MicroEnterprise

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Reform and Rehabilitation of Credit Unions

A way to expand microfinance

By Glenn Westley

Interest in credit unions as a source of microfinance is growing throughout Latin America and the Caribbean. There are three reasons for this renewed interest. First, with approximately $2.6 billion in microenterprise loans, credit unions are far and away the largest source of formal and semiformal credit to microenterprises in Latin America. Second, even though credit unions are not exclusively oriented toward serving the poor, they nevertheless reach large numbers of such people. Third, despite being the dominant supplier of microfinance, credit unions are far from what they could be; they have enormous potential to expand and grow. However, this potential has remained largely unrealized because of a number of weaknesses that characterize most credit unions.

This article highlights four key issues that credit unions must grapple with today to become effective financial institutions: rehabilitation, supervision, governance, and consolidation.

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Credit Bureaus: Leveraging Information for the Benefit of Microenterprises

By Elinor Haider

Perhaps the single most important hindrance to increasing the flow of credit to the microenterprise sector is the lack of reliable information about borrower credit. Borrowers' repayment histories, as well as their current debt profiles, predict future ability and willingness to repay. Without this information, financial institutions and other creditors must offset risks by relying on solidarity group lending, collateral, and uniformly high pricing or fees. Credit bureaus help solve this problem. They provide detailed information that allows financial institutions, including microfinance institutions, to evaluate a borrower's ability and willingness to pay.

The information provided by credit bureaus benefits the microenterprise sector in several ways:

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Issue 1: Rehabilitation

Credit unions were initially set up in Latin America by social activists like Catholic priests and Peace Corps volunteers who wanted to assist the poor. The credit unions generally lacked professional management, were weak at loan recovery, and did not earn or retain profits for future expansion. They also usually kept loan rates very low in order to benefit borrowing members. Low lending rates meant that deposit rates were also normally kept low. Nevertheless, with substantial grant and soft loan funds available from donors, many credit unions managed to expand despite the lack of deposit mobilization, loan recoveries, and retained earnings.

With the elimination of most of this donor funding in the 1980s and 1990s, credit unions all over Latin America entered into a period of crisis—and of opportunity for rehabilitation. When credit unions have ventured down a path of vigorous growth and have achieved a significant measure of financial health, they have generally done so through an aggressive campaign to mobilize savings, strict attention to delinquency control, and a policy of earning and capitalizing profits. More generally, they have avoided what have been called the "Seven Deadly Credit Union Sins":[1]

"Sin" 1: External dependency. Reliance on external funding from donors builds an unhealthy dependency on outside programs that may one day be scaled back or eliminated. It also creates a culture and expertise within credit unions of courting donors rather than providing good service to depositors, controlling the quality of the loan portfolio, and striving for operational efficiency. Furthermore, credit union members often view donor credit programs as quasi-grants that do not really have to be repaid. All

[1] David Richardson, World Council of Credit Unions

> There are four issues credit unions must address to realize their potential: rehabilitation, regulation and supervision, governance, and consolidation.

this jeopardizes the long-term sustainability of the credit unions. To avoid the problems associated with external dependency, deposit mobilization should be stressed because a liquid deposit facility is an important financial service in its own right and should have a prominent place among the products offered by credit unions.

"Sin" 2: Confusing financial information. To properly administer a credit union, managers and directors must have meaningful balance sheets and income statements, devoid of smoke-and-mirrors accounting gimmicks such as overstated asset values or operating expenses that are deferred or amortized over time.

"Sin" 3: Inappropriate interest rates. Deposit rates must be competitive so that the credit union can attract savings and grow. Loan rates need to be set high enough that the credit union can earn profits and build an adequate capital cushion.

"Sin" 4: Poor public image. Many credit unions are in great need of upgrading their physical facilities and human resources, as well as improving their marketing.

"Sin" 5: Undisciplined fiscal operations. Credit unions need to bring discipline and good financial management into five key areas: delinquency control, adequate loan loss provisioning, sufficiency of institutional capital, maintenance of adequate liquidity reserves, and proper asset-liability management.

"Sin" 6: "Cookie-cutter" loan analysis. Credit unions should not give loans to all members as a "right" and should not set the loan amount as a simple multiple of the amount of the member's shares (for example, the traditional 3:1 loan-to-share ratio). Rather, credit unions must base whether and how much to lend on the capacity and willingness of the borrower to repay, and must strictly enforce collection.

"Sin" 7: Social philosophy over common business sense. A credit union must be financially strong before it can effectively help the poor. It must be run first as a business, not as a social welfare institution.

Issue 2: Regulation and Supervision

If credit unions are to have a long-term future as sound financial intermediaries with a substantial share of the market, they will almost certainly have to be supervised. Outside supervision helps credit unions, as it does banks, stay on the straight and narrow path of maintaining disciplined, prudent financial operations. It also helps protect the savings of a multitude of small depositors. However, unlike banks, credit unions have a cooperative ownership and governance structure, are often tiny institutions with much lower levels of professionalization, and are geographically less well diversified than banks. These structural differences lead to a number of important differences in how credit unions should be regulated and supervised. Two of the key regulatory differences relate to capital adequacy and the treatment of shares, and minimum capital in nominal terms and permitted operations.

With respect to *capital adequacy*, there are at least three distinct schools of thought and no clear consensus on how to treat share capital and set capital

Can Attempts to Limit Abuses also Limit Credit Union Services? The Case of Bolivia

In an attempt to limit theft, fraud and abuse, Bolivian authorities have proposed certain restrictions on very small credit unions in Bolivia. Those credit unions with capital below the threshold for supervision of about US$ 200,000 would not be permitted to offer liquid savings deposits, only illiquid share accounts.

Will such restrictions achieve their aim? Credit unions are essentially formalized versions of rotating savings and credit associations (ROSCAs), in which people who wish to borrow and save come together and do exactly that—lending funds to and receiving interest from each other. If governments restrict the ability of small credit unions to take deposits, what is the justification for letting ROSCAs continue to operate? And do the restrictions really improve the welfare of the members?

Presumably the members know that there is the possibility of theft and other problems and have decided—knowing what they know of their neighbors—to participate in the credit union anyway. They have concluded that the benefits outweigh the risks. Who is to say that the government knows better? If participation is voluntary, it should be welfare-enhancing, on balance.

Moreover, under the proposal, small Bolivian credit unions would have the option of merging with one another or with a larger credit union in order to meet mandated minimum capital requirements for deposit taking. The resulting credit unions would presumably be more viable financial institutions because of economies of scale and other benefits of greater size. But is it possible for many of the original, smaller credit unions—some of which are so small that the most appropriate technology for handling their operations is still tabulating information manually—to overcome the management diseconomies imposed by the distance between them and form a single credit union? Are there trusted and respected managers and directors available locally who are up to the task of running such a multi-branch credit union? Or are there larger credit unions that would find it worthwhile to absorb these small credit unions and keep service going in the local community? Finally, are the leaders of small credit unions willing to give up local control and merge with or be absorbed by other credit unions?

The answers to these questions are likely to depend very much on local circumstances. Countries contemplating restrictive regulations like Bolivia's should gather information on their likely impact before putting them into effect. If the answers to these questions in many small communities is no, then the primary effect of the proposed restrictions may be to eliminate financial services—rather than fraud and abuse.

adequacy ratios. While all three methods agree that institutional capital (retained earnings plus uncommitted reserves) should count as capital, this is where the agreement stops.

The World Council of Credit Unions argues for counting as capital only institutional capital, and for maintaining it equal to at least 10 percent of total assets. Another line of argument suggests that member shares should also be counted as capital, provided that credit unions follow the stock corporation model for share transfers in which owners wishing to sell their shares must sell them to other interested parties. This would address the problem of credit unions having to refund the full value of a member's shares when the member leaves the credit union. A third alternative is found in Bolivia, which retains the principle that the credit unions themselves should refund shares to withdrawing members, but restricts redemptions to times when the credit union is not having financial difficulties.

The other key regulatory issue is one of *minimum capital requirements and permitted operations:* what kind of operations should credit unions be permitted to offer, and should such permissions be based on some sort of minimum capital requirement? These issues are being explored in Bolivia (see box). Authorities in this country have imposed minimum capital requirements in nominal terms on credit unions, mandating that credit unions with capital below the threshold for supervision (of about US$ 200,000) cannot offer liquid savings deposits, only illiquid share accounts. These restrictions have generated an intense debate. At the core of the debate is the question of whether the restricted situation is better than the unrestricted situation in which small, unsupervised credit unions mobilize deposits but also commit abuses (such as theft and fraud), some of which could be prevented by curtailing credit union operations.

Issue 3: Governance

One of the principal challenges that credit unions in Latin America face in order to expand and become more significant actors in the financial marketplace is that of establishing proper governance systems. Two major problems of governance have faced credit unions: the principal-agent problem and the borrower domination problem. *The principal-agent problem* occurs when the interests of the elected directors and contracted management (the agents) diverge from the interests of the credit union members (the principals).[2] The resolution of this problem depends upon clearly and properly specifying and enforcing the institutional rules that define the roles and responsibilities of the actors involved in the governance of the credit union. Such rules are normally articulated in credit union bylaws and may be reinforced in banking regulations. These rules distinguish the oversight role of the board from the day-to-day administrative role of management, set appropriate qualification criteria for board members, and specify ethical behavior, controls on insider loans, and penalties for failing to exercise fiduciary responsibility.

The borrower domination problem arises from the fact that credit unions have historically been run to benefit borrowing members by keeping loan rates low and maintaining lax repayment discipline. Most people joined credit unions to access cheap loans, not deposit services, a bias that was reinforced by donor funding of credit unions. This imbalance threatens the long-term sustainability of these institutions. To resolve the borrower domination and resulting financial problems, credit unions should provide balanced services that will attract not only borrowers but also savers to the credit union and its board of directors. The presence of net savers on boards of directors will lead to more effective pressure on credit union management for prudent financial administration. This, in turn, will protect the interests of savers and help ensure the credit unions' long-run sustainability.

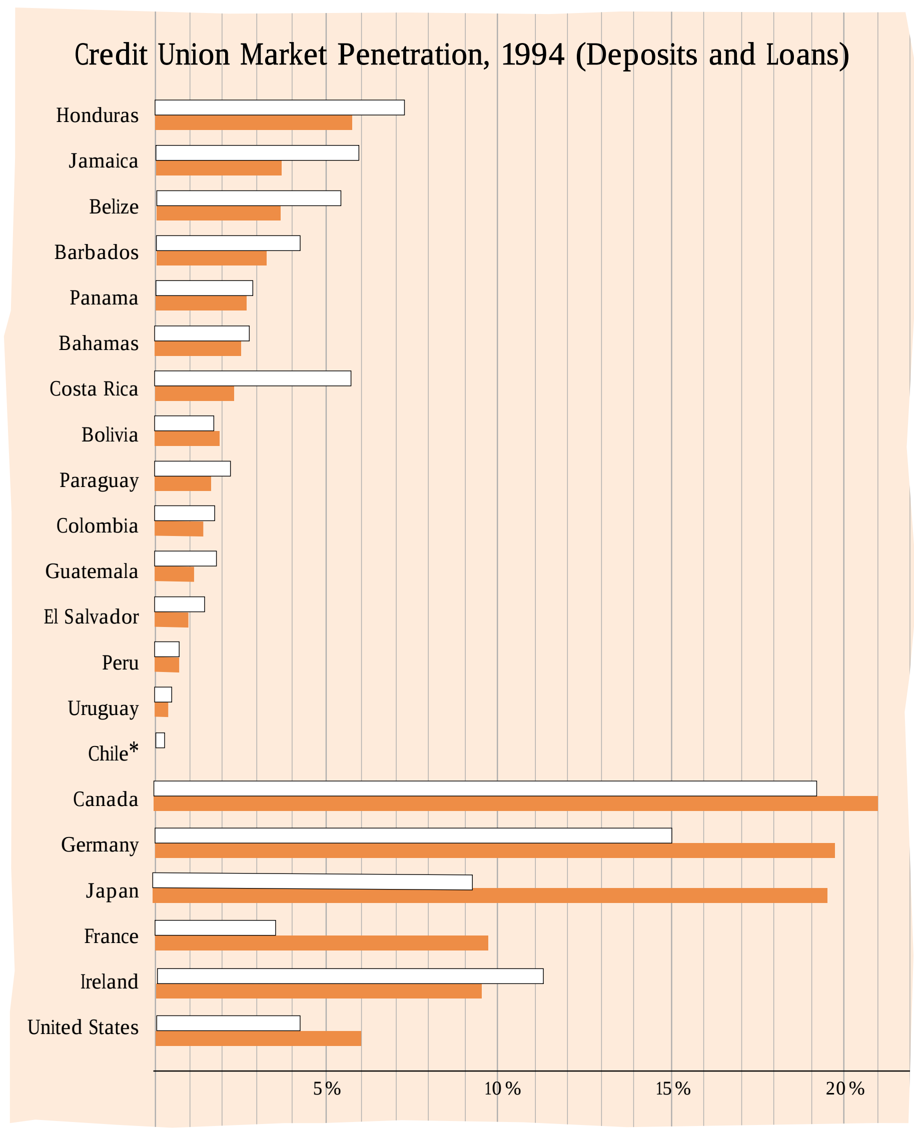
[2] This could happen in the areas of remuneration and insider loans, where the interest of management may be to excessively raise their own salaries and permit insider loans. The board of directors would normally oppose such actions.

Issue 4: Consolidation and Networking

Consolidation has been suggested as a way for credit unions to realize scale economies and increase their competitiveness. However, a group of financially strong credit unions in Guatemala has taken an interesting alternative route to enhanced competitiveness. These credit unions have linked all of their main offices and branches together into a single integrated national network. Members of any of the participating credit unions can walk into any of the more than 80 network offices and deposit or withdraw funds or make loan payments. This arrangement offers clear convenience benefits to clients. Individual credit unions have also obtained cost economies by opening additional branch offices and through the national federation's provision of common services, such as a common information technology, a joint marketing program, and a central liquidity facility.

Realizing the Potential of Credit Unions

Today credit union loans and deposits



Key: For each country, the upper bar presents the ratio of credit union deposits to total money plus quasi-money. The lower bar presents the ratio of credit union loans to private sector loans by the commercial banking system.

* Data refers to 1993 instead of 1994

Source: IMF statistics, 1994

in most Latin American countries constitute only 1 to 3 percent of banking system loans and deposits, versus 10 to 20 percent in a number of industrialized countries (see graph). Clearly, this leaves a lot of room for further growth. By addressing the issues brought forth in this article, the credit union movement can start to realize this potential. However, the resolution to some of the issues mentioned clearly lies with other actors, such as donors and supervisory authorities. These institutions need to do their part in fostering an external environment that will reward credit unions for dealing effectively with their internal challenges. ■

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Credit Bureaus: Leveraging Information for the Benefit of Microenterprises

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- *Lower transaction costs.* Microfinance institutions can spend less time evaluating loan applications, which lowers the cost of providing credit. Microentrepreneurs can spend less time waiting for loans to be approved — one of borrowers' key demands.

- *Reduced risk.* Microfinance institutions are better able to assess borrower risk and, consequently, can more accurately price their services, manage their loan portfolios, and set appropriate risk-adjusted reserves.

- *Greater transparency.* Microfinance institutions gain better knowledge of the liability side of those businesses that use non-standardized accounting procedures. This information also helps regulatory authorities monitor the sector more systematically.

- *More competition.* Microfinance institutions will compete for the clients with favorable credit histories, resulting in better terms for those borrowers.

- *Better incentives to repay*. Credit bureau information disciplines borrowers by letting them know that they risk being locked out of credit markets if they delay or default on their payments.

What is a Credit Bureau?

A credit bureau is an institution through which creditors exchange information about their clients' repayment histories and debt profiles. Bureaus act as brokers by collecting, organizing, and disseminating this information. They operate on a principle of reciprocity among members. This reciprocity—a system of mutual advantage to borrowers and lenders—addresses a fundamental tension between the parties involved in a credit transaction. Borrowers often have strong incentives to limit the information they share with lenders, particularly if they are already highly indebted or if they have adverse repayment histories. The existence of credit bureaus limits borrowers' ability to hide this kind of negative information.

Sometimes credit information is not shared voluntarily but because of compulsory regulation by the central bank. In this case, records are mandated, collected and registered by supervisory authorities that use the information to evaluate the systemic risk of the financial sector. For example, in Bolivia the credit bureau is exclusively managed by the Bank Superintendency and covers formal financial institutions, including seventeen credit unions, six microenterprise-focused *Fondos Financieros Privados*, and all commercial banks. Financial institutions may receive access to records for the entire banking system in exchange for providing client information to the bureau.

> Verification services provided by privately managed credit bureaus include:
>
> - Name, identification and address
> - Place of employment
> - Tax registration
> - Utility bill payments
> - Outstanding warrants or protests

Government-run credit bureaus, also called public credit registers, have significant limitations. Bank secrecy laws typically stipulate that only regulated entities have access to these facilities. Public credit registers are therefore prevented from including credit from microfinance institutions, consumer finance companies, durable goods manufacturers, and commercial store financing in their cash flow analyses. This excludes many microfinance institutions, the majority of which are constituted as not-for-profit organizations. These exclusions also have further repercussions for the microenterprise sector since it makes it harder for regulated institutions to seek out new and smaller clients with less established credit histories.

What is <u>in</u> a Credit Bureau?

The type of information shared through a credit bureau system is primarily determined by the depth of the financial sector and the system's technological capacity (see box, p.7). At first, financial institutions may exchange fairly simple data on past client delinquency or default—so-called "blacklists." This allows institutions to purge bad borrowers from their portfolios, avoiding the largest credit risks. A blacklist system also helps create a culture of repayment by clearly establishing negative future consequences for unpaid debt. For example, Haitian financial institutions have improved their portfolio quality by circulating monthly paper black-lists.

After initially punishing clients with tarnished credit histories, competitive financial institutions will then seek to reward and keep good borrowers by providing them with incentives such as increased loan amounts, longer loan terms, or reduced pricing. This requires consideration of data on over-all debt exposure—so-called white information. In Peru, recent access to white information on microenterprises led to the discovery that some borrowers were impossibly over-indebted and maintained relationships with as many as eight microfinance institutions.

Thus although sharing black information is an important first step for financial institutions seeking to improve portfolio quality, the full benefits of a credit bureau come from exchange of both black and white information. In practice, the categories of record sharing vary widely among financial systems and bureaus. For example, the Peruvian Central Bank Superintendency of Banking and Insurance (SBS) carries the data that all supervised financial institutions are obliged to report. For debts under US$4,500, institutions must report accumulated direct, indirect and guaranteed debt, lines of credit, and arrears less than and over 60 days. Amounts over US$4,500 have more stringent reporting requirements, including all those for lesser amounts as well as leases, current account overdrafts, refinanced credit, commitments for import finance, and arrears being settled in court.

Is Private Better?

Given the restrictions and limitations of public credit registers, privately managed bureaus have taken on increased importance. Today, many Latin American and Caribbean countries have multiple credit bureaus that compete based on the scale and scope of their client data as well as their ability to reconfigure, package and re-sell that information to future potential creditors. For example, Brazil, Colombia, and Peru have both government-run and privately managed bureaus, whereas El Salvador, Uruguay, and Paraguay support only private ones.

Because credit bureaus have fixed costs and are characterized by economies of scale, private entities usually enter the market only after a public credit register has been functioning for some time. Privately managed bureaus then complement the records contained in the public credit registers—and, by expanding the breadth, quality, and accessibility of information, improve

> "As a result of an improved credit bureau system, EDPYMES, Cajas Rurales, and Cajas Municipales are better able to manage their credit risk. The new system lowers the credit risk of microenterprises and encourages commercial banks to start paying serious attention to this market segment."
>
> Orlando Vasallo, Intendente del Central de Riesgos, Peru

Private Credit Bureaus Around the World

	Starting Date	Information Shared (Black or White)	Households Covered (% of Population)	Number of Reports Issued Annually (% of Population)
Argentina	1950s	B & W	57.6 (1997) *	3.4 (1997)
Australia	1930s	B	98 (1990)	34 (1990)
Belgium	1987	B & W	7.9 (1998)	104.8 (1998)
Brazil	1957	B	38.7 (1997)	128.3 (1997)
Canada	1919	B & W	n/a	82.7 (1998)
Chile	1990	B & W	4.7 (1997) *	49.3 (1997)
Denmark	1971	B	4.7 (1996)	50.3 (1996)
Finland	1961	B	4.3 (1990)	70.2 (1990)
Germany	1927	B & W	59.1 (1996)	59.1 (1996)
Ireland	1963	B & W	78.6 (1996)	22.5 (1996)
Italy	1990	B & W	16.6 (1997)	4.6 (1996)
Japan	1965	B & W	47.3 (1990)	121.5 (1990)
Netherlands	1965	B & W	32.7 (1996)	64.1 (1996)
Sweden	1890s	B & W	68.6 (1996)	26 (1990)
Switzerland	1945	B & W	7.6 (1997)	24.1 (1997)
United Kingdom	1960s	B & W	n/a	104.8 (1989)
United States	1890	B & W	76 (1997)	228.1 (1997)

Source: "Information Sharing In Credit Markets", Tullio Jappelli and Marco Pagano, 1999
Note: This is not an exhaustive list; countries are included based on available information. Also note that some of these countries also have a public credit register or more than one private credit bureau (in which case the data from the dominant one is included).
*Data on coverage for Argentina and Chile also includes firms.

and re-package an already valuable product. In a privately managed system, client data can be exchanged by any entity that supervises credit transactions, including trade associations, national or foreign credit-reporting companies, and associations of not-for-profit organizations.

In some cases, the demands of the private sector may change how the government manages its credit bureau. In Bolivia, for example, pressure from microfinance institutions has led the Superintendency to draft modifications to bank secrecy laws in order to include non-regulated institutions. In the interim, microfinance institutions may want to create parallel credit bureaus until they can be incorporated into systemic reporting. In El Salvador, five not-for-profit organizations have been working together since 1994 to set up a private information service for microfinance institutions. As of September 1999, this credit bureau, *InfoRed*, contained data on 44,000 loans.

Credit Bureaus: Getting The Technology Right

Appropriate technology for credit bureaus serves the information needs of end users while taking into account internal and external limitations faced by participants—notably microfinance institutions (MFIs). Internal limitations include an MFI's ability to manage technology, including systems upgrades and troubleshooting, as well as its own budget constraints. External limitations include the availability, reliability, and cost of telecommunications.

Credit bureaus have progressed from using paper lists to conducting reference checks entirely by computer. At first, bureaus installed their data bank directly in the server of their clients, charging for use through a metering system and updating the information periodically. More recently, MFIs have been using personal computers (PCs), modems and telephone lines, which can instantly access the credit bureau's data bank from any remote location. Although software and hardware requirements may be relatively expensive, costs can be recuperated in the form of improved portfolio quality. Furthermore, MFIs do not need dedicated PCs to access a credit bureau, but can use existing systems as long as they meet the required specifications. Obtaining credit reports online is a fast process, particularly if done in batches, which permits the same PC to be used for regular office work.

Development of the credit bureaus themselves will vary, depending on local telecommunications markets and the number of MFI clients. Normally, starting a bureau includes the costs of web-based software development, system testing, software licenses, two servers with 100mb Ethernet cards, an access server, internet licensing, internet service providers (ISP), switches and hubs, and new infrastructure requirements such as rewired buildings. Additional costs depend on the price and availability of digital, analogue or T1 telephone lines, as well as competition among internet service providers.

Source: Guillermo Bolanos, President, Protectora de Creditos, S.A., and Luis Lupiac, Chief of MIS, Superintendency of Honduras

How to Include the Microenterprise Sector

How can the microenterprise sector be better incorporated into the credit bureau system? Several challenges must be overcome, including the lack of unique identification numbers, the cost of access to credit reports, the short-term nature of microenterprise loans, and minimum limits on the credit amount recorded in the bureau.

■ *Unique identification numbers*. To ensure the reliability of information in a credit bureau, a unique identification number must be assigned to each person or business. Without an individualized form of identification, the records contained in a credit bureau may be unreliable or incomplete. Microenterprises generally operate in complete or partial informality and are therefore less likely to possess such a number. Consequently, inclusion in the credit bureau may require prior registration with government authorities, something many microentrepreneurs are reluctant to do.

■ *Cost of access*. Credit bureaus typically charge a user fee based on the number of reports accessed by each lender.[1] Since the portfolios of microfinance institutions may contain thousands of small loans, the cost of accessing credit reports is relatively more significant than for other financial institutions with fewer and larger loans. Furthermore, where credit markets are highly contested, there is a fear that sharing client data invites competition and encourages rival institutions to "steal" the most credit-worthy customers from one another. Such concerns are particularly pronounced in the microenterprise sector, where disproportionately high initial transaction costs make client retention the key to profitability. To avoid this free-rider problem, Peru aggregates financial data in such a way as to keep the financial institutions anonymous, unless the borrower has delinquent payments.

■ *Short loan terms*. The quality of client information can be problematic for the microenterprise sector, where

[1] For example, in Uruguay, access to the credit bureau costs $50 per month, which gives the user the right to 50 reports. After that, credit reports are $1.40 each. In Paraguay, the initial charge is between $90-$100, with an ongoing monthly subscription fee of $35. After 40 reports, additional use is $2.50 per access.

loans are typically short-term in nature. Since shorter- term financing becomes seriously delinquent more quickly, credit information for microenterprises requires frequent downloading of financial data to ensure accuracy.

■ *Minimum limits on credit amount recorded.* In many Latin American countries there is a minimum limit below which credit transactions are not considered significant enough to be recorded in the credit bureau. Consequently, many microenterprises would not be able to enjoy the benefits of a widely recognized credit history. Furthermore, since many microenterprise loans would not be included in the bureau's records, a limit of this kind means that the data in the credit bureau does not accurately measure the overall indebtedness of the private sector. Such considerations are particularly important for supervisory authorities who base policy decisions on such information.

Although private credit bureaus have existed in Latin America since the early 1950s, they have only recently begun to incorporate information on microentrepreneurs. Their recent proliferation serves as an important mark of the financial sector liberalization that has occurred in Latin America throughout the 1990s. The forces stimulating financial sector deepening, such as the abolition of interest rate ceilings, better supervision and regulation, and foreign competition have increased the demand for more comprehensive borrower information. By providing the credit histories of microentrepreneurs, credit bureaus reduce transaction costs, mitigate risk, increase transparency, stimulate competition, and increase incentives to repay. Credit bureaus alone are not the magic bullet for achieving universal access to credit, but they show enormous potential as a strategic investment to stimulate the growth of microenterprise. ■

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