

Merger Mania in Microfinance?

Tor Jansson

Ever since its creation in 1991, BancoSol has been the icon of microfinance in Latin America. By virtue of its early creation, its size and its license to operate as a bank, BancoSol has been seen as the example of what can be achieved in microfinance. However, BancoSol could soon be eclipsed by another institution arising from the merger of the five affiliates of Women's World Banking in Colombia (Bogota, Bucaramanga, Cali, Medellin and Popayan). Although no decision has yet been taken, were such a merger to happen it would create the largest (in terms of clients), fastest growing and most profitable microfinance institution in Latin America and the Caribbean. The merger would surely be accompanied by the formation of a licensed financial intermediary, presumably a bank or finance company.

The Colombian Women's World Banking affiliates would not be the first microfinance institutions that have endeavored to grow by means of a merger. In fact, there are three notable Latin American microfinance institutions that have come about as a result of mergers: Eco Futuro in Bolivia (1999), El Comercio Financiera in

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Microenterprise Growth and Environmental Protection

Mark Wenner

The results achieved by microfinance institutions in Latin America over the past ten years have captured the imagination of policy makers, community

activists, academics and donor organizations the world over: many believe substantial poverty alleviation would follow if financial services could be extended even more widely in the microenterprise sector. In Latin America and the Caribbean alone, an estimated 130 million people—59% of the total workforce of 217 million—depend on microenterprises for their livelihood.

However, there is growing concern that microenterprise activities may

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Features of a Merged WWB in Colombia

Clients	84,275
Average loan balance*	\$323
Portfolio	\$28,130,000
Portfolio Growth*	29.7%
Loans / Credit Officer*	544
Operating Efficiency*	15.9%
Portfolio at Risk (>30 days)*	1.4%
Return on Assets*	12.3%
Return on Equity*	25.1%
Debt/Equity	1.1

Source: MicroRate data, Dec., 2000
*Weighted averages of the five WWBs.

Paraguay (1999-2000), and Confia in Nicaragua (2000). Given that important benefits can be derived from mergers, the microfinance industry will likely see more of them in the future. However, as the experiences of Eco Futuro, Confia and El Comercio Financiera demonstrate, merging is far from simple. There are plenty of challenges that have to be overcome and plenty of things that can go wrong.

Merger Models

What makes the cases of Eco Futuro, Confia, and El Comercio Financiera particularly interesting is that they represent different models of mergers. In

the case of Eco Futuro, four nonprofit foundations (ANED, CIDRE, FADES, IDEPRO) merged to create a Private Financial Fund (basically a finance company). In the case of Confia, a nonprofit foundation (Chispa) merged with a mainstream finance company (Interfin) to form a commercial bank. In the case of El Comercio Financiera, two finance companies (Financiera El Comercio and Emprendimientos Financieros) merged to form a new finance company focused mainly on the small and microenterprise market.

In the cases of Eco Futuro and Confia the mergers not only meant the fusion of distinct organizations and their cultures, but also the simultaneous transformation of unregulated nonprofit foundations into supervised financial intermediaries. Not surprisingly, such transformation added further complications to the merger process.

As it turns out, each one of the three mergers offer an interesting story of high hopes, unexpected challenges and painful adjustments. In the end, only one can be characterized as an unqualified success.

Motivations

Why merge? The case of Eco Futuro in Bolivia reveals a mix of motives. The four participating nonprofit foun-

dations were all strong enough to reasonably think that they could form a Private Financial Fund on their own. However, they chose to pursue a merger because it would give them a broad shareholder base and a nationwide scale of operations. Also weighing in this decision was a somewhat altruistic belief that the country and its financial system would be better off with one medium-sized institution than with four small ones.

In the case of Confia in Nicaragua, Chispa hoped to become the first formal financial intermediary in Nicaragua specialized in microfinance. It wanted to prove to the country that microfinance could be run as a business. Moreover, if it managed to transform itself into a commercial bank specialized in microfinance, it would join a league of only a handful of such institutions in Latin America. Interfin, Chispa's partner in the merger, offered an attractive route to this goal as it already had a license as a finance company, which could be converted to a banking license with relative ease. As far as Interfin was concerned, its motivations were based on the new market opportunity represented by microfinance as well as the capital that Chispa and its international backers could bring to the table. The latter point would take on crucial importance as the merger process revealed that Interfin was less than the ideal partner Chispa had hoped for. Finally, there were also outside pressures for the deal. Profund, a regional investment fund, was encouraging the merger as a way to safeguard the value of an existing investment in Interfin.

While lofty motives may have played a part in the creation of Confia and Eco Futuro, the merger between Financiera El Comercio and Emprendimientos Financieros in Paraguay was all about business. The purpose of the merger was to increase efficiency (and thus profits), instantaneously offer a full range of services to its clients and, importantly, climb the recently raised capital requirements for financial intermediaries in that country.

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Size of Institutions At Time of Merger

	Portfolio (US\$ million)	Clients
Eco Futuro, Dec. 1998		
FADES	\$9.0	26,962
IDEPRO	\$7.3	14,538
ANED	\$6.5	41,803
CIDRE	\$2.9	565
El Comercio Financiera, Dec. 1999		
Emprendimientos Fin.	\$19.4	5,542
Financiera El Comercio	\$18.1	9,435
Confia, Dec. 1999		
Interfin	\$12.0	750
Chispa	\$2.5	6,000

Source: Papers presented at the 4th Inter-American Forum on Microenterprise (Santo Domingo, Nov. 12-15, 2001).

Mess-ups & Make-ups

There are plenty of things that can go wrong in a merger. The agreement may be badly defined or phrased, the parties may not realize the full implications of their agreement, or changing market conditions may alter the incentives for the merger. In extreme cases, one party may even withhold important information from the other institution(s). While the creation of El Comercio Financiera reportedly went fairly smoothly, the same cannot be said for Confia or Eco Futuro. In both cases, the participating institutions quickly found themselves facing unexpected and serious challenges.

In the creation of Eco Futuro, the four participating NGOs encountered their first challenge in simply agreeing on a unified business plan for the new entity. Not surprisingly, each NGO had a distinct idea of what type of clients the new entity should target, what services it ought to offer and where it was to provide them. The discussions were complicated by the participants' distinct organizational cultures, strategic visions, geographical focus, and micro-credit technologies. For example, FADES and IDEPRO offered not only individual loans, but also solidarity loans; IDEPRO operated only in urban areas while ANED and CIDRE operated mainly in rural areas, and so on.

The internal turbulence was mirrored by external challenges. The important task of attracting new investors, for example, proved more difficult than foreseen by the partners of Eco Futuro. Private investors were understandably nervous about committing money to an institution that had no track record as a unified entity. The

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founding NGOs finally managed to convince a sufficient number of investors, mainly international donor organizations, but it was a long and arduous struggle.

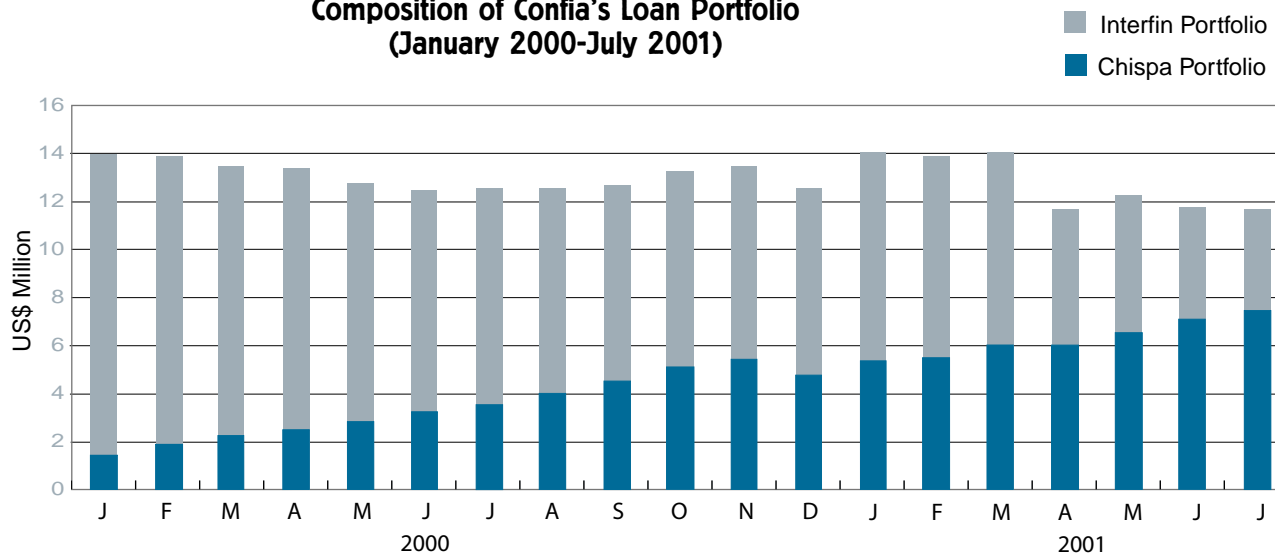
Investors were not the only ones who hesitated. The bank superintendency, which grants operating licenses to new financial intermediaries, also had

serious misgiving about the creation of the new entity. Its main points of concern were the lack of hard data regarding the quality of the NGOs' loan portfolios, an inadequately developed plan for the transfer of those portfolios to the new entity and, given the internal differences, the potential for chaos in the management of the new entity. For these reasons, it would take three years (1996-1999) before the superintendency finally gave the go-ahead for the creation of Eco Futuro.

In the case of Confia, Chispa had originally hoped to complete the merger with Interfin by October 1999. Talks between the parties had progressed well and, by the latter part of that year, it seemed like the merger would indeed take place within three to six months of the target date. The only substantial matter remaining, a due diligence report on Interfin's portfolio, was not expected to produce any significant changes to the terms of the merger. However, to the surprise of Chispa's management, what had seemed almost like a formality turned out to be a source of serious tension between the two merger partners.

To begin with, Interfin's management resisted the due diligence investigation, including attempts to withhold essential information on the portfolio. The uncooperative individuals in Interfin's management were ultimately replaced

Composition of Confia's Loan Portfolio (January 2000-July 2001)



and the due diligence process proceeded as planned. When the report was finally issued in January 2000, at the time the operational merger began, it indicated that that Interfin's portfolio suffered from severe repayment problems and that a large portion of it would have to be written off. This conclusion was subsequently confirmed by the country's bank superintendent, which came to require that Interfin formally recognize the true quality of its portfolio. The resulting charges were so large that Interfin's shareholders were forced to make fresh contributions of

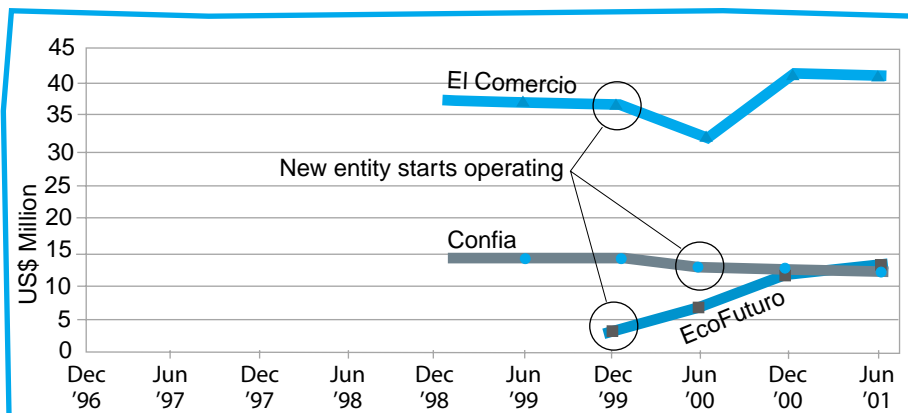
\$3.6 million to maintain the institution's capital at the minimum level required by the law.

Financial considerations took center stage in the merger between Chispa and Interfin, but the deal also suffered from other problems. While Chispa informed and trained its staff in preparation of the merger, Interfin's staff had received little information and no training, and they were therefore thoroughly unprepared to integrate operations. All staff preparations in Interfin had to be rushed through during the last few

months prior to the formal signing of the deal, which took place in August of 2000—almost a year later than originally planned. A final disappointment came when a new law raised the minimum capital requirements for commercial banks to \$10 million, effectively dashing Chispa's hopes of converting Interfin's license into a commercial bank license.

The creation of Comercio Financiera in Paraguay seems to have been a much more pleasant event. In contrast to the cases of Confia and Eco Futuro, the October 1999 merger of Financiera El Comercio and Emprendimientos Financieros proceeded relatively quickly and smoothly. The most significant problems appear to have been related to the integration of information systems and the anxiety felt by staff regarding some of the projected layoffs. While quite normal issues in any merger, they nevertheless resulted in some unexpected delays, portfolio losses and staffing controversies. On the positive side, several factors combined to facilitate the merger, including good personal relationships among board members, compatible institutional cultures, the similar size of the companies, and the fortunate coincidence that both companies were users and shareholders of the same credit card processing firm.

Loan Portfolio
Eco Futuro, Confia, El Comercio Financiera



Explanation: In the cases of Confia and El Comercio, the data prior to the merger include both partners' portfolio. In the case of Eco Futuro, the founding NGOs continue to operate and provide financial services.

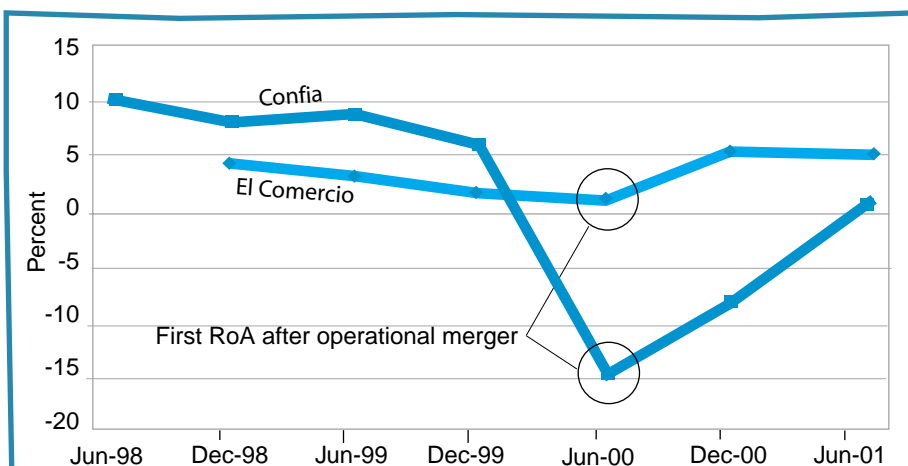
Mantra: "Make Me Money"

Even with the benefit of hindsight it is hard to say whether the decisions to create Confia, El Comercio Financiera and Eco Futuro were good or bad. Sure, the new entities are all doing reasonably well today, but perhaps the participating microfinance institutions would have done even better on their own. In all cases, they were successful and financially healthy prior to the merger.

It may be hard to render a judgment about specific mergers, but it is clear that microfinance institutions will not escape the general trend of increasing consolidation in the banking sector. More microfinance mergers will occur. Given the well-established benefits of scale in the financial services industry, many microfinance institutions will ultimately be pressured to merge, acquire

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Return on Assets
El Comercio Financiera & Confia



Note: For el Comercio Financiero, the RoA up to Dec. 1999 is a weighted average of the two merger partners' individual RoA. For Confia, the RoA up to Dec 1999 is purely Chispa's.

or be acquired. Consequently, the cases Confia, Eco Futuro and El Comercio Financiera probably indicate the start of a new trend in microfinance.

For other microfinance institutions there are some general lessons to be drawn from the difficulties experienced in the creation of Confia, Eco Futuro and El Comercio Financiera. Most important, these cases suggest that a merger is a formidable challenge, especially when it involves the transformation of NGOs into licensed financial intermediaries. Such a transformation adds another layer of complexity and introduces a host of other factors that can delay or even derail the merger. Consequently, thorough preparation and planning are key to a successful merger.

Another lesson to keep in mind is one of selfishness. The smoothest and most successful merger was the one most dominated by selfish considerations of material gain (El Comercio

Financiera), where the stated purposes of the participants was to improve efficiency, increase profits and comply with regulatory requirements. The presence of nonmaterial objectives in the cases of Confia and Eco Futuro (for example Chispa's desire to be Nicaragua's first licensed microfinance intermediary and the desire of ANED, CIDRE, FADES, IDEPRO to contribute to the stability of Bolivia's financial system) may have led them to be less vigilant in examining the intentions, operational compatibility and financial health of their partners. In the case of Confia, there was also pressure by an outside organization (Profund), which had interests of its own. All in all, the lesson to be drawn seems to be that the likelihood of success is improved if the decision to merge is based primarily on a solid calculation of financial gain and sustainability.

As for the Colombian WWB affiliates, they would be wise to study the case

of Eco Futuro, the one most similar to their own situation. While the WWB affiliates certainly have more in common than did the four NGOs of Eco Futuro, this does not automatically mean that a merger among the WWB affiliates would be free from problems. The difference between a well-managed and merely reasonably managed merger can be months or years of delay, frustration and unnecessary costs. Given the importance of the WWB affiliates to their local communities, they can't afford to get it wrong. ■

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Microenterprise Growth and Environmental Protection

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damage the environment through lax or non-existent pollution controls. In the short-run, on a case-by-case basis, the damage may not be significant. But some worry that over time the cumulative effects could become serious. If there turns out to be a trade-off between environmental protection and microenterprise development, then national governments, donor organizations and the private sector will need to face the problem and implement cost-effective pollution mitigation strategies. Microfinance institutions, which each have direct relationships with thousands of microenterprises, will likely find themselves in the center of any efforts to improve environmental conditions in the sector.

But what can microfinance institutions really do? The search for the most effective strategy begins with an appraisal of the problem: how pervasive is pollution in the microenterprise sector?

Pollution in the Microenterprise Sector

Though research on the issue is sparse, anecdotal evidence and the few empirical studies that have been done suggest the vast majority of microenterprise activity is not pollution-intensive. This is because most microenterprises are involved in commerce, the

buying and selling of products, which has little "environmental footprint." While retail businesses generate litter and congestion, they do not normally create health-threatening emissions or dangerous working conditions.

Where problems may arise is in a few pollution-intensive activities such as tanning, brick- and tile-making, elec-

Some Typical Microenterprise Pollution Problems

- Improper disposal and unsafe use of hazardous substances such as pesticides, solvents and other chemicals.
- Intensifying use of natural resources, chemicals and polluting technologies due to increasing population pressure.
- Inefficient use of natural resources resulting in pollution and waste through reliance on obsolete technology.
- Inappropriate location of microenterprises in urban areas and their subsequent contribution to overcrowding and pressure on infrastructure such as water and sanitation services.

troplating, mining, charcoal making, wood processing, painting and printing, textile dyeing, meat processing and chemically intensive agriculture and aquaculture. While the environmental impact of an individual firm may be small due to its limited scale of operations, the toxicity of chemicals used may be long-lasting, especially if the absorptive capacities of the surrounding ecosystems are very limited.

Brick-making kilns are a classic example of microenterprise pollution in urban areas. They generate smoke and airborne particles that lead to respiratory illnesses not only among workers but also among neighbors. A classic example in rural areas is small-scale alluvial gold mining, in which mercury is used to separate gold from dross. The mercury can poison the miners as well as entire streams and rivers.

Such examples point to an important distinction in the environmental impact of urban and rural microenterprises. In urban areas, microenterprises usually do not constitute a major source of pollution in absolute terms. Exceptions may be found when there is a dense clustering of microenterprises engaged in pollution-intensive activities like those mentioned above. But a few large-scale urban manufacturing plants can

easily cause more environmental damage than a host of microenterprises. In rural areas, however, the absence of heavy industries means that microenterprises cumulatively constitute the major source of pollution and degradation. With the exception of large-scale plantation and logging operations, most of the threat to the environment seems to be due to degradation and unsustainable use of renewable natural resources by a multitude of small-scale farmers. Whether the environmental damage done by the few outweighs that done by the many is an empirical question, but the sheer number of small-scale operators gives reason for concern.

In short, the threat of environmental damage from microenterprises is concentrated mainly in certain specific, pollution-intensive activities; and it tends to be greater in rural areas than in urban areas, particularly when compared with larger-scale industry. Therefore, while urban efforts to mitigate the effects of the most pollution-intensive microenterprises are worthwhile, it may be reasonable to focus even more on the promotion of sustainable resource use in rural areas.

Bankers to the Rescue?

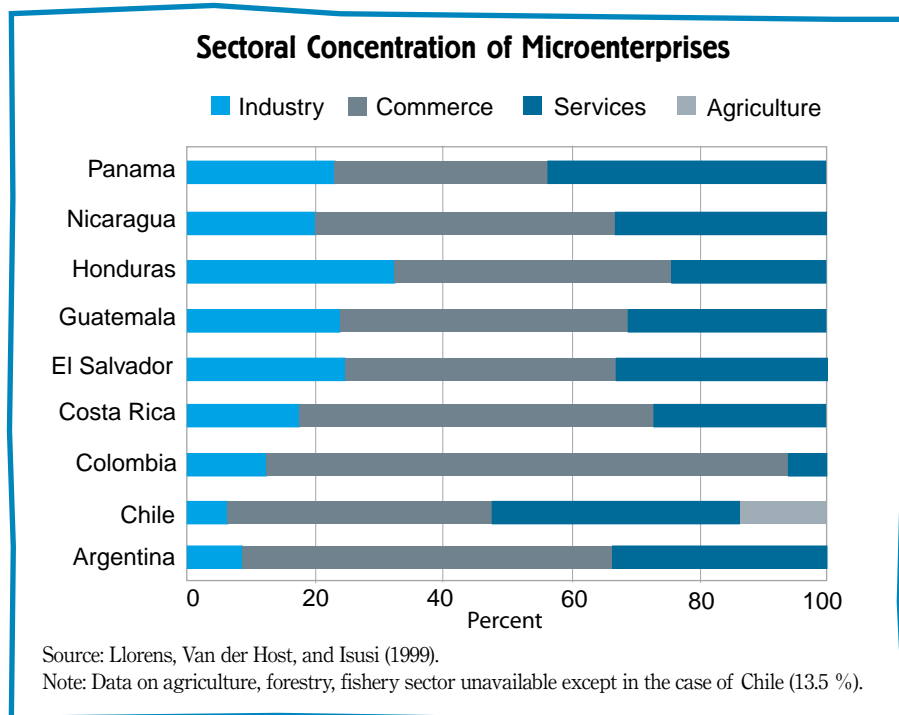
In the last decade, the role of the

financial service sector in facilitating or hindering environmental management has been increasingly scrutinized and criticized by public interest groups. Until recently, financial institutions were not seen as having any responsibility for the environmental impact of their borrowers. That is changing and any neutral ground is fast disappearing. Bankers are now seen either as potential allies in sound environmental management or as potential accomplices in environmental degradation. Finance and ecology have become firmly linked.

This trend is particularly visible in industrialized countries where much of the financial industry's sensitivity to environmental concerns is brought about by fear of economic loss or liability. In the United States a number of public laws and landmark private lawsuits against define the circumstances under which financial institutions may be held liable for environmental damage. The fear is either that a financed project will become nonperforming due to environmental risks or that collateral seized in a foreclosure will be so heavily contaminated or beset by other environmental problems that the value of the property will be much lower than originally projected.

Meanwhile, in Western Europe a more positive attitude has taken hold. A few banks, such as the Dutch bank Triodos, view the environment as a "bankable" concept and actively look to finance projects that involve "clean technologies" and "sustainable resource use." One example of "green banking" in Europe is the financing of housing construction that uses a high percentage of recycled materials.

In contrast, the financial services sector in Latin America is not generally very concerned with the environment. Unclear laws and less environmental advocacy from civil groups make it less of a priority. For example, environmental legislation typically does not clearly address lender liability or define safe harbors. At the same time, however, this ambiguity in the law opens the door to private suits for environmental damage against parties



with “deep pockets”, including banks. The large environmental fines in some recent cases in Brazil (Petrobras) and Colombia (Banco de Colombia) portend a greater willingness of Latin American governments to enforce environmental laws. In the case of Banco de Colombia, the bank was forced to clean up a land site, contaminated with parathion and DDT, that it had recovered as collateral on a loan to an agricultural firm.

In the case of microfinance institutions, the main driver of environmental concern are the policy mandates of funders –mainly donor agencies and multi-lateral development banks– to promote environmental stewardship in all operations. Implementing this mandate, however, has been difficult for both funders and microfinance institutions.

What Can Microfinance Institutions Do?

Efforts among microfinance institutions to encourage environmental prac-

It may be unrealistic to expect microfinance institutions to do more than disseminate information, develop exclusion lists for the most pollution-intensive activities that lack pollution-mitigation plans and refer clients to third-party environmental management specialists.

tices have so far been feeble, sporadic and generally less than satisfactory. Due to their costs, environmental audits, environmental impact assessments and site inspections to screen

and rank loan applicants are not feasible for a microfinance institution with thousands of small loans. Furthermore, even when a problem is identified, the microentrepreneur is not likely to be able to do anything about it in the absence of adequate infrastructure, technologies and/or training. In general, the prevailing opinion in the industry is that mastering microfinance is difficult enough and that adding further requirements to this activity could do more harm than good by impairing the outreach and sustainability of these institutions.

Not surprisingly, therefore, practitioners in the field report that current attempts to make microfinance institutions classify their loans into discrete risk categories, conduct rudimentary environmental assessments and make borrowers sign promissory agreements to improve environmental protection have largely failed. Other attempts to refer clients with environmental problems to third-party technical advisors have been plagued with coordination problems,

Why is Environmental Protection so Difficult to Achieve Among Microenterprises?

1. Pervasive Informality: Many microentrepreneurs either do not know about or are not in full compliance with established business, tax, labor, occupational safety, and environmental regulations. Since the public authorities are very weak and the risk of being discovered and punished is low, it is rational to expect high levels of noncompliance.

2. Limited Education: While the general level of public knowledge about environmental matters has increased significantly in Latin America and the Caribbean during the past 10-15 years, expertise is still lacking with regard to industrial emissions, water quality and, more importantly, alternative production processes and technologies.

3. Higher Incidence of Poverty: Studies indicate that about 40 percent

of microentrepreneurs are poor. Regardless of sector of activity owners and employees in the microenterprise sector are more likely to have individual earnings less than the poverty line. The generally low incomes, especially of the self-employed, constrain entrepreneurs' abilities to adopt adequate environmentally sound practices and technologies.

4. Missing or Weak Infrastructure: In several countries basic environmental services such as trash collection, waste water treatment, and sanitation services cover only a fraction of the total population. Weaknesses in the provision of these services, particularly in poor or rural areas, force entrepreneurs to use less than ideal waste disposal techniques, such as the burning of trash or dumping of raw sewage and industrial effluents into water bodies.

5. Inadequate Legal Frameworks: The environmental frameworks of many Latin American countries were copied from industrialized countries in the late 1980s and early 1990s and, as such, contain standards and norms that are not always appropriate to local realities. Only slowly are the standards being adjusted.

6. Limited Government Enforcement Capacity: Many Latin American and Caribbean countries consider themselves to lack the necessary resources to effectively enforce current environmental laws. Additionally, environmental protection agencies are typically one of the more recently created agencies or departments and therefore do not have the same clout as older, more mainstream agencies in obtaining adequate funding.

institutional difficulties and insufficient funding.

In short, it may be unrealistic to expect microfinance institutions to do anything more than disseminate information, develop exclusion lists for the most pollution-intensive activities that lack pollution-mitigation plans and refer clients to third-party environmental management specialists. While it may be possible to introduce environmental lending criteria in a financially sustainable manner in some cases, donors and policy makers should not count on it—the added transaction costs are simply too high. Instead, the main focus of financial intermediaries should be to make staff and clients aware of potential environmental problems and avoid financing projects that expose the institution to significant losses through environmental risk. Financial institutions cannot and should not serve as substitutes for public sector authorities charged with enforcing environmental protection standards.

Entrepreneurs comply with environmental regulations if they think the net benefit of compliance outweighs the net benefit of noncompliance.

Often it does not. The benefits of compliance tend to be long-term and diffused while the costs tend to be quite significant. Conversely, the benefits of noncompliance tend to be immediate and specific while the costs tend to be long-term and diffuse.

Take soil conservation as an example. The on-farm benefits of improved soil conservation practices are manifested through less need for chemical fertilizers three to five years in the future. However, the up-front costs of conservation investments are immediate and can be quite high. Additionally, most benefits of soil conservation may in fact accrue to other people than the farmers themselves, for example in the form of better water quality for downstream users. When cost-benefit calculations such as these are combined with limited government enforcement capacity, the result is widespread noncompliance.

Thus, it is public sector authorities, donor agencies and development banks—and not microfinance institutions—that should take the lead in encouraging environmentally sound practices in the microenterprise sector, and when they do, they must pay close attention to the

incentives faced by microentrepreneurs. If environmentally sound practices can be aligned with economic incentives, they are more likely to be adopted. ■

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In Future Issues...

Leasing as a way to provide long-term financing to microenterprises

Is there a model for sustainable business development services?

Reforming the Regulatory and Framework for Microfinance

The Effect of Interest Rate Restrictions on Microfinance Institutions

