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Microfinance Meets the Private Sector

Could private sector financing to street vendors, carpenters, seamstresses and other microenterprises become standard practice in developing countries? Until recently, almost all "microcredit" has been funded by foundations, governments and international agencies. Now, commercial banks, finance companies and private investors in Latin America are cautiously turning their attention to the challenge of offering loans, savings accounts and other financial services to the smallest businesses. Recent changes in financial regulation, combined with a growing understanding of how to lower costs and manage risks, have made microfinance a potentially profitable market. Some observers believe private capital could replace donor assistance entirely, while others see it as a compliment to continued subsidies. How strong is the private sector connection to microenterpise and what are the prospects for its expansion? This inaugural issue of *Microenterprise Development Review* looks at some innovative examples of commercial microfinance from around the region and examines the conditions that made them possible.

The Economic Potential of Microenterprise

The microenterprise sector represents a huge untapped market for the financial service industry in developing countries. There are more than 50 million micro-

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INAUGURAL ISSUE

Highlighting Innovations in private microfinance

In This Issue:

The Building Blocks of Commercial Microfinance

The past five years have seen the emergence of a number of exciting experiments with the commercialization of the untapped micofinance market, providing important lessons on what will be required for its future development. A clear message is emerging: a vibrant microfinance industry will require changes at multiple levels—from the national regulatory level to the level of corporate culture in the financial sector, and even decision-making about individual loans.

The Government Role: Policy and Regulatory Reforms

- Governments have a key role to play in maintaining stable currency and price levels. In addition, financial sector reforms are needed to remove controls on interest rates; reduce or

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enterprises in Latin America and the Caribbean alone. Over 80 percent of the region´s businesses have less than 10 employees (the definition of micro-enterprise used by the Inter-American Development Bank), and they employ more than 120 million people. Yet less than five percent of microenterprises have access to institutional sources of credit.

In the past, significant subsidies for microenterpise support organizations have been justified by the high costs of such specialized financial activity. Now, new awareness of the possibilities of the microenterprise market niche is coinciding with a more businesslike approach in the structure, management, and objectives of successful microfinance institutions, a group that until recently was heavily dominated by nonprofit foundations.

Changing Views of Microenterprise in Latin America

The conceptual framework of microenterprise development is changing—for the second time. In the 1970s, the original negative view of the informal sector (an illegal underground economy of tax avoiders and disguised underemployment) was replaced by the benevolent view of the informal sector as microenterprise, providing a livelihood for the poor. The current framework has moved beyond microenterprise as a survival activity to view it as a business. The new paradigm casts microenterprises not as passive beneficiaries to be helped, but as clients or customers of institutions providing services.

—Marguerite Berger
Inter-American Development

Why Invest in Microenterprise?

Different factors are prompting the interest of private investors in microfinance. Pushed by the increasing competitive pressures in the financial sector, some local financial institutions are looking for untapped markets for their services. Other institutions are discovering that their experience in consumer finance or as nonprofits gives them core competencies on which to build a new business of microscale commercial lending. For now, however, most private sector interest in microfinance is not simply profit-driven. The reasons offered by formal financial institutions active in microfinance vary: from improved public relations; to a long-term view of market development; to the perceived need to contribute to the solution of local problems—economic and social—that might otherwise jeopardize their business interests. Some institutions are willing to invest in learning how to manage small deposits and small loans in order to cultivate future clients closer to their mainstream profile.

A few lenders are attracted by the high rates of interest microentrepreneurs are willing to pay, given their limited access to formal sources of finance and the high productivity gains they tend to reap from relatively small infusions of capital. But for mainstream financial institutions, the potential for profits is often offset by the relatively high transaction costs involved in microcredit.

New Microfinance Models in Latin America

Private sector participation in microfinance usually comes about through one of three routes. Formal lending institutions may be created from the loan portfolios of nonprofit organizations (a process known as “upgrading” the institution). Alternately, commercial banks and finance companies may

Credit Cards: A New Wave in Microfinance?

Credit cards targeted to low-income people could be a new wave in microfinance. They offer advantages of lower lender transaction costs, ease of information management, and increased customer access.

As the market for credit cards for the well-to-do becomes increasingly saturated in the region, financial service businesses are looking to lower-income strata. Market research conducted by Mastercard, Citibank, and others has identified medium-low and low-income groups with incomes as low as $250 per month as part of an emerging market for credit cards. These clients are attractive because they tend to maintain a balance on their accounts and have low delinquency rates.

A specialized card for microenterprises has been launched in the Dominican Republic. A microfinance NGO, ADEMI, has teamed up with Banco Popular to offer a Mastercard to ADEMI’s microenterprise loan clients in good standing. Cardholders can receive cash advances, get checking account balances, and make payments through the 60 ATMs and 45 offices of Banco Popular throughout the country. The card also offers travel and theft insurance, bill payment services, and consumer credit lines for up to 12 months. The expansion of mainstream credit cards into the low-income market may herald the creation of more instruments like Mastercard ADEMI Popular.

enter into the microfinance market ("downscaling" the client size). Finally, new kinds of non-bank financial intermediaries may be created specifically for this market.

- **Upgrading.** Nonprofit organizations have been lending to microenterprises in most countries of the region since the 1970s. Long operating in a gray area at the edge of legal regulations, some of these institutions have grown and transformed themselves into regulated financial institutions, providing a vehicle for private capital investment. Others have become majority shareholders in new banks or finance companies that specialize in microfinance. BancoSol in Bolivia led this process, followed by Caja de Ahorro y Crédito Los Andes, also in Bolivia, Financiera Calpiá in El Salvador, and Finansol in Colombia. A host of others are in the works.

- **Downscaling.** As market conditions and the knowledge of how to effectively serve this niche improve, a few commercial financial institutions—including some that formerly offered loans to NGOs that on-lend to microenterprises—are now creating their own microfinance subsidiaries. Banco del Desarrollo in Chile followed this path. Other banks, such as Banco del Pacifico in Ecuador, have built on existing competencies or acted on social concerns to expand their activities, directly providing credit and savings products to micro and small businesses. Commercial bank cost structures and corporate culture tend to present significant challenges to downscaling. Specialized products, information systems and properly trained credit officers are key to overcoming these barriers. (See p. 5)

There is far from a sea change, but a few forward-looking private investors have found market conditions attractive enough to enter the microfinance market.

Credit-Scoring: A Valuable Tool to Control Risk and Cut Costs

Credit-scoring, a common tool of consumer finance in developed countries, is increasingly being used by institutions in developing countries that extend credit to small businesses as part of the application review process. Its known benefits—better management of portfolio risk and lower operating costs—are now inducing financial institutions that work with the microenterprise sector to explore this promising credit decision-making instrument.

The method uses statistical models that predict the likelihood that a client will pay his or her bills in a severely delinquent manner. Commercial credit-scoring models normally examine business performance information—such as financial condition, prior payment history, public filings, industry comparative data, and company demographics—to determine the likelihood of default. Increasingly, credit-scoring models for small businesses are relying on the borrowers' personal credit history to determine future payment behavior.

To improve reliability, a model can be developed from a sample of clients that most resemble a specific customer's characteristics, using an institution's own pool of client information. This method is already being implemented by FUNDES, in Panama, and the finance companies Financiera Familiar, in Paraguay, and Orion, in Peru. The development of this type of credit-scoring requires a large client base and sound client-information database systems, making this a tool that is more likely to be used by larger microlenders.

Based in part on: Rowland, Jan *How to Benefit from Credit Scoring*, Dun & Bradstreet. Internet address: http://www.dbisna.com/dbis/credit/hcredit3.htm; August 1997.

- **Creating new non-bank financial intermediaries.** To reach small business customers, private non-bank financial intermediaries—such as consumer finance companies, small savings banks, credit unions or specialized entities like Peru's EDPYMEs or Bolivia's FFPs—are undertaking various innovations. These intermediaries can offer advantages not available to a commercial bank in terms of lower capital, reserve and provision requirements, leaner cost structures, and greater flexibility and responsiveness. Existing finance companies that have provided consumer credit have the advantage of experience in managing numerous small transactions. Many also maintain extensive payment histories for their clients; these can be adapted to assess the risk of lending to microenterprise using credit-scoring techniques developed for other markets. (See Box, opposite). Some of these intermediaries can mobilize savings.

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eliminate directed credit (mandatory targeting of loans to certain sectors or clients); reduce barriers to entry in the financial sector; and improve prudential regulation and supervision of financial institutions. To help bring interest charges down, regulations that promote competition for micro and small enterprise clients are also important.

Since 1989, the pace of financial sector reform has accelerated in many countries of the region, creating new opportunities for microfinance (See map, opposite). Some countries, most notably Peru and Bolivia, have even adopted new regulations to allow for the creation of specialized non-bank financial intermediaries for micro and small business. Private Financial Funds (FFPs) in Bolivia and Small and Microenterprise Development Entitites (EDPYMEs) in Peru are regulated, supervised financial institutions that offer limited banking services and have capital and reserve requirements tailored to microfinance rather than standard commercial banking. New entrants into the market include Caja de Los Andes, FIE and FA$$IL in Bolivia, and CREDINPET in, Peru.

- A limited direct role for the public sector in the microfinance industry tends to facilitate its development. Where government-owned institutions have captured a significant share of the market, or where microfinance is heavily dependent on government subsidies, private financial institutions will be less interested in offering microfinance services.

By promoting MiBanco ("my bank"), the government of Peru is publicizing and supporting commercial microfinance, but is keeping out of direct investment and decision- making.

- Both private investors and regulators will require accepted standards of financial performance and risk.

Some initiatives in this area are underway. Notably, the accounting firm Deloitte and Touche is now developing uniform auditing standards for microfinance intermediaries, with support from the international donor consortium, CGAP.

Private Sector Initiatives, Inc., a U.S.-based company, is working to establish a kind of rating agency that will assess the financial performance of microfinance institutions based on a standardized diagnostic technique. This information will be made available to both managers and investors.

The Pace of Financial Reform in Latin America and the Caribbean (1989-97)

Substantial new reforms since '89		Some additional reforms since '89	Little or no additional reforms
Argentina	Jamaica	Brazil	Bahamas
Bolivia	Mexico	Chile	Barbados
Colombia	Nicaragua	Costa Rica	Belize
Dominican Republic	Peru	Guyana	Haiti
Ecuador	Trinidad & Tobago	Honduras	Panama
El Salvador	Uruguay	Paraguay	Suriname
Guatemala	Venezuela		

Source: Glenn Westley, "Latin America's Financial Reforms," Inter-American Development Bank, 1995. Economic & Social Progress in Latin America, 1996 Report, IDB–Johns Hopkins University Press, 1996.

The Role of Financial Institutions: Changing Operating Procedures and Corporate Culture

In microfinance, both institutional culture and financial management differ from the standard operating procedure of commercial banks, which may explain why such institutions have shown a preference for establishing separate programs and subsidiaries—and are developing new techniques.

- Appropriate microcredit technology is essential to reduce lenders' administrative costs and manage risk, and to attract clients by keeping transaction costs low. The following elements are key: using alternative guarantees, such as personal guarantors and moveable property; evaluating the business owner, as well as the business; conducting on-site inspections for initial loans; creating a credit history for borrowers; evaluating repayment and savings behavior and other key indicators (this can be accomplished by making initial loan sizes small and keeping terms short, and by offering good customers repeat loans); reducing paperwork; making decisions promptly; locating branches close to clients; setting interest charges to cover all costs; automating transactions; and maintaining an excellent information system on clients and the overall portfolio.

- Specialized management expertise is required. Management may need to be strengthened in such areas as tailored provisioning, liquidity management, advanced information systems, and personnel incentive systems.

- Scale of operation and growth are required to attain profitabilty. The most successful microfinance institutions in Latin America have 20,000 active clients or more. But growth must be cautious; excessively rapid growth of a microcredit portfolio risks undermining the very technology on which microfinance is based. (See Box, p. 6).

Bolivia's Microfinance Industry: Leading the Way

Bolivia is pioneering one path to the future of microfinance in the region. Microenterprise is central to Bolivia's economy, providing the nation's main source of employment and income. Because of extensive regulatory reform and major investments by both donors and commercial sources in new, specialized financial institutions during the 1990s, Bolivian microenterprises are more likely to have access to formal financial services than their counterparts in other Latin American countries.

Growth in the microfinance sector has been rapid. In 1997, the active portfolios of the country's 14 microfinance institutions grew by 45 percent, while the number of clients rose by 16 percent. The leading specialized institutions providing financial services to the sector—which include NGOs, newly created regulated intermediaries called FFPs (Private Financial Funds), and a commercial bank—reach more than 200,000 clients and their portfolios total some US$90 million.

The specialized microfinance bank BancoSol has just been rated the number one bank among the country's seven small banks, and received higher marks in the areas of risk, liquidity, solvency, and profitability than Bolivia's 12 other banks, according to a survey by Nueva Economia. Caja de los Andes, which became a regulated entity three years ago, is highly profitable (see table, p. 7). The second NGO to undergo conversion, the Center for Promotion of Economic Initiatives (FIE), recently received its license to operate as a Private Financial Fund (FFP). Several other NGOs have applied for licenses, as well. Up to ten FFPs will be operating by the end of 1998, according to Bolivia's Superintendency of Banks (although some will focus on consumer credit).

Expansion is continuing in new areas of the country. An NGO, PRODEM, is taking the lead, operating 40 offices in secondary towns and rural market areas. Competition for microclients is intensifying in urban centers, leading to lower interest rates and improved services. The development of new financial services is also being pursued in the areas of housing, leasing, savings services, and consumer credit.

Source: John Owens, USAID/Bolivia

The Role of Investors: Creating New Vehicles for Expanding Commercial Microfinance

- To finance start-up costs—including the tailored information systems, staff training, and risk management techniques that make microfinance work—patient capital is needed. Until now, this role has been largely filled by international aid agencies. If the industry is to take off, new investors and vehicles are required.

A recent episode in Bolivia points out the challenges. The Inter-American Investment Corporation (IIC), the finance corporation of the IDB group,

A Cautionary Tale: Finansol

Finansol, one of the first Latin American microfinance institutions to formalize its operations, is currently trying to overcome a serious financial and operational crisis. A pioneer in the field of microfinance, by 1996, Finansol was on the verge of bankruptcy as its nonperforming loan portfolio exceeded its accumulated provisions and equity. Finansol offers a cautionary lesson for all microcredit operators in Latin America since the source of its problems exists in this market.

The Finansol crisis can be traced back to an inadequate business strategy, overly aggressive expansion, and a lack of clear separation between the for-profit finance company and its NGO parent. Between 1995 and 1996, its loan portfolio grew from US$10 million to US$35 million, its staff increased from 112 to 250, and the number of municipalities served grew from 14 to 72. Clients were offered new credit instruments based on unproved methodologies. Finally, nonfinancial services offered by the parent NGO (CORPOSOL) were not separated in their management from the financial management of Finansol.

As the crisis unfolded, concerned shareholders found it difficult to analyze the company's situation thoroughly and to regain control of the situation. ACCION International took over the leadership of an emergency team whose goals were to rebuild equity, search for new investment partners, form a new management team, and define a business strategy to keep Finansol competitive.

The rebirth of Finansol as FinAmerica is currently being conducted by new shareholders and a renewed board of directors and management team. The management of the old portfolio has been separated from the management of the new portfolio, which appears to be complying with profitability standards for the microcredit sector.

sold 24 percent of the shares of BancoSol, the largest microfinance bank in Bolivia, to a consortium of NGOs that had been involved in the bank's creation. Although a private bank bid for the shares, the consortium took the opportunity to retain control of what continues to be a unique and profitable institution.

- Social investors may provide a good bridge to capital markets for former non-profits enaged in microfinance. These "nontraditional" financial actors constitute the main pool of resources for microfinance institutions at present. Their interest in microfinance is prompted by social concerns, but they are also seeking financial returns. Social investors can help nonprofits engaged in microfinance get used to rigorous financial reporting and to negotiation mechanisms similar to those used by the commercial financial sector. Some social investors may accept below-market rates. But over the long run, microfinance institutions will need to go beyond social appeals to attract needed investments. Examples are proliferating. For instance, the Ecumenical Development Cooperative Society (EDCS) of Holland helps

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"Banco Solidario has learned three important lessons in its first two years of microfinance activities. The first is the difficulty in establishing the true size of the market. The second is the challenge of balancing costs with productivity. And the third is the importance of a methodology that is as effective in loan recovery as it is in loan placement. These are basic challenges, and the Bank is still learning. I believe that all institutions engaged in microfinance will need a subsidized start-up period, and that it is better to mix the offering of traditional financial services with microfinance operations to cover costs."

—Santiago Ribadeneira,
Executive President,
Banco Solidario, Ecuador

Microfinance Industry Leaders

The successful microfinance institutions that have emerged in the past five years have yet to be tested by a major economic slump, but they have shown enormous potential for increasing the access of very small businesses to credit—while turning a profit. The table below summarizes some industry leaders. As the table shows, the institutions have tapped private foundations, social investment funds, emerging market funds, holding companies, large corporations, and private investors for capital, as well as traditional funding sources in development agencies.

Institutions have taken a variety of routes to expand their microfinance services. For instance:

- NGOs have transformed themselves into regulated intermediaries (upgrading);
- Non-profits have bought or invested in for-profit banks;
- NGOs have entered into partnerships with banks;
- Banks and finance companies have established their own microfinance departments and products (downscaling); and
- New types of financial intermediaries have been created, such as Bolivia's Private Financial Funds (FFPs).

The institutions listed in the table below are among today's leaders in microfinance, but a whole new crop of formal microlenders is entering the market this year, including Banco Ademi in the Dominican Republic, MiBanco in Peru, and BanGente in Venezuela. Others, such as Colombia's fourth largest bank, Caja Social, are experimenting with new microloan products for the future.

Performance of Selected Industry Leaders

Institution[1]	Year operations began	Major Shareholders: Founding NGOs	Major Shareholders: Intl. NGOs & Develop. Agencies	Major Shareholders: Private Investors	Equity (US$million)	Loan Portfolio (US$million)	Number of Clients	Average Loan US$	Return on Equity
Bancosol (Bolivia)	1992	35%	25%	40%	$10.15	$63.08	76,216	$828	30%
Financiera Familiar (Paraguay)	1992	–	–	100%	$6.08	28.00	46,000	$1,200	18.8%
Los Andes (Bolivia)	1995	27%	44%	19%	$5.10	20.43	29,545	$692	25%
Financiera Calpia (El Salvador)	1995	30%	69%	1%	$4.8	18.86	21,291	$766	32%
Banco Solidario (Ecuador)	1996	–	35%	65%	$8.6	17.50	11,800	$500	13%

[1] Data as of December 1997.

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provide loans in foreign exchange to microcredit institutions in Latin America. The U.S.-based Bridge Fund of Accion International offers guarantees to its network members that enable them to access loans from local private banks. Funds managed by Triodos Bank of Holland, SIDI of France, the Calvert Fund, and Devcap of the United States also make equity investments in microcredit institutions.

The existence of an appropriate regulatory environment, advanced microfinance technology and products, specialized investment vehicles and transparent standardized financial reporting for microfinance institutions will strengthen the sector. This is happening now.

A regional fund based in Panama, Profund, specializes in microfinance investments in Latin America. Although Profund offers no grants or subsidies to its clients, many of its shareholders are development institutions. All investments made by Profund are on commercial terms that reflect domestic financial market conditions. The investment standards demanded by Profund, and the institutional strengthening effect of its participation, not only provide needed capital, but also serve to bolster private investor confidence in specific microfinance institutions and in the sector in general.

Although still in the early stages, the variety of initiatives occurring at many levels—from the government, to financial institutions, to individual investors—is paving the way for greater private sector participation in microfinance. The optimistic view is that as subsidies decrease, competition increases, and operational efficiencies are gained, the microentrepreneur consumers of these financial services will enjoy the benefits of increased access, lower interest rates, and better service.

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The Microenterprise Unit manages the IDB's microenterprise projects with the private sector and provides training, disseminates best practices, and develops policies and strategies to guide Bank country operations and promote the growth of the microenterprise sector in Latin America and the Caribbean.

Contributions to *Microenterprise Development Review* are welcome. Please send articles and comments to the Technical Notes Coordinator of the Microenterprise Unit. This and other publications of the Microenterprise Unit are available in Spanish and English at the Home Page of the Inter-American Development Bank: http://www.iadb.org/sds/