	12,045	10,365
Fix Investment Income	567	719	914	1,190	1,381	1,042
Other Financial Income	683	833	1,126	1,516	2,739	1,674
Financial income	**5,512**	**6,461**	**8,674**	**12,722**	**16,165**	**13,081**
Deposits	(3,609)	(4,113)	(5,527)	(7,421)	(8,842)	(7,044)
Bank Borrowings	(1,163)	(733)	(921)	(1,783)	(2,210)	(3,131)
Other Financial Expensess	(10)	(23)	(32)	(626)	(1,389)	(29)
Financial Expenses	**(4,782)**	**(4,869)**	**(6,480)**	**(9,830)**	**(12,441)**	**(10,204)**
TOTAL FINANCIAL INCOME	**730**	**1,592**	**2,194**	**2,892**	**3,724**	**2,877**
Write-off	(162)	(91)	(455)	(358)	(368)	(321)
NET FINANCIAL INCOME	**568**	**1,501**	**1,739**	**2,534**	**3,356**	**2,556**
Other Income	1,623	1,293	1,641	1,148	1,307	1,452
Administrative Expenses	(1,424)	(1,904)	(1,976)	(2,473)	(3,126)	(3,731)
OPERATIONAL INCOME	**767**	**890**	**1,404**	**1,209**	**1,537**	**277**
Other Expenditures	(115)	(133)	(244)	(181)	(231)	(88)
NET INCOME	**652**	**757**	**1,160**	**1,028**	**1,306**	**189**

Annex -3

Balance Sheet

Banco de Empresa	**19x7**	**19x8**	**19x9**	**19x10**	**19x11**
Balance Statement	*Rate of growth with respect to the previous year*				
Bank Deposits	44%	59%	48%	17%	-10%
Temporary Investments	8%	53%	-20%	8%	-78%
Net Loan Portfolio	64%	40%	20%	-6%	5%
Gross Portfolio	62%	41%	-9%	3%	-1%
Delinquent Loans				-33%	37%
Loan Loss Reserve	-17%	116%	-7%	-12%	32%
Accounts Receivable	58%	101%	-70%	-20%	19%
Fixed Investments				19%	-6%
Equipment, Furniture and Other Assets	6%	30%	-80%	78%	146%
TOTAL ASSETS	**47%**	**45%**	**8%**	**-1%**	**-5%**
Deposits	63%	34%	8%	-13%	-2%
Obligations with Financial Institutions	21%	138%	20%	22%	-4%
Other Financial Obligations	-28%	99%	-85%	205%	-10%
Other Liabilities	260%	30%	-52%	-91%	83%
TOTAL LIABILITIES	**55%**	**51%**	**8%**	**-4%**	**-2%**
Paid in Capital	5%	5%	19%	23%	-8%
Legal Reserves	22%	20%	13%	9%	-8%
Accumulated Net Income				-97%	700%
Net Income of the current period	47%	46%	-28%	27%	-86%
TOTAL CAPITAL	**12%**	**13%**	**9%**	**22%**	**-19%**
TOTAL LIABILITIES AND CAPITAL	**47%**	**45%**	**8%**	**-1%**	**-5%**

Annex -4

Income Statement

Banco de Empresa	**19x7**	**19x8**	**19x9**	**19x10**	**19x11**
INCOME STATEMENT	*Rate of growth with respect to the previous year*				
Net Loan Portfolio Income	15%	35%	51%	20%	-14%
Fix Investment Income	27%	27%	30%	16%	-25%
Other Income	22%	35%	35%	81%	-39%
Financial income	**17%**	**34%**	**47%**	**27%**	**-19%**
Deposits	14%	34%	34%	19%	-20%
Bank Borrow ings	-37%	26%	94%	24%	42%
Other Financial Expensess	130%	39%	1856%	122%	-98%
Financial Expenses	**2%**	**33%**	**52%**	**27%**	**-18%**
TOTAL FINANCIAL INCOME	**118%**	**38%**	**32%**	**29%**	**-23%**
Provisions	-44%	400%	-21%	3%	-13%
NET FINANCIAL INCOME	**164%**	**16%**	**46%**	**32%**	**-24%**
Other Income	-20%	27%	-30%	14%	11%
Administrative Expenses	34%	4%	25%	26%	19%
OPERATIONAL INCOME	**16%**	**58%**	**-14%**	**27%**	**-82%**
Other Expenditures	16%	83%	-26%	28%	-62%
NET INCOME	16%	53%	-11%	27%	-86%

Annex -4

Income Statement

Banco de Empresa	**19x7**	**19x8**	**19x9**	**19x10**	**19x11**
INCOME STATEMENT	*Rate of growth with respect to the previous year*				
Net Loan Portfolio Income	15%	35%	51%	20%	-14%
Fix Investment Income	27%	27%	30%	16%	-25%
Other Income	22%	35%	35%	81%	-39%
Financial income	**17%**	**34%**	**47%**	**27%**	**-19%**
Deposits	14%	34%	34%	19%	-20%
Bank Borrow ings	-37%	26%	94%	24%	42%
Other Financial Expensess	130%	39%	1856%	122%	-98%
Financial Expenses	**2%**	**33%**	**52%**	**27%**	**-18%**
TOTAL FINANCIAL INCOME	**118%**	**38%**	**32%**	**29%**	**-23%**
Provisions	-44%	400%	-21%	3%	-13%
NET FINANCIAL INCOME	**164%**	**16%**	**46%**	**32%**	**-24%**
Other Income	-20%	27%	-30%	14%	11%
Administrative Expenses	34%	4%	25%	26%	19%
OPERATIONAL INCOME	**16%**	**58%**	**-14%**	**27%**	**-82%**
Other Expenditures	16%	83%	-26%	28%	-62%
NET INCOME	16%	53%	-11%	27%	-86%

Annex - 6

Year	Month	Number of Credits	Total Portfolio (US$)	Average Loan Size (US$)	Loan Loss Reserve %	Averge growth of credits %
19x10	sep	1,460	1,088,139	745	21.76	
	oct	1,658	1,339,048	808	25.57	13.56
	nov	1,873	1,614,795	862	23.75	12.97
	dec	1,987	1,706,602	859	22.50	6.09
19x11	jan	1,970	1,728,983	878	21.41	-0.86
	feb	2,114	1,883,517	891	20.75	7.31
	mar	2,369	2,206,861	932	20.73	12.06
	apr	2,538	2,367,004	916	18.16	7.13
	may	2,957	2,803,568	948	16.03	16.51
	jun	3,179	3,040,583	956	18.50	7.51
	jul	3,438	3,002,654	961	18.61	8.15
	aug	3,557	3,417,390	961	18.17	3.46
	sep	3,666	3,546,777	967	19.19	3.06
	oct	3,881	3,683,680	949	19.85	5.86
	nov	4,063	3,843,335	946	20.04	4.69
	dec	4,128	3,896,652	944	23.71	1.60
19x12	jan	4,023	3,755,157	933	21.18	-2.54
	feb	4,041	3,834,033	949	21.18	0.45
Average monthly Rate of growth		6.17%	7.69%	1.43%	-0.16%	6.29%

Branch	19x9		19x10		19x11	
	Number of Credits	Amount (US$)	Number of Credit	Amount (US$)	Number of Credit	Amount (US$)
Ciudad Negra	444	205,899	598	380,773	817	624,973
Palmar Verde	820	362,029	1,088	592,783	1,678	1,207,970
Santo Tomas			213	573,002	578	824,340
Santiago			37	38,130	222	222,699
San Diego			13	17,903	296	390,474
San Juan					390	410,952
Bayamon					147	221,628
TOTAL	1,264	567,928	1,949	1,602,591	4,128	3,903,036
Average Loan Size (US$)		*449*		*822*		*946*