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How Microfinance Evolves: What Bolivia Can Teach Us

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Nowhere in the Americas is microfinance as far advanced as in Bolivia. Using as examples Bolivia's three largest microfinance institutions (MFIs)—BancoSol, Caja los Andes and FIE—this article describes challenges microfinance has faced from economic recession and borrower revolts; how it stacks up against the rest of the banking sector; and how the industry evolved under those pressures. Finally, the article speculates where Bolivian microfinance—and indeed microfinance in general—may be headed.

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From NGOs to Formal Financial Institutions

Like many Latin American countries, Bolivia is home to a vast number of microfinance programs. Nobody seems to know their exact number, but there certainly are hundreds. What sets Bolivia—as well as Peru—apart from other countries is that some microfinance NGOs formalized early on. BancoSol for instance, was established as a formal bank in 1992. In 1995, Caja los Andes became a non-bank finance company—an "FFP," to use the technical term in Bolivia. In 1998, another NGO, FIE, took that same route. By December 2000, five microfinance NGOs had formalized. By placing themselves under the supervision of the country's banking authority, those five provided an unintended windfall for observers of the microfinance scene; it suddenly became possible to compare their performance to that of the banking sector as a whole.[1]

But before pursuing the question of how MFIs did in comparison to conventional

[1] All dollar amounts in this article are in U.S. dollars.

A Comparison of Formalized MFIs and the Banking System in Bolivia

Gross Portfolio	Formal MFIs (US$ million)	Total banking system (US$ million)	MFIs as % of system
1996	59	3,583	1%
1997	83	4,285	1%
1998	117	4,966	2%
1999	140	4,828	2%
2000	179	4,347	4%

Source: Bolivian Banking Superintendency

banks, let's briefly look at what prompted a few MFIs to break away from their peers and to subject themselves to the rigors of the banking law. At first sight, giving up an existence free of taxes and government oversight doesn't look like a reasonable step. Why did they do it?

Motivations of course vary, but by and large this apparently irrational behavior follows entirely practical considerations. All microfinance NGOs faced huge demand, which they could not meet with donor funding alone. The more successful ones began to borrow from commercial banks, but they soon discovered that commercial lenders are wary of not-for-profit organizations. NGOs have no owners, they mostly don't follow clear accounting rules, and they are difficult to pursue if they default on their obligations. Rare is the microfinance NGO that succeeds in borrowing more than the equivalent of its equity. Debt: equity ratios of more than 2:1 are rare indeed. MicroRate has seen board members of MFIs put up their homes and cars as collateral to enable "their" MFI to obtain additional credit. But such measures, desperate as they are, do not solve the fundamental problem of finding enough money to sustain rapid growth.

For Caja los Andes and FIE, formalization clearly provided a way to break out of their funding constraints. (BancoSol had taken this way from the outset and with spectacular success. By 1997, only five years after it was established, BancoSol's borrowings totaled $64 million.) Let's look at the example of FIE, the latest to formalize. In late 1997, FIE, then still an NGO, was as short of funds as it possibly could have been. Loan portfolio had grown from $4 million to $12 million in only three years and the debt:equity ratio had surged way past 2:1—probably the limit of what local creditors were willing to tolerate. So tight was liquidity that FIE had resorted to a very unusual but clever system of cash management: each day, the MFI disbursed only as much as it collected from its borrowers that day. There simply was not enough cash to do anything else.

In early 1998, FIE began to operate as a formal financial institution (FFP). Although still essentially the same institution with the same borrowers and staff, access to credit was no longer a problem. By year-end 1998, FIE's debt:equity ratio had increase to more than 6:1. Why this sudden and dramatic change? Two things had happened. As a formal financial intermediary, FIE now was able to attract deposits. Even without access to personal savings—banking authorities would grant that only later, after a trial period—FIE could sell certificates of deposit (CDs) to institutional investors. By offering higher rates than the banks, FIE found that this opened up a vast source of funding.

By the end of 1998, the new FFP had over $7 million in outstanding time deposits; a year earlier there had been none. But also banks agreed to increase their lending limits to FIE. For both institutional investors and banks, FIE acquired a new status when it formalized. The new FFP played by known rules—rules that, moreover, were enforced by a fairly tough banking superintendency. Creditors knew which accounting rules were used in producing financial statements; they knew that liquidity requirements, currency risk, provisioning levels and a host of other potential trouble spots were being monitored by the authorities. They probably also assumed that governments, which scarcely care whether an NGO runs into trouble, will go to some lengths to avoid the bankruptcy of a financial institution.

The FIE case is not merely an anecdote in the annals of microfinance. It illustrates one of the basic forces shaping the industry. MFIs are being pushed into formalizing by sheer necessity: the necessity to fund their explosive growth. Naturally, that necessity is strongest for the most dynamic MFIs. So, the leaders in their field have taken the plunge first. But as others see that this removes the funding constraint that blocks their growth, they will follow, as has been the case in Bolivia.

How FIE Has Funded Itself

	Deposits (CDs) (US$ thousands)	Total liabilities (US$ thousands)	Debt : equity ratio
1997	–	13,106	4.5
1998	7,352	14,135	6.5
1999	9,030	16,850	4.2
2000	11,438	22,121	5.1

Source: MicroRate

This is not to suggest that there is a universal rush toward formalization. Far from it. The overwhelming majority of Bolivian MFIs remain unsupervised NGOs. But because formal MFIs are able to grow, they already dominate the industry in terms of volume. If past trends hold, they will increasingly do so in the future. Regulated MFIs like BancoSol, Caja los Andes and even FIE are today so much larger than their unregulated peers that one can hardly any longer speak of the NGOs as competitors.

The most dynamic Bolivian MFIs have been able to grow by becoming formal financial intermediaries. But how have they fared in other respects? Can MFIs hold their own in the financial sector? This question was put to the test rapidly and dramatically in 1999.

Economic Recession: How Banks and MFIs are Coping

Since 1999, the Bolivian economy has been in recession. The recession hit at the worst possible moment for MFIs. By 1999, consumer credit agencies had expanded aggressively into microfinance (see box). Unbeknownst to the MFIs, many of their clients had taken on too much debt just as their sales were beginning to contract. As the recession deepened, borrowers' associations began to emerge; these attracted tens of thousands of members. For a time, the situation looked truly threatening and large-scale defaults seemed a real possibility. But surprisingly, the MFIs have so far emerged relatively unscathed, whereas the main consumer lending agencies were wiped out. Apparently the same borrowers who defaulted on their consumer loans continued to pay the MFIs. They seem to have distinguished between lenders who simply pushed money at them and those who took an interest in their clients and what that money was used for.

But even though the Borrowers' Revolt turned out to be less threatening than it initially appeared, the MFIs nonetheless faced considerable portfolio problems. Traditionally, their loan quality had been extremely high. Until 1997, on average, only about 1 percent of the outstanding loan balance was affected by arrears over 30 days.[5] In 1998, this figure began to creep up, and by December 2000 it had reached an alarming 10 percent. Portfolio at Risk (P@R) does not tell the whole story, however. To measure risk, one also

[5]Portfolio at Risk (P@R) is the most common measure of the quality of microfinance portfolios. Portfolio at Risk over 30 days, the measure used here, shows what percentage of outstanding loan portfolio is tainted by late payments of more than 30 days.

The Bolivian Borrower Revolt of 1999

In Bolivia, as elsewhere, consumer credit is secured by the borrowers' future salaries. If there is a default, the lender collects directly from the borrowers' employer. With high lending rates and low loan losses, consumer credit can be extremely profitable. But in poor countries like Bolivia, consumer credit companies have a problem: there are not that many salaried employees. Faced with an increasingly saturated market, Bolivian consumer credit companies began in 1998 to crowd into microfinance. In the process, they invented a unique form of microfinance: since they did not have the know-how to analyze a client's ability to pay, they simply relied on the fact that someone had borrowed from a MFI as proof of creditworthiness. A successful credit record with established microfinance institutions such as BancoSol, Caja los Andes or FIE automatically qualified a microentrepreneur for consumer credit. In a bit of fateful timing this move coincided with the onset of a major recession in Bolivia, and microentrepreneurs began accepting consumer loans to compensate for declining sales. They then found themselves in a debt spiral from which they could not escape.

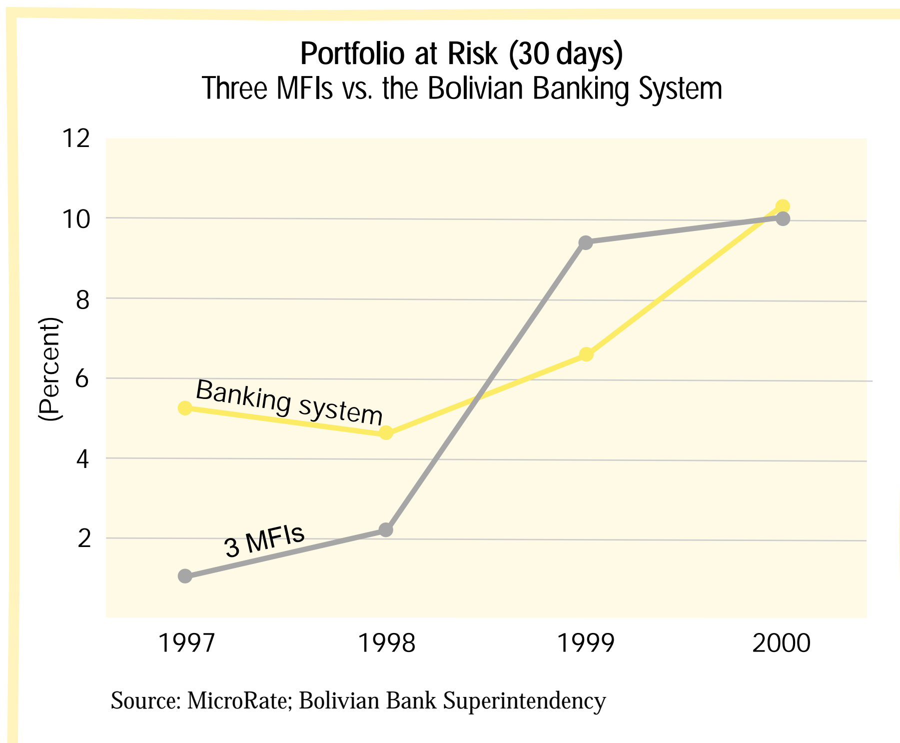
The swelling number of over-indebted borrowers gave rise to the creation of two "borrower associations" that tapped into the growing desperation of these people. Both associations worked on the same principle: for a fixed membership fee of Bs.50 (roughly US$ 8.50), they promised debt relief through borrower revolts. Their appeal was powerful and their membership swelled to huge numbers. Not surprisingly, with municipal elections looming, political parties were attracted to a cause that enjoyed such obvious popular support. However, both borrower associations have since become mired in accusations of embezzlement and their leaders have ended up in jail when they could not account for their members' fees.

In hindsight. it is clear that the borrower revolts were directed at consumer credit agencies with their aggressive lending tactics and collection methods. The three largest MFIs, BancoSol, Andes and FIE, with roughly 140,000 clients among them, reported fewer than 500 cases of arrears directly related to the borrower revolts. Consumer lending, on the other hand, was virtually wiped out. Interestingly, microentrepreneurs discriminated among their creditors. Nearly all of them continued to pay their microcredits, while they defaulted on their consumer oans. Had they not, the MFIs would have faced critical difficulties.

must take into account to what extent institutions have built up reserves—"loan loss provisions," in accounting jargon—to absorb loans they cannot recover. Fortunately for the MFIs, the story is reassuring on that score. For BancoSol and FIE, loan loss provisions cover around 80 percent of the entire P@R and for Caja los Andes, an extraordinary 110 percent.

Profitability—the proverbial bottom line-is of course the ultimate indicator of how well a financial institution is weathering a storm. Return on equity had been extraordinarily high before the recession hit in 1999. The three MFIs earned, on average, returns of well over 20 percent on equity. In 1998, average profitability for the three peaked at 27 percent. Since then, profits have tumbled, as one would expect. The RoE of 7.8 percent in 2000 looks lackluster—unless one compares it to the banking sector as a whole:

Source: IMF International Financial Statistics



Source: MicroRate; Bolivian Bank Superintendency

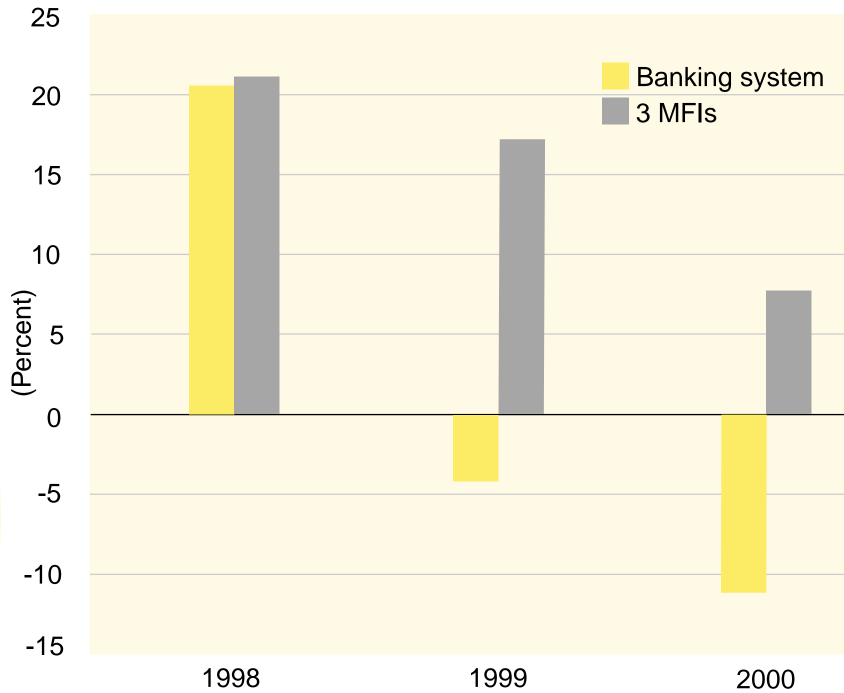
The high returns before 1999 are fairly typical for well-run MFIs. At this stage, they are still less a sign of concern for shareholders than of determination to widen the equity base as the portfolio grows. But BancoSol has been paying regular dividends for a number of years, which shows that shareholders are beginning to matter. Clearly, the recession has taken its toll on profitability. Nonetheless, the performance remains impressive if one considers that both in 1999 and 2000, the three MFIs created very large reserves—they "took provisions," to use accounting jargon–to protect themselves against anticipated portfolio losses.

The MFIs are so far weathering the storm considerably better than the banking system as a whole. They have lost their traditional advantage in portfolio quality, but they have managed to continue to grow while the others contracted. Moreover, they have remained profitable while the banks suffered losses.

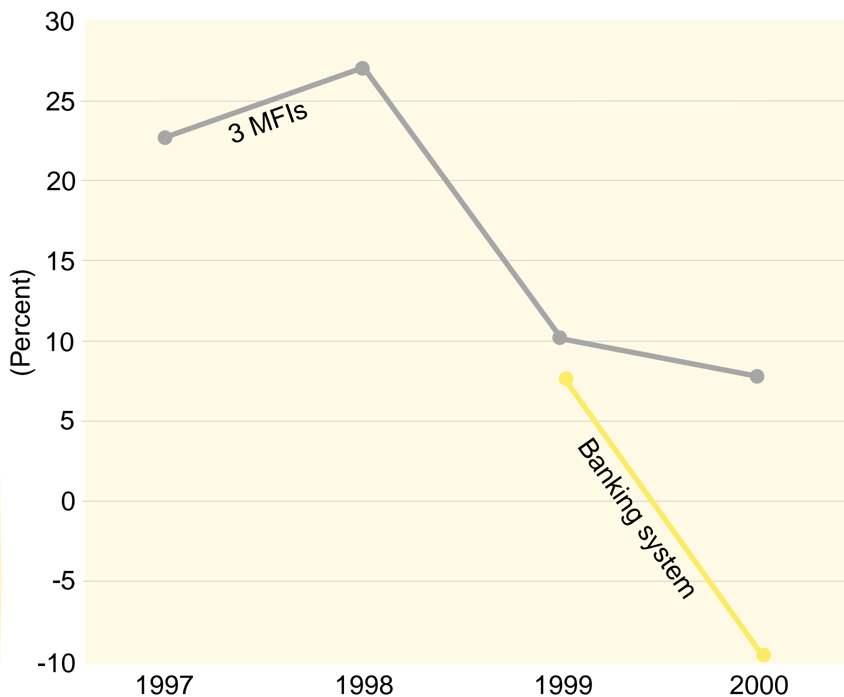
How the Bolivian MFIs Evolved

Continued recession and heightened competition have accelerated the pace at which BancoSol, Caja los Andes and FIE have adapted to a changing environment. Weaknesses have become more obvious than they would have been under more favorable circumstances and competition has forced all three to search for new markets.

BancoSol, for instance, had to rethink the solidarity lending methodology that had been its hallmark. In solidarity lending, borrowers form groups of four or five in which the members guarantee ome another's repayments. The methodology has two advantages. Members self- select, since groups have a strong interest to keep out borrowers of questionable reputation. And guarantees of other group members replace collateral, which microentrepreneurs



Source: MicroRate; Bolivian Bank Superintendency



Source: MicroRate; Bolivian Bank Superintendency

often do not have. The system worked extremely well for BancoSol. In 1994, two years after it opened its doors, the bank had a loan portfolio of $34 million. By 1997 it had reached $63 million, by far the largest of any MFI in the Western Hemisphere. But solidarity loans turned into a weakness as recession struck. Their level declined and arrears were much higher than in other parts of the portfolio. BancoSol's portfolio contraction last year (5%) is largely due to solidarity loans.

Caja los Andes and FIE had lent only to individuals from the outset. Individual lending places a greater burden on loan officers to accurately determine the repayment capacity of prospective clients, but it turned out to be much more popular with microentrepreneurs. It is easy to see why: the borrower no longer needs to worry whether other group members will pay and the methodology avoids the tensions that inevitably arise in groups as loan amounts begin to vary among members. A group member who needs only a $500 loan is not happy about having to guarantee the loan of a more dynamic neighbor who borrowed $1,000.

With the benefit of hindsight, it is obvious that BancoSol pushed the solidarity lending methodology much to far. Loan amounts and the disparity in loans among group members had grown too big. Competitors, meanwhile, were luring away the best clients with promises of individual loans. Growth at Caja los Andes and FIE outpaced that at BancoSol by a large margin.

Competition has also forced all three MFIs to look for new markets. Andes had always been willing to make loans to larger clients as well. Its small-business loan department uses more conventional lending techniques and relies on formal collateral. Pushed by competitive pressure, the other two moved in the same direction. All three now offer loans of up to $100,000 (BancoSol and FIE) and $120,000 (Caja los Andes), and all three have diversified into housing finance, consumer lending and other conventional banking products. They maintain that traditional

Average Loan Balance per Client

	BancoSol	Andes	FIE
1997	–	$732	$539
1998	$899	$897	$674
1999	$1,098	$972	$767
2000	$1,222	$1,121	$958

Source: MicroRate evaluations

banks have largely withdrawn from the bottom end of their market. They are confident that they have an advantage over banks in a market where clients prize simple procedures and quick lending decisions.

The rapid move up-market by all three MFIs shows clearly in their average loan size. To make the numbers comparable, the pawn-lending portfolio of Caja los Andes has not been taken into account. Pawn loans are very small—usually around $50. They account for a minimal part of the loan portfolio in dollar terms and they require little staff effort. Also, in the case of BancoSol's solidarity loans, each member of a solidarity group has been counted as a separate client, even though technically a group receives a single loan, which the members then divide among themselves.

Geographically, FIE had a traditional advantage through a branch network that reached beyond La Paz into smaller provincial cities. The other two had concentrated more on Bolivia's largest cities, but they are quickly discovering the attractions of smaller isolated markets. Caja los Andes has built up specialized know-how in agricultural lending and in pawn loans, but the other two are moving to enter those market niches as well. BancoSol is now finally trying to exploit its advantages as a full bank, which allows it to offer services like checking accounts, overdrafts, and foreign trade financing, from which FFPs are barred. All three are beginning to push personal savings accounts, which are expensive to administer but less rate-sensitive and much more stable than institutional savings.

Where is Microfinance Heading?

Bolivia is hardly representative of the entire developing world and deducing general trends from the experience in one small Andean country is a hazardous business. But some lessons seem to be emerging from Bolivia that may indeed point the way for others.

- First, the polarization of microfinance into a few formalized institutions on the one hand and a multitude of small NGOs on the other seems to be a trend that is being repeated in other places. In this scenario, the formalized MFIs easily dominate the market in terms of volume, whereas the NGOs stay small, because they are donor-dependent. They shelter themselves from competition by the dominant MFIs by looking for specialized market niches that the large players cannot enter easily.

> The real trend is not mission-creep away from microentrepreneurs. It is a movement toward comprehensive banking services for low-income segments of the population.

- Second, MFIs do not formalize because "it's the right thing to do," much less because donors push them to do it. If they formalize at all, they do it out of simple self-interest because they see no other way to obtain the funding they need to sustain rapid growth. In this sense, donors that preach formalization may actually be impeding it if they continue to fund mature NGOs.

- Third, solidarity credit has its place as an entry product at the bottom of the market. But as microenterprises grow, they find group loans increasingly burdensome. The Bolivian example shows that, everything else being equal, MFIs that lend to individuals have a distinct competitive advantage over those that lend to groups.

- Fourth, MFIs are diversifying their services as they grow. No longer will they offer just one standardized loan product or cater to one type of client. Mature MFIs try to reach the gamut of small clients who do not yet have access to conventional banks—and in some cases they begin to go after those who do. They hope to compete with conventional banks by offering service that is tailored specifically to smaller, less sophisticated clients.

The rapid growth in average loan size will no doubt be noted with concern in microfinance circles. Are MFIs abandoning their traditional markets? Are they heading for the greener pastures of lending to established businesses and of catering to the middle classes? Not very likely. True, MFIs like all other creatures, will eventually be attracted by greener pastures, but the real question is: where are these? The experience in Bolivia so far suggests that they are at the bottom end of the market. Margins are still much more attractive in microcredit even though, thanks to competition, lending rates are now far lower in Bolivia than in any other country in the Hemisphere.

The real trend is not mission-creep away from microentrepreneurs. It is a trend toward comprehensive banking services for low-income segments of the population. MFIs are beginning to evolve into banks, which can accompany their clients as they grow and can offer them a full menu of financial services tailored to their special needs. Long gone are the days when MFIs

would impose relatively low loan ceilings beyond which they would refuse to go. Institutions like Caja los Andes realized early on that in this way they were losing their best clients. Other MFIs soon followed Andes' lead.

MicroRate has seen MFIs that allowed themselves to be lured away from microcredit either because usury laws prevented them from covering the high cost of running a microcredit portfolio or because they could not master the required lending techniques. In all those cases, the MFIs concerned found that life upmarket is considerably tougher than they thought. Larger clients are much more rate-sensitive, making it hard to earn adequate spreads. Larger enterprises also tend to be harder hit by economic recession than extremely small ones, which have few fixed assets and hardly any overheads. In some cases, these MFIs have hurried back down-market; in others, they are struggling just to survive.

No doubt, some of the MFIs that are expanding their services to include larger clients will feel the same temptation to abandon microcredit. They will give in to it at their own peril. A good guess is that the winner in the current fierce competition in Bolivia will be the institution that successfully adds small-business lending and other banking products, without losing its edge in microenterprise. If that prediction holds true, then the future of microfinance consists of full-scale banks, which serve businesses ranging from informal street vendors all the way to corporate clients. They will look much like conventional banks, except that they have learned how to do business with the poorer half of the population.

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Why Some MFIs Fail…

It goes without saying that the fate of an MFI, like that of any firm, will hinge on countless factors both internal and external, some predictable and some not. However, some factors seem more critical than others, particularly during hard economic times. In a recent report submitted to the Inter-American Development Bank, specialized consultant Felipe Portocarrero identified the lack of sufficiently deep-pocketed shareholders, both for financial support and monitoring, as a crucial factor in virtually all MFI failures seen in Peru during the 1990s.

With ownership structures that did not include any shareholders big enough or invested enough to monitor the MFIs, their mismanagement went unnoticed until government regulators stepped in to conduct audits, and their ability to take corrective measures was curtailed by lack of access to capital. Contrary to the case of Banco Solidario in Ecuador, which was in trouble during 1999 but able to draw on its international investors, the Peruvian MFIs found their financial position deteriorating and, in some cases, tried to cover it up with "creative" accounting methods.

In all, Peruvian bank regulators closed down 8 MFIs between 1997 and 2000, including 7 small rural banks known as Cajas Rurales, which offer microcredit in rural areas, and one specialized microfinance company of the institutional form called EDPYME. Bank regulators stated several reasons for closing the MFIs down. In some cases, portfolio quality had been allowed to deteriorate to the point where delinquent loans accounted for 30% to 70% of gross portfolio. There were also insufficient loan-loss provisions, sometimes as little as 10% to 30% of the amount in arrears. Other problems included accounting irregularities, non-compliance with various regulations, failures to implement corrective measures and even embezzlement.

According to Portocarrero:
"…In each and every case of these failures, shareholder structure played a crucial role. In the case of the rural banks, the shareholder base was very fragmented, with shareholders numbering in the thousands but no single shareholder having enough invested to have an incentive to keep close track of the management of the institution. Moreover, once an institution got into trouble, there was no single shareholder that could contribute enough additional capital to shore up the solvency of the institution. In the case of the failed EDPYME, its main shareholder, a nonprofit organization, could not raise the needed capital either. These cases highlight the importance of requiring an appropriate ownership structure for financial institutions, and ensuring that the main shareholders are solvent…"

Source: Report submitted by Felipe Portocarrero to IDB's Micro, Small and Medium Enterprise Unit in May of 2001.

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