

Strategies and Structures for Commercial Banks in Microfinance

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Foreword

One of the critical decisions that bankers looking to serve the microenterprise market niche must make is whether to do microlending in house or through some sort of external organization such as a service company or subsidiary. Up until now there really has not been a comprehensive set of guidelines available on how to make this crucial choice.

As noted in the paper, there is no one-size-fits-all solution to the question of best organizational structure. The list of pros and cons of each structure is long. Many of these pros and cons may not be readily apparent to bankers who are unfamiliar with the demands of microfinance or to those who have not undertaken an extensive analysis of this choice. In addition, the importance of each factor varies depending on numerous country and individual bank characteristics. Despite these difficulties, the choice is an important one: whether the bank chooses to do microlending in house or through one type or another of external organization will often have a major impact on the success of the bank in this venture. Unless the bank understands the pros and cons of the different structures and how they depend on country and bank circumstances, it may not choose well.

It would be fair to view this paper as a kind of checklist of all the factors a bank should consider when deciding the type of organizational structure it should use to do microlending. In addition, the paper discusses key best practices banks should follow in order to be successful in microlending—in addition to picking the best structure. Some (though not all) of these best practices provide a useful test: if the bank is not willing to follow them, it may be best to stay away from microlending, for the chances of success are greatly diminished. This paper is aimed both at banks entering microfinance and at banks with existing microfinance operations which they may wish to expand or reorganize.

Board members and bank executives without direct involvement in microfinance may find it useful to at least read the executive summary in order to understand the basics of choosing the best structure and the other microfinance best practices. Those who are charged with delving in depth into whether and how the bank should enter microfinance or expand or reorganize its operations will want to read—and indeed study—the paper in its entirety. Those who do so will find it an invaluable resource.

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Executive Summary

In the last few years, banks have been entering microfinance at an impressive rate. They are drawn by the increasing competition many find in their traditional market niches, by the lure of high profits reported in the media and elsewhere from serving microenterprises and other major segments of the “bottom of the pyramid,” and by the presence of a large unserved market, which holds out the promise of rapid growth.

One of the key decisions facing any bank that wishes to downscale—that is, to offer loans and perhaps other financial services to microenterprises—is whether to provide these loans through an internal unit or through a subsidiary or other kind of external organization. The degree of success of the microlending program often depends crucially on this choice, for reasons that will be made clear in this executive summary and in the study itself.

The Choice of Microlending Structure

To understand why the choice of microlending structure is crucial and what the key factors are that should be considered in making this choice, consider the case of a commercial bank trying to decide: a) whether the bank should get into microlending and b) whether to do microlending in house or through an external organization that the bank would own either partially or in full. In order to answer the first question, one must begin by tackling the second. This is because there are many important advantages and disadvantages of doing microlending in house versus through an external organization. The balance of these pros and cons varies greatly from one bank and set of circumstances to the next, and is often of great importance in answering the first question. In addition, each of the individual pros and cons bears directly on the question of whether the bank should do microlending at all. This paper, and therefore this executive summary, focuses on the second question.

Some banks start from the premise that microlending might best be carried out by an inter-

nal unit, rather than by creating a separately-regulated entity such as a *financiera*. This, they argue, might allow microlending to be **started up more quickly**. And, by avoiding the duplication of functions that already exist within the bank, an internal microlending unit might have **lower operating costs**.

On the other hand, other banks have been concerned that microlending is a new area for the bank and one with clear risks, a perception that is heightened by many past failures of banks to successfully break into microlending. These other banks argue that by placing microlending operations in an independently-managed subsidiary (such as a *financiera*), they would **limit their losses** to a maximum of the amount they had invested in the subsidiary.¹ Another kind of risk that concerns some banks is reputational risk, particularly if they are a bank that primarily serves corporations and wealthy individuals. More broadly, for reasons of **image and branding**, it may be useful to place microlending in a separate subsidiary with its own name, logo, and image, different from those of the bank.² This may help the bank to both retain its existing clientele and attract new microenterprise borrowers. In any case, regardless of whether microlending is done in house or through a subsidiary, branches will have to be expanded or added in order to accommodate the thousands of new clients that successful microlending will bring to the bank’s lobbies.

¹ While this loss-limiting feature of subsidiaries is generally available in Latin America and the Caribbean, it may not be available in every country. Local bankruptcy and banking laws should be consulted. Typically, in addition to independence of management, all transactions between the bank and subsidiary must be at arms length (that is, not subsidized) for this limit to apply.

² To help the reader, factors favoring an internal unit are put in **bold** while factors favoring an external organization are put in **bold italics**. For reasons discussed in Chapter 2, image and branding considerations may favor either an internal unit or external organization (or neither) depending on the circumstances.

One important advantage of using an external organization (such as a *financiera*) is **greater freedom to do microlending right**. This refers to the fact that successful microlenders generally offer loans that have much shorter terms than most commercial banks are used to offering; sometimes utilize weekly or biweekly, instead of monthly, repayments; and charge much higher interest rates to compensate for the smaller sizes, shorter terms, and more frequent repayments of these loans. Successful microlenders also employ lending procedures whose characteristics seem quite alien to most bankers: much greater reliance on character and household cash flow analyses than on collateral, acceptance of a lack of borrower financial statements and other business records, loans that are decided upon quickly by branch managers rather than being approved by several bank departments, loan officers who spend 80-90 percent of their time in the field screening loan applicants on site and dunning borrowers with overdue payments, and a salary scheme in which a substantial share (perhaps 30-70 percent) of loan officer remuneration is obtained from bonuses that are tied directly to the delinquency rate and volume of the loan officer's credit portfolio. There are other differences between microlending's products and processes and those used in traditional bank lending, but equally important, perhaps, are the severe consequences that regularly occur when appropriate microlending products and processes are not used. These can include high loan delinquency rates, high operating costs, slow program growth, and poor profitability performance. In fact, failure to do microlending right is one of the leading reasons that banks fail in their efforts to downscale and end up exiting microfinance. In most of these banks, microlending never achieves the scale or profitability that would justify continued involvement.

Banks are increasingly realizing that if they are going to get into microlending, they had better do it right. And the chances for doing it right (or at least closer to right) are greater in the relative freedom of an external organization than in the relatively more rigid and bureaucratized environment of the bank. In light of its own particular circumstances, each bank should consider all the ways an internal unit might or might not be

able to do microlending right and of how much of an advantage an external organization would likely have in this area.

The external organization has other possible advantages, including several that arise when the bank takes on outside shareholders and is only a partial owner of the microlender. When some outside shareholders, such as Accion International and ProCredit Holding, take an equity stake in a microlending organization, they also typically **provide high quality technical assistance** to the organization in how to do microlending right. This may save the bank from making the same costly mistakes that others have already learned from. In addition, such outside shareholders often make important **contributions to governance** from their seat on the board because of their long experience in microfinance. Naturally, all outside shareholders **provide some of the capital** needed to start up microlending and may also be able to respond in emergencies with additional capital. Finally, by **sharing in any of the microlender's losses**, outside shareholders reduce the risks to the bank of entering this new field. On the other hand, the use of external organizations with outside shareholders means that these shareholders will also **take their share of the profits and can create conflicts in governance**.

Another drawback of doing microlending through a subsidiary is that most countries' prudential regulations (in particular, the credit concentration and related-party lending limits) **restrict bank lending to a subsidiary** to only a small percentage of the bank's capital.³ By contrast, the bank can fund an internal unit's microloan portfolio without restriction. Hence, an internal unit will never have to go looking outside the bank for funding, whereas a subsidiary may eventually have to do this. Therefore, at some point, the subsidiary may have to **pay more for loanable funds** and may even be **un-**

³ These restrictions on lending to a subsidiary vary by country, but a limit of 10-20 percent of the bank's capital is typical in many Latin American and Caribbean countries. Table 8 in the text gives these limits for 13 countries.

able to expand its microloan program due to a lack of available funding.⁴

The chart below sums up the factors discussed so far that favor an internal unit over an external organization and vice-versa.

So far, the only type of external organization considered in this analysis is what we will now call a heavily regulated subsidiary. A heavily regulated subsidiary is a financial institution, such as a *financiera*, that itself is directly regulated by the superintendency of banks. The other two types of external organizations that a bank needs to consider to choose the best structure for its microlending operations are the lightly regulated subsidiary and the service company. Like the heavily regulated subsidiary, these two new structures are also generally constituted as corporations, whose shareholders include the bank and may or may not include outside investors. In all three cases, the external organization has its own board of directors, management, and staff that are focused on offering loans and perhaps other financial services to microenterprises.

Lightly Regulated Subsidiaries and Service Companies

To better understand these two types of entities and the differences between them, recall that the banking regulations of many Latin American and Caribbean countries permit the creation of what are often called “auxiliary providers of financial services.” These entities are allowed to engage in one, or sometimes more than one, of the bank’s permitted operations. Perhaps the best known of these auxiliary providers are leasing companies and factoring companies, which have been set up as bank subsidiaries in a number of countries. Auxiliary providers of financial services have also been created in several countries in the region in order to do microlending, in some cases as a lightly regulated subsidiary and in other cases as a service company. The essential distinction between these two types of institutions is that the subsidiary owns the loan port-

folio that it originates and collects, while the service company does not. Service companies originate and collect the microloans, but the parent bank actually owns the loans and thus books them on its own balance sheet.

The banking laws of many Latin American and Caribbean countries allow banks to set up auxiliary providers of financial services with little or no review from the banking superintendency. Hence, the lengthy licensing procedures that must be followed when creating a heavily regulated subsidiary are often completely or almost completely eliminated when creating a lightly regulated subsidiary or service company.

Parent banks typically fund much or all of the loan portfolios of their microlending service companies and lightly regulated subsidiaries, and to a lesser extent, of their heavily regulated subsidiaries. However, all three types of external organization can and sometimes do obtain outside funding.

The service company is paid a fee by the parent bank for all of its efforts in promoting, originating, and collecting microloans. In contrast, since a subsidiary (either lightly or heavily regulated) is the owner of its own loan portfolio, it simply keeps the interest and commissions earned on this portfolio.

Typically, service companies and lightly regulated subsidiaries receive little or no separate regulation and supervision from the banking superintendency. Even the lightly regulated subsidiaries, which own their own loan portfolios, are generally not subjected to separate capital adequacy and provisioning requirements, insider lending limits, credit concentration restrictions, and other prudential controls. Rather, the practice is to consolidate lightly regulated subsidiaries (and service companies) with the parent and impose all of these restrictions on the consolidated entity.

⁴ This brake on expansion may not be an important problem if the subsidiary is permitted to capture savings and is successful in doing so.

The Choice of Structure

Advantages of an Internal Unit over an External Organization	Advantages of an External Organization over an Internal Unit
Can be faster to start up	The bank's losses are limited to the amount it has invested in the external organization
Can have lower operating costs	Image and branding
	Greater freedom to do microlending right
Outside shareholders are avoided. Such shareholders reduce bank profits and can create conflicts in governance.	Allows outside shareholders to be incorporated. These shareholders can contribute to governance, provide capital and technical assistance, and reduce risks for the bank.
No restrictions on loan portfolio funding. These restrictions can eventually limit the expansion of the microlending program and drive up the cost of acquiring loanable funds.	

As is logical given how they are supervised, service companies and lightly regulated subsidiaries typically do not send any reports directly to the banking superintendency. They simply produce the usual financial statements that a corporation would produce each month (mainly, a balance sheet and income statement) and pass these on to the parent bank. The parent bank then consolidates these statements with its own and those of any other service companies and subsidiaries in which it has a substantial interest, and sends all of the statements (separate and consolidated) to the banking superintendency.

The Best Structure

The next question is whether the earlier chart showing the pros and cons of an internal unit versus an external organization still applies to these two new forms of external organization (not merely to the heavily regulated subsidiary we had in mind when the chart was created). While the same set of pros and cons holds for lightly regulated subsidiaries, this is not true for service companies. For service companies, the same set of pros and cons holds except for the last advantage of an internal unit (no restrictions on loan portfolio funding) and the first advantage of an external organization (bank's losses limited to the amount it has invested in the external organization). We now explain these two exceptions in the service company case.

As for the last advantage of the internal unit, recall that in the case of a service company, the bank owns the entire microloan portfolio. In fact, the bank makes each of these loans directly to the microentrepreneur after the loan is approved by the service company, rather than making a loan to the service company so that the service company can then onlend these funds to microentrepreneurs. Since the bank makes no loan to the service company, it does not face the credit concentration or related-party lending restrictions it encounters when it funds a subsidiary's portfolio by means of a loan to the subsidiary. In this area, then, internal units and service companies have an important advantage over lightly and heavily regulated subsidiaries.

Turning to the first advantage of an external organization (bank's losses are limited to the amount it has invested in the external organization), this holds for both types of subsidiary but does not hold for a service company. Service companies do not have this advantage because the bank owns the microloan portfolio (the service company merely provides loan origination and processing services). Since the size of this portfolio is typically many times the amount of the bank's investment in the service company (due to leveraging), the bank's losses can far outstrip its investment in the service company. In this area, then, lightly and heavily regulated

subsidiaries have an important advantage over internal units and service companies.

There are also important differences among the three types of external organizations in two other key areas, namely, those related to the first two advantages given for internal units over external organizations in the above chart: faster start-up and lower operating costs. In these two areas, the size of the advantage that an internal unit has over an external organization depends on the type of external organization. While it typically takes 6-12 months or more for the banking superintendency to approve the start-up of a heavily regulated subsidiary, lightly regulated subsidiaries and service companies normally receive regulatory clearance in 1-2 months or less. Sometimes the superintendency makes no review at all of these entities. Thus, there can be big differences among external organizations in their speed of start-up. Similarly, service companies and lightly regulated subsidiaries have lower ongoing costs of regulatory compliance than heavily regulated subsidiaries, reducing their operating costs.⁵

While we have discussed a number of important pros and cons that banks should consider when deciding which microlending structure is best, there are a number of other pros and cons that banks must take into account as well. These are summarized in the two tables below and each is explained in Chapter 2.⁶

⁵ There are other important considerations that affect the operating cost ranking among the three types of external organizations, and that may even overturn the result that the internal unit has the lowest operating costs of all. For example, if the bank bureaucracy ties the internal microlending unit up in knots with costly and unhelpful procedures, forces it to accept a high wage scale, or denies it the technical assistance it might have used to cut costs, the internal unit may, in fact, have the highest overall operating costs of any of the four structures. Similarly, the internal unit may not always be the fastest to start up. Both of these points are discussed in Chapter 2.

⁶ These two tables are simply replicas of Tables 5 and 6, found below at the start of Chapter 2. The reference number beside each pro or con in the two tables refers to the section of Chapter 2 that discusses the pro or con and may be helpful to those who wish to

There is no one-size-fits-all solution to the question of best structure. The list of pros and cons of each organizational structure is long. Many of these pros and cons may not be readily apparent to bankers who are unfamiliar with the demands of microfinance or to those who have not undertaken an extensive analysis of this choice. In addition, the importance of each factor varies depending on numerous country and individual bank characteristics. Despite these difficulties, the choice is an important one: whether the bank chooses to do microlending in house or through one type or another of external organization will often have a major impact on the success of the bank in this new venture. Unless the bank understands the pros and cons of the different structures and how they depend on country and bank circumstances, it may make a bad choice.

Best Practices

In addition to choosing the best microlending structure, Chapter 1 discusses a number of other best practices, which are given here in very abbreviated form:

- If you do microfinance, do it right! As discussed above, microlending must be done with appropriately-designed products and processes or else the bank may suffer a number of serious consequences. In addition, there are several other aspects of doing microfinance right besides employing appropriate loan products and processes, as discussed in Chapter 1.

rapidly locate the discussion of a specific point. The first table compares the pros and cons of the bank structuring its microlender as an internal unit versus an external organization (service company, lightly regulated subsidiary, or heavily regulated subsidiary). The second table summarizes the pros and cons of the different external organization options.

Internal Unit vs. External Organization: Pros and Cons

Reference Number	Advantages of an External Organization over an Internal Unit
A1	Greater freedom to do microfinance right (e.g., to use appropriate loan products and processes, open new branches and change interest rates at will, generate and apply budgetary resources with greater discretion to meet priority needs)
A2	The microlender's directors, managers, and staff may have much higher-powered incentives to be efficient and profitable
A3/B3	Image and branding (may be a disadvantage in some circumstances)
A4	If outside shareholders are incorporated, this can bring several benefits, including additional capital, improved governance, and high-quality technical assistance
A5	Can reduce the risks to the bank of the microlending operations
A6	May escape certain pay-related problems and the wage scale of the bank
A7	May escape from union wage scales and agreements
A8	Subsidiary may have more favorable treatment under a usury ceiling than an internal unit or even a service company
	Advantages of an Internal Unit over an External Organization
B1	Greater integration into the bank reduces operating costs (perhaps by 1-10%)
B2	By eliminating initial tasks, start-up cost and often start-up time are reduced; possibly less initial capital is needed; idle capital is easily avoided
A3/B3	Image and branding (may be a disadvantage in some circumstances)
B4	Outside shareholders in an external organization reduce bank profits and can create conflicts
B5	Funding advantages: a) unconstrained capital backing from the bank, b) greater availability and less uncertainty about the availability of loan portfolio funding, and c) lower funding cost than subsidiaries
B6	Value added tax may be levied on: a) payments made by an external organization to the bank for use of bank infrastructure and services and b) fees paid by the bank to a service company
B7	Duplicate capital problem (most likely to negatively affect heavily regulated subsidiaries)

Service Company vs. Subsidiary: Pros and Cons

Reference Number	Advantages of a Service Company over a Subsidiary (Heavily or Lightly Regulated)
B1*	Greater integration into the bank reduces operating costs
B2*	By eliminating initial tasks, start-up cost and often start-up time are reduced; possibly less initial and initially-idle capital—all especially with respect to heavily regulated subsidiaries
B5*	Funding advantages: a) greater availability and less uncertainty about the availability of loan portfolio funding and b) lower funding costs
B7*	Duplicate capital problem (most likely to negatively affect heavily regulated subsidiaries)
A7*	May escape from union wage scales and agreements
	Advantages of a Subsidiary (Heavily or Lightly Regulated) over a Service Company
A1*	Greater autonomy in certain limited spheres including, for heavily regulated subsidiaries that can mobilize deposits, the chance to offer more appropriate savings products
A5	Can reduce the risks to the bank of the microlending operations
A8*	Subsidiary may have more favorable treatment under a usury ceiling than an internal unit or even a service company

Note: An asterisk (*) indicates those factors where the effect is (or may be) different depending on whether the comparison is made to a heavily regulated subsidiary or a lightly regulated subsidiary.

- Leaning on the bank. The bank's microlender—whether it be an internal unit, service company, lightly regulated subsidiary, or heavily regulated subsidiary—should make the best possible use of the bank's infrastructure and all of the relevant services the bank provides. These facilities and services might include, for example, branch networks and ATMs, information systems hardware, telecommunications systems, and services from such bank departments as accounting, auditing, finance, information technology, legal, marketing, personnel, and treasury.
- Branch locations. Whether microlending is done through an internal unit or external organization, it needs to operate out of appropriately-located branch offices.
- Special considerations for internal units:
 - The internal microlending unit should have high bureaucratic rank, perhaps out of line, especially at first, with microlending's importance in the bank's overall loan portfolio.
 - The microlending unit should have specialized loan officers.
- Get technical assistance. It is both difficult and unnecessary to reinvent the wheel in microfinance. Much has been learned about how to do microfinance right and about the other best practices discussed here. Banks can save themselves from expensive mistakes and earn greater profits more quickly by accessing good quality technical assistance.
- From champions to institutional commitment. Early writers on bank downscaling such as Baydas, Graham, and Valenzuela (1997) and Valenzuela (2001) emphasized the importance of a board champion, who inspired and protected the microlending program, and an operational champion, who knew how to run the program. These champions were committed to the vision of microfinance in the bank. While this is a good start, things are likely to go significantly better for the microlending program if more of the bank's directors, managers, and staff understand microfinance and are convinced that it is truly a worthwhile *commercial* venture for the bank to engage in.

1. Downscaling Performance, Options, and Best Practices

WHAT THIS STUDY OFFERS

There are a number of good papers that should be read by bankers looking to downscale, that is, to offer loans and perhaps other financial services to microenterprises. A short list of the key works might include Baydas, Graham, and Valenzuela (1997), Valenzuela (2001), López and Rhyne (2003), Young and Drake (2005), and Isern and Porteous (2005), though there is much else that is also worth reading. The purpose of this paper is not to repeat or summarize what these and other works already cover. Rather, it is to offer something that is not very well provided by existing work: a reasonably comprehensive discussion of the pros and cons of the different organizational structures through which banks can downscale.⁷ The main structural options we consider are an in-house microlending unit and an external microlending organization, with the latter structured as a service company, lightly regulated subsidiary, or heavily regulated subsidiary.⁸ This paper also attempts to correct a number of errors that exist in the literature, in which certain advantages or disadvantages are claimed for some structures that are either not true or else also hold for other structures as well. The conclusions reached in this study—both with respect to the pros and cons of different organizational structures and with respect to best practices (which are also discussed in this paper)—are based on discussions held with numerous bankers and experts in

the field and on the existing downscaling and related literature.

The central topic of this paper is an important one. Whether the bank chooses to do microlending in house or through one type or another of external organization will often have a substantial impact on the success of the bank in this new venture. The list of pros and cons of each organizational structure is long and the importance of each factor varies depending on numerous country and individual bank characteristics. Hence, there is no one-size-fits-all solution to the question of best structure. Unless the bank understands the pros and cons of the different structures and how they depend on country and bank circumstances, it may not choose well. Of the 22 large commercial banks surveyed by Valenzuela (2001), 11 wanted formal technical assistance help with the choice of organizational structure, indicating that this is indeed a complex and important choice.

In examining the pros and cons of the different organizational structures, this paper adopts the point of view of the bank. This is because the guidelines given here are meant to help commercial bankers decide which structure would best suit their microfinance operations. Such guidance is likely to have social repercussions as well. Banks that have a successful experience in microfinance are more likely to expand their program and thus serve the social goal of increasing outreach to this greatly underserved sector. Nonetheless, because the paper is written from the bank's point of view, the best structure would likely mean the one that maximizes profits, where profits are derived from all of the bank's operations, including its in-house operations as well as its investments in any microlending (or other) service companies or subsidiaries.⁹

⁷ Here and unless otherwise specified in this document, we use the term "banks" to include banks, *financieras*, and any other regulated financial institution that is downscaling into microfinance. Downscaling financial institutions are those that have traditionally served larger (often corporate) clients but now make loans to microenterprises. *Financieras* are regulated financial institutions with lower minimum capital requirements than banks. Like banks, a number of *financieras* have downscaled into microfinance in Latin America.

⁸ These structures are defined and discussed later in this chapter.

⁹ Most banks aim to maximize their earnings (profits) over time and prefer less risk to more. The goal of the bank can be stated more completely as aiming to

After this introductory section, the remainder of the chapter covers five additional topics:

- It briefly examines the performance of downscaling banks, noting in particular their rapid penetration of the microlending sector and the increasing quality of their microloan portfolios.
- It presents the major reasons banks have given for their rapid entry into microfinance.
- It discusses the four different organizational structures that banks can use to downscale: the internal unit, service company, lightly regulated subsidiary, and heavily regulated subsidiary.
- It presents a number of best practices that banks serving the microfinance market should observe.
- It extends the discussion of one of these best practices by describing in greater detail how the bank's microlender (that is, the internal unit or external organization doing the microlending) can and should utilize the bank's infrastructure and services, and do so to best advantage.

The remainder of this paper builds heavily on the discussions of the last three of these five topics.

An innovation in our discussion of the structural options banks have for downscaling is to distinguish between two types of subsidiaries, the

maximize, over the medium to long run, the bank's risk-adjusted profits from its in-house operations plus the risk-adjusted profits derived from its investments in any affiliates (including a microlending service company or subsidiary). The term "risk-adjusted" indicates that most banks implicitly or explicitly discount profits that are earned from riskier activities. The usual caveat that profits be maximized over the medium to long run is particularly appropriate for microfinance where several years are normally required to build a microloan portfolio to the point where it makes an appreciable contribution to the bank's overall profits. Banks with goals other than profit maximization (e.g., maximization of their size or market share) are still likely to find most of the discussion in this paper appropriate; only a few points may have to be recast because of differing bank goals.

lightly and heavily regulated. This is done because the pros and cons of each type of subsidiary differ in a number of important regards. Although many readers may be unfamiliar with lightly regulated subsidiaries and how they differ from service companies, both structures are actively used in the region. These structures are described and contrasted later in this chapter.

The presentation of best practices is useful in and of itself and also because, in several instances, whether and to what extent these lessons are heeded affect which structure is best. Some of these best practices reflect lessons that have already been learned and written about while a number of others are new.

Linking models—for example, in which an NGO develops and sells a microloan portfolio to a bank or develops a microloan portfolio that is owned all along by a bank—are relatively rare in Latin America and the Caribbean. Because of this, and in order to keep the discussion as simple as possible, linking models and other kinds of strategic alliances are not analyzed here.

The balance of this study consists of two chapters. Chapter 2 discusses the pros and cons of the different structural models and Chapter 3 is devoted to several other topics. As discussed in Chapter 2, it is useful to break down the choice among the structural models into a series of simpler choices. This is done primarily as a way to help organize the discussion; the bank may or may not find it useful to actually make its decision in this way. Following this organizing device, the first step is for the bank to choose whether it prefers to do microlending in house or through an external organization (where the latter consists of a service company, lightly regulated subsidiary, or heavily regulated subsidiary). If it chooses to do microlending through an external organization, then it has two further choices to make: which of the three external organization structures to use and whether to be a full or partial owner of the external organization. Chapter 2 is devoted to the first two of these three choices and Chapter 3 to the last. Chapter 3 also examines how the balance of factors (pros and cons) might turn out in a number of simplified and commonly-encountered situations. And

it discusses how different country and individual bank circumstances can affect the importance of some of the pros and cons of each structural model and thus the choice of best model. Thus, while Chapter 2 discusses each of 14 individual pros and cons of the different structures in detail, Chapter 3 tries to see the forest (the overall decision of best structure) instead of the individual trees (each pro and con). Chapter 3 concludes with a brief section on the role of governments and donors.

THE PERFORMANCE OF DOWNSCALERS

Banks are an important part of the microfinance landscape and their microlending has been growing rapidly. According to data gathered recently by Marulanda and Otero (2005) on 120 leading microfinance institutions (MFIs) in Latin America, at the end of 2004 banks were serving nearly one million microloan clients and providing over US\$ 1 billion in credit to these micro-entrepreneurs (Table 1). According to this study, the banks' share of the overall microlending market is substantial, with banks serving 26 percent of total microloan clients and providing 35 percent total microcredit at the end of 2004. Since nongovernmental organizations (NGOs) appear to be more underrepresented in this survey than banks and upgrades, these shares may be somewhat high. Though older, the mid-2001 survey carried out by IDB and CGAP of 184 MFIs in Latin America probably has a more balanced representation of the three types of MFIs. In that survey, banks were found to serve 20 percent of total microloan clients and provide 29 percent total microcredit. In either case, banks are clearly important. Moreover, bank microlending has been growing quickly, with annual growth rates during the 2½ years between the two surveys averaging 40 percent for the number of clients and 64 percent for total microlending.¹⁰ The fact that the banks have an

average loan size that is not too far above the overall average in both surveys provides some evidence that banks are reaching clients that are broadly similar to those reached by the other MFIs.

Based on somewhat older surveys, Baydas, Graham, and Valenzuela (1997) and Valenzuela (2001) raise a number of important concerns about how well banks are mastering microlending. Some of these concerns are discussed later in this paper. Recent data provided by Marulanda and Otero (2005) on a certain segment of banks indicate that at least in the key area of delinquency control, these banks appear to be catching on reasonably well (Table 2). The 30-day portfolio at risk of the banks is within a few percentage points of the rates achieved by the upgrades and NGOs, in years of recession (2002), expansion (2004), and transition (2003). There are two important caveats to this result. First, it is based on a limited number of MFIs: 11 banks, 10 upgrades, and 13 NGOs. Second, of the 11 banks, nearly all have a large share of their overall loan portfolio in microlending or else have constituted a specialized affiliate that does only microlending. Thus, the case of a large commercial bank with only a small percentage of its loan portfolio in microcredit, all generated by an in-house microlending unit, is hardly represented. Yet, according to the surveys of Baydas, Graham, and Valenzuela (1997) and Valenzuela (2001), these are the types of banks that may encounter the greatest difficulty in making the rather demanding and peculiar microlending methodology work within the confines of the sometimes rigid procedures, competing priorities, and culture of the larger bank.

WHY BANKS ARE ENTERING MICROFINANCE

Many reasons are given by bankers in Latin America and the Caribbean for entering microfinance, which, together, explain the rapid growth of downscaling noted in the last section:

- Increased competition in the banks' traditional markets, such as serving large firms, small and medium-size enterprises, and consumers.

¹⁰ Since the two surveys have substantial overlap in the banks they cover, and thus are broadly comparable, these growth rates are probably reasonably indicative of the growth rates of all banks serving the microenterprise sector in Latin America and the Caribbean.

Table 1
Latin American Microlending by Type of Institution

Type of MFI	No. of MFIs in Survey	Microloan Portfolio (US\$ million)	Number of Microloan Clients	Average Microloan Size (US\$)
<i>Data from December 2004</i>				
Banks ¹	17	1175	847,498	1387
Upgrades ²	47	1790	1,540,920	1162
NGOs ³	56	384	868,544	442
Total	120	3350	3,256,962	1028
<i>Data from mid 2001</i>				
Banks ¹	21	343	365,171	940
Upgrades ²	39	558	571,765	976
NGOs ³	124	288	869,509	332
Total	184	1190	1,806,445	659

¹ As noted earlier, the term “banks” is used throughout the paper to include banks, *financieras*, and any other regulated financial institution that is downscaling into microfinance. Downscaling financial institutions are those that have traditionally served larger (often corporate) clients but now make loans to microenterprises.

² Upgrades are microlending NGOs that have transformed into regulated financial institutions.

³ NGOs (nongovernmental organizations) are unregulated financial institutions constituted as nonprofit organizations.

Sources: The 2004 data are from Marulanda and Otero (2005). The 2001 data are from a survey carried out by Glenn Westley of the IDB and Bob Christen, then of CGAP (Consultative Group to Assist the Poor). The two surveys cover 16 and 17 Latin American countries, respectively, including all of the major microfinance markets in the region.

Table 2
Loan Delinquency Rates by Type of Institution (%)

	Banks	Upgrades	NGOs
2002	9.0	8.8	3.7
2003	6.7	4.7	3.0
2004	6.9	3.4	3.0

Note: The numbers given in the table are unweighted averages of individual MFI loan delinquency rates. All loan delinquency rates are calculated as the 30-day portfolio at risk and, in the case of banks, are measured only on the microloan component of the bank’s overall credit portfolio. See Marulanda and Otero (2005) for additional details.

Source: Marulanda and Otero (2005).

- The lure of profits. For example, the latest *Microbanking Bulletin* (Issue 11, August 2005) reports that of 52 Latin American MFIs reporting for 2003, the median adjusted return on assets (ROA) was a very respectable 1.8 percent and the median adjusted return on equity (ROE) was 9.5 percent. Much higher ROA and ROE values

are reported by numerous leading MFIs (as shown, for example, at the MIX Market and MicroRate websites).¹¹ For example, Mi-

¹¹ The *Microbanking Bulletin* is the premier source of high-quality information on the microfinance industry worldwide and now covers over 200 MFIs. The MIX Market covers over 600 MFIs worldwide (and over 100 in Latin America and the Caribbean), though with somewhat lower quality data. While the

croRate reports that in December 2004 the average ROA and ROE values of the 30 leading MFIs they track in Latin America were 4.4 and 17.7 percent, respectively, while the maximum values were 17.5 and 48.7 percent, respectively.

- A large unserved market in most countries, which holds out the prospect of rapid growth. Westley (2001) shows that only about five percent of microenterprises in Latin America had credit as of the latter half of 1999. Despite the impressive expansion of the microfinance industry since then, there are still vast pools of unserved clients in most Latin American countries.
- Ample proof that microlending works, and continues to work well even in bad economic times. For example, Westley (2005, Table 5) presents individual data on 11 leading individual MFIs in Bolivia, Colombia, and Peru that show remarkably low delinquency rates and high ROAs during the particularly deep and difficult 1998-99 recession. The same study (Table 6) also examines the average 30-day portfolio at risk (a measure of loan delinquency) and ROA of the approximately 100 MFIs in Latin America reporting these measures to the MIX Market. Even during the recessions of 1998-99 and 2001-02, which hit most Latin American countries very hard, the average annual MFI portfolio at risk remained in the 4.5-6.4 percent range and the average annual ROA remained in the 2.2-4.3 percent range. Both measures improved during the recovery year of 2003.
- Diversification. By making loans to thousands of small borrowers, the microlending portfolio itself achieves substantial diversification. In addition, the performance of the

microlending portfolio may have low correlations with traditional bank business lines due to the very different nature of the clients and activities and the resilience of microentrepreneurs and microlending in times of economic recession.

- Consumer lending. The rise of consumer lending in a number of countries has sometimes stimulated banks to enter microlending given the similarities between the two in providing large numbers of borrowers with relatively small loans.
- The availability of free or cheap donor technical assistance to banks wishing to enter this field.
- By serving the poor, banks may burnish their public image.
- Credit coefficients. The governments of some countries, such as Brazil, Colombia, and Venezuela, encourage or force all banks to dedicate a certain percentage (typically, two percent) of their demand deposits, loan disbursements, or loan portfolio to microloans.
- Underutilized capacity. Excess liquidity or underutilized branches or information systems can reduce costs and encourage banks to get into microlending.

With so many good reasons for entering microfinance, it is hardly surprising that banks are a large and growing presence.

FOUR WAYS TO DOWNSCALE

In increasing order of effort for and cost to the bank to establish, the possible structures through which a bank can do microlending are the internal unit, service company, lightly regulated subsidiary, and heavily regulated subsidiary. The last two options are both variants of a single model, the subsidiary. Some of the pros and cons of these two subsidiary variants are the same and others are different, and so the distinction between the two variants is an important

Microbanking Bulletin only gives data on groups of MFIs, the MIX Market provides individual MFI data. Both of these data sources can be accessed at www.MIXmarket.org. MicroRate is an MFI rating firm, which provides high quality data on 30 individual MFIs in Latin America at its website www.MicroRate.com.

one to make. This section describes, contrasts, and gives examples of these four models, and thus lays the foundation for the balance of the paper. Annex A provides a list of examples of banks that use each one of the four models and presents outreach data on the number of microloans, the value of the microloan portfolio, and the average microloan size for each downscaling bank listed.

The Internal Unit

Using an internal unit, or integrated approach to microlending, simply means that the bank does microlending in house, for example through a department or division within the bank. As shown by Valenzuela's (2001) fairly comprehensive survey of downscales in Latin America and the Caribbean as well as by our own, more recent canvassing, this is how most banks have chosen to do microlending in the region.

Setting up an internal unit to do microlending is often the fastest and cheapest way to launch a microcredit operation since no separate organization needs to be created. However, it is not necessarily the best way or the way that maximizes profits in the short or longer run. Baydas, Graham, and Valenzuela (1997) and Valenzuela (2001) document this very well. For example, the latter paper shows that of the 18 large banks surveyed that used an internal unit, no more than three had over 5000 loans. A key problem that most of these and other banks have encountered (and that we will describe in more detail below) is that the internal unit can run into a bureaucratic buzz saw when it attempts to offer appropriately-designed microcredit products and use best-practice microlending procedures. Many banks are simply not ready to offer small, short-term loans with such features as: frequent loan repayments, little or no documentation or formal collateral, a very decentralized loan approval process with little or no input from bank departments outside of microlending, much higher interest rates than the bank may be used to charging, a collection process that comes down very hard on poor people who don't repay their loans, a system of remunerating loan officers that is based on the performance of their loan portfolios, and many other characteristics that

can run counter to established bank risk-control measures, operating procedures, and general sensibilities. The problem may be further aggravated by the fact that at least for the first few years, the microlending portfolio typically remains small in size and in its raising the issue of what the bank gets in return for making so many special allowances.

External Organizations: Service Companies and Subsidiaries

In contrast to the relatively poor historical performance of many internal microlending units, most banks that have created service companies and subsidiaries find that, because these external organizations are much freer to offer appropriate products, use sound microlending procedures, and follow other best practices, they have expanded their outreach and profitability much more quickly. For example, in her survey, Valenzuela (2001) finds that four out of the five banks that had turned microlending over to an external organization (service company or subsidiary) were above average both in their microlending outreach and in their general microlending practices. While it is common to think of the question of whether to use an internal unit or an external organization as a tradeoff between cost and flexibility, there are actually many additional important factors to consider. Moreover, as the pitfalls of doing microlending in inflexible ways have become better known (through some of the excellent studies that have been carried out, as well as by other means such as conferences), a new breed of enlightened banks seems to be emerging in the last 2-3 years. These banks often want the cost and other advantages of the integrated model and understand that the microlending unit must be given the flexibility to do microlending properly. One must then ask what the pros and cons of the various downscaling structures are under those circumstances.

External organizations are normally corporations, whose shareholders include the bank and may or may not include outside investors such as international NGOs (for example, Accion International and ProCredit Holding), multilateral and bilateral donors, local private investors, and

others. Creating one of these external organizations is in many ways like creating a specialized MFI. The external organization has its own board of directors, management, and staff that are all focused on offering microloans.

The external organization may offer other, non-loan products as well, although this depends on local prudential regulations, the powers granted to the external organization when it was set up, and the external organization's own strategic aims and business plan. In addition to loans, most of the external organizations in Latin America and the Caribbean can offer non-deposit products such as insurance and remittances. Bangente, a licensed bank in Venezuela—and a subsidiary of the much larger Venezuelan universal bank, Banco del Caribe—offers deposit products as well. The same was true of Financiera Solución in Peru before it was absorbed by its parent bank, Banco del Crédito, in 2004. Some of the other external organizations in the region can sign up their clients for deposit accounts that are owned by the parent bank, but they are not licensed to mobilize deposits themselves. In most of these cases, all deposits, withdrawals, and other transactions with the deposits accounts must be made at the parent bank's offices.

Heavily Regulated Subsidiaries

The heavily regulated subsidiary is perhaps the most familiar kind of external organization. The parent bank simply creates another bank, *financiera*, or other type of financial institution that is regulated by the banking superintendency. This subsidiary does the microlending and perhaps offers other financial services as well. The name “heavily regulated subsidiary” refers to the direct regulation and supervision of this external organization by the superintendency, in contrast to the lightly regulated subsidiary and the service company, which receive little or no such direct regulation or supervision. Thus, heavily regulated subsidiaries must satisfy minimum capital, capital adequacy, provisioning, related-party lending, and all other regulations imposed on their type of financial institution; must file all applicable daily, weekly, monthly, and other reports with the superintendency; and are sub-

jected to on-site inspections as stand-alone financial institutions. Heavily regulated subsidiaries must also pass through an elaborate approval process to be initially granted an operating license by the superintendency, a process that can often take a year or more. While Bangente and Financiera Solución are examples of heavily regulated subsidiaries that can (or could) offer deposits, some heavily regulated subsidiaries are not permitted to engage in deposit-taking. This is the case with Pronegocio, the microlending subsidiary of the Mexican bank, Banorte. Pronegocio was set up as a SOFOL, a type of *financiera* that is not allowed to capture deposits under Mexican banking law.

Lightly Regulated Subsidiaries and Service Companies

The banking regulations of many Latin American and Caribbean countries permit the creation of auxiliary providers of financial services, which are allowed to engage in one, or sometimes more than one, of the bank's permitted operations. Perhaps the best known of these auxiliary providers are leasing companies and factoring companies, which have been set up as bank subsidiaries in a number of countries.¹² Auxiliary providers of financial services have also been created in several countries in the region in order to do microlending, in some cases as a lightly regulated subsidiary and in other cases as a service company. The essential distinction between these two types of institutions is that the subsidiary owns the loan portfolio that it originates and collects, while the service company does not. Service companies originate and collect the microloans, but the parent bank actually owns the loans and thus books them on its own balance sheet.

The banking laws of many Latin American and Caribbean countries allow banks to set up auxiliary providers of financial services with little or no review from the banking superintendency.¹³

¹² Westley (2003, Chapter 3) discusses leasing subsidiaries and their use in eight Latin American countries.

¹³ For example, this was the case for all of the service companies and lightly regulated subsidiaries shown

Hence, the lengthy licensing procedures that must be followed when creating a heavily regulated subsidiary are often completely or almost completely eliminated when creating a lightly regulated subsidiary or service company.

While many Latin American and Caribbean countries allow for the creation of auxiliary providers of financial services (lightly regulated subsidiaries and service companies), not all countries do. For example, the Mexican banking superintendency (the CNBV) rejected Banorte's attempts in this area, and so Banorte decided to set up a heavily regulated microlending subsidiary instead. Therefore, if a bank is considering engaging in microlending through the use of a service company or lightly regulated subsidiary, it should check with the banking superintendency first to make sure that these structures are permitted.

Funding. Parent banks typically fund much or all of the loan portfolios of their microlending service companies and lightly regulated subsidiaries, and to a lesser extent, of their heavily regulated subsidiaries. However, all types of external organizations can and sometimes do obtain outside funding. For example, Bandesarrollo Microempresas, a wholly-owned microlending service company of the Chilean bank, Banco de Desarrollo, is in the process of obtaining a loan from the IFC in order to diversify its funding sources away from exclusive reliance on the parent bank and also in order to increase the term of its funding. Jamaica National Small Business Loans (JNSBL), a lightly regulated microlending subsidiary of the Jamaica National Building Society (JNBS), has received most of its funding from the parent savings bank, but also has a loan from the Trafalgar Development Bank of Jamaica. Bangente, a heavily regulated subsidiary of Banco del Caribe in Venezuela, funds its lending in roughly equal parts from deposits, loans from the parent bank, and loans from other banks.

Fees and Profits. The service company is paid a fee by the parent bank for all of its efforts in promoting, originating, and collecting mi-

croloans. In contrast, since a subsidiary (either lightly or heavily regulated) is the owner of its own loan portfolio, it simply keeps the interest and commissions earned on this portfolio. Thus, a subsidiary's net income (profits) equals this interest and commission revenue minus all of the expenses the subsidiary incurs. These expenses consist of portfolio funding and provisioning costs, the subsidiary's own operating expenses (for their own personnel, premises, materials, and other costs), and any payments made to the parent bank for use of the parent's infrastructure and services (such as branch space rental, use of the bank's teller services, and use of other services from such bank departments as accounting, auditing, finance, information technology, legal, marketing, personnel, and treasury). That is, a subsidiary's profits are calculated just like that of any financial institution—as revenue from the loan portfolio minus the three costs financial institutions usually face: funding, provisioning, and operating costs. The only difference from a completely independent, stand-alone financial institution is that among the subsidiary's operating costs are the rental payments to the bank for the use of the bank's infrastructure and services.

The way in which the service company fee is calculated need not be any different from this subsidiary profit calculation. In fact, that is exactly how Sogesol, the microlending service company of the Haitian bank, Sogebank, is remunerated. Sogesol is paid an amount by Sogebank equal to all interest and commissions earned on the microloan portfolio that Sogesol originates and services minus the funding and provisioning costs of this portfolio and minus the costs incurred by Sogesol in utilizing Sogebank's infrastructure and services (using a set of unsubsidized prices agreed to in advance). When Sogesol's own operating costs (for its own personnel, purchased materials, etc.) are subtracted from this transfer payment, one can see that Sogesol's net income is calculated in exactly the same way as it would be if it were a subsidiary.

While not all banks have used such a direct profit calculation to set the service company fee, as a matter of best practice this may be the optimal (profit-maximizing) method for the bank to use. At least this is true provided that the bank

below in Table 3.

charges the service company no more than what it actually costs to provide funding and other services to the service company—as would be fair to the service company, which may, after all, have a different set of shareholders than the bank, and, in fact, will almost certainly have different shareholders unless the service company is wholly owned by the bank. Provided this condition on the maximum charge to the service company is met, the use of the direct profit calculation to set the service company fee ensures that when the service company maximizes its own profits it also maximizes the parent bank's profits. To see that this is the case, consider what would happen if, for example, the bank charged the service company only half of the true cost of providing its services. Then the service company would have incentives to overuse bank-provided services and underuse alternative services from outside companies, a clear inefficiency that reduces bank profits. For example, suppose the bank can provide a legal or other service at a cost to itself of \$100, but only charges the service company \$50. The service company will use this service even if it could have bought the same service from an outside company for \$70. While the service company gains \$20 by using the bank's subsidized service, the bank loses \$50. This situation produces a clear net loss for the bank even if it owns 100 percent of the service company and thus obtains all of the \$20 the service company gains. By similar reasoning, the service company should also pay the full cost of the funding the bank provides to it and, for incentive reasons explained in the next paragraph, should pay the full cost of all provisions and write-offs on its loan portfolio. Finally, the service company should receive the full amount of interest and commissions earned on its portfolio. To see why, suppose that the service company received less. Then, it might reduce service to small borrowers, for example, in its market area since they are costly to serve. This would reduce both service company and bank profits if some of these clients were profitable to serve once the full amount of interest and commissions they paid were taken into account. Thus,

the ideal service company fee is simply the profits it would earn if it were a subsidiary and paid the full cost of all the services it obtains from the bank.

Credit Risk. Some people erroneously believe that the service company is an inferior structure because it does not bear the credit risk of the loans it makes. Hence, the reasoning goes, the service company may be careless in screening potential borrowers and weak in following up on loan delinquency. This belief is rooted in the fact that the bank, rather than the service company, owns all of the microloans. While true, what is overlooked is the fact that service companies can be and often are contractually obliged to: a) pay all of the provisioning and write-off charges associated with their delinquent loans and b) maintain sufficient capital to cover the capital adequacy requirements imposed by the superintendency on the microloan portfolio. Such service companies bear all of the credit risk and have full incentives to screen borrowers carefully and do forceful collection. Only in the extreme case in which the service company goes bankrupt does the bank, as the owner of the microloan portfolio, inherit the credit risk. However, this does not change the fact that the service company has as much incentive as a subsidiary or stand-alone financial institution to carefully screen and forcefully collect loans, provided that the service company pays the full provisioning and write-off costs of its mistakes and meets the superintendency's capital adequacy requirements.

Regulatory Issues. In all cases, the service companies and lightly regulated subsidiaries that we have investigated in Latin America and the Caribbean (Table 3) receive little or no separate regulation and supervision from the banking superintendencies. Even the lightly regulated subsidiaries, which own their own loan portfolios, are generally not subjected to separate capital adequacy and provisioning requirements, insider lending limits, credit concentration restrictions, and other prudential controls. Rather, the prac-

Table 3
Examples of Service Companies and Subsidiaries

Name	Parent Bank	Country	Start of Lending	Ownership and Deposit-Taking
<i>Service Companies (cannot mobilize own deposits)</i>				
Bandesarrollo Microempresas	Banco de Desarrollo	Chile	1994	Service company is owned 99% by parent bank and 1% by another bank affiliate.
Banestado Microempresas	Banco del Estado	Chile	1996	Service company is 100% owned by parent bank.
Credife	Banco del Pichincha	Ecuador	1999	Credife is owned 80% by parent bank and 20% by Accion International.
Sogesol	Sogebank	Haiti	2000	Sogesol is owned 35% by parent bank, 19.5% by Accion International, 20.5% by Profund, and 25% by private investors.
Real Microcredito	ABN AMRO Real	Brazil	2002	Real Microcredito is owned 80% by parent bank and 20% by Accion International.
<i>Lightly Regulated Subsidiaries (cannot mobilize own deposits)</i>				
Micro Credit National (MCN)	Unibank	Haiti	1999	MCN is owned 50% by parent bank, 25% by ProCredit Holding, 20% by IFC, and 5% by ICDF (Taiwan).
Jamaica National Small Business Loans (JNSBL)	Jamaica National Building Society (JNBS)	Jamaica	2000	JNSBL is 100% owned by JNBS.
<i>Heavily Regulated Subsidiaries</i>				
Bangente	Banco del Caribe	Venezuela	1999	Bangente is a <i>banco de desarrollo</i> and thus can and does capture deposits. Since 12/05 it is owned 89% by Banco del Caribe, 10% by CESAP (a local NGO), and 1% by Accion International. Initially, Banco del Caribe owned 25% of the shares. In 8/02 it increased its shareholding to 52%.
Créditos Pronegocio	Banorte	Mexico	January 2004	Pronegocio is a SOFOL (<i>financiera</i>), which are not allowed to capture deposits. It is 100% owned by Banorte.
Financiera Solución (merged into parent bank in March 2004)	Banco del Crédito	Peru	1996 consumer credit; 2000 microlending	Banco del Crédito owned 52% of Financiera Solución until 9/03 when it acquired the remaining shares from the Chilean group Banco de Crédito e Inversiones. It then merged Solución into the bank in 3/04.

tice is to consolidate lightly regulated subsidiaries (and service companies) with the parent and impose all of these restrictions on the consolidated entity.¹⁴

¹⁴ Under such consolidation, all of the loans and investments flowing from the parent to the subsidiary are eliminated since they are assets of the bank and equal size liabilities or capital of the subsidiary, and thus cancel themselves out. The microloan portfolio remains as an asset of the consolidated entity.

Service companies and lightly regulated subsidiaries in the region have generally not been separately regulated and supervised because they have fulfilled three conditions: a) they are not permitted to mobilize deposits, b) their microlending portfolios are only a small share of their respective parent's overall loan portfolio, and c) their microlending portfolios have generally been of high quality. However, these external organizations should not take it for granted that they will never be visited or directly inspected by the superintendency. This is because they are responsible for lending money that often has been largely borrowed from the parent bank, which, in turn, has obtained these funds mostly from savings deposited in the bank. Hence, service companies and lightly regulated subsidiaries are effectively lending out deposits the public has made in the banking system. As a result, the superintendencies of many countries in the region have the right to enter the premises, inspect, and obtain information from service companies and lightly-regulated subsidiaries in order to fulfill their mandates of safeguarding depositors and also of protecting the safety and soundness of the banking system. The probability of the superintendency exercising this right increases as microlending portfolios become larger or deteriorate in quality. For example, Banesarrollo Microempresas, the oldest microlending service company in Latin America, reports that it has been subjected to on-site inspections twice since it began operations in 1994, both times when its portfolio delinquency rates rose well above normal levels.

As is logical given how they are supervised, the service companies and lightly regulated subsidiaries in the region typically do not send any reports directly to the banking superintendencies. They simply produce the usual financial statements that a corporation would produce each month (mainly, a balance sheet and income statement) and pass these on to the parent bank. The parent bank then consolidates these statements with its own and those of any other service companies and subsidiaries in which it has a substantial interest, and sends all of the statements (separate and consolidated) to the banking superintendency. Since the microloan portfolios are usually small and of good quality, the bank-

ing superintendency normally does not focus much of its attention on the microlending operations, regardless of whether they are done in house or through an external organization. Occasionally, it will take a sample of microloans to check for adequate loan provisioning and may well supervise the microlender more closely if it detects a serious problem.

Linking Models and Other Strategic Alliances

Linking models, in which a microlending NGO acts as a service company for a bank or in which it develops and then periodically sells a microloan portfolio to the bank, are not considered here. This is because, in practice, these linking models are a relatively rare phenomenon in Latin America and the Caribbean. Thus, analyzing them here would further complicate what is already a fairly complex set of comparisons. Other types of strategic alliances are more common but are of a simpler nature, and for that reason are not analyzed here either. The most widespread example is a simple bank loan to an NGO or other microfinance institution so that the MFI can onlend to its microenterprise clients. Another common arrangement is when a bank permits an MFI's clients to receive their loan proceeds and repay their loans to the MFI using the bank's branch offices and teller facilities, or provides the MFI's clients with savings services.

BEST PRACTICES

This section provides a checklist of some key best practices downscaling banks should follow if they are to be successful in microlending—apart from picking the best structure, which is the subject of the rest of the paper. As will be discussed further in Chapter 3, heeding or not heeding several of these best practices affects some of the major pros and cons of the different structures and thus the choice of which structure is best. For example, using appropriate microlending procedures and products is an important part of the first of the eight best practices discussed below. At the same time, one advantage of doing microlending through an external organization instead of an internal unit is that the external organization can generally escape the

rigidities, bureaucracy, and culture of the bank to a much greater degree and thus use more appropriate microlending procedures and products. The external organization may be an especially useful structure for more rigid banks that would greatly restrict an internal microlending unit's ability to use appropriate procedures and products. On the other hand, to the extent that the bank is able to take a more enlightened approach and allow an internal microlending unit the flexibility to use appropriate procedures and products, the balance of the pros and cons is tipped more towards the internal unit. Thus, there is an interrelation between following the best practices discussed here and choosing the best structure. The eight best practices are as follows:

1. If you do microfinance, do it right! Microlending must be done with appropriately-designed products and processes or else the bank may suffer a number of serious consequences, which include high loan delinquency rates, high operating costs, slow program growth, and poor profitability. Much of the discussion of what banks are doing right or wrong in their microlending operations often centers around the many aspects of offering appropriately-designed products and employing appropriate processes, including offering loans with short terms, little or no formal collateral, high interest rates, rapid approvals, strong and effective loan collection procedures, and a number of other characteristics.

There are several other aspects of doing microfinance right besides employing appropriate loan products and processes. These include freeing the bank's microlender (that is, the internal unit or external organization doing the microlending) as much as possible to do the following at will in order to best meet the competition, successfully expand its microlending business and other product lines, and increase the profitability of the microlender and bank:

- ❖ Introduce new products (e.g., equipment loans, housing loans, small and medium-size enterprise loans, credit cards, remit-

tances, insurance, and, for deposit mobilizing subsidiaries, deposit products)

- ❖ Modify existing products to better fit microenterprise clients (e.g., savings accounts with low minimum balances)
- ❖ Locate new branches and other points of service in areas best suited to offer microloans and other microenterprise products, and utilize part-time or mobile branches where demand does not warrant a full-time, fixed branch
- ❖ Change prices (e.g., interest rates charged on the different loan products)

In addition, the microlender must have the financial resources to be able to effectively compete and maximize profit generation. These resources include:

- ❖ A sufficient operating cost budget so that the microlender can optimally expand the number of branches in which it is present, hire and train new loan officers and other personnel, avail itself of an appropriate management information system, design and pilot test new products, and meet all other operating cost needs
- ❖ Sufficient portfolio funding from which to make loans

2. Leaning on the bank. The bank's microlender—whether it be an internal unit, service company, lightly regulated subsidiary, or heavily regulated subsidiary—should make the best possible use of the bank's infrastructure and all of the relevant services the bank provides. These facilities and services might include, for example, branch networks and ATMs, information systems hardware, telecommunications systems, and services from such bank departments as accounting, auditing, finance, information technology, legal, marketing, personnel, and treasury. Regardless of the microlender's structure (internal unit or external organization) it should make the best possible use of the bank's infrastructure and services in order to: a) reduce its operating costs by taking advantage of the bank's installed capacities and the economies of scale that come from

the bank providing additional services to the microlender and its clients using those installed capacities and b) avail itself of specialized personnel resident in the bank, such as computer programmers, specialized auditors, and marketing experts that the microlender could not justify hiring only for itself. The extent to which an external organization can and should lean on the bank's infrastructure and services is sometimes not appreciated. Just because the external microlender is a separate corporation with its own board of directors, management, and staff does not mean that it cannot buy many or even most of the services it needs from the parent bank or rent the parent's facilities. For example, during its early operations, Bangente functioned as a virtual bank, relying almost entirely on the infrastructure and services of Banco del Caribe (OMTRIX, 2000, p. 1). On the other hand, what the bank offers may not always meet the needs of the microlender, for example, branches that are not in the right location or a personnel department that has no idea of how to recruit or train microfinance loan officers. In these cases, the microlender needs to be free *not* to use the bank's installed capacities. This may be especially challenging for internal units, which may not have the budget or bureaucratic discretion to readily replace the bank's inadequate services or facilities. The final section of this chapter examines this important issue of leaning on the bank in greater detail, both to further explore this best practice and to help set the stage for the discussion of the pros and cons in Chapter 2.

3. Branch locations. Whether microlending is done through an internal unit or external organization, it needs to operate out of appropriately-located branch offices. When some of the bank branches are located in low-income neighborhoods, near to markets with substantial concentrations of microentrepreneurs, or in other areas suited to microlending, it may be best for microlenders to utilize these branches, provided two conditions are met: a) there is either sufficient space for their operations already or else the branch can be expanded at reasonable cost to ac-

commodate microlending and b) the bank and microlender wish to be associated (see discussion in Chapter 2 on image and branding, point A3/B3). This first condition should not be overlooked; microlending can potentially bring thousands of new clients into bank branches, and the bank needs a well thought out plan for how to accommodate this.

There are at least two important advantages of sharing branch space. First, costs may be reduced by sharing telecommunications and computer systems, security systems and personnel, and other branch infrastructure and services. Second, microloan clients typically must go a bank branch to cash their loan disbursement voucher or check, repay loans, and access deposit and other services that may be offered only at the bank. Thus, having the microlender and bank in one place reduces client transactions costs and facilitates cross-selling. The latter can be an important additional source of profits for the bank.

The microlender may also wish to open its own branches, either because the bank's branches are not in appropriate areas or do not have enough space, or else because of image and branding considerations. In deciding where to locate its new branches, the microlender should take account not only of where there are concentrations of potential microloan clients but also of where the existing bank branches are. Being near bank branches facilitates both the teller transactions required by the microloan clients as well as the cross-selling of deposit accounts and any other products that are offered only at the bank. Going a step further by locating microlending branches just upstairs from or adjacent to existing bank branches may also facilitate the sharing of infrastructure and services (such as security systems and personnel, telecommunications, and computer systems), which can yield the microlender significant cost savings.

4. Special considerations for internal units:

- ❖ The internal microlending unit should have high bureaucratic rank, perhaps out of line especially at first, with microlending's importance in the bank's overall loan portfolio. If microlending is not placed in its own department, it should at least be placed in a department that has experience making: a) large numbers of fairly small business loans, typically the small and medium enterprise loan department and/or b) large numbers of small consumer loans, typically the consumer lending department. The internal microlending unit is least likely to succeed when it is placed in the bank's corporate lending department, given the completely different cultures and procedures associated with corporate lending versus microlending.

The reason for giving the microlending unit high bureaucratic rank is to enable the microlending unit to: a) better develop what is, for the bank, a rather non-standard set of operating procedures and products and b) obtain the freedoms, cooperation, and resources from the bank's managers and directors that are needed to make microlending a success for the bank. For example, Bancafé in Guatemala is a large commercial bank with a very successful microlending program. Initiated in November 1999, this microlending program now serves 15,000 clients and has never suffered a 30-day delinquency rate (measured as portfolio at risk) above 2.5 percent. The head of the microlending unit reports directly to the head of the micro, small and medium enterprise department, which, in turn, is one of four basic line departments, and thus is equal in bureaucratic rank to the other three departments: personal banking, private and corporate banking, and insurance. Another example is Banefe, the very successful retail and microlending unit of Banco Santander in Chile. Banefe is one of six major divisions in the bank and cur-

rently has a portfolio of over 50,000 microloans.

- ❖ The head of the microlending unit should be someone with a genuine interest in and aptitude for microlending. Related experience may also be helpful. A number of successful microlending unit heads in Latin American banks have had several years of experience making small business or consumer loans within their banks, and thus have gained valuable experience in retail banking. It may also be useful for the head of the microlending unit to have a total of 10-15 years or more of experience inside the bank in order to understand the intricacies of the bank's operations and to be well connected to other managers. This may facilitate the many special adjustments the bank will inevitably have to make to its procedures, products, information systems, and general operations in order to successfully accommodate the particular characteristics and needs of microlending. Such a person may be better able to convince skeptical managers and board members to give the microlending unit the resources and freedoms it needs to do microfinance right (as described in point 1, above).
- ❖ The microlending unit should have specialized loan officers. Existing consumer or small business loan officers should not be asked to do double duty and also serve as microenterprise loan officers. Rather, since microlending has its own specialized methodology that takes substantial time to master, it is generally best to utilize specialized loan officers. High levels of loan officer productivity (400 borrowers per loan officer or more) are only achieved by microlenders using specialized loan officers. Moreover, when small business or consumer lending units use their loan officers to also make microloans, it is quite common to see high delinquency rates in the microloan portfolio because the demands of microlending are so different.

5. Special considerations for external organizations (service companies and subsidiaries)—reducing start-up delays. One of the attractions of doing microlending through an internal unit instead of an external organization is that it is often cheaper and faster to start up operations when lending is done in house. This is because external organizations, being stand-alone corporations, require: a) a shareholders agreement, whenever the bank is not the sole owner of the external organization, b) a service agreement with the bank (which details the bank facilities and services the external organization can use and the price it must pay the bank for using them), and possibly c) regulatory approval from the bank superintendency. All of these impose costs and possibly delays on the start-up of microlending. None are needed if microlending is carried out by means of an internal unit.

The start-up delays (but not the additional start-up costs) associated with doing microlending through an external organization may be reduced or possibly even eliminated by using two time-saving tricks. The essence of these tricks is to carry out the three additional tasks (negotiate the shareholders and service agreements, and obtain regulatory clearance) in parallel with other tasks that must be done by any microlender, even an internal unit. To understand this idea, recall that once a bank decides to engage in microlending, there is a long list of technical tasks that it must carry out regardless of whether lending is to be done in house or through an external organization. These include, for example, carrying out detailed market and feasibility studies, creating operating and other manuals, hiring and training loan officers and other personnel, setting up loan tracking and accounting systems, and doing detailed product design work. Although it is difficult to generalize, these tasks often take approximately 6-9 months to accomplish. Once completed, the microloan product is ready for pilot testing, which may consume another 6-12 months or more, depending on whether the pilot test results indicate that product, organizational,

or other changes are needed. Thus, it is difficult to go into full rollout of the microloan product in less than a year, even if microlending is done through an internal unit and no shareholders agreement, service agreement, or regulatory clearance are needed.

The first trick for reducing the start-up delays that can arise when microlending is done through an external organization is simply to negotiate the shareholders and service agreements while carrying out the technical tasks. An important limitation on the use of this trick is that the bank or some other entity must be willing to pay the costs of carrying out these technical tasks until a shareholders agreement can be reached and capital is paid in by all of the shareholders.

The second trick for reducing the start-up delays that can arise when microlending is done through an external organization is to pilot test the microlending product in house or through a foundation connected with the bank while awaiting regulatory clearance for the external organization to begin operations. This is mainly useful when creating a heavily regulated microlending subsidiary since such subsidiaries normally require a significant period of time (6-12 months or more) to obtain regulatory approval. Point B2 of Chapter 2 discusses these two tricks more fully and gives actual examples of their successful application.

6. Special consideration for service companies—setting the service company fee. The formula used to set the fee paid by the bank to the service company can be chosen in such a way that the service company, in maximizing its own profits, also maximizes the bank's profits. This is clearly a desirable result for the bank. To achieve this result, the fee should be set such that the bank does not subsidize the funding or any of the services it provides to the service company. Neither should the bank withhold any part of the interest or commission income the service company earns from its lending operations. Finally, the service company should

pay all of the provisioning and write-off costs associated with its loan portfolio. Thus, the ideal service company fee is simply the profits it would earn if it were a subsidiary and paid the full cost for all of the services it obtains from the bank. This result is explained in the discussion of fees and profits in the above section, "Four Ways to Downscale."

7. Get technical assistance. It is both difficult and unnecessary to reinvent the wheel in microfinance. Much has been learned about how to do microfinance right and about the other best practices discussed here. Banks can save themselves from expensive mistakes and earn greater profits more quickly by accessing good quality technical assistance.
8. From champions to institutional commitment. Early writers such as Baydas, Graham, and Valenzuela (1997) and Valenzuela (2001) emphasized the importance of a board champion, who inspired and protected the microlending program, and an operational champion, who knew how to run the program. These champions were committed to the vision of microfinance in the bank. While this is a good start, things are likely to go significantly better for the microlending program if more of the bank's directors, managers, and staff understand microfinance and are convinced that it is truly a worthwhile *commercial* venture for the bank to engage in. Even if the microlending program is headed by an able manager, who has the backing of the chairman of the board and the bank's general manager, there are still many other upper- and middle-level managers and staff who can create any number of roadblocks and problems for the microlending program. The chairman and general manager simply may not have the time or energy to deal with all of the obstacles that a bank bureaucracy can muster when not convinced of the merit of microlending.

Consequently, it may be useful for the bank to engage in a more general education and consciousness-raising campaign. The aim of

this campaign would be to make the directors, managers, and other key staff of the bank aware of why microlending is important for the future of the bank, reinforce the message that the bank is committed to making microfinance work, educate these personnel in the essentials of microlending, and explain what is expected of them as a result of the bank's entry into this field. With such demonstrated commitment by the bank, microlending has a much greater chance of being: done right (in the sense of best practice 1, above), placed in an appropriate structure even if this entails the extra costs and delays associated with creating a service company or subsidiary, provided with good access to bank infrastructure and support services, allowed to open its own branches and obtain its own outside services when the bank's are not sufficient or appropriate, and generally treated like a product line that is important to the future of the bank.

An excellent example of how a consciousness-raising campaign can help is given by the case of Unibank, the second largest commercial bank in Haiti. Carl Braun, the chairman of the board of Unibank, is also the chairman of the board of Micro Credit National (MCN), Unibank's microlending subsidiary. The strategic vision of the bank and of chairman Braun is that Unibank should be a universal bank, not only in the sense of providing a wide array of services, but also in the sense of serving all segments of Haitian society, including microenterprises, with products that are well designed to meet each segment's needs. While Unibank serves 500,000 depositors, it has only 1100 loan clients; thus, MCN's 8000 additional loan clients represent a significant democratization of credit for the bank. Because of the bank's strategic vision, chairman Braun has taken great pains to emphasize on many occasions to his fellow directors, managers, and staff that the future of MCN is of great importance to Unibank. It is clear that such efforts have paid handsome dividends. MCN has not had the kinds of problems securing the cooperation of the bank's managers and staff that are reported

by other subsidiaries, service companies, and internal units, such as opening new branches, resolving information systems issues quickly and effectively, and getting the many other bank departments to be responsive to the needs of microlending.

Valenzuela (2001) notes that while recessions, banking crises, and other external shocks have shut down some banks and their microlending programs, internal failings have been a much bigger killer of bank-based microlending programs. Chief among these failings are some of the points discussed in this paper, including the failure to adopt a microlending structure that is appropriate to the bank and its environment, to do microfinance right, and to muster sufficient institutional commitment. Such problems have led many banks to enter microfinance, encounter difficulties or disappointing results, and leave. This cycle of failure is expensive for banks and society, not only in its direct monetary costs, but also in the lost opportunity to make profits and a social contribution.

LEANING ON THE BANK

As discussed in point 2 of the preceding section, the bank's microlender, whether it be an internal unit or external organization, should make the best possible use of the bank's infrastructure and services. This section presents a number of important areas in which the microlender can and should lean on the bank and discusses how it might do so to best advantage.¹⁵ Ten such areas are listed in Table 4. The purpose of this section is both to further explore an important best practice and to help set the stage for the discussion of the pros and cons in Chapter 2.

1. *Branch space and infrastructure.* See discussion in preceding section, point 2.

2. *Money-handling facilities.* Because systems for disbursing and receiving cash have large fixed setup costs, nearly all microlenders use the parent bank's systems to handle microloan pay-

outs and collections, rather than set up their own separate systems. Even Bangente, which offers its own deposit products, does not handle any cash. Instead, it makes use of Banco del Caribe's tellers and ATMs whenever money must be handled in any deposit, loan, or other transaction. While there are obvious cost savings to having the microlender's clients use the bank's money-handling facilities, there may be serious drawbacks as well. For example, Sogesol's microloan clients often have to wait in long lines at Sogebank, and also complain of second-class treatment by the bank's tellers compared to the treatment the tellers give to Sogebank clients.

There are at least three types of systems for disbursing and collecting microloans from which the bank and microlender must choose:

- **Manual.** Clients are issued a check or voucher, which they then cash at a bank teller window. They make all loan repayments to a bank teller as well.
- **Semiautomatic.** The loan client opens a savings account, and all loan proceeds are automatically deposited into this account after the loan is approved. Loan repayments are still done manually, though now through the savings account: the client comes to a branch and fills out a slip of paper that authorizes the teller to withdraw the loan payment from his/her account.
- **Automatic.** The loan client opens a savings account and has the loan proceeds automatically deposited into this account and loan repayments automatically deducted from it. Clients need only ensure that they have sufficient balances to cover the automatic deductions.

The first system imposes the greatest operating cost burden on the bank's tellers, while the third imposes the least. Although the third option requires an initial investment in computer systems, it may well be the cheapest way to handle a large number of microloan disbursements and collections in the longer run. In deciding which system is best, banks should consider not only which has the least cost over time but should

¹⁵ The term "leaning on the bank" is used as a shorthand to denote the microlender making use of the bank's infrastructure and services.

Table 4
Leaning on the Bank

1. Branch space and infrastructure (computer hardware, telecommunications, vaults, etc.)
2. Bank tellers, ATMs, and systems for handling money
3. Information systems: a) loan tracking, b) accounting, and possibly c) loan analysis software and hardware
4. Information systems: reporting to the bank superintendency
5. Human resources department: a) payroll and benefits (with information technology department), b) personnel recruitment, and c) training
6. Legal department: a) tools, b) advice, and c) collections
7. Internal auditing and controls
8. Marketing
9. Financial management (asset-liability management)
10. Funding

also take into account the benefits and costs of the additional savings accounts brought in by the last two systems. As discussed in Portocarrero, Tarazona, and Westley (2006, Ch. 3), savings accounts typically have low interest costs but high operating costs and hence may or may not be cheap sources of funding for banks compared to time deposits, borrowing, and other ways banks have to fund themselves. Very small savings accounts (with balances of under US\$ 100) may be particularly expensive; the authors find that such accounts have annual operating costs averaging over 200 percent of the account balance in the five MFIs they analyze.

Finally, the bank should quantify the cost of handling microloan disbursements and collections by undertaking a costing analysis, and should charge the microlender accordingly. For example, on the basis of such a study of Sogebank's manual disbursement and collection system, Sogesol pays Sogebank 80 gourdes (approximately US\$ 2) every time one of its micro enterprise loan clients makes a transaction with a Sogebank teller. On the other side of the ledger, it might also be reasonable for the bank to pay the microlender a finder's fee whenever one of the microlender's clients opens a new deposit account in the bank, at least if these accounts have sufficient size and longevity that they are profitable for the bank.

3. Loan tracking, accounting, and loan analysis. Banks have loan tracking and accounting systems, which, depending on their characteristics, may serve the needs of the microlender to a gre-

ater or lesser degree. For example, a common problem is that microlenders require certain loan tracking reports that the bank's management information system (MIS) may not produce, such as daily listings of each loan officer's delinquent clients. However, the MIS of many banks is flexible enough that microlending can simply be added as a new product and the system programmed to generate whatever reports are needed. This has been the experience in such cases as Credife (the microlending service company of Banco del Pichincha in Ecuador), Pronegocio (the microlending subsidiary of Banorte in Mexico), and the internal microlending units of Banco del Crédito (Peru) and Bancolombia (Colombia). This may be the ideal solution if the programming can be done at reasonable cost and if the MIS can produce the required reports in a timely fashion. Bangente decided early in its history that Banco del Caribe's MIS was too slow and inadequate to meet its needs. Bangente acquired its own MIS, but this has generated continuing interface problems between the two systems, a headache that also plagues Sogesol, which also opted for its own MIS. Even the intermediate solution of the microlender acquiring its own loan tracking software, which then feeds the bank's accounting system, can generate frustrating and costly interface issues. Given the variety of software packages used by banks, it is difficult to generalize about how best to meet the loan tracking and accounting needs of the microlending program; each case must be dealt with individually and the best solution found given the capabilities of the bank's MIS and the needs of the microlender.

Banks rarely have the kind of specialized software microlenders sometimes use to carry out cash flow analyses of potential borrowers and to calculate certain ratios—all in an effort to assess the borrower's ability to pay and to help set the size and term of the loan. Microlenders wishing to use such loan analysis software (in order to reduce the need for manual calculations) typically need to acquire or develop their own applications, perhaps with the aid of an outside company. This can cause procurement issues particularly for in-house microlenders since they typically lack the budget autonomy enjoyed by external microlending organizations. For example, Bancolombia's internal microlending unit has been waiting for the bank to provide it with both Palm Pilots (for field entry of client data) and appropriate loan analysis software, but has finally decided the bank was taking too long and has gone with an outside vendor.

4. *Superintendency reports.* Heavily regulated subsidiaries must file their own reports with the banking superintendency since they are, by definition, regulated separately from the parent bank. They may be able to lean on the work of the parent bank in this area since the bank has already invested heavily in systems that prepare the necessary reports. In particular, these subsidiaries may be able to have the bank prepare the necessary reports for them or else import the report-generating routines and adapt them to their own systems. The operations of lightly regulated subsidiaries, service companies, and in-house microlending units are generally consolidated with those of the parent and thus generate relatively small additional reporting burdens, although the lightly regulated subsidiaries and service companies typically must also prepare monthly financial statements (especially balance sheets and income statements).

5. *Human resources department.* Even when the bank's microlender takes the form of an external organization, it is usually relatively cheap and easy for the bank's human resources department to prepare the payroll and benefits statements for all microlending staff, as they already do for all bank staff. Consequently, most banks take care of this administrative chore. On the other hand,

most microlenders do their own recruiting and training of loan officers and of others directly involved in microlending. This reflects the banks' lack of experience in this area and the bad outcomes that have typically occurred when bank human resources departments have taken on these tasks. Recruitment of other staff and training in areas other than microfinance may more reasonably be done by either the bank or microlender. Sometimes the bank offers generic training in such areas as accounting, information technology, and management that the microlender's personnel can utilize at low cost to all.

6. *Legal department.* The microlender can reduce its costs by using the parent bank's legal department to create the tools it needs to operate, such as loan contracts and promissory notes, and to give it advice from time to time on such issues as whether the superintendency's regulations are being followed and whether new loan product documentation is adequate. Because the bank's lawyers already have substantial experience with this kind of work, it would normally be wasteful for the microlender to create its own capacity in these areas.

The microlender also needs lawyers to take defaulting borrowers to court in order to seize their collateral and collect outstanding loan balances. This is only done once loan collection agents fail, and may be carried out by the bank's lawyers, the microlender's lawyers, or outside lawyers—with the last option being perhaps the most common. Sogesol uses outside lawyers but hopes to economize some on these costs by hiring a lawyer to head its loan collection department. In addition to overseeing Sogesol's loan collection work, this lawyer would perform some of the legal work of taking debtors to court.

7. *Internal auditing and control.* Microlending's very decentralized loan approval and monitoring systems create the potential for such abuses as phantom loans and kickbacks. The way these and other potential problems are best detected and solved in microlending is not by creating elaborate paper trails and multilevel loan approval processes. While these methods work well in traditional banking, the added transac-

tions costs of using such methods on thousands of tiny loans make them completely inappropriate for microfinance. Because of such differences, microlenders need specialized staff who understand where the risks of microlending lie and conduct their audits accordingly. These specialized staff may be employees of either the bank or microlender, though the latter appears more common. The main point is simply that this service not be missed; more than a traditional financial audit must be conducted. As for the traditional financial audit—which is important in microfinance just as it is in banking—the microlender may find it cost effective to rely on the parent bank’s auditors. For example, Credife reports that the bank’s auditing department is more sophisticated than anything Credife could afford to create, offering many specialized skills, and so Credife relies heavily on this department for most of its traditional auditing needs.¹⁶

8. *Marketing.* Some microlenders, such as Credife, rely entirely on the bank’s marketing department. These microlenders may cite the bank’s skilled graphic designers, advertising campaign managers, and other specialized personnel as advantages of this strategy. Other microlenders, such as MCN, feel they know the types of clients they are trying to reach better

than the bank ever will, and so hire their own marketing staff, which does all of the microlender’s marketing work. However, MCN does take advantage of the potential for cost economies by bundling its purchases of radio time together with those of its parent bank, thus obtaining more favorable prices by means of these bulk purchases.

9. *Financial management.* There are a number of ways that the microlender can lean on the bank in order to help it avoid asset-liability mismatch risks. These are discussed in section B1 of the next chapter.

10. *Funding.* As discussed further in section B1 of Chapter 2, there are economies of scale in all of the methods a financial institution uses to fund itself: mobilizing deposits, borrowing, issuing bonds, and issuing stock. Therefore, to the extent the microlender relies on the bank to obtain funding for both institutions, the costs of funding the microloan portfolio may be reduced. A common arrangement in the cases where the microlender is an external organization is for the bank to obtain funding from a variety of sources and then provide loans or a line of credit to the microlender at the bank’s weighted average cost of funding. External microlenders may complement these bank loans with outside funds.¹⁷

¹⁶ For an excellent reference on auditing in microfinance, which is useful for both internal and external auditors and even for bank supervisors, see CGAP (1998). Other useful material can be found at the Microfinance Gateway website (<http://www.microfinancegateway.org>, then go to the “Resource Centers” heading and select “Audit Services”).

¹⁷ When the bank’s microlender is an in-house unit, this unit typically relies on the bank for all of its funding needs and therefore enjoys the cost economies described here. Service companies and subsidiaries may use a mix of bank and outside funding, and thus enjoy at least some of these cost economies.

2. Pros and Cons of the Four Ways to Downscale

This chapter discusses the pros and cons for the bank of the four ways to downscale that are described in Chapter 1. Although the bank may or may not wish to make its decision this way, it simplifies the exposition greatly if we break the process of choosing among the four models into two steps. First, we examine the pros and cons of the bank structuring its microlender as an internal unit versus an external organization (service company, lightly regulated subsidiary, or heavily regulated subsidiary). Second, we discuss the pros and cons of the different external organization options.

Turning to the first of these two decisions, Table 5 summarizes the eight factors that favor an external organization (numbered A1 through A8) and the seven factors that favor an internal unit (numbered B1 through B7). Factors A3 and B3 are a special case in which a single factor (image and branding) could favor either an internal unit or external organization, depending on the circumstances. Consequently, this factor is numbered A3/B3 to indicate this special status.

Turning to the second of the two decisions, Table 6 presents the factors that favor a service company over a subsidiary or vice-versa. An asterisk appears next to the reference number of any factor that is (or may be) different depending on whether the comparison is made to a heavily or a lightly regulated subsidiary. For example, a service company may have an advantage over a heavily regulated subsidiary but not over a lightly regulated subsidiary, or the service company's advantage may simply be greater with respect to the former subsidiary than the latter. An asterisk is used to indicate either of these cases. As it turns out, all factors that appear in Table 6 have already appeared in Table 5. Hence, the same set of reference numbers are used in both tables (A1-A8 and B1-B7), though only a subset of the Table 5 factors actually appear in Table 6.

The organization of the chapter is simple. Tables 5 and 6 are presented and then the 14 pros and cons are discussed in order (starting with A1 and ending with B7).¹⁸ The discussion of each factor starts with the Table 5 comparison of internal unit versus external organization and then covers the Table 6 comparison if the factor also appears there.

The appearance of a factor in both Tables 5 and 6 does not necessarily mean that all the same pros and cons apply in both cases. For example, factor A1, greater operating freedom or autonomy, appears in both tables. In Table 5 it represents a broad range of advantages that service companies and subsidiaries generally have over internal units because of their greater autonomy. In Table 6, it turns out that while subsidiaries have some advantages over service companies stemming from their greater autonomy, the set of advantages is far narrower than the ones discussed in relation to Table 5. The discussion of each of the 14 factors makes this distinction clear wherever it applies.

A1. GREATER FREEDOM TO DO MICROFINANCE RIGHT

“Doing microfinance right” refers to the ability: a) to employ appropriate products and processes in granting loans and delivering other financial services to microenterprises and b) to do whatever else is needed to best develop all of these microfinance business lines in order to successfully compete and maximize profits over the medium to long run (such as introduce new products, open new branches, and carry out the other activities discussed in points 1-7, below). Heads of external organizations often cite their ability to do microfinance right as a major advantage they enjoy over internal units and an important reason for going to the extra trouble

¹⁸ The factors A1-A8 and B1-B7 give 14 factors, not 15, because factors A3 and B3 are combined, as already noted.

Table 5
Internal Unit vs. External Organization: Pros and Cons

Reference Number	Advantages of an External Organization over an Internal Unit
A1	Greater freedom to do microfinance right (e.g., to use appropriate loan products and processes, open new branches and change interest rates at will, generate and apply budgetary resources with greater discretion to meet priority needs)
A2	The microlender's directors, managers, and staff may have much higher-powered incentives to be efficient and profitable
A3/B3	Image and branding (may be a disadvantage in some circumstances)
A4	If outside shareholders are incorporated, this can bring several benefits, including additional capital, improved governance, and high-quality technical assistance
A5	Can reduce the risks to the bank of the microlending operations
A6	May escape certain pay-related problems and the wage scale of the bank
A7	May escape from union wage scales and agreements
A8	Subsidiary may have more favorable treatment under a usury ceiling than an internal unit or even a service company
	Advantages of an Internal Unit over an External Organization
B1	Greater integration into the bank reduces operating costs (perhaps by 1-10%)
B2	By eliminating initial tasks, start-up cost and often start-up time are reduced; possibly less initial capital is needed; idle capital is easily avoided
A3/B3	Image and branding (may be a disadvantage in some circumstances)
B4	Outside shareholders in an external organization reduce bank profits and can create conflicts
B5	Funding advantages: a) unconstrained capital backing from the bank, b) greater availability and less uncertainty about the availability of loan portfolio funding, and c) lower funding cost than subsidiaries
B6	Value added tax may be levied on: a) payments made by an external organization to the bank for use of bank infrastructure and services and b) fees paid by the bank to a service company
B7	Duplicate capital problem (most likely to negatively affect heavily regulated subsidiaries)

Table 6
Service Company vs. Subsidiary: Pros and Cons

Reference Number	Advantages of a Service Company over a Subsidiary (Heavily or Lightly Regulated)
B1*	Greater integration into the bank reduces operating costs
B2*	By eliminating initial tasks, start-up cost and often start-up time are reduced; possibly less initial and initially-idle capital—all especially with respect to heavily regulated subsidiaries
B5*	Funding advantages: a) greater availability and less uncertainty about the availability of loan portfolio funding and b) lower funding costs
B7*	Duplicate capital problem (most likely to negatively affect heavily regulated subsidiaries)
A7*	May escape from union wage scales and agreements
	Advantages of a Subsidiary (Heavily or Lightly Regulated) over a Service Company
A1*	Greater autonomy in certain limited spheres including, for heavily regulated subsidiaries that can mobilize deposits, the chance to offer more appropriate savings products
A5	Can reduce the risks to the bank of the microlending operations
A8*	Subsidiary may have more favorable treatment under a usury ceiling than an internal unit or even a service company

Note: An asterisk (*) indicates those factors where the effect is (or may be) different depending on whether the comparison is made to a heavily regulated subsidiary or a lightly regulated subsidiary.

and expense of setting up an external organization. The heads of internal microlending units of even those banks that have demonstrated some of the greatest flexibility in their treatment of microlending also agree that they would enjoy important additional freedoms if they did microlending through an external organization. We first discuss the advantages external organizations typically enjoy over internal units in their ability to do microfinance right (Table 5) and then turn to the much smaller set of advantages subsidiaries may have over service companies in this regard (Table 6).

Internal Unit vs. External Organization

The advantages enjoyed by an external organization over an internal unit may include the following, which are collectively referred to as the ability to “do microfinance right”:

1. Greater freedom to do *microlending* right.¹⁹ By doing microlending right, we mean the ability to use an appropriate microlending methodology, that is, to employ appropriate products and processes in granting loans to microenterprises. Box 1 describes many of the key elements of an appropriate microlending methodology. The products and processes described in Box 1 are generally quite different from those that banks are accustomed to using with their larger clients. As a result, banks sometimes resist: offering loans with such short terms (which may seem wasteful of bank manpower); charging such high interest rates or engaging in forceful collection efforts (which may seem unfair to poor clients or bad for public relations); allowing loans to be approved in a decentralized fashion, without formalized collateral, or with what bankers may deem to be inadequate loan documentation (all of which may seem to be risky practices); or permitting the use of loan officer incentive pay schemes (which may seem out of step with the bank’s culture or contrary to the need to foster teamwork). Box 2 presents

some of the consequences of not using appropriate microlending products and processes, which can include high loan delinquency rates, high operating costs, slow program growth, and poor profitability performance. These consequences can be quite severe. Failure to do microlending right is one of leading reasons that banks fail in their efforts to downscale and end up exiting microfinance. In these banks, microlending never achieves the scale or profitability that would justify continuing involvement.

2. The freedom to introduce new products. These may include new loan products such as equipment loans, housing loans, small and medium-size enterprise loans, lines of credit, and credit cards, and also new non-loan products such as insurance products and remittances. Heavily regulated subsidiaries that mobilize deposits also have the advantage of being able to introduce savings products that are designed for their target group (for example with low minimum balances), instead of only being able to lobby the bank to do so.
3. The freedom to modify existing loan, insurance, savings, and other products and product delivery mechanisms to better fit the needs of clients.
4. The freedom to locate new branches and other points of service in areas best suited to develop microlending and other product lines, and utilize part-time or mobile branches where demand does not warrant a full-time, fixed branch.
5. The freedom to set prices, for example, to charge much higher loan rates than is typical in banking, in order to cover the high operating cost margins associated with making very small loans. Similarly, microenterprises may demand savings accounts with small minimum balances. External organizations that can capture deposits may have greater discretion both to offer small savings accounts and to choose whether to cross-subsidize them (by paying market deposit

¹⁹ Doing *microlending* right is one of the many aspects of the broader concept of doing *microfinance* right.

Box 1
Key Elements of an Appropriate Microlending Methodology
(Appropriate Products and Processes)

- Small, short-term loans that may increase in size and term if successfully repaid
- High interest rates (much higher than banks charge for their larger loans)—to compensate for the high operating cost margins associated with making small loans
- Greater reliance on cash flow and character analyses than on collateral, in which:
 - ❖ The unit subjected to the cash flow analysis is the entire household, not just the business
 - ❖ The character analysis is based on visits to the client's home and work place and on talks with business associates, neighbors, friends, and relatives—not just on a work site visit and reference letters, for example
 - ❖ Collateral generally consists of unregistered household goods and business equipment and/or group guarantees
- Some use of non-traditional repayment frequencies to facilitate greater monitoring of borrowers (weekly or biweekly instead of monthly), or even of installment payments that vary in size and/or frequency (for clients with strong seasonal variations in their income, as often occurs in the agriculture and tourism sectors)
- Decentralized loan approval processes, rather than several departments signing off on loan approvals
- Rapid loan approvals and disbursements, with little or no formal documentation required of clients (such as financial statements and collateral appraisals)
- Loan officers who spend 80-90 percent of their time in the field (developing and screening new clients and checking on old ones, especially those who are delinquent)
- Loan officers who see their loans through from origination to collection and have an important part of their remuneration (perhaps 30-70 percent) determined by their portfolio delinquency rate and loan volume
- A strong and effective loan collection program that includes immediate and repeated follow-ups on loan delinquency and a management information system that supports this with daily reports to loan officers showing which of their clients are delinquent
- Operating costs are often held down by having loan officers use inexpensive modes of transportation and by operating out of relatively modest branch offices, in keeping with the fact that the program serves a clientele of limited means

rates and not levying low balance fees) or not. Cross-subsidizing small savings accounts has obvious benefits for the small savers and, by increasing the number of depositors, may also offer scope economies and other advantages to the microlender. However, if the scope economies and other advantages are insufficient, it is also important for the microlender to be able to choose to reduce or eliminate these subsidies. External organizations potentially offer greater freedom in making all of these choices.

6. Greater freedom to dedicate additional resources to its operating budget so that the external organization can more rapidly expand the number of branches in which it is present, hire and train new loan officers and other personnel, appropriately equip the branches with telecommunications and other infrastructure, avail itself of an appropriate management information system, design and pilot test new products, and meet all other operating costs it deems important.

Box 2

Consequences of Not Adhering to an Appropriate Microlending Methodology

Experience has shown repeatedly that commercial banks that try to lend to microentrepreneurs without adopting an appropriate microlending methodology (that is, appropriate products and processes) run into serious problems, including the following:

- High delinquency rates—for example, because: a) too much attention is paid to collateral and not enough to character or cash flow, b) an inappropriate cash flow analysis is made (for example, one that analyzes only the business, rather than the entire household), c) the management information system doesn't give loan officers and their supervisors daily reports on which borrowers are delinquent, d) responses to loan delinquency are slow or weak, or e) an adequate loan officer pay system is not used to help motivate good loan analysis and forceful collection
- Higher operating costs than necessary—for example, if several departments involve themselves in the loan granting and approval process, or if the bank makes the loan granting and approval process unduly formal and cumbersome for the loan officers by requiring more client documentation than is needed
- Slow program growth—for example, because of slow loan approval processes, excessive collateral requirements, high transactions costs imposed on borrowers, products that aren't designed to meet the needs of the target population, excessive loan delinquencies that cause loan officers to get bogged down in loan collection instead of developing new business (for reasons such as those given in the first bullet), or failure to open branches during appropriate days and hours (e.g., market days) or in appropriate locations
- Poor profitability performance—the microlender may incur serious losses instead of making healthy profits if, for example, loan interest rates are set too low or operating costs or delinquency rates are insufficiently controlled

7. The freedom to seek additional portfolio funding from sources other than the bank in order to expand lending more rapidly than the bank may be willing. As noted in Chapter 1, all types of external organizations, even service companies and lightly regulated subsidiaries, can and do seek outside funding.

This is a formidable list of advantages. Even if the bank has the good sense to recognize that microlending is a very different product, which must be offered in accordance with its own rules of best practice (point 1 above), most banks are still large bureaucracies which impose significant operating limits on their constituent units. Because of this and because external organizations are also separate corporations with their own boards of directors while internal units are not, internal units do not have as much budget-

ary autonomy as external organizations, nor do they have as much freedom to set prices, locate branches, or introduce or modify products.

Moreover, even if the bank understands microlending and intends to do microfinance right, it may fail to carry through on these intentions because microfinance is simply not one of the bank's highest priority areas. For example, more than one internal microlending unit located in this type of bank have stories of important information technology requests that go into the queue, waiting for attention from the bank's information technology department. Since this department typically first meets the needs of those bank units serving corporations and other large clients, requests made by the internal microlending unit, even if very important to that unit, may not be dealt with for many months or even more.

Examples abound of the benefits of being an external microlending organization and consequently having greater freedom to do microfinance right. As the Chilean service company, Bandesarrollo Microempresas, points out, microlending is a fast business, with a need to take decisions rapidly in order to stay competitive and profitable. Bandesarrollo Microempresas notes that its US\$ 50 million portfolio, sizable as it may be in microfinance terms, would still be much too small to get the parent bank to move quickly on many of its requests if it were an internal unit of the bank. The Haitian service company, Sogesol, states that it has greater commercial agility and has enjoyed faster growth and larger profits because it is an external organization. Sogesol has achieved these results because it has been able to make its own decisions and make them more quickly in most of the seven areas discussed above. The case of Bancolombia, a large commercial bank in Colombia that began microlending operations in March 2004 and uses an internal microlending unit, reinforces these ideas. Bancolombia appointed a seasoned and well-respected manager with many years of experience in the bank—including several years in small and medium-size enterprise lending—to head its microlending unit. This manager has enjoyed the support of the president of the bank and many high level managers. With the rapid growth of the microlending program and its increasing contributions to bank profits, many more in the bank have become convinced of the program's merit. Nonetheless, even in this rather ideal situation, the head of the microlending unit readily concedes that he would have much more freedom and agility if microlending were placed in an external organization instead of an internal unit. For example, he could introduce new products, modify old ones, and change prices immediately, instead of having to seek approval from the bank. And his critical need for loan analysis software would have been met much more quickly.

Service Company vs. Subsidiary

Subsidiaries may enjoy certain freedoms that service companies do not, giving the former an advantage. This is especially apparent for heavily regulated subsidiaries that can mobilize their

own deposits. These subsidiaries can decide the kinds of deposit products that are offered to microenterprise clients, the interest rates paid on these deposits, the fees charged (if any), and all other characteristics of these products. In contrast, service companies and subsidiaries that do not mobilize deposits must rely on the bank to offer savings products to their microloan clients. These microlenders may or may not have much influence over the characteristics of these very important products. If the bank is too busy with other priorities to devote substantial attention to designing and testing deposit products that are appropriate to the microenterprise client segment, these clients may find that the bank's deposit products do not meet their needs very well. Such clients may decide to take their deposit and possibly other business elsewhere, potentially representing a lost profit opportunity for both the microlender and bank. By creating a deposit-mobilizing subsidiary, the bank helps ensure that the deposit products offered to microenterprises are more likely to meet the needs of this group and thus prevent the erosion of its business in this sector.

Subsidiaries of all types have more autonomy than service companies in at least one other potentially beneficial way. Although service companies are separate corporations from the bank, they depend on long-term contracts with the bank for all of the income they derive from their microlending activities. In contrast, subsidiaries earn their interest income directly from their microloan clients. This allows the subsidiary to remain in existence and in the microlending business even if the bank is taken over by bank directors, managers, or outside parties who are not sympathetic to microlending, and who may either not renew the service company's contract or may reduce the bank's payments for microlending services. Such reductions in payments can occur even before contract renewal time if the contract is written in such a way that the bank can exercise accounting discretion to reduce the fee it pays to the service company. Thus, if the current directors and managers of a bank want to ensure that microlending continues regardless of which way future political winds may blow in the bank, they may wish to create a subsidiary instead of a service company.

A2. HIGH-POWERED INCENTIVES TO BE EFFICIENT AND PROFITABLE

The preceding section points out that, compared to an internal unit, an external organization typically enjoys a number of important *freedoms* that help it to more successfully engage in microfinance, compete and grow, and maximize its profits over the medium to long run. This section examines why an external organization may also have greater *incentives* to be efficient and profitable than an internal unit.

Pierre-Marie Boisson, founder of the Haitian microlending service company, Sogesol, observes that a service company or subsidiary may benefit from greater “staff motivation, commercial drive, sense of purpose, and accountability” than an internal microlending unit of a bank (Boisson, 2002). Laurence Carter, summing up the IFC’s long experience with leasing companies, observes that the IFC greatly prefers to work with stand-alone leasing companies rather than internal leasing units of commercial banks since the stand-alone leasing companies generally perform with higher levels of professionalism, focus, and dynamism (Carter, 1996). What exactly are these advantages that a stand-alone company, such as a microlending service company or subsidiary, enjoys over a unit in a large bank that does the same work? And where do these advantages come from?

These questions are answered in Oliver Williamson’s (1985) classic treatise on firms and incentives.²⁰ Stand-alone firms get to keep the profits they earn and they also exert direct influence over the gross revenue and cost streams that determine these profits. Williamson uses the term “high-powered” to describe the incentives that stand-alone firms face to be efficient and profitable. In contrast, the microlending units of banks (like the divisions of any firm) generally do not receive the profits they earn, and many of their efforts to influence the revenues and costs that determine these profits may be stymied by the larger bank. Even if the bank uses profit center accounting for its microlending unit and includes the unit in a bankwide profit-sharing

plan, the incentives for this unit to be efficient and profitable will not be as great as for a stand-alone company, for reasons that are discussed below. That is, even if the bank attempts to create high-powered incentives for its microlending (or any other) unit, it is only able to do so imperfectly.

The profits of a stand-alone company, such as a microlending service company or subsidiary, provide it with a clear accounting and an unambiguous signal of how well it is doing commercially. And since the stand-alone company has its own governance, the directors, managers, and staff of the company can be held accountable for these commercial results. For example, if loan officers don’t screen potential borrowers well or follow-up forcefully on loan delinquency, there are effects on credit quality and ultimately on profits for which these loan officers can be held accountable. Such loan officers may receive smaller pay increases or may be otherwise disciplined or even dismissed. Similarly, if the board of directors and management don’t take appropriate steps to contain costs, move into new, high-profit product lines or geographic areas, generally create a high-productivity culture, and take other measures to maximize profits over the medium to long run, the company will feel the results directly in its bottom line. The owners of the company may then take appropriate punitive measures. Hence, the stand-alone company benefits from the clarity of the profit calculation and its inescapable accountability for these results.

What would a bank have to do to replicate this kind of accountability and these kinds of incentives for its internal microlending unit? First, the bank would have to adopt profit center accounting for the unit. Second, the bank would have to agree to permanently transfer all imputed profits to the unit—that is, all loan interest, commissions, and other revenues that the unit has generated, minus the imputed cost of all the services the bank has provided to the unit (accounting, legal, marketing, branch space, tellers, etc.). Third, the bank would have to agree that the unit could permanently utilize these imputed profits in any way it saw fit, for example, to grant management and staff bonuses, to open new

²⁰ See especially Chapter 6.

branches, to invest in new information systems, to pay for market studies and pilot testing of new products, to fund increased lending, and, in general, to cover the expenses of anything it desires. Few if any banks would be willing to grant an internal unit such freedoms! As a result, internal microlending units cannot be expected to be as entrepreneurial or to have the “staff motivation, commercial drive, sense of purpose, and accountability” of a stand-alone company, to use Boisson’s (2002) excellent characterization.

Even if banks initially agreed to let the internal unit have all of the spending freedoms that an external organization enjoys (third point in the last paragraph), few if any banks could credibly guarantee that they would continue to abide by these rules no matter what happens in the future. For example, the bank may fall upon hard times and want to tap some of the profits being earned by the microlending unit for other purposes, for example, to help rescue some other strategically-important business line. Since the microlending unit falls within the bureaucratic hierarchy of the bank, the bank could simply change the rules and not permit the microlending unit to go ahead with costly expansion or modernization plans, the payment of large staff bonuses, etc. If the microlending unit resists, its manager could simply be replaced (since banks are unlikely to give any individual a long-term guarantee of continued employment in the same job). Or the bank could utilize its accounting discretion to reduce the profits it calculates the microlending unit has earned. The microlending unit, knowing that the bank can do these things, may be reluctant to pay large staff bonuses or invest in expensive new information systems, branches, or product testing, all for fear that such spending could be deemed excessive by the bank and curtailed. Therefore, as Williamson demonstrates in greater detail and with many more illustrations, attempts to create high-powered incentives for internal units end up being illusory. This is one of the advantages that smaller companies (such as microlending service companies or subsidiaries) have over larger companies trying to engage in the same activity.

Williamson (1985, p. 160) cites the following story as an example of the kinds of things that

can happen when an attempt is made to create high-powered incentives in a bureaucracy:

.... There was a Computer Center that could not cover its costs. We decided to introduce an incentive scheme whereby the members of the center would share in all positive and negative differences in business results compared with those of previous years. Improvement did not appear very likely and, in any case, the incentive differences were very modest. The new manager of the center turned out to be an exceptionally capable man, however, and at the time of the annual business debate, the center could boast of phenomenal improvements. Instead of giving full recognition to what had been achieved, the council decided to ignore its own decision of a year earlier, proclaimed the incentive scheme inapplicable, and distributed the surplus in an arbitrary fashion.... We did not know they could do so well, was the [explanation], and it cannot be tolerated that they should earn more than others. The center lapsed into losses again.

A3/B3. IMAGE AND BRANDING

Image and branding considerations are a special case that may favor either the internal unit or external organization, depending on the circumstances. We first discuss the circumstances that favor an external organization and then those that favor an internal unit. We end this section by examining strategies that might permit banks to delink the choice of structure from image and branding considerations. This would allow the bank to have the best of both worlds—that is, to have both the structure and image/brand that it wants—and thus would eliminate A3/B3 from the list of pros and cons that needs to be considered when deciding which structure is best.

Considerations that Favor an External Organization

From an image and branding point of view, external organizations are advantageous for banks that want to create a separation between their traditional operations and microlending. The bank may want to do this for the sake of the traditional clients it hopes to keep, the new micro-enterprise clients it wants to attract, or because of general reputational considerations. These three motives are now discussed in turn.

Some banks may be concerned about maintaining their image as financial institutions that give special emphasis and service to corporations and wealthier individuals. Such banks may welcome a separately-named microlending service company or subsidiary as a way to help preserve the image of the bank as one that serves its traditional clientele—while letting the separately-named external organization serve the new client segment. If the bank is sufficiently concerned about keeping the two client groups physically separated as well, it may even go to the extra expense of having separate branch offices for the external organization and bank.

The bank may also favor an external organization for the sake of the microenterprise clients it hopes to attract. For example, Banorte's market research indicated that microentrepreneurs in the market segment it has targeted would feel uncomfortable and even intimidated using Banorte's branches. For this and other reasons, Banorte decided to create a subsidiary, Pronegocio, to serve the microenterprise market. The bank and subsidiary share very few branches. Where they do share a building, they put in separate entrances and a wall from floor to ceiling that completely separates the bank and subsidiary. The case of Sogebank in Haiti is a variation on the Banorte theme. Sogebank opted to create an external organization, Sogesol, but has done so in a way that intentionally plays down, rather than emphasizes, the separation between the bank and its microlender. Sogebank is a large, retail bank with recognized financial strength and prestige. Nonetheless, Sogesol was created as a separate microlending organization (a service company) partly to signal potential microenterprise clients that they would be treated in a more personalized, friendly way than they typically have been at Sogebank. At the same time, by locating Sogesol and Sogebank branches in the same or adjacent buildings and by using similar names, Sogesol aims to benefit from its connection to its financially strong parent and also economize on costs.

Finally, the bank may wish to create an external organization in order to protect its general reputation. For example, the bank may be concerned about having its name connected to tactics in

which poor people are charged high interest rates, pressured to repay loans, and have their household goods or equipment seized.

Considerations that Favor an Internal Unit

Where the microlender and bank want to be as closely associated as possible, an internal unit is advantageous. The desire for close association may come about either because the bank wants the favorable publicity and image associated with serving the poor or because the microlender wants to benefit from being closely linked to the much larger bank, which may be seen as financially strong, prestigious, or as an excellent provider of financial services.

Bancolombia, which opted to create an internal microlending unit for several reasons that included image and branding, illustrates the latter consideration. Bancolombia is the largest bank in Colombia and serves over four million clients, many of them poorer than the microentrepreneurs the bank began lending to in March 2004. Many microentrepreneurs want to be connected to Bancolombia, with its size, prestige, and track record of already serving low income groups. In these circumstances, it would be disadvantageous to create a separate company and put any distance between the microentrepreneurs and the prestigious bank many of these clients have dreamed of accessing.

Unibank exemplifies the case of a bank that wants the image associated with (as well as the reality of) serving large numbers of poor microentrepreneurs. Unibank is the second largest bank in Haiti. It has 376 shareholders, mostly Haitian elites, and, outside of the nearly 8000 clients in its microlending program, serves only 1100 borrowers, also elites. The strategic vision and image Unibank has set for itself is to provide a broad range of financial services to all segments of Haitian society. The microlending program clearly advances this goal. Hence, image considerations favor the creation of an internal microlending unit, so that the bank could benefit to the maximum from the outreach efforts of this unit. However, Unibank has opted to do its microlending through a subsidiary, Mi-

cro Credit National (MCN), because of other considerations, including the desire to have ProCredit Holding as a shareholder in and technical assistance provider to the microlending program. To compensate, Unibank tries to tie itself as closely as it can to MCN.

Delinking Image and Branding from the Choice of Structure

For a number of important reasons that have nothing to do with image and branding, the Chilean bank, Banco de Desarrollo (BD), has opted to do its microlending through a service company, Bandesarrollo Microempresas (BM). BM relies on the bank's good name and solid reputation to help attract clients. In fact, clients don't even know that BM exists. With no signs other than BD's ever posted (even in branches used only by BM and not at all by BD) and with no BM or BD employees ever speaking of anything but BD, clients believe they are patronizing the bank. To the extent that this can be replicated elsewhere, banks that want to make maximum use of their good name and image to attract microloan clients but otherwise prefer to do their microlending through an external organization may be able to have the best of both worlds. While this might seem deceptive to some, it is regularly practiced in the commercial world. Examples abound in which one company takes over another and a decision is made about which name to keep for the combined company and for its various products depending on considerations such as consumer acceptance.

The reverse may also be possible, as suggested by the case of Banefe, an internal microlending unit of Chile's Banco Santander. A bank that wants to put some distance between itself and the microlender (for any of the reasons noted above, such as the microcredit clients being intimidated by the large bank), but otherwise finds that the balance of pros and cons favor the use of an internal unit, can also try to have it both ways. To do this, the bank would create an internal microlending unit, but give this unit its own image and branding, including, for example: a) its own name and logo, separate from the bank's, b) its own marketing campaign that prominently features this name and logo, and c)

dedicated space in the parent's branches, or even its own branches, all of which prominently display the microlender's name and logo.

To the extent that these strategies can be successfully implemented, the image and branding considerations discussed in this section can be ignored as factors in deciding which structure is best for the bank's microlending operations. Instead, the choice of structure can be made based on all of the other pros and cons discussed in this chapter. Image and branding would then be chosen independently, regardless of the choice of microlending structure. One possible limitation on the use of the strategies discussed in the previous two paragraphs would be any superintendency regulations that require a bank to make clear the relationship between it and any of its units or affiliates, for example, through the posting of signs, the distribution of informational pamphlets, or as part of the disclosure clauses of the loan contract.

A4. OUTSIDE SHAREHOLDERS CAN SUPPLY CAPITAL, IMPROVE GOVERNANCE, AND PROVIDE TECHNICAL ASSISTANCE

About half of the external microlending organizations shown in Table 3 are wholly owned by the parent bank and the other half have outside shareholders. Admitting outsiders as shareholders of an external organization can have a number of benefits (considered here) and drawbacks (considered in section B4, below).

Among the benefits of admitting outsiders as shareholders of an external organization is the fact that these shareholders help provide some of the capital needed to start up microlending and may also be able to respond to emergencies by supplying or helping to raise additional capital. This is especially useful if the bank finds itself short on capital initially or could find itself so during future emergencies.

Admitting outside shareholders such as Accion International, ProCredit Holding, Profund, and others with specialized knowledge of how to run a microlending operation can have at least two other important benefits. First, these outside ex-

perts typically are granted a seat on the board of directors of the external organization, from which they often make important contributions to the governance of the institution. Second, when outside organizations such as Accion International and ProCredit Holding take an equity stake in a microlender, they also typically provide valuable technical assistance (TA). While such technical assistance is normally of high quality, the TA provider's equity stake in the microlender reinforces its incentives to ensure that this is so. Unibank in Haiti provides an example of the importance that these two considerations can take on: a major reason that Unibank created the external organization MCN to do its microlending was so that ProCredit Holding could come in as a shareholder and technical assistance provider to MCN.

Admitting other types of outside shareholders may bring other types of benefits. For example, admitting international organizations such as IFC, IDB, and CAF as shareholders may bring rigor to the microlender, access to technical assistance and funding, and political legitimacy (giving the microlender access to policymakers, protection against corruption, and other benefits). The board representatives of international organizations may or may not have expertise in microfinance, may or may not live in the country, and may be rotated frequently. Thus, their contributions to the microlender in other ways may be limited.

A5. REDUCING RISKS TO THE BANK

By using an external organization, banks can reduce the risks associated with microlending in two ways. The first method, which works equally well for any kind of external organization (service company or either type of subsidiary), is simply to take on outside investors and thus reduce the percentage of total shares that the bank holds in the external organization. Naturally, this also brings with it a commensurate decrease in the rewards the bank derives from its shareholding. For example, if the bank holds 50 percent of the shares in the external organization instead of 100 percent, it bears only half the losses but is rewarded with only half of the gains.

The second method works only for subsidiaries (of either type), but not for service companies. Provided the subsidiary meets certain conditions that are normally set out in local bankruptcy or banking laws, the bank's losses are limited to the capital it has invested in the subsidiary, which is typically far less than the bank's entire capital. These conditions generally include the requirements that the bank and subsidiary maintain arms-length transactions with each other and that the subsidiary be managed independently of the bank. These requirements aim to ensure that the subsidiary is effectively being run as a separate company and not just as another division of the bank.

To appreciate the importance of this loss-limiting feature of subsidiaries, consider an example of a bank and its microlending subsidiary, which have the following characteristics. First, the bank has total capital of 200, of which five percent, or 10, is invested in a wholly-owned microlending subsidiary. Second, this subsidiary meets the conditions for limiting the bank's losses to the capital the bank has invested in the subsidiary. Third, the subsidiary creates a total loan portfolio of 100 by using its capital of 10 to leverage borrowed funds and perhaps deposits. Fourth, because of bad management, fraud, or other reasons, the subsidiary loses 80 of this 100 to bad loans. Because the bank has invested in a qualified subsidiary, its losses are limited to its initial investment of only 10 (five percent of its capital), rather than equaling the subsidiary's full losses of 80 (40 percent of the bank's capital). As this example shows, even relatively small subsidiaries can create potentially large losses for a bank by leveraging the bank's investment. Consequently, the ability of the bank to limit its losses in a subsidiary can make a great deal of difference to the bank's financial condition in the event that the microlending goes badly.

The loss-limiting feature of qualified subsidiaries does not carry over to service companies. This is because with a service company the bank owns the loan portfolio. If the service company makes bad loans and goes bankrupt because it can no longer afford to make whatever loan loss provisions it has agreed upon with the bank to

make for its bad loans, the bank must still meet the banking superintendency's loan loss provisioning requirements since it actually owns the portfolio.

The loss-limiting benefits of qualified subsidiaries are subject to three caveats. First, not all countries grant these benefits. For example, Mexican law provides for no such loss limitations, and so, for instance, Banorte's investment in its microlending subsidiary is backed by the full capital of the bank. Second, even if the loss-limiting feature is in effect, many banks will still lose more than the capital they have invested in their subsidiary. This is because it is often the case that the bank is the main supplier of funding to the subsidiary. Hence, when the subsidiary goes bankrupt, the bank stands to lose not only the capital it has invested in the subsidiary but also the loans it has made to the subsidiary as well. Although such loans are limited in most countries to 10-20 percent of the bank's capital due to credit concentration and related-party lending limits (as discussed in point B5, below), this is a source of additional loss for the bank. Third, the loss-limiting feature is only useful insofar as the bank is willing to let the subsidiary go bankrupt. For example, following standard practice, Haitian law limits Unibank's losses from its investment in its microlending subsidiary (MCN) to the amount of Unibank's investment in MCN. However, Unibank has said that it would be unlikely to let MCN go bankrupt because of the possible contagion effect on Unibank's other operations. For example, depositors might pull their deposits out of the bank, and other bank investors and clients might get nervous about Unibank's solvency and its ability to honor its commitments. On the other hand, if MCN were to grow substantially and then fail, the resulting losses for Unibank might be sufficiently large as to make the bank rethink this strategy.

A6. ESCAPING PAY-RELATED PROBLEMS AND THE WAGE SCALE OF THE BANK

Bancolombia, the largest bank in Colombia, provides a dramatic example of how external organizations (service companies and subsidiar-

ies) can be useful in escaping the wage scale of the bank. Banks in Colombia are well known for offering excellent pay and benefits, and Bancolombia is no exception. Although Bancolombia decided to do its microlending through an internal unit (for a variety of reasons), *the* major advantage for Bancolombia to do its microlending through an external organization would have been that it could have paid its employees only half as much in salaries and benefits, an impressive savings in operating costs.²¹ On the other hand, Bancolombia estimates that the personnel turnover rate, which is extremely low in the bank, would have been significantly higher in a lower-wage external organization. The resulting need for training new hires would have cut somewhat into the operating cost savings.

The bank surveys carried out by Baydas, Graham, and Valenzuela (1997) and Valenzuela (2001) both find instances of staff tensions arising from pay differentials, a problem that may be reduced or eliminated by doing microlending through an external organization rather than an internal unit. We first describe this problem and then examine why an external organization may be less affected by it than an internal unit.

The incentive bonuses received by loan officers and other microlending staff can ignite jealousies among the regular bank staff. Regular bank staff are often more highly educated and trained but typically don't receive such bonuses, and therefore, in some cases at least, may receive less total compensation than the microlending staff. These jealousies can sap productivity and even result in scrapping the incentive pay scheme, which would be unfortunate since such schemes have demonstrated productivity benefits in microlending. Alternatively, the bank, fearing that such jealousies could be aroused, may simply prohibit the use of an incentive pay scheme from the outset of the microlender's operations, also an unfortunate outcome.

²¹ Typically in microlending, personnel costs are approximately one-half of total operating costs. This would imply a 25 percent savings in overall operating costs in the present case.

These problems may be reduced or eliminated by doing microlending through an external organization. Using an external organization bureaucratically and often physically separates bank and microlending employees to a greater degree than they would be separated if microlending were done through an internal unit. For example, some Sogesol loan officers and branch managers outearn their Sogebank counterparts when the Sogesol performance bonuses are factored in. Sogesol credits the lack of tension and envy over pay to the fact that it is separate from the bank. Sogesol believes that these tensions and problems of envy would be much more likely to arise if microlending were done through an internal bank unit. This is because the contact between the microlending and regular bank personnel would increase greatly as the two groups began to “live together” in a single organization.

Bandesarrollo Microempresas, a service company of Banco de Desarrollo in Chile, believes that the use of an external organization has helped it to avoid the opposite kind of pay problem. Bandesarrollo Microempresas personnel are paid significantly less than their bank counterparts, a situation that would be much harder to maintain if microlending were done through an internal bank unit.

The importance of these pay-related problems should not be exaggerated, however. In most banks they are not a problem at all, even when microlending is done in house.²² This is because in most banks, loan officers who are engaged in microlending generally have less education and training than their bank counterparts and they also earn less money even when their incentive pay bonuses are included. Although some loan officers engaged in microlending may sometimes outearn their bank counterparts, there is often recognition that microlending is a different, and in many ways more difficult, job. Bank loan officers sit behind a desk in relatively pleasant surroundings while their microlending counterparts spend most of their day out on the

road, often visiting poor clients in urban slums and impoverished rural areas. This makes bank personnel less prone to be jealous of their microlending counterparts and more forgiving of at least some pay differentials in favor of the latter.

A7. ESCAPING UNION WAGE SCALES AND AGREEMENTS

Credife, the microlending service company of Banco del Pichincha in Ecuador, provides a good example of this potential benefit of external organizations. Since Credife is a service company, and not a banking institution in its own right, it is exempted from the collective bargaining agreements that cover banking institution employees in Ecuador. As a result of not having to pay union-mandated wages and benefits, Credife saves approximately 25 percent in its personnel costs.

Depending on the extent of the coverage of existing union wage agreements, service companies, lightly regulated subsidiaries, and even heavily regulated subsidiaries may have a labor cost advantage over an internal microlending unit. And if the union is particularly conflictive, there may be additional benefits to doing microlending in a non-union setting. On the other hand, it may be that no type of microloan provider has any advantage at all in this area. For example, this is the case in Haiti and Venezuela, where unions are not present at all in the financial sector. It is also the case in Jamaica, where unions are present everywhere in the financial sector, even in bank service companies and subsidiaries.

A8. ESCAPING USURY CEILINGS

Unfortunately for microfinance, usury ceilings are making quite a comeback in Latin America, with approximately half of the countries in the region now having some kind of limitation on the interest rate borrowers can be charged on their loans. Given the high cost of making microloans, if the usury ceiling is set low enough, it can substantially reduce the profits associated with microlending, and, in extreme cases, can turn these profits into losses, eliminating the

²² This result comes out both in Valenzuela's (2001) survey and in our own canvassing of banks in Latin America and the Caribbean.

commercial incentive to continue lending to microenterprises.

In some instances, such as Paraguay up until 2004, these loan rate ceilings vary by type of lender. In the Paraguay case, for example, banks had a lower loan rate ceiling than *financieras*, giving *financieras* the potential advantage of being able to charge higher interest rates. What this means in the present context is that until 2004 it may have been advantageous for banks to do their microlending through a *financiera* (a heavily regulated subsidiary), rather than through an internal unit or perhaps service company (since with a service company the loans belong to the bank). Isern and Porteous (2005) cite a similar case, that of Finadev, a subsidiary of Financial Bank of Benin. Under the West African interest rate caps, banks such as Financial Bank can charge a maximum of only 18 percent on loans, while Finadev, as a nonbank microfinance institution, is permitted to charge 27 percent.

In light of these examples, Tables 5 and 6 cite more favorable treatment under a usury ceiling as a possible advantage of subsidiaries over internal units and perhaps even over service companies. Reinforcing this contention, logic would also dictate that less restrictive interest rate caps might be applied to smaller, nonbank financial institutions that often make smaller business and consumer loans. However, usury ceilings can be structured in any arbitrary way. Therefore, in reality, usury ceilings can favor any of the microlending structures discussed here over any of the others. Bankers simply have to assess the usury ceiling situation in their own country, as well as how far into the future this situation is likely to persist.

B1. GREATER INTEGRATION INTO THE BANK REDUCES OPERATING COSTS

By its nature, an internal microlending unit is more completely and seamlessly integrated into the bank than a service company or subsidiary—which are always separate, stand-alone corporations. Therefore, internal units should normally have a leaner structure than external organiza-

tions. This greater integration and consequent leaner structure typically give an internal unit certain operating cost advantages over an external organization. There are at least five areas in which additional operating costs are incurred when microlending is done through an external organization rather than an internal unit, all of which stem from the external organization's lower degree of integration with the bank: separate board of directors, additional management, regulatory compliance, funding, and asset-liability management. These additional operating costs, which are discussed in turn below, arise for the external organization even if it follows best practices and makes optimal use of the bank's infrastructure and services, as discussed in the final section of Chapter 1.

Compared to an internal unit, some types of external organizations have greater additional operating costs than others. These differences are observed in the last three of the five operating costs listed above. In particular, heavily regulated subsidiaries have greater regulatory compliance costs than lightly regulated subsidiaries and service companies (third cost). Subsidiaries of both types generally have greater funding costs than service companies (fourth cost). Certain subsidiaries—namely, those that are partially owned by the bank—have greater asset-liability management costs than service companies and fully-owned subsidiaries. Thus, the ranking in terms of the operating cost considerations discussed in this section is, from lowest to highest cost: internal unit (lowest cost), service company, lightly regulated subsidiary, and heavily regulated subsidiary (highest cost)—though the ordering of the last two could be inverted if the heavily regulated subsidiary were fully owned by the bank and the lightly regulated subsidiary were partially owned by the bank and the asset-liability management costs of the latter were sufficiently large.

It should be stressed that this is not a ranking of structures according to their *overall* operating costs. This ranking does not mean, for example, that the internal unit has the lowest overall operating costs and that the heavily regulated subsidiary has the highest overall operating costs.

Rather, it means that from the point of view of the set of considerations discussed in this section (integration with the bank and consequent leanness of structure), the internal unit has the lowest operating costs and the heavily regulated subsidiary has the highest operating costs. There are many other considerations that go into determining which microlending structure has the lowest operating costs overall. For example, if the bank bureaucracy ties the internal microlending unit up in knots with costly and unhelpful procedures, forces it to accept a high wage scale, or denies it the technical assistance it might have used to cut costs, the internal unit may, in fact, have the highest overall operating costs of any of the structures. Or it may be that funding, tax, and capital considerations (discussed below in sections B5-B7) reinforce the considerations given in this section, and that therefore the internal unit has the lowest overall operating costs of any of the structures. That is, the many other factors described in this chapter must be considered to decide which structure is the least costly overall and, even beyond that, which structure is the most desirable overall (taking all considerations, not just cost, into account). This task, of examining the balance of the pros and cons when all factors are considered, is taken up in Chapter 3.

The remainder of this section discusses the five additional operating costs incurred by external microlending organizations. The section concludes by presenting estimates of the overall reduction in operating costs from using an internal unit instead of an external organization; the small number of approximate estimates we have generally fall in the 1-10 percent range. The five additional operating costs are as follows:

1. *Separate board of directors.* Since the external organization is a stand-alone corporation, it needs its own board of directors. The additional costs resulting from this include the costs of the board members' time and that of any support staff, the board's meeting and office space, travel and lodging for any nonresident directors, and any other resources devoted to board operations.

2. *Additional management.* As noted in Chapter 1, there are a number of ways in which an external organization can and should utilize the bank's infrastructure (e.g., branches, telecommunications systems, and computer systems) and its many services (e.g., accounting, auditing, finance, information technology, legal, marketing, personnel, and treasury). However, the external organization may have to maintain its own departments in a number of these areas. Each of these departments may be small, with only a few or even no employees other than the department manager. The middle- or upper-level managers in charge of these departments are needed to supervise those activities that the external organization still does for itself and to act as liaisons with the bank-provided services. As a result of needing managers and other senior personnel to coordinate and oversee services that are primarily provided by the bank, the external organization is often at least somewhat more top heavy with managers and senior personnel than it would be as an internal unit. For example, Bangente has a number of small departments—such as payroll, risk, auditing, and anti-money laundering—each of which has a middle- or upper-level manager and little or no staff. Significant savings could be realized if Bangente were merged with its parent bank and operations combined. Additional examples are given at the end of this section, when the cost savings estimates are discussed.

3. *Regulatory compliance.* The regulatory compliance burden of service companies and both types of subsidiaries is greater than that of internal units. As noted in Chapter 1, service companies and *lightly* regulated subsidiaries in Latin America and the Caribbean typically must prepare monthly balance sheets and income statements and pass these on to the parent bank. The parent bank then consolidates these statements with its own and those of any other service companies and subsidiaries in which it has a substantial interest, and sends all of the statements (separate and consolidated) to the banking superintendency. In contrast, internal microlending units require no separate reporting. Rather, their operations are simply included in the overall financial statements of the bank. This provides

some operating cost savings to internal microlending units.

In comparison to the other structures, the regulatory compliance burden of *heavily* regulated subsidiaries is the greatest of all. Heavily regulated subsidiaries must satisfy minimum capital, capital adequacy, provisioning, and all other prudential regulations imposed on their type of financial institution (e.g., *financiera* or development bank); must file all applicable daily, weekly, monthly, and other reports with the superintendency; and are subjected to on-site inspections as stand-alone financial institutions. As noted in Chapter 1, heavily regulated subsidiaries may be able to lean on the work of the parent bank for many routine reporting requirements since the bank has already invested heavily in systems that prepare the necessary reports. Thus, these subsidiaries may be able to have the bank generate the necessary reports for them or else import the report-generating routines and adapt them to their own systems. Nonetheless, there is still significant work that the subsidiary must do to make sure it is in compliance with all superintendency regulations, ensure the accuracy and timeliness of all the reports it submits, reply to requests for additional information and clarifications from the superintendency, and respond as needed to on-site inspection visits.

4. *Funding.*²³ Whenever microlending is done through an internal unit, the bank's finance department provides all of the loanable funds for this unit as well as for the rest of the bank's operations. On the other hand, if microlending is done through an external organization and the external organization mounts its own funding operations that are separate from those of the bank, the overall operating costs associated with providing loanable funds for microlending and for the rest of the bank's operations are likely to increase. The reason for this is that, as noted in

Chapter 1, there are economies of scale in all of the methods a financial institution uses to fund itself: borrowing from donors, banks, and other sources; mobilizing deposits; issuing bonds; and issuing stock. For example, it is generally less costly to run one deposit-taking operation (that provides joint funding for both the microlender and the rest of the bank) rather than two separate operations (that provide separate funding for the microlender and the rest of the bank). Similarly, it is generally cheaper (in terms of operating costs) to obtain one large bank loan or issue one large bond, rather than obtain two smaller loans or issue two smaller bonds.

In Latin America and the Caribbean, most subsidiaries and the occasional service company obtain some of their loanable funds from outside sources, that is, from sources other than the parent bank.²⁴ External organizations may do this for a number of reasons, including the desire to lengthen the maturity of their liabilities, replace the bank's variable interest rate funding with fixed rate funding, or generally diversify their funding sources. In such cases, the combined operating costs of the bank's and external organization's funding programs are likely to exceed what the operating costs would be if the bank did all the funding, as it does for all internal units, most service companies, and few if any subsidiaries. Thus, internal units and any external organizations that rely entirely on the bank for funding will generally economize on the operating costs associated with funding. Close behind this case in terms of operating costs is the case of external organizations with very simple outside funding structures, perhaps just a credit line from one or two outside banks. If these credit lines can be obtained, managed, and renewed at low cost, then the additional operating costs associated with this outside funding may not be very important.

5. *Asset-liability management (management of market risks).* Internal units, service companies, and fully-owned subsidiaries have three advan-

²³ This discussion examines the effect of the choice of microlending structure on the *operating* costs associated with funding the microloan portfolio. Section B5 examines the effect of the choice of microlending structure on the *financial* costs associated with funding the microloan portfolio (that is, on the interest rate paid for loanable funds).

²⁴ As a service company example, Bandesarrollo Microempresas (a service company of the Chilean bank, Banco de Desarrollo) is in the process of obtaining a loan from the IFC.

tages over partially-owned subsidiaries in asset-liability management. The first is an advantage in operating costs, and arises because a partially-owned subsidiary normally must create its own treasury department to carry out the asset-liability management function while the internal microlending unit, service company, and fully-owned subsidiary use the existing bank treasury department. This difference is rooted in the fact that a bank fully owns the microlending portfolio originated by its internal unit, service company, or fully-owned subsidiary. Hence, it is the bank that takes responsibility for matching these loan assets to liabilities—in currency, term, and duration—or else mitigating or bearing the risks of an unmatched position. In contrast, because the bank is only a partial owner of the microlending portfolio originated by the partially-owned subsidiary, the subsidiary must take responsibility for matching these loan assets to liabilities or else mitigating or bearing the risks of an unmatched position. This means that a partially-owned subsidiary normally must create its own treasury department to manage these market risks. The fact that an internal microlending unit, service company, and fully-owned subsidiary can use the existing bank treasury department gives them important savings in personnel, systems, and other operating costs. These savings stem from the fact that it is normally less expensive in terms of operating costs to have one department managing the risks associated with a single balance sheet (for the microlender and the rest of the bank together) rather than to have two separate departments each managing the risks associated with the two components of this overall balance sheet (that for the microlender and for the rest of the bank).

Internal units, service companies, and fully-owned subsidiaries enjoy two other market risk management advantages over partially-owned subsidiaries besides a savings in operating costs. These advantages can yield cost savings as well as reductions in market risks, meaning that internal units, service companies, and fully-owned subsidiaries can be both cheaper and safer to operate than partially-owned subsidiaries in terms of market risks and their management. The first advantage is the natural reduction in market risks stemming from balance sheet net-

ting. With less risk, risk-mitigation costs are normally reduced. The second advantage is a further reduction in risk mitigation costs when risk mitigation techniques are applied to one balance sheet (as in the internal unit, service company, and fully-owned subsidiary cases) instead of two (as in the partially-owned subsidiary case). Each of these advantages is now explained in turn.

Balance sheet netting refers to the reduction in market risks that is typically produced when two balance sheets are combined. To understand these gains, consider a simple example in which entity A has US\$ 1000 more in U.S. dollar assets than it has in U.S. dollar liabilities while entity B has US\$ 1000 more in U.S. dollar liabilities than it has in U.S. dollar assets. In isolation, each entity bears the foreign currency risk of potentially facing losses if the exchange rate between U.S. dollars and the local currency changes. However, since the two entities have exactly offsetting foreign currency positions, the combined entity has no foreign currency risk whatsoever. Of course, this is an extreme example. In practice, the gains from such balance sheet netting are only partial. Since the combined entity always has the option to break its combined balance sheet back down and treat it as though it consisted of the balance sheets of the two individual entities, the act of combining balance sheets can never increase market risks. That is, balance sheet netting can only be beneficial. The balance sheet of a bank is combined with its microlender and netted whenever microlending is done by means of an internal unit, service company, or fully-owned subsidiary, but not when it is done by means of a partially-owned subsidiary. Therefore, the internal unit, service company, and fully-owned subsidiary enjoy the advantages of balance sheet netting, while the partially-owned subsidiary does not. Although we have illustrated this principle with a foreign exchange example, the same logic holds for matching the terms of assets and liabilities in order to avoid term mismatch risks (including liquidity risks in the case of matching short-term assets and liabilities) and interest rate risks (where assets and liabilities are matched by the length of time until their interest rates can

next be changed or alternatively by their overall duration).²⁵

Turning to the final advantage enjoyed by internal units, service companies, and fully-owned subsidiaries, financial institutions with mismatches between their assets and liabilities (in currency, term, or duration) have many options available to them to mitigate these risks, each with its own cost. It is generally cheaper to mitigate the risks associated with a single combined balance sheet (as arises in the case of an internal unit, service company, or fully-owned subsidiary) than to mitigate the risks associated with the two component balance sheets (as arise in the case of a partially-owned subsidiary). For example, an excess of foreign currency liabilities—which could be produced by borrowing from donors or mobilizing dollar-denominated time deposits—may be mitigated by buying a swap in the local swap markets.²⁶ Normally, it is cheaper

²⁵ See Portocarrero, Tarazona, and Westley (2006, Ch. 2) for a discussion of market risks and their management. Westley (2003, Ch. 5) discusses market risk management in general and with specific regard to the issues that arise when longer-term equipment loans (and leases) are made. Saunders and Cornett (2006) provide an excellent and much longer textbook presentation of market risk management for financial institutions.

²⁶ To understand the swap transaction, consider a simple case in which the owner of the microloan portfolio (i.e., the parent bank when microlending is done by an internal microlending unit, service company, or fully-owned subsidiary and the subsidiary itself when microlending is done by a partially-owned subsidiary) must repay a dollar loan in two years time with a single payment of US\$ 1 million in principal and interest. To utilize the local swap markets, which exist in a number of Latin American countries, the owner of the microloan portfolio might contact a third-party bank with which it has a solid credit history or can otherwise establish its creditworthiness. For a fee, this third-party bank may agree to sell one million U.S. dollars in two years to the owner of the microloan portfolio in exchange for a predetermined amount of local currency (pesos, say). For the third-party bank, this is just one more future dollar liability and future peso asset in its off-balance sheet accounts, which it will balance off together with all of its other future dollar and peso commitments. The third-party bank requires that the owner of the microloan portfolio be creditworthy in order to

to buy one large swap (to cover the overall needs of the bank and internal microlending unit, service company, or fully-owned subsidiary) than two smaller ones (to cover the needs of the bank and partially-owned subsidiary separately, as each manages the risks of its own portfolio). Foreign exchange risk may also be mitigated, at a cost, by engaging in back-to-back operations.²⁷ Again, there would typically be economies in taking out one such loan rather than two. In addition, when the microlender is joined to the larger, more creditworthy parent bank (as occurs in the internal unit, service company, and fully-owned subsidiary cases), the microlender may receive a more favorable interest rate on its back-to-back loan from the third-party bank. Similarly, because of the greater creditworthi-

limit the former's counterparty risk, that is, the risk that the owner of the microloan portfolio will not come forward with the predetermined amount of pesos in two years time. For this purpose, the third-party bank may insist that the owner of the microloan portfolio have a line of credit available to it, particularly if the owner of the microloan portfolio is a partially-owned subsidiary instead of a bank.

²⁷ To understand these operations, again suppose that the owner of the microloan portfolio must repay a dollar loan in two years time with a single payment of US\$ 1 million in principal and interest. To reduce the risk associated with this foreign exchange obligation, the owner of the microloan portfolio may engage in a back-to-back operation. To do this, the owner of the microloan portfolio places the U.S. dollar loan proceeds in a third-party bank (or possibly in the parent bank if the owner of the microloan portfolio is a partially-owned subsidiary—as occurs with MCN in Haiti) where it earns interest in dollars. The owner of the microloan portfolio then takes out a local currency (peso) loan from the third-party bank using this dollar deposit as collateral. The peso loan from the third-party bank is used to fund loans to microentrepreneurs, which are also in pesos. To the extent that the interest earned on the dollar deposit is not enough to cover the interest due on the original dollar loan, there is some residual foreign currency risk and some cost to the owner of the microloan portfolio. There may also be a significant additional cost to the owner of the microloan portfolio since the peso loan may carry a substantially higher interest rate than the original dollar loan. Nonetheless, the owner of the microloan portfolio has succeeded in converting a large foreign currency risk into a much smaller risk at a cost it knows in advance.

ness of the parent bank, the third-party bank may also charge less in the case of a swap since the third-party bank would typically face less counterparty risk.

Micro lenders that fund themselves from deposits have a much more complex job of asset-liability management than those that do not. This is because deposit-takers must deal with a large number of liabilities that have differing and often uncertain maturities and may also be denominated in more than one currency. With greater management costs involved, there is more to gain from being able to consolidate management of market risks with the parent, as is done with an internal unit, service company, or fully-owned subsidiary, but not with a partially-owned subsidiary. This can yield the internal unit, service company, or fully-owned subsidiary significant cost advantages over the partially-owned subsidiary in all three areas described above.

However, even if the micro lender funds itself using only capital and borrowed funds, it may still face significant market risks and risk mitigation costs, potentially giving the internal unit, service company, and fully-owned subsidiary important advantages over the partially-owned subsidiary in all three areas described above. For example, many loans from donors and government second-tier facilities are available only in foreign currency, giving rise to exchange rate risks. In addition, donor and government second-tier facility loans are often made at variable interest rates (tied to LIBOR or other indices), as are many commercial bank loans. This often creates interest rate risks for micro lenders since the loans they make to their microenterprise clients often carry fixed interest rates.

How Much Is the Cost Savings?

We have a small number of approximate estimates of the operating cost savings that an internal unit may realize from all of the sources discussed in this section. These estimates fall in the 1-10 percent range, with values toward the lower part of this range for comparisons with service companies and toward the upper part of the range for comparisons with subsidiaries. In the

case of service companies, Bandesarrollo Microempresas estimates that out of 275 total personnel, it could eliminate 10 staff jobs if it were merged with its parent bank, Banco de Desarrollo, and became an internal bank microlending unit. This would reduce the operating costs of microlending by approximately three percent. Sogesol believes that it is already so lean that the only real cost savings from moving microlending into Sogebank would be those associated with Sogesol's board of directors. Eliminating Sogesol's board would reduce its total operating costs by approximately one percent. As an interesting cautionary tale, Sogesol notes that if its operations were folded into Sogebank's, the bank would likely cut a number of Sogesol staff, rather than simply eliminate the Sogesol board. However, Sogesol believes that these staff cuts would be a mistake, reflecting the bank's lack of understanding of microfinance and the need to invest in people and pay their salaries in order to raise the microlending business to a higher level. In the longer run, the bank would likely lose more than it saved from such a "rationalization" of operations. Sogesol also notes that if it were a subsidiary instead of a service company, it would have to create its own treasury department to manage liquidity and other market risks and procure funding. While Sogesol noted that these activities would add substantially to the extra operating costs of being an external organization, it declined to provide a numerical estimate of their size. Hence, we can only say that the estimated cost savings of being an internal unit instead of a *subsidiary* would be well above the one percent estimate Sogesol gives for the internal unit/service company comparison.

As for the case of subsidiaries, MCN notes that since it is a stand-alone corporation it must be self-sufficient in a number of areas. Thus, it must have at least some of its own legal, auditing, information technology, personnel, and finance staff. If MCN became an internal unit of Unibank (its parent), it estimates that the operating cost savings would be significant, though definitely less than 10 percent. While MCN is a lightly regulated subsidiary, Banguente is a heavily regulated subsidiary and thus is supervised directly by the Venezuelan banking superintendency. Banguente believes that if it were

merged with and became an internal microlending unit of its parent bank, Banco del Caribe, the operating cost savings would be at least 10 percent.

B2. ELIMINATING INITIAL TASKS REDUCES START-UP COST AND OFTEN START-UP TIME; POSSIBLY LESS INITIAL CAPITAL NEEDED

One of the attractions to some banks of doing microlending through an internal unit instead of an external organization is that three important initial tasks are eliminated. This gives an internal unit a start-up cost and often a start-up time advantage over an external organization. The three initial tasks that external organizations, being stand-alone corporations, undertake and that internal units do not are: a) creating a shareholders agreement (which must be done whenever the bank is not the sole owner of the external organization), b) creating a service agreement with the bank (which details the bank facilities and services the external organization can use and the price it must pay the bank for using them), and possibly c) obtaining regulatory approval from the bank superintendency. All of these tasks impose costs and possibly delays on the start-up of microlending. And all are avoided if microlending is carried out by means of an internal unit. The additional start-up delays, but not the additional start-up costs, associated with an external organization carrying out these three tasks may be reduced or possibly even eliminated by using two time-saving tricks discussed below.

It is also important to inquire about the impact of these three tasks on the relative cost and speed of start-up of the different *external organizations*. As discussed below, this ranking among external organizations depends on individual bank and country circumstances. However, it is often the case that heavily regulated subsidiaries are the most expensive and slowest to start up. There is also some tendency for service companies to be cheaper and faster to start up than lightly regulated subsidiaries. Hence, the ranking among the microlending structures from cheapest and fastest to start up to most expensive and slowest tends to be: internal unit, service com-

pany, lightly regulated subsidiary, and heavily regulated subsidiary. However, the ranking among the external organization structures, and particularly between the service company and lightly regulated subsidiary, is uncertain and dependent on individual circumstances.

It should be stressed that the rankings discussed in the preceding two paragraphs are not rankings of structures according to their *overall* cost or speed of start-up. The rankings presented above do not mean, for example, that the internal unit is necessarily the cheapest and fastest way to start up microlending and that the heavily regulated subsidiary is the most expensive and slowest. Rather, they mean that from the point of view of carrying out the three important tasks given above, the internal unit is the cheapest and often the fastest way to start up microlending operations while the heavily regulated subsidiary is often the most expensive and slowest. There are many other considerations that go into determining which microlending structure is the cheapest and fastest to start up overall. For example, if the bank bureaucracy ties the internal microlending unit up in knots with costly and unhelpful procedures, forces it to accept a high wage scale, or denies it the technical assistance it might have used to cut costs and expedite its start-up, the internal unit may, in fact, be the most expensive and slowest of any of the structures to start up. Or it may be that outside shareholders or funding considerations (discussed below in sections B4 and B5) reinforce the arguments given in the first two paragraphs, and that therefore the internal unit is the cheapest and fastest to start up. That is, the many other factors described in this chapter that refer to the cost and efficiency of operations in general (both during start-up and afterwards) must be considered to decide which structure is the cheapest and fastest to start up.

The ordering among structures for the amount of capital needed to start up microlending tends to be, from least to most start-up capital: internal unit, service company, lightly regulated subsidiary, and heavily regulated subsidiary. However, a great many factors affect the amount of start-up (or initial) capital that is needed, so that it is difficult to make generalizations about which

structure can claim this start-up advantage. The assertion that the internal unit needs the least amount of start-up capital is subject to the greatest uncertainty since there are many common circumstances in which this would not hold. Finally, the internal unit has the start-up advantage of easily escaping the idle capital problem, which heavily regulated subsidiaries cannot avoid. Service companies and lightly regulated subsidiaries also cannot avoid this problem unless the bank is their only shareholder. The balance of this section explains and discusses the assertions made in this and the preceding three paragraphs.

Cost and Speed of Start-up

We now examine in greater detail the three key tasks presented at the start of this section and the extra costs and delays they generate for banks that decide to do microlending through an external organization rather than an internal unit. We also discuss how these factors affect which type of *external organization* may be the cheapest and fastest to start up, as well as two time-saving tricks that banks using an external organization may wish to employ to reduce start-up time.

Shareholders Agreement

Service companies, lightly regulated subsidiaries, and heavily regulated subsidiaries can either be fully or partly owned by the parent bank. In fact, Table 3 contains examples of all six cases. When the parent bank has only partial ownership of the external microlending organization, it must reach a shareholders agreement with the other owners, with the attendant costs and delays this implies.

Because they deal with money and power, shareholders agreements *can* be difficult and time-consuming to negotiate, although the experience here is highly variable. Among the key elements that must be decided upon in these agreements are the total amount of share capital to be raised, each owner's percentage of total shares, the voting rights and other powers of each owner, the number of directors, which owners will be directors, exit strategies (some donors and other investors may wish to have the

option to be bought out at a prespecified price within a certain period of time, such as five or ten years), and other corporate governance issues. In the case of MCN, the lightly regulated subsidiary of Unibank in Haiti, the shareholders agreement required nearly a year to negotiate. Unibank and ProCredit Holding, the two original partners that came together to create MCN, could have quickly concluded an agreement. However, negotiations were substantially prolonged when IFC and FMO were brought in, two large donors that required multiple layers of internal approval to hammer out and sign a shareholders agreement.

Bangente's shareholders agreement took well over a year to reach. Negotiations began between the parent bank (Banco del Caribe) and three local NGOs to create Bangente. These partners grappled for a long time with such issues as whether to use an existing leasing company license to start up Bangente, how many directors to have, and a number of other corporate governance issues. Then, four additional partners were added—CAF (Corporación Andina de Fomento, a development bank for the Andean countries of South America), Profund, IDB, and Accion International—which brought additional issues into the negotiations and extended the time to complete the shareholders agreement.

In contrast, the shareholders agreements for the three service companies with which Accion International is involved—Credife in Ecuador, Sogesol in Haiti, and Real Microcredito in Brazil—all took approximately one month or less to negotiate. This short time frame may reflect more the investors involved than the fact that a service company model was used instead of a subsidiary. In the case of Credife and Real Microcredito, the only shareholders were the parent bank and Accion International. While the Sogesol shareholders also included Profund and a group of 33 local investors in addition to the parent bank and Accion International, the negotiations still went very smoothly and quickly. The largest issue was accommodating Profund's need for a put option, which was finally priced at 20 percent over book value at the time of Profund's exit. The absence of donors with large

bureaucracies is likely to have speeded the process in all three cases.

Service Agreement

As discussed in Chapter 1, external organizations generally should and do make extensive use of the bank's infrastructure and services. This arrangement is normally formalized by means of a written service agreement, which details the facilities and services the external organization can use and the price it must pay the bank for using them. In the case of service companies, the agreement also stipulates the fee the service company is to be paid by the bank for the services it renders and spells out how the loan loss provision expenses associated with the microlending portfolio are to be apportioned between the bank and service company. While internal microlending units also make extensive use of the bank's infrastructure and services, such usage is normally governed by the internal operating rules of the bank, rather than by a separate service agreement.

The length of time it takes to negotiate a service agreement depends on such factors as how detailed this contract is to be and the readiness of the parties to enter into such an agreement. For example, it took four months of difficult negotiations for Sogesol and Sogebank to complete a service agreement. Sogesol wanted a very detailed contract, spelling out what each bank department would do for Sogesol and the associated cost. At first, the bank resisted the idea of such a detailed, arms-length agreement. However, once the bank accepted this concept, each bank department then got into the act, suggesting many substantive and wording changes. Sogesol reports that all of this difficult and very time consuming work has proven to be very worthwhile; time and again it has used this written agreement to ensure its access to bank-provided services and enforce the agreed-upon price for these services. In contrast, Sogexpress, a Sogebank affiliate that handles remittances, did not obtain a written service agreement with Sogebank, and must repeatedly renegotiate the content and price of Sogebank-provided services.

Regulatory Approval

As noted in Chapter 1, the banking laws of many countries in Latin America and the Caribbean allow banks to set up service companies and lightly regulated subsidiaries with minimal or no review from the banking superintendency. The three service companies affiliated with Accion International and the lightly regulated subsidiaries JNSBL and MCN all confirm that prior to their commencing operations the banking superintendency either made no review or else a very cursory review of their proposed operations (which always took less than one month). Another service company, Bandesarrollo Microempresas of Chile, notes that it takes approximately two months in Chile nowadays to clear the regulatory hurdles and create an *asesoría financiera*, the institutional form used by Chile's two microlending service companies.

In contrast, it typically takes 6-12 months or more for the superintendency to approve a heavily regulated subsidiary. This process can begin only after the shareholders agreement and service agreement have been drawn up and submitted to the superintendency along with a market study, feasibility study, manuals, detailed information on shareholders, and other required materials. For example, Banorte, a powerful bank in northern Mexico, needed 18 months to obtain a SOFOL (*financiera*) license for its microlending subsidiary, Pronegocio. Banco de Venezuela has begun the process of creating a heavily regulated microlending subsidiary (to be licensed as a *banco de desarrollo*), and expects the process to take 6-14 months.

Reducing Start-up Time for External Organizations: Two Time-Saving Tricks

Once a bank decides to engage in microlending, there is a long list of technical tasks that must be carried out before lending can commence—regardless of whether lending is to be done in house or through an external organization. These tasks include, for example, carrying out detailed market and feasibility studies, creating operating and other manuals, hiring and training loan offi-

cers and other personnel, setting up loan tracking and accounting systems, and doing detailed product design work. Although it is difficult to generalize, these tasks often take approximately 6-9 months to accomplish. Once completed, the microlending product is ready for pilot testing, which may consume another 6-12 months or more, depending on whether the results indicate that product, organizational, or other changes are needed. Thus, it is difficult to go into full rollout of the microloan product in less than a year, even if microlending is done through an internal unit and no shareholders agreement, service agreement, or regulatory clearance is needed.

If microlending is done through an external organization, then additional delays may be created by the need for a shareholders agreement, service agreement, and regulatory approval. These delays may be reduced or possibly even eliminated by using two time-saving tricks. The essence of these tricks is to carry out the three additional tasks (negotiate the shareholders and service agreements and obtain regulatory clearance) in parallel with the technical tasks and pilot testing that must be done by any microlender. The first trick is to negotiate the shareholders agreement and service agreement while carrying out the technical tasks. An important limitation on the use of this trick is that the bank or some other entity must be willing to cover the costs of carrying out these technical tasks until a shareholders agreement can be reached and the microlender's capital is paid in by all of the shareholders. In addition, the bank or other entity must be willing to face the risk that the shareholders agreement may not be successfully negotiated with the current group of investors, in which case the bank or other entity must either find a different constellation of investors, enter the microlending business alone, or abandon the project and absorb the losses associated with the technical tasks it has already carried out. The second trick is to pilot test the microlending product in house or through a foundation connected with the bank while awaiting regulatory clearance for the external organization to begin operations. This is mainly useful when creating

a heavily regulated microlending subsidiary since these organizations normally require a significant period of time (6-12 months or more) to obtain regulatory approval. The delays associated with this approval can be reduced or eliminated by overlapping the approval process with product pilot testing. We now illustrate these two tricks with examples of their successful application.

As noted earlier, nearly a year was required for Unibank to conclude a shareholders agreement for its lightly regulated microlending subsidiary, MCN. In order to save time, many technical tasks were carried out in parallel with these negotiations. A grant from the German international aid agency, KfW, was used to meet much of the expense of carrying out these technical tasks, with ProCredit Holding (one of the shareholders) covering the balance. By using this trick, Unibank estimates that it was able to start up microlending at least six months earlier than if it had waited to complete the shareholders agreement before turning to the technical tasks.

The Mexican bank, Banorte, illustrates the second trick. A few months after Banorte submitted its application to the banking superintendency to obtain an operating license for its heavily regulated microlending subsidiary, Pronegocio, the bank began microlending operations in house. It pilot tested its microloan product in three bank branches starting in January 2004, thus gaining valuable experience with the microlending methodology and building up its microloan portfolio. An operating license was granted to Pronegocio in January 2005. In March 2005, Banorte moved all microlending operations and the microloan portfolio to Pronegocio. By then, Pronegocio had 3000 microenterprise clients and over a year of lending experience. With the pilot testing phase successfully completed, Pronegocio rapidly expanded to 39 branches by December 2005, increasing its client base to 14,000 borrowers. Banco de Venezuela is considering a variation of this method: starting up microlending through its foundation (Fundación de Venezuela) while awaiting an operating license from the banking superintendency for its heavily regulated microlending subsidiary.

Cost and Speed of Start-up

The discussion we undertake now of the cost and speed of start-up of the different microlending structures considers only the impact of the three important initial tasks presented at the start of section B2 (creating the shareholders and service agreements and obtaining regulatory approval). As noted earlier, many other factors can affect the *overall* cost and speed of start-up; these other factors are not considered in the discussion here. The impact of the three initial tasks is sufficiently important that it warrants the separate analysis to which we now turn.

It is cheaper and usually faster to start up microlending through an internal unit than through any type of external organization. Among the external organizations, the heavily regulated subsidiary is the most expensive and usually the slowest to start up. There is a weak tendency for the service company to be somewhat cheaper and faster to start up than the lightly regulated subsidiary. We now discuss the reasons for these relationships.

The internal unit is the cheapest and usually the fastest way to start up microlending because it avoids all the costs and delays of starting up an external organization, namely, those associated with obtaining a shareholders agreement, service agreement, and regulatory approval. The cost savings can be quite substantial. These savings consist of the salaries of some of the most highly-paid personnel in the bank and external organization, namely, of those top executives charged with working out the shareholders and service agreements and meeting the requirements of the bank superintendency. In addition, internal units save the cost of all the staff, outside lawyers, and other outside contractors who are also working on these same issues.

We say that the internal unit is *usually* the fastest way to start up microlending because it is possible that a service company or lightly regulated subsidiary could be just as fast. For instance, this could occur if the two time-saving tricks discussed above are used sufficiently well that the shareholders agreement, the service agreement, and regulatory approval are all obtained during

the same period of time used to carry out the technical tasks (preparation of market studies, feasibility studies, manuals, etc.) and the pilot testing of the new microloan product. This equality of start-up times is more likely to be achieved if the bank is the sole owner of the external organization (so that no shareholders agreement need be negotiated) and if, as is usually the case for service companies and lightly regulated subsidiaries, regulatory clearance is not needed or is quickly obtained.

The heavily regulated subsidiary is the most expensive and usually the slowest option of all. This is explained by all of the additional material that superintendencies normally require before granting an operating license to such institutions. The preparation of these materials involves significant additional costs. This preparation, together with the superintendency's licensing review period, normally result in start-up delays unless the bank is able to use the two time-saving tricks very effectively.

Two other factors related to the choice of structure and to the three important initial tasks presented at the start of section B2 (creating the shareholders and service agreements and obtaining regulatory approval) may affect the cost and speed of start-up: the presence of outside shareholders (i.e., shareholders besides the bank) and the amount of initial capital that is needed. On the first point, the presence of outside shareholders in any type of external organization tends to make start-up slower and more costly because a shareholders agreement must now be negotiated. On the second point, for reasons discussed in the section below on initial capital, service companies tend to require the least amount of start-up capital of all external organizations, followed by lightly regulated subsidiaries and then heavily regulated subsidiaries. This tends to impart the same ranking to the cost and speed of start-up; that is, service companies are the cheapest and fastest, followed by lightly regulated subsidiaries, and then heavily regulated subsidiaries. This is true because, when more initial capital is needed, additional shareholders may have to be found to meet these requirements. Finding additional shareholders may be time consuming and costly. Also, negotiating

the shareholders agreement may become more complex when there are more participants or simply more money at stake. For all of these reasons, the time and cost involved in starting up operations may increase.

Initial Capital Needs and Idle Capital

Microlending, whether it is done through an internal unit or any type of external organization, requires initial capital (also called start-up capital) sufficient to cover: a) the cumulative losses of the microlender—including both pre-operating and operating losses—up until the time when microlending becomes profitable on a month-to-month basis, and b) the capital adequacy requirements of the microloan portfolio during this loss-making period.²⁸ Suppose, for example, that it takes 24 months from the time the first expenses are incurred on behalf of microlending until the time at which microlending operations become profitable on a month-to-month basis, and that cumulative losses during this period are US\$ 1 million. Also, suppose that the microlending portfolio grows steadily and reaches US\$ 3 million after the 24 months. Finally, suppose that the pertinent capital adequacy ratio is 10 percent.²⁹ Then, the total initial capital needed is US\$ 1.3 million (= US\$ 1 million to cover initial losses + .10 (US\$ 3 million) to meet capital adequacy requirements). This initial capital is sufficient to permit the microlender to sustain its operations throughout the

initial loss-making period. It is provided by the bank in the case where microlending is done by an internal unit and by the bank and/or external organization in the case where microlending is done by an external organization.

Idle Capital Problem

While initial capital is sometimes constituted as a lump sum by shareholders before any pre-operating expenses are incurred, it can also be contributed at any time during the initial loss-making period. Contributing these funds in advance has an important drawback for shareholders, which we call the idle capital problem: it leaves a substantial sum of money idle for as much as 1-2 years or more, while the microlender passes through the pre-operating phase, ramps up its operations, and eventually achieves profitability.

An advantage of an internal microlending unit is that it can easily escape the idle capital problem. With an internal unit, the bank can simply cover the microlending unit's start-up capital needs (that is, its initial losses and the capital adequacy requirements) continuously out of the bank's general revenues and capital reserves. In contrast, external organizations generally find it convenient to ask shareholders for an initial investment that is at least sufficient to cover the whole of their estimated start-up capital needs, and perhaps additional funds as well to provide a margin of safety. In this way, external organizations avoid the transactions costs and risk of returning to ask shareholders for additional capital, beyond their initial contributions. Even if start-up capital is collected in two or three tranches, this only reduces, but does not eliminate, the external organization's idle capital problem.

Which type of external organization is likely to suffer most from the idle capital problem? As we discuss shortly, there is a tendency for the amount of initial capital needed to cover start-up losses plus capital adequacy requirements to be lowest for the service company, followed by the lightly regulated subsidiary and then the heavily regulated subsidiary. Consequently, the severity of the idle capital problem tends to follow the same ordering.

²⁸ Pre-operating losses refer to all the expenses incurred during the time period before any microloans are granted. Operating losses are losses that occur once microlending has begun.

²⁹ If microlending is done through an internal unit or service company, the pertinent capital adequacy ratio is the one applied to the bank since the bank owns the microloan portfolio. If microlending is done through a lightly regulated subsidiary, the pertinent capital adequacy ratio again is normally the one applied to the bank. This is because the subsidiary's operations are normally consolidated with those of the bank, and the capital adequacy requirement is imposed on the combined portfolio. Finally, if microlending is done through a heavily regulated subsidiary, the pertinent capital adequacy ratio is whatever ratio the superintendency applies to the institutional form that the subsidiary has adopted (*financiera*, etc.).

An exception to the rule that external organizations suffer from the idle capital problem may occur for service companies and lightly regulated subsidiaries when the bank is the sole owner of these external organizations. Rather than endowing these organizations with substantial start-up capital, the bank may instead choose to meet the microlender's initial losses and capital adequacy requirements on a continuous basis, as it would do for an internal unit. This would eliminate the idle capital problem completely in these cases. In the case of a heavily regulated subsidiary, at least some capital must be paid in before microlending operations commence in order to meet the banking superintendency's minimum capital requirements. Hence, there will be at least some idle capital problem even when the bank is the sole owner of a heavily regulated subsidiary.

Ranking of Microlenders by Initial Capital Needs

There is a tendency for the amount of initial capital needed to cover start-up losses plus capital adequacy requirements to be lowest for the internal unit, followed by the service company, lightly regulated subsidiary, and heavily regulated subsidiary, in that order. The reasons for this ranking are twofold. First, there is a tendency, examined below, for initial losses to follow this same ranking. As will be discussed, this is only a tendency; the actual ordering in any given set of circumstances may be very different. The ranking of the internal unit is particularly uncertain, reflecting the fact that it is easy to conceive of many circumstances in which the internal unit will have the greatest initial losses and consequently the greatest initial capital needs. Second, as can be seen for a number of countries in Table 7, the capital adequacy ratio for banks is generally the lowest of any type of financial institution. Since the bank's capital adequacy ratio is generally the one that pertains to microlending done through internal units, service companies, and lightly regulated subsidiaries (see previous footnote), these structures receive the most favorable treatment. On the other hand, heavily regulated subsidiaries constituted as nonbank financial institutions (*financieras* or other types of entities) may need to put up more

in capital for every dollar they have lent. And, as will be seen in section B7, this problem of heavily regulated subsidiaries having greater capital adequacy requirements is further compounded in some countries where the capital adequacy regulations fail to consolidate out loans from a parent bank to its subsidiary. In such countries, when heavily regulated subsidiaries obtain funding by means of a loan from the parent bank, both the parent and subsidiary have to put up capital: the parent for its loan to the subsidiary and the subsidiary for its loans to microenterprises (using the funds borrowed from the bank). This further increases the amount of initial capital needed to do microlending through a heavily regulated subsidiary.

The tendency for heavily regulated subsidiaries to need the greatest amount of initial capital is further reinforced by the fact that banking superintendencies impose minimum capital requirements on heavily regulated subsidiaries (but not on any other type of microlender). The amount of these requirements (in US\$) are shown in Table 7 for banks, *financieras*, and specialized microfinance institutions in a number of countries. In some cases, the amounts are less than US\$ 300,000—so low as to almost certainly be below the amount needed to cover start-up losses and the capital adequacy requirements of the microloan portfolio. In these cases, the minimum capital requirements have no real effect: the shareholders in the heavily regulated subsidiary will almost certainly put up more in initial capital than the minimum required by the superintendency. In other cases, the minimum capital requirements are substantial (US\$ 1-2 million or more) and may exceed the amount needed to cover start-up losses and the capital adequacy requirements of the microloan portfolio. These are the cases in which the tendency for heavily regulated subsidiaries to need the greatest amount of initial capital are further reinforced by the banking superintendency's minimum capital requirements.

Ranking of Microlenders by Initial Losses

Here, we examine the tendency, noted above, for initial losses to be lowest for the internal unit, followed by the service company, lightly regu-

lated subsidiary, and heavily regulated subsidiary, in that order.

While there is some tendency for the initial losses to be lower for internal units than for any type of external organization, this tendency is based on a limited number of considerations, and, as such, may easily be reversed when all factors are considered. As discussed above, an internal microlending unit is spared the start-up costs associated with crafting shareholders and service agreements and with gaining regulatory

approval. These factors *tend* to give it lower initial losses than any type of external organization. However, if, for example, the bank bureaucracy ties the internal microlending unit up in knots with costly and unhelpful procedures, forces it to accept a high wage scale, or denies it the technical assistance it might have used to cut costs or increase program growth and revenues, the internal unit may, in fact, have the greatest initial losses of any of the structures. Or it may be that the funding, tax, and capital considerations discussed below in sections B5-B7 reinforce the

Table 7
Minimum Capital and Capital Adequacy Requirements

Country	Specialized Microfinance Institutions	Minimum Capital (US\$)	Capital Adequacy Requirement	Minimum Capital for Banks and <i>Financieras</i> (US\$)
Bolivia	Fondo Financiero Privado – FFP	820,000	10%, same as banks	Bank: 7,500,000 <i>Financiera</i> : none exist
Brazil	Sociedad de Crédito para el Microempresario – SCM	53,000	16.6%, more than banks and <i>financieras</i> (11%)	Bank: 6,500,000 <i>Financiera</i> : 2,600,000
El Salvador	Sociedad de Ahorro y Crédito – SAC	2,850,000 1,140,000 ¹	12%, same as banks	Bank: 11,400,000 <i>Financiera</i> : none exist
Honduras	Organización Privada de Desarrollo Financiero – OPDF	60,000	16.6%, more than banks and <i>financieras</i> (10%)	Bank: 6,000,000 <i>Financiera</i> : 1,200,000
Mexico	Sociedad Financiera Popular – SOFIPO	45,000	8–11%, more than banks (8%)	Bank: 19,000,000 <i>Financiera</i> (SOFOL): 3,500,000
	Sociedad Cooperativa de Ahorro y Préstamo – SOCAP			
Panama	Banco de Microfinanzas – BMF	3,000,000	8%, same as banks	Bank: 10,000,000 <i>Financiera</i> : none regulated by superintendency
Peru	Caja Municipal de Ahorro y Crédito – CMAC	270,000	9%, same as banks	Bank: 5,200,000 <i>Financiera</i> : 2,600,000
	Caja Rural de Ahorro y Crédito – CRAC			
	Entidad de Desarrollo a la Pequeña y Microempresa – ED-PYME			
Venezuela	Banco de Desarrollo Especializado en Microcrédito – BEM	2,370,000	12%, same as banks	Bank: 19,800,000 <i>Banco de desarrollo</i> : 5,700,000

¹ This lesser requirement is applied if the institution lends only to micro and small enterprises and mobilizes savings only from its borrowers.

Sources: Jansson, Rosales, and Westley (2004, Tables 1.4 and 1.5); private communication with Alberto Francisco Bucardo for minimum capital of SOFOLs in Mexico.

factors noted in this section (related to the shareholders agreement, service agreement, and regulatory approval), with the result that the internal unit has the smallest initial losses of any of the structures. In summary, the many other factors described in this chapter must be considered to decide whether an internal unit or an external organization has the lowest initial losses.

There is a somewhat stronger tendency for heavily regulated subsidiaries to have the greatest initial losses of any of the types of external organizations. This is true not only because of the additional costs associated with obtaining regulatory approval (as discussed earlier in this section) but also because of the greater costs of regulatory compliance once the subsidiary begins to operate (as discussed in section B1). On the other hand, heavily regulated subsidiaries have two potential advantages over other types of external organizations: a) they may be able to offer their own, more appropriate savings products (in cases where they are permitted to mobilize deposits) and b) they may be able to escape a usury ceiling.³⁰ Hence, compared to the initial losses of other types of external organizations, those of a heavily regulated subsidiary may be the lowest, highest, or somewhere in the middle. While any outcome is possible, unless the heavily regulated subsidiary gains significant advantages from mobilizing deposits or escaping a usury ceiling, it is likely to have the greatest initial losses of any type of external organization.

Finally, there is a tendency for service companies to have lower initial losses than lightly regulated subsidiaries. This is because, as noted in section B1, service companies economize on funding and asset-liability management costs. However, since funding and asset-liability management needs may not be very great in the early months of operations, these operating cost savings may not be very great. Nonetheless, it is hard to see how a lightly regulated subsidiary would have lower initial losses than a service company unless a usury ceiling were crafted in such a way that the lightly regulated subsidiary were able to escape it but the service company

(whose loan portfolio belongs to the bank) could not.

B3. IMAGE AND BRANDING

See section A3/B3 (Image and Branding) above, immediately following section A2.

B4. AVOIDING THE DISADVANTAGES OF OUTSIDE SHAREHOLDERS

About half of the external microlending organizations shown in Table 3 are wholly owned by the parent bank and the other half have outside shareholders. Admitting outsiders as shareholders of an external organization can have disadvantages (considered here) and advantages (considered in sections A4 and A5, above).

There are at least two drawbacks of admitting outsiders as shareholders of an external organization. First, outside shareholders can create conflicts in the governance of the organization. The bank and outside shareholders may disagree about corporate governance issues in any of a number of areas, such as dividend policy, senior personnel appointments, budget, minority shareholder rights, and many others. Second, admitting outside shareholders reduces the profits earned by the bank from microlending operations (and reduces risk commensurately, as noted earlier in point A5). Both drawbacks can be avoided either by doing microlending in house or through a wholly-owned external organization.

B5. FUNDING ADVANTAGES

Banks that choose to do microlending in house rather than through an external organization avoid two types of regulatory limits that are imposed by many countries and that constrain the funding of microloan operations of service companies and especially subsidiaries. These are lending limits and capital investment limits, and are described below. Service companies avoid the first, but not the second, of these two regulatory limits. Subsidiaries are subject to both limits, which can be an important disadvantage—especially as time passes and the loan portfolio,

³⁰ These two advantages are discussed in sections A1 and A8, respectively.

and the consequent need for funding, grows. As a result of the lending limits that they alone face, subsidiaries may eventually have higher funding costs than internal units and service companies. Heavily regulated subsidiaries are generally more able to mitigate some of these funding disadvantages than lightly regulated subsidiaries. Thus, the ranking of the organizational structures from that which has the greatest funding advantage to that which has the least is: internal unit, service company, heavily regulated subsidiary, and lightly regulated subsidiary. The balance of this section explains these points.

Lending Limits

One of the common ways that bank superintendencies try to limit bank risk is by restricting the amount that a bank can lend to any single borrower (credit concentration limits) and the amount that it can lend to a related party (related-party lending limits). In most countries, related parties include companies in which the bank has an investment interest, such as a bank subsidiary or service company.³¹ For example, in Haiti, banks cannot lend more than 20 percent of their capital to any single borrower and cannot lend more than 10 percent of their capital to a related party. As a result of these restrictions, MCN, the microlending subsidiary of the Haitian bank, Unibank, can borrow no more than 10 percent of Unibank's capital since MCN is considered one of Unibank's related parties. Service companies effectively escape both of these lending limits because the bank makes each loan directly to the microentrepreneur after the loan is approved by the service company, rather than making a loan to the service company which the service company then onlends to the microentrepreneur.

Capital Investment Limits

While banks can back the operations of their internal microlending units with all of their available capital, the banking superintendencies in many countries put limits on how much of their capital banks can invest in another com-

pany, such as a bank subsidiary or service company. For example, in Jamaica, a bank can invest no more than 10 percent of its capital in any single company, including a subsidiary or service company. In Honduras, the *total* amount a bank can invest in one or more companies is limited to 20 percent of its capital.

Impact of These Limits

Table 8 shows these limits for 13 countries, including most countries with major microfinance markets in Latin America and the Caribbean. All limits are expressed as a percentage of the bank's capital and all are relevant for bank loans to and investments in another company, such as a bank subsidiary or service company. Thus, they are the relevant limits for the issue at hand of parent bank funding of a subsidiary or service company. As can be seen in Table 8, some countries have separate credit concentration and investment limits while others have a combined limit on the maximum amount that can be lent to and invested in a single entity (second column). Related-party lending limits are also sometimes combined with investment limits, but more often are specified separately. Limits on a bank's investments in and/or loans to other companies may be given for a single company (that receives the investment and/or loan) or for all companies together. The latter type of limits are marked with an asterisk (*) in the second and third columns of Table 8.

Impact on the Availability of Parent Bank Funding

The impact of all these Table 8 limits taken together is rather severe for the funding of subsidiaries in nearly all of the 13 countries. In nearly all cases, a bank is limited to lending no more than 10-20 percent of its capital to a single subsidiary.³² In a number of cases, this 10-20 percent limit also includes the bank's capital investment in the subsidiary. In Bolivia, Ecuador, and El Salvador, banks are prohibited from mak-

³¹ Other related parties often include the bank's directors, managers, staff, and their family members.

³² Often, but not always, the related-party lending limit is more severe than the credit concentration limit, and thus is the binding constraint.

Table 8
Credit Concentration, Related-Party Lending, and Investment Limits
(% of bank capital)

	Credit Concentration Limits (L) and Investment Limits (I)	Related-Party Lending Limits (L) and Investment Limits (I)
Bolivia	20 (L) 100* (I+fixed assets) ¹	0 (L)
Chile	30 (loans to a regulated financial institution) 5 (other loans)	100* (L)
Colombia	10 (L)	
Dominican Republic	10 (L+I) ²	
Ecuador	10 (L+I) ³	0
El Salvador	25 (L+I)	0
Guatemala	15 (L+I)	
Haiti	20 (L)	10 (L)
Honduras	20 (L) 20* (I)	30* (L)
Jamaica	20 (L) 10 (I)	10 (L+I)
Nicaragua	30 (L)	15 (L)
Paraguay	20 (L) 60* (I)	20* (L)
Peru	10 (L+I) 40* (I)	30* (L+I)

Notes: L – limit on loans to a single party (second column) or single related party (third column).

I – limit on investments made in a single company.

L+I – limit on loans plus investments (where the loans are to a single party if L+I appears in the second column and to a single related party if L+I appears in the third column).

Asterisk (*) indicates that the related-party lending limit and/or investment limit apply to all related-party loans taken together and/or to all investments taken together, respectively.

Blank cells indicate that no related-party lending limits for loans to outside companies in which the bank has an interest were found.

¹ The total amount that a Bolivian bank can invest in one or more outside companies and in the bank's own fixed assets (such as branch premises, vehicles, and equipment) is limited to 100 percent of the bank's capital.

² This limit on loans plus investments increases to 20 percent of capital if there are real guarantees, as defined by the Monetary Board.

³ This limit on loans plus investments increases to 20 percent of capital if there are guarantees acceptable to the Superintendent of Banks.

Sources: Bank laws and regulations of each country as of December 2005. Thanks to Lene Mikkelsen for help in preparing this table. The regulatory database maintained by IRIS and CGAP was also useful, although the data generally referred to 2004.

ing any loans at all to a subsidiary (or to any other related party).

To appreciate the impact of such restrictions on the funding of subsidiaries, consider the case of a fairly sizable Latin American bank, with assets of US\$ 1 billion. Assuming a rather typical capital adequacy requirement of 10 percent, total

bank capital is likely to be around US\$ 100 million. A limit of 10 percent of capital on the amount the bank can lend to its subsidiary restricts such lending to only US\$ 10 million. A great many microfinance institutions in Latin America have loan portfolios in excess of US\$ 10 million and even in excess of US\$ 50

million.³³ Hence, a bank that wants to develop a substantial microloan portfolio through a subsidiary may face the prospect that the subsidiary will eventually need to find other funding sources for its microloan portfolio besides loans from the parent bank. For example, while neither JNSBL nor MCN—lightly regulated subsidiaries in Jamaica and Haiti, respectively—have hit their borrowing limits yet, both are beginning to get close, and so this issue is receiving increasing attention by these and their parent financial institutions. Pronegocio, the heavily regulated subsidiary of Banorte in Mexico, has had only two years in which to build its microloan portfolio, and so this problem is still a ways off. Nonetheless, Pronegocio is already taking steps to diversify its funding sources away from its current heavy reliance on loans from Banorte.

In contrast, the impact of the Table 8 restrictions on the funding of service companies is much less severe. As already noted, service companies escape the banking superintendency's lending limits but not its capital investment limits. How do these latter limits affect a service company's operations? First, it should be noted that impacts can occur when the service company is held contractually responsible by the bank for meeting the capital adequacy requirements of its microloan portfolio. This responsibility is likely to be imposed on the service company whenever the bank is not the sole owner of the service company. Otherwise, the other service company shareholders would get a free ride, with the bank providing all of the capital to back up the microloan portfolio, but receiving only that part of the service company's profits equal to its percentage ownership of the service company.

To see the impact of investment limits on service companies that must meet the superintendency's capital adequacy requirements, again consider the example of a bank with US\$ 1 billion in assets and a capital adequacy requirement of 10 percent, so that total bank capital is US\$

100 million. A limit of 10 percent of capital on the amount the bank can *invest* in its service company restricts such investments to US\$ 10 million. However, a capital base of US\$ 10 million is quite substantial, enough to support a loan portfolio of US\$ 100 million (assuming the same 10 percent capital adequacy requirement holds for the microlender). The service company's portfolio would have to become quite large before it would need more capital than the bank alone could provide it. With the service company possibly garnering additional capital from retained earnings and other shareholders, the superintendency's investment limit is not likely to be an important constraint on the growth of the service company for at least a number of years. In many cases, it may never be an important constraint.

Impact on Uncertainty of Parent Bank Funding

Not only do subsidiaries face potentially severe limits on the amount of loan funding they can receive from the parent, but this amount is subject to some uncertainty as well. This is because the borrowing limit is always given as a percentage of bank capital, and bank capital changes over time. The resulting uncertainty may especially cause problems as the subsidiary approaches the borrowing limit. Suppose that the bank expects its assets and capital to grow 15 percent this year. A subsidiary that is already near to its borrowing limit may therefore expect to be able to borrow 15 percent more from the bank this year as well. If, however, it turns out that the bank has a bad year and that its assets and capital grow much more slowly, the subsidiary may have to revise its lending program since it will have much less funding available to it from the bank. Even worse, if the bank's assets and capital decline, the bank may have to recall some of its loans to the subsidiary, potentially creating a liquidity crisis for the subsidiary from which there may be no easy escape. For example, JNSBL believes that it can receive enough loan funding from its parent to continue its rapid expansion of microlending during 2006. However, this projection depends on the success of the parent's operations and the trajectory of its capital during the year. Clearly, JNSBL's lending cannot continue grow faster than the parent's

³³ See, for example, the data for over 100 Latin American microfinance institutions given in the MIX Market (www.MIXmarket.org) or for 80 of the largest microfinance institutions in Latin America given by Miller and Martinez (2005).

capital base for much longer unless outside funding is found.

Impact on Cost of Funding

When microlending is done through a subsidiary, the limited availability of loan funding from the parent bank has one further implication. Once the subsidiary can no longer obtain all of its loan funding from the bank, it is likely to face higher funding costs than would an internal microlending unit or service company, which can obtain unlimited funding for its microloan portfolio from the bank. This is because the bank normally has a lower cost of funds than a subsidiary. Deposits are often the cheapest source of funds. Even if the subsidiary can mobilize deposits (as in the case of some heavily regulated subsidiaries such as Bangente), the bank normally mobilizes far more in deposits than the subsidiary and thus enjoys greater economies of scale. Probably even more important, banks typically mobilize deposits that are of much larger average size than those mobilized by microlenders, which gives the banks a great advantage in terms of cost per dollar mobilized.³⁴ In addition, banks are usually more creditworthy than most microlending subsidiaries and thus are able to access commercial borrowing sources more cheaply, for example, by borrowing from other commercial banks or by issuing bonds. For all of these reasons, then, microlending that is done through a subsidiary may eventually run into higher portfolio funding costs than microlending that is done in house or through a service company. Heavily regulated subsidiaries that can mobilize deposits may be able to obtain outside (i.e., non-parent-bank) funds more cheaply than other subsidiaries and thus mitigate this disadvantage at least somewhat. Even those heavily regulated subsidiaries that cannot mobilize deposits are likely to be deemed more creditworthy than lightly regulated subsidiaries (because of the direct prudential supervision the former receive) and thus may have a cost advantage in borrowing from outside commercial banks and other sources.

³⁴ Portocarrero, Tarazona, and Westley (2006, Ch. 3) discuss these issues and provide actual cost data for 10 microfinance institutions.

B6. AVOIDING THE VALUE ADDED TAX

In most Latin American and Caribbean countries the payment of interest on loans and deposits is exempt from value added tax (VAT). On the other hand, fees and commissions are often subject to VAT. As discussed in Chapter 1, both microlending service companies and subsidiaries should economize on their operating costs by making good use of the bank's services in such areas as accounting, auditing, finance, information technology, legal, marketing, personnel, and treasury, and the bank's infrastructure, such as branch space and telecommunications facilities. Service companies and subsidiaries typically pay the bank according to an agreed-upon schedule for the use of bank services and infrastructure. Depending on the country, these payments *may* be considered fees or commissions that are subject to VAT. Similarly, in the service company model, the bank must pay the service company a fee for all the loan origination and loan servicing it does, which also may or may not be subjected to VAT. The need to pay such taxes was a major factor in Bancolombia's decision to do microlending in house, rather than through an external organization.

A Possible Escape

The Haitian service company, Sogesol, faced exactly this issue and devised a neat escape, which it continues to use to this day. First, Sogesol nets out all that it owes the bank for using the bank's services and infrastructure from the much larger amount of income Sogesol is due from the bank for originating and servicing microloans. Second, Sogesol calls this single accounting entry its "share of interest income," instead of a commission or a fee. Since interest is not subject to VAT in Haiti, Sogesol has avoided payment of this tax.

B7. THE DUPLICATE CAPITAL PROBLEM

The capital adequacy regulations of some countries impose an extra burden on microlending carried out through a heavily regulated subsidiary. This extra burden is called the duplicate

capital problem for reasons that will be made clear shortly. The duplicate capital problem rarely arises when microlending is carried out through a lightly regulated subsidiary or service company. It never arises for an internal microlending unit.

The duplicate capital problem occurs when prudential banking regulations require that *separate* capital adequacy requirements be met both for a parent bank's loan to a heavily regulated subsidiary and for a heavily regulated subsidiary's loans to final borrowers such as microenterprises. In the worst case scenario, double the normal amount of capital would need to be maintained for every dollar lent to microenterprises—reducing by half the amount of microenterprise lending that can be done from a given amount of capital and substantially increasing the cost of microenterprise lending. For example, if the capital adequacy ratio were 10 percent, for every \$1000 lent to the final borrowers, \$200 would need to be maintained in capital. The bank would need to maintain \$100 in capital to back up its \$1000 loan to the subsidiary, and the subsidiary would need to maintain another \$100 in capital to back up its \$1000 in loans to the final borrowers. This problem does not arise when microlending is done through an internal unit because there is no intermediate bank loan to a microlender; rather, the bank makes the loans directly to the final microenterprise borrowers.

Two types of regulations can reduce or eliminate the duplicate capital problem for heavily regulated subsidiaries: a) reduced risk weighting and b) application of the capital adequacy requirements to the consolidated entity. The first regulation permits a reduced risk weight to be used when banks lend to or make deposits in regulated financial institutions. For example, Peru assigns a 20 percent risk weight for such loans and deposits, while Venezuela applies a 60 percent risk weight. Consider the case of Bangente, a heavily regulated subsidiary located in Venezuela, where the capital adequacy ratio is 12 percent both for Bangente and its parent bank, Banco del Caribe. Banco del Caribe provides significant portfolio funding to Bangente by purchasing Bangente certificates of deposit. For

every Bs 100 that Banco del Caribe deposits in Bangente, it must maintain Bs 7.2 in capital ($=0.60 \text{ risk weight} \times 0.12 \text{ capital adequacy ratio} \times \text{Bs } 100 \text{ deposit}$). And for every Bs 100 that Bangente then lends to microentrepreneurs it must maintain Bs 12 in capital. Hence, a total of Bs 19.2 ($= 7.2 + 12$) in capital must be maintained for every Bs 100 lent by Banco del Caribe to microentrepreneurs through Bangente. In contrast, if Banco del Caribe did its microlending in house, only Bs 12 in capital would be needed for every Bs 100 lent to microentrepreneurs.

The second type of regulation, which is found in a number of countries in Latin America and the Caribbean, completely eliminates the duplicate capital problem. This regulation permits capital adequacy requirements to be met on a consolidated basis, for banks and their subsidiaries taken together (or for an entire financial group taken together, where the bank and microlending subsidiary are two of the members of the financial group). Under such consolidation, the intermediate loan from the bank to the subsidiary is eliminated since it represents an asset of the bank and an equal size liability of the subsidiary. Hence, the capital adequacy requirement associated with this intermediate loan is also eliminated. Only the final loans to the microentrepreneurs remain as assets on the balance sheet of the consolidated entity, and so only the capital adequacy requirement associated with these loans remains. By eliminating the intermediate loan from the bank to the subsidiary, consolidation completely eliminates the duplicate capital problem.

Lightly regulated subsidiaries and service companies are normally consolidated with the parent bank for purposes of meeting capital adequacy requirements. Hence, they normally do not suffer from the duplicate capital problem.³⁵ Heavily

³⁵ Alert readers may wonder why there would ever be a duplicate capital problem for service companies. They might argue that with a service company there is no intermediate bank loan to the service company; rather, the bank makes the loans directly to the microenterprises. Hence, there should be no duplication of the capital needed to meet the capital adequacy requirement. While this is true, the duplicate capital problem could arise in a different way for service

regulated subsidiaries may or may not be consolidated with the parent bank. This depends on each country's regulations and possibly on the percentage of the subsidiary's stock that is owned by the bank. Hence, if there is a duplicate capital problem, it is generally a problem that affects only heavily regulated subsidiaries.

companies, in particular, for those service companies in which the bank is only a partial owner. In such cases, the bank would normally require that the service company maintain enough capital to cover the capital adequacy requirements associated with its microloan portfolio. For example, Sogebank requires this of its microlending service company, Sogesol. This is done because otherwise the bank would put itself in an unfair position. It would provide all of the capital to back up the microlending portfolio but receive only a fraction of the service company profits derived from this portfolio (equal to its percentage holdings of the service company's stock). However, requiring the service company to provide its own capital only helps the bank meet the superintendency's capital adequacy requirement if the service company's capital is consolidated with that of the bank (or otherwise counted) for purposes of meeting these requirements. Because service companies and banks are normally consolidated for purposes of meeting capital adequacy requirements, no problem normally arises in this area. If such consolidation (or counting) were not permitted, then the duplicate capital problem could potentially arise for service companies.

3. Putting It All Together

Chapter 2 provides a detailed examination of the many pros and cons to the bank of doing microlending through various alternative structures: internal unit, service company, lightly regulated subsidiary, and heavily regulated subsidiary. The main goal of this chapter is to help the reader see the forest instead of the trees; that is, this chapter discusses how the overall balance of the pros and cons might turn out in different commonly-encountered situations, and how different country and individual bank circumstances might affect the choice of best structure. Before turning to this task, the chapter briefly discusses one further decision that banks choosing to do microlending through an external organization must make: whether to be a full or partial owner of the external organization. The chapter concludes with a brief section on the role of governments and donors.

FULL VS. PARTIAL OWNERSHIP OF AN EXTERNAL ORGANIZATION

Table 9 presents the major pros and cons to the bank of being a full versus partial owner of an

external microlending organization (service company or subsidiary). None of these pros and cons are completely new points, as the references to the Chapter 2 sections (and the corresponding points in Table 5) make clear. Therefore, the discussions here are kept brief.

Points a1 and b1 refer to the simple point that when the bank reduces its shareholding below 100 percent, it reduces its share of the profits and losses (and thus the rewards and risks of microlending) by the same proportion.

Points a2 and b2 refer to the Chapter 2 discussions of how incorporating outside shareholders can provide a number of benefits to the microlender but also has the potential to create conflicts in governance.

To understand point b3, recall that when the bank is the sole owner of the external microlending organization, it avoids the expense and possible delays associated with negotiating a shareholders agreement (which, for example, took nearly a year in the case of MCN in Haiti

Table 9
Full vs. Partial Ownership of External Organizations

Reference Number	Pros of <i>Partial</i> Ownership of an External Organization
a1	Reduces the risks to the bank of microlending (section A5)
a2	Incorporation of outside shareholders can bring several benefits, including additional capital, improved governance, and high-quality technical assistance (section A4)
a3	May help to reduce bank meddling in unhelpful ways in microlending (section A1)
	Pros of <i>Full</i> Ownership of an External Organization
b1	Increases the bank's profits from microlending (section B4)
b2	Outside shareholders can create conflicts, which are avoided with full ownership (section B4)
b3	Eliminating outside shareholders cuts out certain initial tasks, which has several benefits: start-up cost and often start-up time are reduced, possibly less initial capital is needed, idle capital can be more easily avoided or reduced (section B2)
b4	In the case of subsidiaries (but not service companies), full ownership confers an advantage over partial ownership, namely, that asset-liability management is cheaper because the bank can combine the microlending portfolio together with its own and manage the two portfolios as one (section B1—see point 5, on asset-liability management)

and much longer in the case of Bangente in Venezuela). And, as a result of the additional start-up costs associated with negotiating the shareholders agreement, the external organization may also need greater initial capital.³⁶ Finally, external organizations with a single owner (the bank) can more easily avoid the idle capital problem or at least reduce the amount of idle capital that must be carried by meeting much or all of the microlender's initial losses and capital adequacy requirements on a continuous basis, rather than by providing a large chunk of up-front capital.³⁷

Point b4 refers to the Chapter 2 discussion of the economies in asset-liability management that result from full ownership of a subsidiary instead of partial ownership.

Finally, to understand point a3, it may be helpful to think of the bank as divided between those who understand microfinance and appreciate its potential to contribute to the bank's profits, and those who don't. If the bank is the sole shareholder of the external microlending organization, it may turn out that the external organization's board is dominated by bank people who lack this understanding and who may meddle in unhelpful ways in microlending. In such a case, the board may limit the freedom of the external organization to "do microfinance right" (in the sense discussed in section A1 of Chapter 2). In such circumstances, it may be helpful for the external organization to take on outside share-

³⁶ We say "may" because there are other factors that determine the external organization's need for initial capital. That is, there are other factors that determine the size of the external organization's initial losses and capital adequacy requirements during the initial loss-making period.

³⁷ For more on the issues discussed in this paragraph, see section B2 of Chapter 2, especially the last paragraph in each of the discussions, "Cost and Speed of Start-up," and "Idle Capital Problem." Note that when the external organization is a heavily regulated subsidiary, at least some capital must be paid in before microlending operations commence in order to meet the banking superintendency's minimum capital requirements. Hence, there will be at least some idle capital problem even when the bank is the sole owner of a heavily regulated subsidiary.

holders, especially, perhaps, shareholders who have a deep understanding of microfinance and can reduce this meddling. It may even be useful to take this a step further and make sure that the bank has a minority shareholding position in the microlender. For example, Sogesol argues that it has been, and still is, important that Sogebank be in a minority shareholding position (it has 35 percent of Sogesol's shares) since microfinance and its potential are still not widely enough appreciated in the parent bank. Keeping Sogebank in a minority position has allowed Sogesol to expand its branch network, redesign products, introduce new products, and generally spend money as it believes best without being overruled by its board of directors, as it might have been had this board been dominated by the parent.

OVERALL BALANCE OF PROS AND CONS

This section examines how the overall balance of pros and cons might turn out to favor one microlending structure over another in a number of simplified and commonly-encountered situations, and how different country and individual bank circumstances might affect the choice of best structure. No attempt is made to cover all possible situations; rather, we aim only to provide some basic guidance on the selection process.

First Check the Banking Regulations for Allowable Structures

The first point to recall is that, as noted in Chapter 1, the banking regulations in some countries do not allow auxiliary providers of financial services (service companies and/or lightly regulated subsidiaries). Such a restriction limits the available choices—potentially to only an internal unit and a heavily regulated subsidiary—greatly simplifying the selection process.

Possible Dominance of Service Companies over Subsidiaries

As a general proposition—and with some clear exceptions—the service company may be preferred to both the lightly and heavily regulated

subsidiaries over a wide variety of circumstances. To see why, consider first a lightly regulated subsidiary and the list of three advantages of subsidiaries over service companies given in Table 6. To the extent that advantages A1 and A8 (greater autonomy and more favorable treatment under a usury ceiling, respectively) hold at all, they are mainly advantages that heavily regulated subsidiaries, rather than lightly regulated subsidiaries, have over service companies. Most usury ceilings in Latin America and the Caribbean are neutral with respect to the choice of microlender. The one exception we have found, Paraguay, offered benefits to heavily regulated subsidiaries (set up as *financieras*) but not to lightly regulated subsidiaries. Similarly, the largest benefit from greater autonomy (point A1) typically accrues to heavily regulated subsidiaries that can mobilize deposits. Such subsidiaries may be able to offer their microenterprise clients more appropriate savings products than service companies or lightly regulated subsidiaries (since service companies and lightly regulated subsidiaries cannot offer savings products themselves, but must rely on the bank to do so). The third and final advantage of subsidiaries, their loss-limiting feature (point A5), holds for both lightly and heavily regulated subsidiaries. While this can be an important advantage of subsidiaries over service companies, individual country and bank circumstances play a large role in determining whether this factor is, in reality, an important one. As noted in the discussion of point A5, some countries do not limit the parent bank's losses to the amount it has invested in the subsidiary, negating this advantage. And for banks that are unlikely to let a subsidiary go bankrupt for fear of contaminating their other business lines, the loss-limiting feature may also have little practical value. In conclusion, the lightly regulated subsidiary appears to have at most one significant advantage over the service company.

On the other hand, the advantages of a service company over a lightly regulated subsidiary can be substantial. The generally strict limitations on bank funding of subsidiaries and the resulting higher cost of funding (point B5) can both be important reasons to opt for the service company model. Service companies are also generally

cheaper and faster to start up and less expensive to run (points B1 and B2). Hence, unless the lightly regulated subsidiary enjoys the loss-limiting feature noted in the previous paragraph and unless this feature is highly valued by the bank, the service company is likely to be the better choice of structure.

The service company may also be preferable to the heavily regulated subsidiary over a wide variety of circumstances. This is because heavily regulated subsidiaries have a number of disadvantages. For example, they are generally more expensive and slower to start up than service companies and lightly regulated subsidiaries (point B2), more expensive to run than service companies and lightly regulated subsidiaries in terms of their operating costs (point B1), and sometimes suffer from the duplicate capital problem (point B7). Therefore, unless the heavily regulated subsidiary has important offsetting advantages in one or more of the three areas discussed in the paragraph before last, the balance of the pros and cons may well favor the service company over the heavily regulated subsidiary. As a result, the service company may often be the preferred choice of external organization.

Internal Unit vs. External Organization

As Table 5 makes clear, there are many pros and cons to consider when deciding between an internal unit and an external organization. While all of these pros and cons are potentially important in any given case, it may be helpful to consider common situations in which only a reduced set of factors need be considered. To start, suppose that the choice is between an internal unit and a service company, an interesting simplification since the service company is often the best choice of external organization. Further, let us consider only those pros and cons that arise all of the time, rather than just occasionally. This allows us to focus on the first few external organization advantages (A1-A5, and perhaps just A1-A2) and the first few internal unit advantages (B1-B4, and perhaps only B1-B2). This reduction is possible because points A6-A8 and B6 arise only occasionally, while B5 and B7 have little or no relevance to service companies. This leaves us with the reduced problem of bal-

ancing off points A1-A5 versus B1-B4. If outside shareholders are not being considered for the external organization (that is, if the bank is the sole shareholder), then we need only compare points A1-A3 versus B1-B3.³⁸ Finally, if the strategies discussed in section A3/B3 for delinking image and branding from the choice of structure can be used, or if image and branding considerations are simply not important, then the choice between an internal unit and service company can be made based on comparing points A1-A2 to B1-B2.

This still may not be an easy matter. As discussed in point A1, there are a great many freedoms that the external organization may enjoy that are likely to be restricted to a greater or lesser degree when microlending is done through an internal unit. And, as noted in point A2, the directors, managers, and staff of an external organization may have much higher-powered incentives to be efficient and profitable than would the managers and staff of an internal unit. On the other hand, the internal unit may offer enduring cost savings as well as a cheaper and faster start-up. The choice inevitably comes down to the specifics of the circumstances of *how* much more freedom the external organization is likely to enjoy and *how* much greater its incentives to be efficient and profitable would be versus *how* much cheaper and faster to start up and cheaper to run the internal unit is likely to be.

Adherence to Best Practices and the Choice of Structure

A useful lens through which to examine the choice between an internal unit and an external organization is the degree to which the bank follows best practices in its microlending program. As noted in the best practices section of Chapter 1, there is an important link between some of the

eight best practices discussed there and the choice of best microlending structure. We now examine this link with regard to best practices number 1 (doing microfinance right), 7 (getting technical assistance), and 8 (degree of institutional commitment).

One advantage of doing microlending through an external organization instead of an internal unit is that the external organization may be able to escape the rigidities, bureaucracy, and culture of the bank to a much greater degree and thus use much more appropriate microlending procedures and products. Similarly, the external organization may have greater freedom to introduce new products, modify old products, appropriately locate branches, change prices, and access sufficient budgetary resources; that is, it may have greater freedom “to do microfinance right.” However, to the extent that the bank is able to take a more enlightened approach and allow an internal microlending unit the flexibility to at least do microfinance close to right, the balance of the pros and cons may tip more towards the internal unit. Contrarily, more rigid banks, which are much further from following this best practice, may be better off using an external organization in order to insulate microfinance from the bank’s rigid procedures and other inflexibilities to a much greater degree.

As noted in Chapter 1, a great deal is known about how to do microfinance right and other best practices. By accessing good quality technical assistance, banks can save themselves from making expensive mistakes and can earn greater profits more quickly from their microlending activities. Yet it is surprising how often internal microlending units fail to get such help. On the other hand, many external organizations obtain technical assistance, often from international partners. If a bank is likely to deprive its internal microlending unit of technical assistance, this could be a strong argument for placing microlending in an external organization, particularly if other shareholders that can provide this assistance are taken on.

Finally, when the bank is having trouble making a strong commitment to microlending, it may be best served by using an external organization.

³⁸ The elimination of outside shareholders eliminates points A4 and B4. The combination of a service company and no outside shareholders eliminates point A5, reduced risk of microlending done through an external organization. This is because with a service company it is only the presence of outside shareholders that reduces the risk to the bank.

The idea is to remove microlending from the bank and give it over to a dedicated group of people who are focused solely on this product. This may help to avoid having microlending getting “lost in the shuffle” the way it might in an internal bank unit—a fairly common occurrence given all the special handling microlending requires and its initially small contribution to overall bank profits.

Special Situations

There is no limit to the variety of different country and bank circumstances, and consequently to the number of subgroups of factors and weightings of each factor that can favor each of the different structures. While the preceding discussion is far from exhausting all possibilities, we close this section by noting that in some cases, one or two special considerations may dominate the decision on choice of best structure. For example, the application of the value added tax to financial flows between the bank and external organization was a key factor in Bancolombia’s decision to do microlending in house. Similarly, escape from a usury ceiling, the wage scale of the bank, or the need to employ union personnel may be key considerations in other situations. Or, the desire to have outside shareholders may argue strongly for an external organization.

THE ROLE OF GOVERNMENTS AND DONORS

While the government and donor role in fostering downscaling need not be a very costly one, it can be catalytic in getting banks to play a much larger and more effective part in bringing financial services to microenterprises. Most banks have sufficient loanable funds to mount a microlending program; however, they often lack knowledge of best practices in microlending. Therefore, the provision of technical assistance can be critical in enticing banks to enter this field and in giving banks a much better chance to succeed once they do. The technical assistance program may be designed to not only transfer best practice microlending methodologies to banks but also to help them: a) select the most appropriate structure for their microlending operations, given a realistic assessment of what

kind of environment and resources microlending really needs to be successful, and b) follow the other best practices discussed in Chapter 1.

As a result of such technical assistance provision, the revolving door syndrome noted by Valenzuela (2001) and others may be avoided. Here, a bank enters microfinance with high expectations and leaves disappointed, perhaps after only a few years or even less. Typically, the bank has lost money or earned only meager profits for all of its efforts. There are two main causes for this syndrome, which has affected numerous banks in Latin America and the Caribbean. First, there is the technical failure that these banks often don’t really understand microfinance and how to make it into a profitable business line. Second, there is the commitment failure that these banks often are not sufficiently committed to microfinance that they are willing to do the many things needed to make microfinance work and also to wait the years it can take for the microfinance portfolio to grow to where it has an appreciable impact on overall bank profits. The provision of technical assistance is designed to overcome the first of these two problems. The selection of committed banks as recipients of the technical assistance and the conditioning of the technical assistance program’s disbursements and repayment should help with the second problem, as is discussed below.

Some may argue that banks have sufficient discretionary funds that they can buy their own technical assistance, and so governments and donors should save their scarce resources for needier microfinance institutions. There is some validity to this argument. However, it is also true that banks have an enormous ability to deliver microfinance services to hundreds of thousands and even millions of microentrepreneurs in Latin America and the Caribbean if they wished to do so. This capacity reflects the banks’ generally extensive branch networks, well-established back office systems, large capital base, access to loanable funds, system of private ownership which encourages sound governance and the efficient delivery of services, control by established regulatory authorities, and ability to offer deposits, loans, and other financial services.

Moreover, banks looking for new business lines have many choices besides microfinance. Therefore, to accelerate the entry of banks into microfinance, it may be wise for donors and governments to spend modest sums to help banks successfully start up operations in a field most of these financial institutions know little about.

As noted above, experience has shown that bank commitment is a key factor in creating a successful and durable microlending program. Therefore, governments and donors should look for signs of such commitment in choosing which banks to assist. Indicators of bank commitment include:

- The presence of microfinance champions in the bank, including one or more board members who may inspire and protect the microlending program and one or more managers who know how to run it
- An appreciation in the bank that microfinance serves the institution's *commercial* interests (since banks that mainly do microfinance for public relations purposes tend to have small and/or short-lived programs)
- The bank's willingness to carry out initial tasks such as market and feasibility studies at its own expense, prior to the start-up of any government or donor assistance programs

- The bank's willingness to commit the resources needed to effectively develop microlending, including capital to start up an external organization if that is the best choice of microlending structure, as well as money for: training of loan officers and other key personnel, an adequate management information system, detailed design and pilot testing of the new microfinance products, and new branch offices if needed

Beyond looking for signs of commitment in the banks they choose to support, governments and donors should seriously consider providing technical assistance grants on both a *conditional disbursement* and a *contingent repayment* basis. Again, the idea is to support only banks with a serious commitment to microfinance. By conditional disbursement we mean that disbursement of the technical assistance funds should be tranching or otherwise conditioned on performance indicators such as those measuring outreach to the target group and the delinquency rate of the microlending portfolio. By contingent repayment we mean, for example, that if the bank does not maintain a certain minimum level of client outreach to the target group for at least two years after the last disbursement of the technical assistance grant, it would be contractually obligated to repay part or all of the technical assistance funds it has received from the government or donor.

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Annex A

Examples of Banks and *Financieras* Doing Microlending through an Internal Unit, Service Company, or Subsidiary (with outreach data from December 2005)

Bank or <i>Financiera</i> (date of outreach data if not 12/05)	Country	Microloan Portfolio (US\$)	Number of Microloans	Average Out- standing Bal- ance of Mi- croloans (US\$)
1. Banks and Financieras with an Internal Unit				
Banco Santander (BANEFE) (12/04)	Chile	85,570,651	54,607	1567
Bancolombia (8/05)	Colombia	5,895,197	10,065	586
Banco Caja Social	Colombia	228,449,000	79,970	771
Banco Centro Mundo	Ecuador	24,693,000	31,819	776
Banrural (12/04)	Guatemala	117,644,365	77,108	1582
Bancafé (12/04)	Guatemala	27,424,875	14,746	1909
Banhcafé	Honduras	10,171,769	3694	2754
Financiera Visión de Finanzas	Paraguay	30,144,344	14,985	2012
Interfisa Financiera	Paraguay	14,532,122	14,004	1038
El Comercio Financiera	Paraguay	10,451,948	11,526	907
Financiera Familiar	Paraguay	12,141,536	10,124	1199
Banco de Crédito ¹	Peru	225,875,802	52,452	4306
Banco del Trabajo	Peru	126,542,274	88,702	1427
2. Banks with a Service Company				
ABN AMRO Real	Brazil	5,205,140	8238	519
Banco de Desarrollo (12/04)	Chile	39,020,774	41,093	950
Banco del Estado (12/04)	Chile	142,368,412	81,204	1753
Banco del Pichincha	Ecuador	80,944,000	52,755	1534
Sogebank (9/05)	Haiti	4,727,581	6896	686
3. Banks with a Lightly Regulated Subsidiary				
Unibank	Haiti	6,214,484	8488	732
Jamaica National Building Society (1/05)	Jamaica	2,683,000	8972	299
4. Banks with a Heavily Regulated Subsidiary				
Banorte	Mexico	29,204,328	16,295	1792
Banco del Caribe	Venezuela	25,985,100	29,818	887
Subtotal: Internal Unit (group 1)		919,536,883	503,802	1825
Subtotal: External Organizations (groups 2-4)		336,352,819	253,759	1325
TOTAL		1,255,889,702	757,561	1658

¹ In March 2004, Banco del Crédito absorbed its heavily regulated microlending subsidiary (Financiera Solución) and since that time has engaged in microlending through an internal unit. Consequently, Banco del Crédito is listed as currently using an internal unit in this table and as using a heavily regulated microlending subsidiary up to March 2004 in Table 3.

Sources: Outreach data are from Westley (2005, Annex A) for Jamaica National Building Society and from Navajas and Tejerina (2006) for all other entities. All data are for December 2005 unless otherwise noted.