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DOING WELL BY DOING GOOD: THE FUTURE OF MICROFINANCE VIA REGULATED FINANCIAL INSTITUTIONS

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I. Introduction: What's So Special About Regulated Financial Institutions?

There are some obvious characteristics of developing countries that we often forget or choose to ignore. Most people are poor. Working poor. Working hard to support themselves and their families. Most of their employment and income generating opportunities are created by very small family businesses. Informal, diversified family businesses. Unregulated, unregistered, untaxed, unnoticed family businesses. Profitable family businesses. Family businesses without access to formal financial services. Families without access to formal financial services. This is the foundation of most developing country economies. This, ***the unbanked majority***, is also the potential market for microfinance.

More accurately, this provides the potential markets for microfinance services. Not a single market, but many markets. Populations are diverse. Needs differ by location, economic activity, and priorities. Some potential clients are accessible, others are not. Rural environments differ dramatically from urban markets. Cultural norms and social values are rich in their diversity. Commerce has a different cash flow profile than manufacturing or handicraft production. Farming and livestock activities have yet another economic profile. Household savings accounts are different from business transaction accounts. Provision of funds transfer facilities requires a special financial infrastructure.

A multiplicity of markets requires a variety of institutional models for serving these markets. The five major microfinance institutional models, ranked by scope of impact and sustainability of operations, are as follows: full service commercial bank; restricted service bank; regulated non-bank financial institution; membership society; and non-governmental organization (NGO)/project.

The remainder of this paper will focus on the future of microfinance via the first three models, namely some form of regulated financial institution, as these are the models that offer the greatest potential for maximizing the scale, scope, and longevity of impact.

This does not imply that the other models are less important. Sometimes full cost recovery is not possible. For example, if the goal is to reach a highly marginalized clientele or to deal only with business start-ups, costs and risks will be high. While efficiency and cost-effectiveness are crucial, as are transparency and accountability, subsidies will probably nevertheless be required. The criteria for provision of such a subsidy should be the costs and benefits of alternative interventions to assist the same population, not whether the microfinance institution is profitable.[1]

Rather, it is an acknowledgement that the institutional form of the other models, while perhaps facilitating more rapid and targeted impact, are more of a complement instead of a substitute for nationwide, commercially based microfinance institutions. ***The microfinance institutions that have the largest and longest-term impact are those that are financially sustainable.*** This means that they can cover all of their costs, including operational expenses, the cost of funds, and loan losses. They should also be able to generate a modest surplus for reinvestment in new products, delivery systems, and technology. The emphasis on sustainability promotes economic efficiency, decreases dependency on external resources, and creates the principal positive incentive for savers to deposit their funds (trust that their savings are secure) and borrowers to repay their loans (continued access to capital).[2]

Section II examines regulated financial institutions that either "downscale" to include microfinance in their array of products and delivery systems, or that were created exclusively to provide microfinance services. Section III explores the transformation of NGOs that "graduate" to a regulated financial institution. Section IV concludes with a brief prognosis of the future of microfinance via regulated financial institutions.

[1] See Morduch (1999) for a more detailed discussion of this proposition.
[2] For more detailed analyses of microfinance best practices, see Yaron et al. (1997) and Christen et al. (1995).

II. Increasing Profits: New Markets, New Products, New Delivery Systems

Commercial banks are in business to make money. When financial systems are closed and protected, and competition is limited, it is possible for a handful of banks to control the prime market for banking services. Banking cartels can generate considerable profits by "creaming" the market for its best customers and setting rates as the price giver.

However, recent worldwide financial sector trends have been forcing banks to look for new markets. Deregulation of financial institutions, liberalization of financial markets, and globalization of financial services have lowered barriers to entry, increased competition, contributed to market saturation, and made oligopoly pricing untenable in such environments.

These changes have encouraged two significant new developments:

- Regulated financial institutions that **downscale** to include microfinance in their array of products and delivery systems.
- Regulated financial institutions that are **created exclusively** to provide microfinance services.

In either case, the banks are out to penetrate a new and potentially lucrative market, the unbanked majority.

In a recent survey of 220 banks in 60 countries, 49 percent of the 148 banks that reported they make micro and small enterprise loans stated profitability as the reason for entering this market. The second most common response, by 44 percent of these banks, was changing market conditions and increasing competition in lending to medium and large enterprises. Few banks were motivated by non-commercial factors: just 20 percent stated poverty alleviation or social objectives as the rationale for making micro and small enterprise loans, while only 17 percent gave government regulations as the reason for making these loans.[3]

Banks and other regulated financial institutions bring many competitive advantages to microfinance. They are experienced in:

- ***managing financial risk***, whether it be credit, liquidity, interest rate, or foreign exchange risk;
- ***raising their own funds***, via savings mobilization, capital market borrowing, or equity contributions;

[3] See Jenkins (September 2000) for a more detailed discussion of the survey methodology and results. Some banks indicated more than one reason for making micro and small enterprise loans, so the total is greater than 100 percent.

- ***establishing extensive retail distribution networks***, such as branch offices and electronic banking outlets;

- ***offering a wide range of financial services***, including loan products, savings instruments, and funds transfers; and

- ***creating sound ownership and governance structures, together with management systems***, that maximize profitability while maintaining compliance with prudential norms and regulations.

The above-summarized financial infrastructure of a large bank offers the potential for sustainable, nationwide impact if the bank decides either to devote its resources exclusively to microfinance, or to make microfinance a major profit center within the bank. For example, in a World Bank survey of 206 microfinance institutions serving at least 1,000 clients, the 25 banks that responded accounted for 70 percent of total micro loans outstanding, whereas the 150 NGOs that responded held just 4 percent of micro loans outstanding.[4]

The most successful example of full service commercial bank that has made microfinance a significant component of its business is Bank Rakyat Indonesia (BRI). BRI is one of three state-owned commercial foreign exchange banks in Indonesia. BRI is owned entirely by the Government, but operates under all of the prudential norms and regulations that every commercial bank must adhere to in Indonesia. BRI's primary mission is the provision of rural and urban community banking services by mobilizing family savings and delivering credit products to medium, small, and micro enterprises.

Although BRI was established in 1968 under National Law Number 21/1968, it is actually the successor to a series of banks in Indonesia going back more than 100 years, beginning with De Poerwokertosche Hulp-en Spaarbank der Inlandsche Hoofden, founded in 1895. BRI grew to become one of Indonesia's largest banks, as indicated by its position early in the East Asian crisis: as of December 1997, BRI's total assets were $16.7 billion, including a net loan portfolio of $12.6 billion, and 1997 pre-tax profits totaled $56.7 million. It had 324 branches covering the entire nation, overseas offices in Singapore, Hong Kong, and New York, and a workforce of over 44,000 employees.

During the same year the East Asian crisis hit, BRI re-organized into four Strategic Business Units (SBUs): Treasury and Investment, Corporate, Retail Banking, and Micro Banking.

SBU Treasury and Investment handles treasury functions, including the maintenance of BRI primary reserves in Bank Indonesia and the purchase of Bank Indonesia certificates (SBIs). It also controls BRI financial subsidiaries.

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[4] See World Bank (1996) for complete survey results and a more in-depth analysis. Composition of the respondents was as follows: 150 NGOs, 28 credit unions, 25 banks, and 3 other institutional types.

SBU Corporate makes large corporate loans (above Rp 3 billion, or US$373,599), including dollar-denominated loans.

SBU Retail Banking is in charge of BRI's branches, which provide full banking services. They make small business loans up to Rp 3 billion (US$373,599), loans against salaries and pensions, and "program loans" (channeling of loans for government schemes, such as those to cooperatives or to the government agency that provides agricultural price support). The branches also provide savings, giro, and time deposit accounts. The branches have recently introduced an on-line facility for holders of savings accounts.

SBU Micro Banking is in charge of BRI's 3,694 Units. A Unit is a small bank office with four to eleven staff. The Units also maintain 319 cash posts that are open three to five days a week to receive and pay out savings, and to receive loan repayments. Each Unit is a separate profit/loss center with its own balance sheet and profit and loss statement. The Units make loans up to Rp 25 million (US$3,113), soon to be increased to Rp 50 million (US$6,227).

The story of the commercialization and subsequent performance of the BRI Units is well documented, so will not be recounted here.[5] The results to date offer a dramatic example of the potential scope and scale of outreach and coverage if microfinance is done in a sustainable manner through a commercial bank. There were 2.6 million micro loans outstanding totaling Rp 7.0 trillion (US$871.7 million) at the end of August 2000. During the month of August 2000, the BRI Units lent Rp 740.9 billion (US$92.3 million) to 161,789 borrowers. The Units also provide savings, giro, and time deposit accounts; there were 25.3 million accounts in the Units at the end of August 2000 totaling Rp 18.8 trillion (US$2.3 billion). The Units have been extremely profitable, even during the East Asian financial crisis: the moving twelve-month loss ratio[6] was 1.23 percent at the end of August 2000, and year-end net profit for 1999 was Rp 1.2 trillion (US$149.4 million).[7]

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[5] Patten and Rosengard (1991) provides a detailed history of the commercialization of microfinance at BRI. The story continues in Patten, Rosengard, and Johnston Jr (September 2000), an analysis of the performance of the BRI Units during the East Asian financial crisis.

[6] The total amount overdue, including everything that has been written off, divided by the total amount which has fallen due.

[7]The reader must treat the United States dollar figures with extreme caution. Usually a paper such as this states key financial data in local currency and U.S. dollar terms, so that readers can make comparisons with microfinance operations in other countries. However, during the crisis period, the exchange rate has been extremely volatile, and the meaning of changes in the dollar value of these figures is unclear. For example, the dollar value of the Units' Kupedes loan portfolio has swung from US$1.7 billion in June 1997, before the crisis, to US$308 million at the peak of the crisis in June 1998, to US$724 million after conditions stabilized at the end of June 1999. BRI Unit customers deal almost exclusively in rupiahs, and during the period there was virtually no change in the rupiah loan volume or the number of Kupedes borrowers. The U.S. dollar values given in the text use the interbank average rate from 1 January to 31 August 2000, which understates the U.S. dollar value of these figures in terms of local purchasing power. For comparison, these same figures using both the pre-crisis exchange rate of Rp 2,450 to the U.S. dollar and the current post-crisis exchange rate of Rp 8,030 to the U.S. dollar are as follows: Rp 7.0 trillion outstanding (US$2.9 billion/US$871.7 million); Rp 740.9 billion lent (US$302.4/US$92.3 million); Rp 18.8 trillion in savings (US$7.7 billion/US$2.3 billion); and Rp 1.2 trillion 1999 profits (US$490.0 million/US$149.4 million). As the consumer price index has roughly doubled since the beginning of the financial crisis, a more credible dollar figure would probably be about mid-way between each set of dollar values cited above.

While there is not yet a general commercial bank in Latin America active in microfinance on the scale of BRI, even adjusted for population differences, there are several commercial banks in the region that have made a substantial commitment to microfinance, including Banco del Desarrollo (Chile), Multi Credit Bank (Panama), and Banco de la Pequena Empresa (Dominican Republic).[8] In fact, 148 banks have been identified worldwide as active in making loans to small and microenterprises.[9]

Although the rewards can be tremendous, it is very difficult for a large commercial bank to undertake microfinance profitably. The most common reasons for failure are as follows: [10]

- ***Social Mission***: A bank is supposed to be profitable, and offer a market return to its shareholders. Microfinance programs that are established not as commercial initiatives but to fulfill social objectives or regulatory requirements will end when funding is exhausted or the rules change.

- ***Underpricing Micro Loans***: Lender transaction costs for micro loans are higher per unit lent than larger loans, so micro credit should carry a higher interest rate. Instead, micro loans are often a bank's cheapest loans.

- ***Inappropriate Lending Methodology***: Micro loans are not small big loans. They are for low income, family businesses. The lending methodology should be information rather than collateral based, stressing speed and simplicity.

- ***Inappropriate Organizational Structure***: Microfinance should be undertaken via a separate unit of account within the bank, such as an independent division or wholly owned subsidiary. This allows the bank to introduce new operating procedures, hire staff officers with non-conventional profiles, and offer profit incentives paid on the basis of transparent financial statements.

- ***Poorly Designed Loan Products***: Micro loans should match the cash flow of the borrower, in terms of maturity and repayment schedule. Often, they don't.

- ***Poorly Designed Savings Products***: Savers want instruments that are safe and liquid. Limits on monthly transactions reduce perceived accessibility.

[8] NGOs that have become banks are discussed in the following section.
[9] The lending behavior and loan characteristics of these banks are described in Jenkins (September 2000).
[10] The successes and failures of commercial banks in microfinance are discussed in great detail in Baydas, Graham, and Valenzuela (August 1997).

III. Achieving Sustainability: New Services, New Regulations, New Governance

Not only have regulated financial institutions downscaled to include microfinance in their array of products and delivery systems, but NGOs have been increasingly transforming themselves into regulated financial institutions. That is, the movement of regulated financial institutions down market has been complemented by the graduation of NGOs into regulated financial institutions.

As discussed in the previous section, the primary motivation for a regulated financial institution to downscale has been the search for increased profits. The main reason for an NGO to become a regulated financial institution has been to achieve long-term sustainability, via a combination of the following factors:

- ***growth in the scale and scope of operations***, which in turn increases the magnitude of development impact while reducing operational costs and diversifying operational risks;

- ***access to funds***, whether in the form of local voluntary savings, large investor deposits, interbank loans, or capital market debt or equity, which decreases funding dependency and uncertainty while increasing capital leverage and the scope for business expansion;

- ***improved governance and operations***, usually the result of regulations regarding ownership composition, management standards, prudential norms, and accounting and reporting requirements; and

- ***enhanced customer service***, in the form of a wider range of products and delivery systems, together with the increased likelihood of developing a long-term banking relationship for savings, credit, and other financial services.

The first major case of a microfinance NGO becoming a regulated financial institution was the transformation of the Bolivian NGO PRODEM (Fundacion para la Promocion y Desarrollo de la Microempresa) into a licensed commercial bank, BancoSol (BancoSolidario), in 1992. PRODEM was established in 1986, and by the end of 1991, was serving 22,743 active clients, and had loans outstanding totaling US$4.5 million. By the end of 1998, BancoSol's business had grown to 81,500 active clients with a gross loan book valued at US$75 million and total savings of US$54 million.

This pioneering case has been followed by several more NGOs that have become either banks or finance companies: Corposol to Finansol (finance company) in Colombia (1993); AMPES to Financiera Calpiá (finance company) in El Salvador (1995); PRO-CREDITO to Caja Los Andes (finance company) in Bolivia (1995); CARD to CARD Rural Bank in the Philippines (1997); ADEMI to Banco-ADEMI in the Dominican Republic (1998); ACP to Mibanco in Peru (1998); and K-Rep to K-Rep Bank in Kenya (1999).

Furthermore, there are at least four more major transformations being planned: BRAC in Bangladesh; PRODEM (again) in Bolivia; ACLEDA in Cambodia; and PRIDE in Tanzania.[11]

The transformation process is extremely difficult and time-consuming. The main challenges center around the following key issues:[12]

- ***Strategic***

  Commercialization and corporatization of an NGO can be quite painful. Although it is essential to attain financial sustainability, it can lead to a divergence from the institution's mission and market, for example, by making larger loans to achieve economies of scale in credit operations.

  If credit operations are split from the NGO in establishing a finance company or bank, there can be conflicting views of the relative roles and responsibilities of the old NGO and the new regulated financial institution: Are they complementary or competitive, especially if they are both expected to be financially sustainable?

- ***Operational***

  A key attraction of becoming a bank is the authority to mobilize voluntary savings. This can be extremely difficult if the former NGO required mandatory savings as a condition of borrowing, as prospective savers might question the accessibility of their savings in the new institution.

  In addition, the operational requirements, both back office and front office, differ significantly for savings from those needed to administer a credit program: not only are the transactions both smaller and more numerous and the interest calculations more varied, but it is the saver and not the lender who determines the timing of these transactions.

- ***Regulation and Supervision***

  Microfinance is a new market for most regulatory agencies, and considerable dialogue is often necessary to find a way to adapt the objectives and norms of standard prudential regulation and supervision to measures and standards appropriate for microfinance. The most controversial are usually requirements for ownership and governance, loan classification and provisioning, and reporting.

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[11] The data for PRODEM/BancoSol is taken from Campion and White (1999), pp. 5-6. This study is a good overview of the issues and experiences of NGO transformation into regulated financial institution, and presents several case studies. Berenbach and Churchill (1997), Churchill (1997), and Kumar (1997) all deal with issues in the regulation and supervision of microfinance institutions, especially as they differ by institutional form. Maguire and Conroy (1997) investigates NGO-bank linkages.

[12] These issues are dealt with in detail in Rosengard, Rai, Dondo, and Oketch (1999).

IV. Conclusion

The landscape of commercial banking is littered with failed attempts to undertake microfinance profitably. It usually takes a considerable amount of up-front costs and socialization time, together with substantial design and field experimentation to get the microfinance products and delivery systems right in a commercial bank. But when it works, it is well worth the wait. Who will be the next BRI?

Likewise, there are many failed or stalled attempts by NGOs to become banks or finance companies. This often entails a reexamination of primary mission, learning a new way of doing business, and adjusting to accountability to new owners and regulators. But the successful transformations have produced remarkable results. Who will be the next BancoSol?

Nonetheless, one size does not fit all. There is ample room for multiple approaches to the provision of microfinance services. Potential markets are not only large, but also heterogeneous. Competition should benefit the microfinance consumer by lowering costs and improving service. The guiding principles should be institutional diversification, product differentiation, and market segmentation. ***Match the model with the mission.*** Disregard the microfinance evangelists proselytizing one way of doing business.

Whatever the microfinance institutional model, the objectives are the same. Microfinance institutions serve as formal business financing sources for microenterprises, offer communities safe and remunerative depositories for household savings, and provide complementary financial services. If structured effectively, microbanking institutions are financial intermediaries for low-income citizens, integrating formal financial markets with informal real markets and delivering financial services to previously unbanked entrepreneurs and communities. They allow the working poor to benefit from economic opportunities and to participate in economic growth. Microfinance allows the poor to accumulate assets, either by savings mobilization or the productive investment of loan capital, so that they can increase their standard of living and improve their quality of life.

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