Commercial Banks and Microfinance

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Summary

The term "microfinance" (MF) refers to the provision of banking services to lower-income people, especially the poor. In the history of MF, microfinance institutions (MFIs)[1] have been the first to identify the large unserved demand for microcredit in developing countries, develop methodologies for delivering and recovering small loans, and begin credit programs for the poor. Given their nature, though, MFIs can normally meet only a fraction of the demand for microloans in their service areas. Commercial banks have begun to see MF as a potentially profitable business and are starting to venture into this field. This approach to MF (known as "downscaling") is different from that of "upgrading" or transforming MFIs into regulated institutions. Evidence is currently showing that financial institutions can profitably attend MF needs on a massive scale. This paper aims at exploring the main aspects and future outlook in connection with commercial banks provision of MF services. A review is made of the incentives and disincentives for financial institutions to venture into the MF sector, and their specific advantages and disadvantages when competing in this market. A classification of the main operating models currently adopted by banks for entering the MF market is established as well as an analysis of the local regulations that could potentially apply to each of these models.

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[1] In the context of this paper the term MFI is reserved for non-regulated organizations that provide microfinance services, typically in the form of non-profit NGOs.

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Acronyms

ATM: Automatic Teller Machine
ANIF: National Association of Financial Institutions
BCI: Banco de Crédito e Inversiones (Chile)
BACEN: Central Bank of Brazil
BCP: Banco de Crédito del Perú
BCRA: Central Bank of Argentina
BNA: Banco de la Nación Argentina
BRI: Bank Rakyat Indonesia
CDM: CrediFe Desarrollo Microempresarial S.A. (Ecuador)
CGAP: Consultative Group to Assist the Poor
FOGAPE: Guarantee Fund for Small Entrepreneurs (Chile)
FOMICRO: Fondo Nacional para la Creación y Consolidación de Microemprendimientos (Argentina)
FOSIS: Solidarity and Social Investment Fund (Chile)
GLP: Gross Loan Portfolio
IADB: Inter-American Development Bank
IFC: International Finance Corporation
INC: Instituto Nordeste Cidadania (Brazil)
MF: Microfinance
MFIs: Microfinance Institutions
MIS: Management Information System
MIX: Microfinance Information Exchange
NGO: Non Governmental Organization
PNMPO: National Program of Oriented Productive MicroCredit (Brazil)
RC: Regulatory Capital
ROA: Return On Assets
ROE: Return On Equity
SC: Service Company
SBIF: Superintendency of Banks and Financial Institutions (Chile)
SEBRAE: Brazilian Micro and Small Business Support Service
SEFyC: Superintendency of Financial and Exchange Institutions (Argentina)
SENAC: National Commercial Training Service (Brazil)
SFC: Solución Financiera de Crédito del Perú S.A.
SME: Small and medium-sized enterprise
USAID: United States Agency for International Development

1. Introduction

The term "microfinance" (MF) refers to the provision of banking services to lower-income people, especially the poor.[2] These services include small loans for microenterprises and individuals, savings, money transfer services, means of payment and insurance. Given their nature, microentrepreneurs tend to operate on the margins of the formal economy, often without permits and commercial documentation, and usually lacking fixed assets that could serve as collateral. Formal expense and income records are generally scarce. Income is often on the lower end of the scale, although operating margins for microenterprises in percentage terms can be significant.[3]

In the history of microfinance, MFIs[4] have been the first to identify the vast unserved demand for microcredit in developing countries, develop methodologies for delivering and recovering small loans, and begin credit programs for the poor. Successful programs have reached high loan repayment rates. One of the obstacles that even successful programs had to overcome were the severe capital constraints faced by lending institutions. Unregulated and unable to access substantial amounts of commercial finance —and usually to provide voluntary savings services— these institutions can normally meet only a small fraction of microcredit demand in the regions they serve. Some MFIs have been able to overcome this situation by gradually turning themselves into commercial banks specialized in MF (upgrading).

The demand for microfinance services has rarely been met by the formal financial sector, and this may be due to several reasons, including the following:

- failure to perceive the poor households' demand for financial services;
- belief that microfinance cannot be profitable for banking institutions;
- existence of public, legal and regulatory policies that ignore MF;
- high operating costs;
- lack of specific experience in the provision of microfinance services;
- lack of adequate platforms for the provision of microloans.

However, it has been proven that this demand can be met profitably and on a large scale,[5] and many commercial banks have already identified the business opportunities of MF.[6] Commercial banks[7] have now ventured into microfinance in many countries, where microfinance is at different stages of development. In its most advanced form, in banks and other formal financial institutions, all microloans are fully financed by savings, commercial debt and retained earnings. However, in most developing countries, the formal financial sector still does not serve microfinance clients on a massive scale.

This paper aims at exploring the main aspects related to commercial banks' provision of

[2] CGAP (2003); Delfiner, Pailhé, Perón (2006).
[3] Rosenberg, R. (1996).
[4] In the context of this paper the term MFI is reserved for non-regulated organizations that provide microfinance services, typically in the form of non-profit NGOs.
[5] Robinson, M. S. (2001).
[6] In its February 2005 edition, *The Banker* featured a special article on microfinance which emphasized the fact that microfinance has become a commercial attraction for banks.
[7] Throughout this document, the terms "commercial banks" and "financial institutions" are used synonymously unless otherwise specified.

microfinance services and the future prospects for this activity.

Chapter 2 begins by analyzing the relationship between commercial banks and MF. First, it discusses which population segment would be the potential target for financial services. Afterwards, a trend that is gaining growing consensus is analyzed. According to this trend, commercial banks[8] can adequately meet the massive demand for microfinance services sustainably and on a large scale. A review is made of the incentives and disincentives for financial institutions to venture into the MF sector, and their specific advantages and disadvantages when competing in this market.

Chapter 3 offers a classification of the main operating models currently used by financial institutions for entering the MF market and provides examples of successful cases of implementation of such models.

Chapter 4 analyzes some local regulations under which the mentioned models may operate, in an attempt at defining the regulatory provisions that may possibly govern such downscaling models.

Chapter 5 analyzes a number of cases of government policy efforts aimed at spreading microfinance in several countries of the region, and their impact on the provision of microlending services. Chapter 6 offers a brief review of downscaling experiences in Argentina. Chapter 7 presents the conclusions of this paper.

2. Commercial banks and microfinance

2.1 Financial services target clients

Within the spectrum of lower-income population who lack access to financial services, a distinction can be drawn between the extremely poor and the economically active poor. The extremely poor are considered to be those individuals who have insufficient resources to meet defined basic consumption needs, including people who are not qualified to work (due to age, health and ethnic origin reasons, among others) or whose income is so low that they are not able to meet their household basic needs. This group has prior needs such as food and shelter, and therefore requires tools distinct from financial services to get out of poverty.

In this regard, Robinson M.S. (2001) asserts: "*It is sometimes forgotten —although generally not by borrowers— that another word for credit is debt. When loans are provided to the very poor, the borrowers may not be able to use the loans effectively because they lack opportunities for profitable self-employment (…),* (thus being) *unable to repay loan principal and interest.*"

Placing people who will not be able to repay the loans in debt may help neither borrowers nor lenders. In the case of borrowers, this can lead to diminishing their already low level of self-confidence. In turn, lending institutions' capacity to make loans may be reduced. Government policies aimed at development, employment generation and skill training may become an

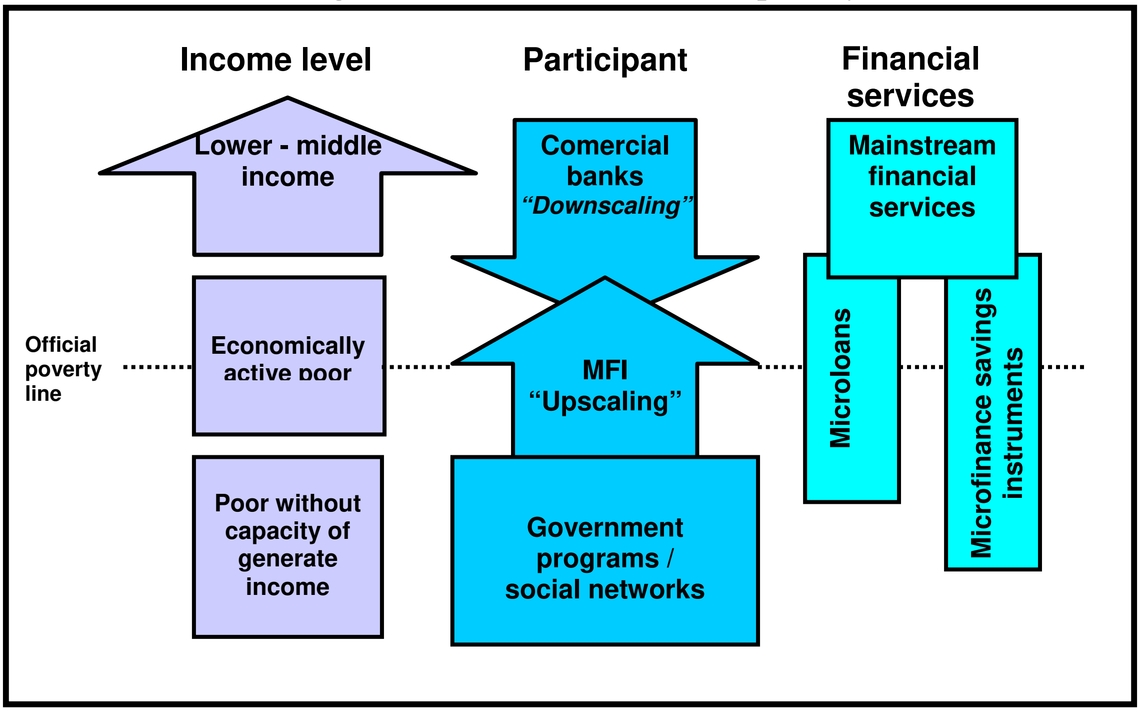
[8] Throughout this document, the term "commercial bank" is used as a synonym for "financial institution" (regulated formal institution).

adequate tool for helping the poor become microcredit beneficiaries.

The economically active poor include microenterprises, small farmers and, more recently, the concept has expanded to include low-income salaried employees, pensioners and poor households. Unlike the extremely poor, the economically active poor tend to be people who work on part-time jobs, own some private property or small business, and are capable of working and carrying out projects. Their basic needs are usually unsatisfied because their income is generally unstable due to the informal nature of their employments or self-managed productive projects.

This is the target group chosen by commercial banks when venturing into MF. Therefore, commercial microfinance is a complement to, not a substitute for, government and donor alleviation and employment generation programs for the extremely poor. The figure below shows the manner in which effective effort coordination between social welfare programs, MFIs' financial services and commercial banks could contribute to alleviating poverty.

Figure 1: Effort coordination for poverty alleviation[9]



Although the needs of the economically active poor do not differ much from those of the higher-income population, the personal and commercial characteristics of the former, as well as the amount of their commercial transactions, are significantly different from those of the latter. In particular, microfinance customers consider service, speed and agility a much more important issue than the cost of a microloan. Regarding loans, this brings about the need for documentation to be simple and for disbursements to be timely. Regarding savings, clients will consider it more important to have unrestrained access to savings accounts with low requirements than to obtain an attractive rate of return on their savings.[10]

It is important to understand the distinction between the economically active poor and the poor

[9] Adapted from Robinson, M. S. (2001).
[10] Robinson, M. S. (2001).

whose basic needs remain unsatisfied, as targeting government subsidies at the former —who could be well served by regulated financial institutions or MFIs— may have several negative effects:

- Scarce donor and government funds that would be better spent on other forms of extreme poverty alleviation would be squandered.
- The volume of credit available to the poor would be severely limited because subsidized loans are usually rationed.
- There is a risk that subsidized loans may be captured by influential groups.
- Commercial banks would refrain from entering this market because they cannot compete with other lending institutions that provide loans at subsidized interest rates (besides the damage caused to the already existing institutions which provide non-subsidized microfinance services).

2.2 A paradigm shift in microfinance

Some authors[11] speak of the consolidation of a new microfinance paradigm involving the participation of a number of complementary players.

On one hand, there is a set of policies implemented in the MF sector that are focused on providing largely subsidized loans. This somehow limits the number of loans that can be provided due to the budgetary restrictions that can be faced by government and donors. Below follows an analysis of the budgets on which the implemented policies and practices depend, and the resulting outcomes derived from the implementation of these policies and practices. As regards credit, it is widely held that the poor, due to their condition, would be unable to repay the loans that are provided at commercial interest rates. In addition, it is believed that loans need to be targeted to specific activities. Both factors have led to the development of supply-driven —rather than demand-driven— subsidized credit programs. Some of these policies have resulted in high levels of default and heavy losses. At times, subsidies were used with different purposes and targeted at influential elites. As regards savings, it is believed that the poor have no capacity to save or that those who save prefer non-financial forms. As a consequence, the provision of voluntary saving instruments is not even considered, therefore threatening the MFI's sustainability because of lack of funds.

However, experience has demonstrated that through an adequate legal, political, macroeconomic and regulatory environment, the development of financial institutions that provide the economically active poor with financial intermediation services can be possible. These services could be provided on a profitable, sustainable, unsubsidized and large scale fashion, and they may serve as a complement to government and MFIs poverty alleviation and employment generation programs for the extremely poor.

For a better understanding of the growing consensus on which this new paradigm is being built, it is worth considering the following assumptions and the relevant programs implemented as well as their results:

- There is extensive demand for microcredit that could be met at the commercial interest rates that commercial providers need to charge to achieve full cost recovery. In turn, the economically active poor are capable of repaying loans at commercial rates when loan terms

[11] E.g., Robinson, M. S. (2001) and Harper & Arora (2005).

are appropriate and borrowers have a reason to preserve their relationship with the institution throughout time. Under these assumptions, the provision of microfinance services is commercially viable as long as the use of short-term working capital loans with simple procedures and built-in repayment incentives is emphasized.

- There is massive demand for savings instruments among the poor driven by transactional and security reasons, rather than by return rates. In a stable economy other forms of savings will often be inferior to financial savings. MFIs need to learn in what forms and for what purposes their clients save in order to design instruments that adequately meet the demand, due to the fact that a mature microfinance intermediary is likely to capture more savings accounts than microfinance loans.

- The magnitude of the global demand for microfinance services is such that it can be met only by sustainable financial institutions. In order to remain sustainable, the spread between loan interest rates and the cost of funds demanded by these institutions will be higher than that of traditional ones due to their higher operating costs. What these institutions require for their adequate functioning is only an enabling macroeconomic, political, legal and regulatory environment. Thus governments and donors should be increasingly concerned with disseminating information about best practices in commercial microfinance, rather than with funding the ongoing loan portfolios of particular institutions.

2.3 Incentives and disincentives for commercial banks entry into MF

Banks and financial institutions have been entering the microfinance market in increasing numbers over the past years. This phenomenon (known as downscaling), together with that of upgrading, is resulting in a growing number of formal regulated institutions partially or totally moving into MF.

It is necessary to analyze what drives a traditional banker to engage in MF in order to fully understand why downscaling has developed so much worldwide. There are several factors that motivate the bank to start making microloans. These factors are related both to the bank's internal organization and to the market in which this bank operates. However, the main incentive is basically related to the fact that profits are in line with the risks incurred.

Growing competition in markets traditionally served by banks —e.g., loans to big companies, small and medium-sized businesses and consumers— along with the resulting fall in banks' returns has encouraged the search for new market *niches*. In countries with no experience in MF, there exists an unattended market segment which may be viewed by banks as a potential source of rapid growth and positive returns.

The first products generally developed by institutions entering MF are microloans. However, as the business progresses, institutions start offering a broader range of products. The possibility of cross-selling is another positive aspect that commercial banks take into account when deciding to enter this sector. Commercial banks can offer their clients a range of products, including banking services, means of payment, money transfer services and insurance. Major banks have adapted their structure (contacts with insurance providers, branches abroad for fund transfers, ATM networks across the country) precisely for the delivery of these products.

Entering a new sector enables banks to diversify their loan portfolio, focusing on a population segment previously unattended by them. By making loans to thousands of small borrowers, the microlending portfolio itself achieves substantial diversification in terms of number of clients served, although the level of diversification by activity and geographical area is usually low. Commercial banks can overcome this obstacle thanks to their branch networks across the major cities in the country. 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.[12] Similarly, having a sector specialized in MF may help commercial banks improve their public image, as caring for the most disadvantaged social sectors is welcomed by clients and society in general.

The IADB[13] points to the existence of underutilized capacity in some banks as one of the reasons for them to enter MF: excess liquidity or underutilized branches or information systems can reduce costs and encourage banks to get into microlending. Another reason for entering this field is the availability of free or cheap donor technical assistance. Many case studies show cooperation agreements between banks and international MF support networks, in which the latter provide training to institutions that have recently begun to operate in the field of MF.

Table 1: Drivers for bank entry into microfinance

Internal Factors	External Factors
Profit	Large microenterpise or low-income market
Risk diversification	Competition
Excess liquidity	Trend or fad
Image	Regulations
Cross-selling opportunities	Government or donor initiative
Bank leadership	Market pressure on margins
Social responsibility	Desertion of traditional clients
Public relations	
Compatibility with bank strategy	

Source: USAID (2005).

Regardless of the commercial reasons encouraging banks to enter MF, policies imposed by some governments, aimed at contributing to the development of the MF sector, have driven or even compeled the financial system to provide loans to low-income sectors.[14]

The decision of commercial banks to enter MF is also affected by external factors. In this sense, the most effective way for governments to encourage commercial banks to become involved in microfinance is to ensure an appropriate regulatory and prudential framework. The elements of an optimal non-restrictive policy context identified by literature are:[15]

- sound macroeconomic policies and basic infrastructure to ensure a growing economy;
- a growing range of financial products;
- minimal restrictions to profitable lending, particularly no interest rate caps.
- enhanced ability to establish a small commercial bank which can focus on this sector;
- appropriate prudential regulations for this market including capital adequacy ratios and asset quality indicators.

[12] Transformation of MFIs into commercial banks specialized in MF.
[13] Westley, G. D. (2006).
[14] Chapter 5 includes a list of national policies implemented by some governments in the region.
[15] Goodwin-Groen, R. (1998).

Having all these elements in place will not necessarily guarantee that commercial banks will start microfinance lending. However, there certainly won't be external constraints to start the activity.

The Harvard University[16] has carried out a survey in order to better understand what encourages banks to enter MF. A detailed questionnaire was sent to 220 banks in 78 countries. This questionnaire was designed to identify the banks that were involved in micro (USD 0 - USD 10,000) and small (USD 10,000 - USD 100,000) enterprise finance. Out of the 220 surveyed banks, 148 (98 of which are privately owned and 50, state owned) reported that they have been making small and microenterprise loans (60 banks are making microloans, 49 banks are making small loans and 39 banks are making both micro and small loans). The answers given by these banks to the question "what were the main reasons for the bank to start making loans in this sector?" are shown in Table 2. Survey results indicate that banks enter this market mainly for commercial reasons.

Table 2: Reasons why banks make micro and small enterprise loans

Reasons	Number of banks	% of total
Profitability of micro and small loans	72	49%
Increasing market competition in lending to large/medium enterprises	64	44%
Social objectives	29	20%
Regulations imposed by the government	25	17%

Some banks indicated more than one factor that affected their decision; therefore, the total number of responses exceeds the number of banks (148) in the sample.

It is worth analyzing the reasons that discouraged the 72 banks which did not make small and microenterprise loans from entering in this market [Table 3]. Contrary to a widespread belief that banks are not interested in microenterprises, only 7% of these 72 banks indicated that they were not interested in microenterprises.

Table 3: Disincentives for making micro and small enterprise loans

Desincentives	Number of banks	% of total
Higher administrative costs	29	40%
Lack of network and personnel to serve this market	23	32%
Interest rate controls	21	29%
Other	18	25%
Risky borrowers	12	17%
Not interested in microenterprises	5	7%

Some banks indicated more than one factor that affected their decision; therefore, the total number of reasons for making small loans exceeds the number of banks (72) in the sample.

Higher administrative costs seem to be the main discouraging factor that prevents banks from entering microfinance. Administrative costs are high due to the nature of the business, which involves charging high interest rates for making successful micro and small enterprise loans that are commercially sustainable. The implementation of interest rate controls in some countries has been one of the major factors that discouraged banks from entering MF,

[16] Jenkins, H. (2000).

although the situation is changing as governments are gradually lifting these controls.[17]

There is extensive evidence that banks that enter microfinance are successful and that their performance indicators outdo the general standards of the banking industry. Table 4 below shows averages weighted by assets drawn from a MIX's sample of commercial banks engaged in MF.[18]

Table 4: Performance Indicators for Commercial Banks Engaged in MF[19]

Indicators	Average Weighted by Assets
Average Loan Balance per Borrower	1,432
Average Savings Balance per Saver	1,260
ROA	4.0%
ROE	22.9%
Profit margin	15.8%
Operational Self-Sufficiency	121.1%
Borrowers per Staff Member	147
Savers per Staff Member	138
Cost per Borrower	206
Operating expense / GLP[20]	19.7%
PAR > 30 days	4.4%
Write-Off Ratio	2.0%
Women Borrowers (%)	53.6%

Note: Grameen Bank and Bandesarrollo have been excluded from these averages.

From this table and the table included in Annex 1 the following conclusions can be drawn:

- The microloan portfolio is largely financed with savings of small savers. It can therefore be inferred that these institutions no longer depend on government or international donor lines of credit to subsidize their operations.
- Profitability and operational self-sufficiency indicators do not differ significantly from those shown by the MFI industry,[21] suggesting that these figures are closely connected with the microfinance activity, regardless of the institutions engaged in it.
- Out of the 30 institutions, only 5 small banks reported losses due to low operational efficiency (high operating expenses/GLP ratio and small number of borrowers per staff member) as compared to the rest of the surveyed banks.
- The 2% write-off ratio indicates a rather low portfolio risk (even in the 5 institutions reporting losses), although these values are higher than those reported by the traditional banking

[17] The section below includes a more comprehensive discussion on interest rates controls and their impact on MF.
[18] 2005 Data. Annex 1 includes complete information on all the commercial banks engaged in MF selected for this study. The criteria for selection were based on the quality of the information provided in accordance with MIX standards (banks rated 4* and 5*; the latter are required to have an audit performed). Grameen Bank and Bandesarrollo (Chile) were not considered in this analysis as some of the ratios reported by these institutions evidenced miscalculations. Credit unions have not been included, as in many countries they are not regulated by the banking authority.
[19] 2005 Data. Profit margin = Net operating income / Total revenue; Operational Self-Sufficiency = Total Financial Revenue / (Financial Expense + Operating Expense + Net Loan Loss Provision Expense). Amounts denominated in US dollars.
[20] Gross loan portfolio.
[21] See Delfiner, Pailhé, Perón (2006).

industry (an average of 0.41% in the U.S. for the year 2006; 0.80% in Chile for the year 2006 and 1.46% in Argentina for August 2006).[22]

By contrast, profitability indicators - such as ROE and ROA - are generally above those reported by traditional banks.

Table 5: Banking system versus MF profitability[23]

	Banks Microfinance	Banking System U.S. 2005	Banking System Argentina 08/06	Banking System Brazil 2005	Banking System Chile 08/06
ROE	22.9%	14.73%	12.85%	24.0%	19.6%
ROA	4.0%	1.21%	1.60%	2.2%	N/A

Institutions entering the MF market, however, will not always be successful. Many banks have failed to understand MF idiosyncrasy or have hastened to enter into this market. The experience thus far shows that, to succeed, bankers interested in entering the microfinance market must understand the real challenges and means to achieving growth and profitability in this field. Once microfinance operations are under way, banks must constantly balance three pillars to achieve the expected success:[24]

- High *volume of operations,* which is achieved by reaching thousands of clients, each with numerous, small and short-term transactions.
- *High quality client service*, which is delivered to meet the socio-economic needs of clients often living in the informal economy and traditionally marginalized from formal financial institutions.
- *Risk management systems* managed by trained people and customized to the high volume of operations and informal nature of the clients.

The advantages and disadvantages of commercial banks entry into MF are directly connected with MF's unique features, which differ from those of traditional banking. Below is a summary of the characteristics that apply to banks in general.[25]

Table 6: Competitive advantages for commercial banks entry into MF

- Extensive network of branches.
- Technology infrastructure: ATMs, MIS, among others.
- People with skills in areas such as information technology, marketing and legal management who can support microfinance operations.
- Market presence and brand recognition.
- Access to low-cost funds through deposit-taking.
- Lower operating cost structure.

Large commercial banks often have an extensive network of branches, frequently covering all major cities in a country. Banks can take advantage of the cities that prove suitable for microfinance by venturing into this market and thus benefiting from their long-time presence in the area. The advantages are often connected with benefiting from the already established

[22] Sources: Federal Reserve (2006); SBIF (2006); SEFyC (2006). In Argentina unrecoverable loans are classified within categories 5 and 6 under BCRA regulations.
[23] Source: Federal Reserve (2006); BCB (2006); SBIF (2006); SEFyC (2006).
[24] Young, R. & Drake, D. (2005).
[25] Lopéz, C. & Rhyne, E. (2003).

connections with clients (through ATMs and branches), internal service areas suitable for large scale economies (marketing, human resources, information technology) and brand recognition.

Access to finance through taking deposits from the general public is another comparative advantage of commercial banks as opposed to MFIs engaged in microlending, which in many countries are not allowed to take deposits and, if allowed, only have access to lower-income depositors' savings.[26]

Table 7: Disadvantages for commercial banks entry into MF

- Higher operating costs.
- Lack of knowledge of the microfinance market.
- Implementation of credit methodologies inappropriate for the MF market.
- Labor-intensive nature of microenterprise credit as the antithesis of the banking sector drive toward automation.
- Conservative corporate culture contrary to MF.
- Lack of human resources who are comfortable working with lower-income social sectors.

Disadvantages are mainly related to the high operating costs involved in MF due to the very nature of the business as opposed to traditional banking practices. Permanent contact with the client and the need for adequate staff are one of the challenges that commercial banks must face, as the MF service approach is different from that of traditional banks and requires staff especially prepared to work with lower-income sectors.

Besides the aspects listed above, which apply to banks in general, each institution will possess additional advantages and disadvantages according to its particular structure (market segment, geographic location, internal bureaucracy, source of funding) and the way in which the bank may choose to enter MF (these issues are discussed in Chapter 3).

2.4 The "interest rate" issue

Poor residents in many countries could benefit from the expansion of microfinance as financial institutions can serve clients with more useful and less expensive financial products than those available from moneylenders. However, large scale expansion of microfinance is only feasible if it can be accomplished self-sufficiently, without subsidy, or with a temporary subsidy that the government can support and in a way that will enable financial institutions to become self-sustainable in a near future.[27] For example, Ravicz (1998) examines five Indonesian microfinance programs and finds that subsidies can play a valuable temporary role in the supply of microfinance. If these programs had been not subsidized in their early years, they would have been forced to charge interest rates that clients couldn't have afforded to pay. Subsidies have given these programs time to develop the approaches, scale and staff and client experience necessary to move towards self-sustenance while charging high but affordable interest rates.

In many countries, due to different reasons, there are regulations that limit the interest rate that the financial sector may charge. In the case of microfinance, although there seems to be consensus in the specialized literature as regards the benefits that the liberalization of interest

[26] Lopéz, C. & Rhyne, E. (2003).
[27] Ravicz, R. Marisol (1998).

rates would bring to the microfinance industry, in practice there seems to be no consensus yet, as there are cases in which interest rates are capped or subsidized. Protecting the poor is generally seen as politically correct. However, in most cases, the negative impact that these policies may have on market development are not taken into consideration.

It is widely acknowledged[28] that interest rate restrictions do not generally achieve the intended public policy purpose of expanding access to credit by lowering the price. In fact, low interest rate ceilings have adverse effects on the supply of credit, its price and the transparency of the terms offered to borrowers: in some cases, financial institutions circumvent the ceilings by adding fees and other charges, thus raising the cost of credit. In other cases, enforcement is weak, putting into question the rationale of such policy decisions. But in both cases, it is clear that the supply of credit, particularly to rural areas and borrowers who are perceived as high risk, is simply withdrawn, obliging them to resort to informal moneylenders against whom they have little or no protection.

Given the low effectiveness of the policies designed to protect the poor by establishing interest rate ceilings and the need of institutions to charge interest rates that may allow them to remain sustainable and able to supply resources uninterruptedly, other policies are recommended which governments may implement for the benefit of low-income people, allowing, in turn, the microloan market to develop. In this sense, CGAP[29] proposes to promote innovation and competition among institutions, which will improve efficiency and lower prices (e.g., in Bolivia, BancoSol's effective interest rate was 65% per year when it began its operations in 1992 with 4,500 clients; today, in a highly competitive market and with 55,000 clients, its annual percentage rate is 22%)[30] and pass transparent consumer protection laws that may allow borrowers to comparison-shop for loans. This stimulates competition among lenders and teaches consumers to analyze credit costs, advising them on how and where they can obtain complete and understandable information.[31]

Beyond these considerations, the concern about high interest rates charged to the poor by financial institutions is legitimate. High interest rates may reduce profitable business opportunities and limit asset accumulation by low-income people. However, evidence shows that liberalized interest rates lead to the entry of new participants who, through competition, manage to reduce costs by using advanced technologies.[32]

Rosenberg[33] points out that there is overwhelming empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support MFI sustainability. In particular, he asserts:

- informal credit markets already exist in most poor communities. One typically finds lower-income borrowers taking and repaying repeated informal loans at interest rates much higher than any formal MFI would charge.
- MFIs charging very high interest rates almost always find that demand far outstrips their

[28] United Nations (2006).
[29] Duval, A. (2004).
[30] Presentation by Lic. Pilar Ramírez, president of the FIE (Fondo Financiero Privado S.A.) in Bolivia, during the "Seminario Nacional de las Microfinanzas," Ministry of Foreign Affairs, Buenos Aires, 11/23/2005.
[31] In South Africa, for example, the government requested the Microfinance Regulatory Council to protect consumers and regulate microfinance institutions. Nowadays, it requests microfinance institutions to spread the cost of loans and launches educational campaigns for consumers, among other protection measures.
[32] Duval, A. (2004).
[33] Rosenberg, R. (1996).

ability to supply it. Most of their customers repay their loans and return repeatedly for new loans: this pattern demonstrates the customer's conviction that the loans are convenient for them.
- several informal surveys suggest that it has never been heard of a microfinance program that ran into trouble by driving away clients because interest rates were too high.

The assertion that poor people's small businesses can often pay interest rates that would strangle a larger business is often counterintuitive. This can be explained in the following terms: interest rates will not be high for credit borrowers as long as they can add an additional unit of capital to raise production levels, thus offsetting credit costs. Rosenberg illustrates this with the case of a Bolivian woman who sells merchandise from a blanket that she spreads every day on a street in La Paz. Her sales, and thus her income, are directly proportional to the time she is sitting on the street, offering her goods. Because of her shortage of working capital, she spends two hours of each ten-hour workday traveling to purchase supplies from her wholesaler, whose warehouse is outside the city. These two hours produce no sales or income for her. If a working capital loan allows her to buy inventory for three days at a time instead of one, she can save eight hours in travel time each six-day week. This translates into 17% increase in selling time, and thus in her sales, every week. If the amount of the working capital loan doubles her daily sales, and her gross profit is 25% of sales, then she could afford to pay 40% a month on the loan and she still come out slightly ahead. This kind of analysis makes it easier to understand the assertion that poor entrepreneurs consider ongoing access to credit much more important than the actual credit cost.

The example above is also helpful for understanding that microentrepreneurs incur several types of costs when they apply for and receive a loan. The loan effective interest rate, which includes the commissions and fees charged in addition to the interest, represents the loan financial cost. The nominal interest rate is generally considered the most important component of the financial cost. However, depending on the structure of the loan, the financial cost may be quite above the interest rate and, in turn, the financial cost may represent a small fraction of the total costs incurred by the borrower.[34]

Apart from the financial costs, which are explicity fixed by the credit institution to generate income, the microentrepreneur incurs transaction and opportunity costs. These are indirect costs born by the borrower which are not received by the lender.

Castello, Stearns and Christen[35] —on the basis of a survey on income and expenses conducted with eleven debtor microentrepreneurs from programs affiliated to ACCIÓN International in Chile, Colombia and the Dominican Republic— found that, on the one hand, in all of the cases the interest rate charged was equal or higher than the nominal commercial interest rate in the pertaining country. On the other hand, they found that the average monthly financial costs of the loans was below 1% of the total costs incurred by half of the sample participants, and for the rest it did not exceed 3.5%.

Another factor that should be taken into account when assessing the financial impact of microcredit programs is whether the credit replaces a costlier source of funding. Many times, in order to prove how costly MF is for the poor, the interest rate of microfinance operations

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[34] Castello, C., Stearns, K. & Christen, R. P. (1991).
[35] Castello, C., Stearns, K. & Christen, R. P. (1991).

is compared with the interest rate charged by traditional banking institutions, but generally this comparison is not outright correct, since bank loans are not always the alternative source of funding for low-income people. In general, the alternative source of funding for microentrepreneurs are informal lenders; there are statistics of debtors of programs affiliated to ACCIÓN International showing that 70% of the people surveyed had obtained informal credits at an interest rate ranging from 7% a month to 20% a day before joining ACCIÓN International programs.[36]

There is no evidence either that poor people find it more difficult to repay loans with commercial or higher financial costs than highly subsidized credit. Evidence shows, by contrast, that subsidized credit is more likely to be associated with greater payment delays.

For borrowers, it seems to be more important the quickness of the credit disbursement and the simple steps to obtain it —all of which is evidenced by the transaction and opportunity costs— than the interest rate. Informal lenders often grant loans immediately, and this reduces significantly the borrower's transaction and opportunity costs. In such informal sectors, lenders do not impose on borrowers costs which the former cannot collect directly. However, in order to compensate for the lack of an appropriate credit assessment, they charge extremely high financial costs. Informal lenders operate on a small scale and face investment opportunites similar to those faced by their debtors; therefore, for a private lender the financial income must be as high as the income obtained from capital invested in other small-scale activities. This income is far greater than the market interest rates. They also have to charge an interest rate enough to cover losses arising from failures to perform and compensate their risks. Furthermore, in some places, the demand for quick credit is greater than the supply and the only suppliers of funds are private lenders. As a result, interest rates charged by informal lenders are extremely high.

The high cost of microloans does not necessarily entail a greater inherent risk for low-income people. As a matter of fact, well-defined microloan programs have lower default interest rates than commercial banks. Microloans imply higher operating costs given the higher distribution costs of small loans which require a face-to-face relationship between debtor and creditor and because microfinance institutions use personal contact as a substitute for traditional collaterals or credit scoring computerized techniques. The cost of a small loan will always be greater in percentage terms as compared with the cost of a large loan. With the interest rate charged, three kinds of costs have to be covered: the costs of lent funds, the cost of risk (for loan losses) and administrative costs (identification and selection of clients, processing of credit applications, distribution and collection of loans and follow-up of loans in arrears).[37]

3. Operating models for downscaling

There is not one single way in which banks become engaged in MF market —they can do it directly or indirectly, according to the type of relationship the bank has established with the clients. Some banks enter the market directly by expanding their retail operations to reach micro clients by creating an internal unit or launching a separate company, such as a service company or a specialized microfinance institution. Others take an indirect approach by

[36] Castello, C., Stearns, K. & Christen, R. P. (1991).
[37] Helms, B. & Reille, X. (2004).

working with existing microfinance providers.

One of the major challenges that banks have to face in order to establish a division that provides microfinance services consists in selecting the proper model. To do so, they should consider the implications in terms of costs, the risks that they are prepared to assume when starting operations, the regulatory effects and the decision of whether to operate independently or with strategic alliances. To some degree, the model implemented will depend on the bank's business goals and the existing competitive and regulatory environment.

ACCIÓN International identifies four models of commercial bank entry into MF:[38] the internal unit, the financial subsidiary, the service company and the strategic alliance. The main characteristics of each model and the challenges they present are described below.

3.1 Internal unit

Banks can create MF units or even introduce a microcredit product within an existing unit. The unit is neither a separate legal entity nor regulated separately from the commercial bank.

The advantage of this model is that the internal unit can be closely integrated into the bank cost-effectively and fast, since the creation of a separate organization is unnecessary. This avoids high start-up costs associated with the formation of a new entity to perform the same function. Furthermore, it leverages the bank's public image and the development of its trademark.

There might be variations within this model since banks can give further autonomy to the internal unit by creating exclusive loan procedures, computing systems, and staffing and governance policies. The additional staff required are mainly those directly involved with operating microfinance services. While the creation of an internal unit can be successful, two major disadvantages must be overcome:

- the bank must somehow differentiate the staff of the MF unit from the staff of the mainstream bank in order to build a distinct corporate culture within the MF unit.
- more difficult to overcome is the lack of independent governance for the MF unit. Without separate governance, the MF unit comes under the governance of the mother bank, where critical decisions are taken by groups of bankers with limited exposure to MF.

Likewise, CGAP[39] has identified six successful drivers for success under this model:

- Structure the unit within a relevant bank department.
- Leverage use of existing bank infrastructure including branch network, ATM network, database terminals and proximity to potential clients.
- Build the model product and financial projections so that the bank will serve a large number of clients within 1-3 years to reach high-volume economies of scale needed for profitability.
- Motivate and train personnel for specialized operations of MF.
- Adapt bank systems and lending procedures.

[38] Lopéz & Rhyne (2003).
[39] Isern, J. & Porteous D. (2005).

- Ensure that the systems provide timely and accurate information on the loan portfolio.

A survey carried out in 18 Latin American banks[40] has proven that there is a key problem among most banks that implement this model but could not achieve a considerable number of loans —the internal unit can be immersed in a bureaucratic environment by trying to offer microcredit products properly designed and by using processes according to best practices.

Many banks may simply need additional time to get organized in order to grant small short-term loans characterized by:

- frequent repayments,
- little or no documentation or formal guarantee requirement,
- highly decentralized approval procedures with little or no participation of the bank departments other than microcredits,
- interest rates much higher than what the bank may be used to handling,
- a strict recovery process that strongly affects poor people who cannot pay their loans,
- a compensation system for loan officers based on the performance of their portfolios and
- other features that may not be consistent with the risk control measures established by the banks, the operating procedures and the general responsiveness.

Moreover, at least during the first couple of years, the microcredit portfolio usually remains small and its contribution to the bank's global earnings is modest, which might bring doubts about how the bank is benefited.

Therefore, an advantage of granting microcredits by implementing an external organization model as opposed to the internal unit one is that it can generally avoid the inconveniences resulting from the rigidity, bureaucracy and culture of the bank. This structure may be especially useful for the most inflexible banks, which would assess much more the microcedit internal unit capacity of using adequate products and procedures.

Establishment of a MF division has succeeded in a number of cases, however, including Banco do Nordeste in Brazil and Bank Rakyat Indonesia (BRI – Unit Desa), two of the largest MF programs in the world, and both being state-owned. Another successful case of this model, but in the private sector, is the Agricultural Bank of Mongolia. This bank emerged from an ambitious turnaround strategy launched in 1999. It is the main provider of financial services in rural areas of Mongolia.

3.1.1 Internal unit implementation example: Banco do Nordeste (CREDI-AMIGO Program)[41]

Banco do Nordeste is a state-owned bank that acts as a first-tier regional development bank in the Northeast Region of Brazil. In 1997, it approached ACCION International for help in designing a microcredit program: CREDIAMIGO.[42] This program is part of a general program of the bank to assist the northeast region of Brazil, which is the poorest area of

[40] Valenzuela, L. (2001).
[41] Information drawn from the Banco do Nordeste 2005 Audit Report, web page and from a survey carried out directly to the bank's authorities.
[42] See www.bnb.gov.br.

the country. CREADIAMIGO was launched as a pilot project in five branches and it expanded to 51 branches in only a year. Today, it is one of the largest microlenders in the world, serving 195,000 active borrowers through a network of 193 branch offices as of December 2005.

Since 2003, Banco do Nordeste signed an agreement with Instituto Nordeste Cidadania (INC) with the aim of implementing the CREDIAMIGO program and training its clients. INC was founded in 1993 by Banco do Nordeste officers. It is an independent non-profit civil organization with a staff of collectors, administrative consultants, loan consultants, coordinators and human resources consultants.

CREDIAMIGO acts as a fist-tier bank in partnership with INC, which is in charge of the operating procedures and the human resources administration. As part of that partnership, the bank is responsible for approving loans, defining goals and strategies for training loan officers as well as the methodological procedures, providing information systems, furniture and equipment, and publishing the institutional advertising campaigns. INC is in charge of presenting credit proposals to the bank for final approval, assisting the clients, and selecting, hiring and training loan officers and clients. The credit risk of the loans granted by CREDIAMIGO is assumed by Banco do Nordeste.

Banco do Nordeste's credit lines are the main funding sources of the program as well as a loan granted by the World Bank in 2000 to consolidate and expand the program. Another funding source are the funds from the Workers' Support Fund and those from the National law that binds banks to leave 2% of their demand deposits for microcredit operations.[43] The program consists in just granting loans but not receiving deposits. The microfinance loan portfolio accounts for more than 99% of the total assets.

Although being part of Federal Government policy, CREDIAMIGO is a sustainable program with an arrears rate of 0.84% in 2004.[44]

More than 90% of the program clients work with the group loan model (a solidarity group formed by 3 to 10 unrelated people in which the borrowers become jointly liable) though individual loans can be obtained if the applicant was previously granted two group loans and has somebody to act as a guarantor. Personalized assistance is provided to the client and within the same office of the entrepreneur. The bank acknowledges that training the borrower is crucial in order to ensure the operation success.

The clients that form the loan portfolio of the program have a homogeneous profile. They mostly own microenterprises that operate in the informal sector of economy with assets varying between USD 430 to USD 3,400 approximately,[45] intended for production, goods trading and service provision. Mainly, the owners of the project are involved in the operating areas of the business.

The major product of the program is the *popular solidarity working capital*, which stands out for having a 2% interest rate per month. Amounts limited to USD 430 can be granted with an

[43] Laws regulating the Brazilian microfinance market are detailed in Chapter 5.
[44] Source: www.bnb.gov.br/ambiente de microfinanzas. Arrears rate is the list of amounts in arrears by 1 to 90 days, with active portfolio at the end of each year.
[45] Exchange rate: 0.43 USD /Real (on 30/12/05).

up to six-month repayment term in biweekly or monthly fixed payments. This loan is intended for financing the purchase of goods and raw material. Other loans offered by the bank to buy goods also have a six-month term and can amount up to USD 3,400. The credit for *fixed assets* has an interest rate of 3% per month repayable in monthly installments within 36 months, and a collateral is required.

The program also provides business consulting services to its clients so that they can enter the market competitively. According to the bank, the resulting success of the project is the best guarantee to reimburse the loans that were granted. Mandatorily, everyone who applies for a loan receives a free current account to manage their funds with cards. Moreover, an optional insurance is available that indemnifies the borrower's relatives in the event of death.

Since mid-2005, a new loan model started to be implemented. It consisted of establishing *village banks* integrated by 15 to 30 microentrepreneurs who owned or wanted to start a productive activity.

Table 8: CREDIAMIGO policy for microloan provision and repayment*

The program's policies for the provision and management of loans stipulate the creation of an *Approval Committee* formed by a coordinator consultant, an administrative consultant, an independent loan consultant and the loan consultant responsible for the proposal (who has no right to vote when deciding about the granting.) The loan consultant, who is in charge of the proposal, handles the committee a summary with information related to the project. If approved, the proposal is submitted for regional validation before fund disbursement is implemented. The parameters considered for loan provision are related to the personal and financial profile of the borrower. Emphasis is laid on analyzing the actual need for funding and on the repayment capacity generated by the project.

Once the loan is granted, the loan consultant must schedule monthly business meetings, as well as occasional informal ones. After these visits, the loan consultant must prepare and submit a form including a summarized report of the situation. The bank believes that scheduling these business meetings is a key strategy to build customer loyalty and to maintain an adequate arrears rate. In addition, the aim of such meetings is to undertake the necessary corrections, guide the client and evaluate their future borrowing capacity.

In the event of arrears in payment, the coordinator consultant and the loan consultant will be in charge of collecting the loan. The latter should meet the client at least four times during the next two weeks, and the first meeting should be scheduled on the first day of delay. A letter requesting the client to pay, signed by the loan consultant, is sent to the client during that period. If no answer is received, the coordinator consultant should meet the client twice (between the 16 and the 30 days of arrears) and send another letter signed by him.

If the length of delay reaches 30 days, the client's name is included in the Credit Protection Service. Legal action for collection is the last available resource, although in many cases such legal action is not taken due to the high legal fees and the low amounts of the operations.

Ninety seven per cent of the portfolio did not present delayed payments as of December 2005, and provisions accounted for 0.8% of total portfolio, which amounted to over USD 60.3 million.[1]

There are incentive plans for loan consultants and their salary is directly affected by their performance. In order to decide on their salary, some defined indicators are taken into account. Such indicators reflect the number of new clients, the rate of loan renewals (cancelled loans / granted loans), the portfolio at risk and the loss flows (loans overdue >90 days). The coordinator consultants and

managers use these Budget Management indicators and the return on the active portfolio. Factors are determined based on the program strategy so that they can be adjusted according to the needs.
All this compensation system is possible due to the managerial information systems that the technicians from Banco do Nordeste especially developed for CREDIAMIGO.

1 According to Resolution No. 2682 of Banco do Brasil S.A., credit transactions of up to R$ 50,000 (around USD 21,400) may be classified according to the number of days past due. In Brazil, regulations establishing overdue loan classification do not allow for a special treatment of microcredits.

Source: External Audit Report, December 2005.

3.1.2. Internal unit implementation example: Bank Rakyat Indonesia (BRI)[46]

Another key example of a microfinance provider on a large scale is Bank Rakyat Indonesia (BRI) with its Unit "*Desa*" (Village Units) System —its MF division.

BRI is a state-owned commercial bank that traditionally focused on rural areas with special emphasis on agricultural credit. In the early 1970s, BRI developed a subsidized credit program for rice producers, in a massive effort aimed at getting self-sufficiency of production for local consumption (goal accomplished in 1985). In order to do so, 3600 units *"desa"* were established. Such units formed a network of offices located in villages and were created to channel credits. This system set loan rates subsidized by an annual 12% or 15% to pay the deposits, which completely discouraged the actions aimed at savings deposit-taking by BRI units *"desa"*.

Long-term results showed that the low cost credit program was often targeted at small groups that had certain influence to obtain such credits. Low-income people ended up turning to the informal market, which operated with higher interest rates. Moreover, as the program was undergoing a high rate of defaults and heavy losses, in 1983 a discussion was held concerning its conclusion or a complete restructuring. Finally, the second alternative was chosen and the government decided to transform the units "*desa*" into a state-owned self-sufficient commercial banking system at local level, offering a wide range of loans according to market-based rates. Unlike what was stipulated in the past, each unit *"desa"* would manage local transactions in an autonomous and self-sufficient manner, being the local manager responsible for the quality of the loan portfolio and the profit margins.

After a first stage, a new program called KUPEDES[47] was designed. It consisted of small loans at market-based rates, and it was to be offered through the units *"desa"* network. These loans would be quickly granted for working capital (short-term) or for investment capital (up to 5 years). In order to ensure the borrower's compromise to repay his loan, it was also required the signature of a joint debtor (usually the applicant's couple) or collateral (generally, property). Ultimately, BRI's goal is to offer a massive and highly standardized product, designed to satisfy the demand of millions of applicants and minimize the unit transaction costs.

During 1984 and 1985 new saving instruments were introduced, which made possible to meet the flexibility, liquidity and convenience demand required by investors. *"Spreads"* were fixed so that they could cover all the estimated costs and provide the bank with a profit margin.

[46] This example is based on Robinson, M.S. (2001) and United Nations (2006).
[47] Kredit Umum Pedersan or General Rural Credit in English.

Soon after its implementation, the loan program was to be financed almost exclusively by local savings. In 1989, the system was extended to low-income urban areas.
Between 1984 and 1996 the unit *"desa"* system worked perfectly well, increasing the number of loans up to 18.5 millions, which amounted to USD 11.1 billion. By the end of 1996, the average loan size stood at USD 687,[48] even though the scope of available loans ranged between USD 11 and USD 10,685. Since 1986 the system started to be profitable, and in 1987 it became independent of subsidy. In 1996, the division's ROA was 5.7% before tax compared with the national average of 1.5%. It should also be considered that loans were granted in a very conservative way as opposed to the rest of the banking system; that is to say, the performance was even better than what these figures showed.

In addition, deposits increased substantially, reaching 16.1 million of deposits at a value of USD 300 million in 1996 (in 1983, the system had only attracted USD 18 million). This was achieved with low rate deposits, but which allowed unlimited withdrawals, apart from awarding prizes. In view of the fact that these instruments were designed based on a deep knowledge of the financial local markets, there was a constant and growing demand. In 1996, the average account was of USD 185, which was equivalent to 17% of the per capita gross national product.

The financial crisis that overcame Indonesia between 1997 and 1999 showed the BRI microfinance division as one of the most stable institutions throughout the country. No run on the deposits of the units *"desa"* was observed, and in terms of local currency, loans remained stable and the repayment rate stayed particularly high given the current circumstances. Despite the drastic decline in real income and a higher rate of unemployment, this could be pointing out that clients regard their credit history and want to keep open the possibility to renew their loans at difficult times. Consequently, the crisis did not have a significant impact on the units *"desa"*, this could also be due to the fact that this division did not operate with loans denominated in foreign currency. An interesting aspect is that, during the crisis, BRI had serious problems with the other business units, and these were being supported by cross-subsidies coming from the MF division. Paradoxically, small microentrepreneurs were subsidizing their peers, who were usually in a better economic situation.

3.2. Financial subsidiary

Some banks have established financial subsidiaries to serve the microfinance sector. This option is attractive when banks and technical experts seek to work together in a transparent and commercial manner without disturbing the operations of the bank. The decision to create a financial subsidiary depends on the local legal framework, though in practice it is generally implemented as a legal entity separate from the bank. However, they are licensed and regulated by the local banking authorities.

The use of the financial subsidiary addresses the main drawbacks of the internal unit. It creates a separate staffing, management and governance structure, giving the microfinance operation the independence and flexibility it needs. Moreover, the creation of a subsidiary provides confirmation to the staff of a long-term commitment to microfinance. Nevertheless, unlike the internal unit, it has the disadvantage of duplicating certain functions (accounting, human resources and information technology). These operating costs can be reduced if the subsidiary entity uses the existing banking infrastructure and the bank's specialized resources,

[48] It accounts for 64% of the Gross National Product per capita.

such as marketing and legal advice.

In creating a financial subsidiary, a bank has the opportunity to limit its risk of entry into MF by sharing risk with other shareholders, particularly if those shareholders bring "*know-how*" in MF (which ensures that the operation sticks to its mission and applies best practices). More intangible risks, such as image or reputation risk, are also limited by the separation between the bank and the MF subsidiary.

CGAP (2005) has identified some success factors for this model:

- align risks, return and responsibilities of all shareholders (including the bank and other equity partners),
- ensure independent operations with an adequate management control system,
- manage potential differences in organizational culture and staff incentives between the parent bank and the subsidiary,
- motivate and train the personnel for specialized microfinance operations and
- use the existing bank infrastructure, including branch network, ATM network and proximity to potential clients.

Examples of this downscaling model are the case of Solución Financiera de Crédito in Peru (SFC), which was a subsidiary of Banco de Crédito of the same country, but was later absorbed by it in 2004, and the case of BanEstado Microempresa, subsidiary of Banco de Estado de Chile. On the other hand, Fininvest S.A., subsidiary property of UNIBANCO, is one of the largest finance companies, focused on the low-income consumption sector in Brazil. Since 1998 it has been working in the microcredit sector, through subsidiaries with specific purposes located in low-income areas in Río de Janeiro. As a finance company, Fininvest S.A. has been a pioneer, having granted more than 4,000 credits by the end of 2002, for a total value of USD 2.6 million.[49]

3.2.1. Financial subsidiary example: Solución Financiera de Crédito del Perú[50]

SFC was founded in 1996 as part of a strategic alliance between the corporate groups Credicorp in Peru, integrated by Banco de Crédito del Perú (BCP), and Yarur in Chile, integrated by Banco de Crédito e Inversiones (BCI). The goal of the alliance was to enter Peru's consumer banking market, taking full advantage of BCP's infrastructure and scale in the local market, as well as of the knowledge that BCI from Chile had about the consumer business, and its administrative technology.[51] The financial subsidiary model implemented until the merger with BCP was that of a financial institution authorized to perform all the operations allowed under Peru's Superintendency of Banks and Insurance Companies and the Central Reserve Bank financing and banking regulations.

[49] IFC.
[50] IADB (2002).
[51] In 2003, BCP became the only shareholder of the institution, after buying BCI's shares and those of minor shareholders within the merger plan of the entity. The entity merged with BCP during 2004, organization that is currently in charge of the MF activities. At present, BCP is using an Internal Unit model and all MF activity continues developing within this structure (between March 2005 and March 2006, credits for microenterprises rose by 35.2% although its participation on the total loan portfolio remains low —less than 10%). See: Pacific Credit Rating.

At first, SFC had the classic administrative structure of consumer lending companies: large sales teams, highly standardized credit assessment processes, high interest rates offsetting the elevated levels of delinquency, and above all high profitability levels. By the end of 1997 and during 1998, a crisis undertook the consumer banking in Peru, due to excessive competition among the organizations, customer overindebtedness and the context of the economic crisis which directly affected the consumer segment.[52] This situation led to the disappearance of several consumer lending companies. At that point, SFC decided to focus on the microentrepreneur segment, acquiring loan portfolios of two consumer companies that had gone bankrupt.

Since then, SFC eventually modified its procedures, technologies and strategies in order to enter this segment in an effective and significant way, learning and implementing improvements that led it to position itself as one of the leading MFIs in Peru.

Unlike other microfinance institutions, SFC's business process had a structure of separate activities with executives specialized in different areas:

- a sales and marketing team in charge of finding clients, offering the financing institution's services and granting the loans.
- a credit assessment team responsible for rating the loan applications and evaluating the clients' credit risk.[53]
- an operations team that gathers the outstanding loan payments and a specialized collection team in charge of recovering loans in arrears.

This business process structure allowed an organized development of the financial institution's operations in a context of fast growing of the MF segment. However, the main disadvantage of this type of system is that it increases four-fold the need of operating personnel as opposed to the administration methodology of one officer per portfolio, which small organizations can manage. Therefore, operating costs increased at the same speed as operations, preventing the creation of economies at scale in the organization.

3.2.2. Another financial subsidiary implementation example: BancoEstado Microempresas[54]

BancoEstado is a Chilean state-owned commercial bank. By June 2005, it had USD 15,4 billion in assets, a network of 311 branches throughout the country, and more than 50 special access points.[55] The bank performs its microfinance operations through the program specialized in microenterprises, a BancoEstado's subsidiary. As with the rest of the banking industry members, the program is supervised by the Superintendency of Banks and Insurance Companies of Chile.

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[52] Specially, segments of low and middle urban socioeconomic levels.

[53] To fulfill its assignment, a loan officer or "appraiser" visits the business, where he verifies the available funds flow, creditworthiness, and management quality, as well as other legal issues indirectly related to the applicant's business.

[54] Based on José Mena's presentation at the 35th General Assembly of ALIDE (Rio de Janeiro, June 2005), as well as on information published in the bank's web page, and information obtained from a survey carried out directly in the area of BancoEstado's microenterprises.

[55] These are offices that employees of the closest branch open for a day or for some hours several days during a week in order to assist their clients from distant areas.

The program offers a range of products developed according to the microentrepreneur segment. Products include different types of insurance, means of payment, credit and savings, and none is mandatory to access a loan. More than 95% of the loans granted by the program have no guarantee requirement. The remaining loans are backed with FOGAPE[56]'s guarantees or through collaterals, depending on the risk associated with the credit transaction and the amount requested. The bank has a special decision committee for the provision of microcredits, and credit scoring models are used for evaluations.

In general, the process for granting a loan is the following:

1. The client applies for a loan.
2. First interview: borrower's background checking, documentation request and establishment of a schedule of visits.
3. The client is visited at workplace and his application is evaluated.
4. The loan conditions and amount are defined.
5. The client signs the relevant documents.
6. The branch proceeds with the loan.
7. The funds are granted to the client.

Field evaluations are the key phase of the loan granting process, since during this stage each executive visits the microentrepreneurs in their workplaces, where the credit assessment is carried out.

BancoEstado Microempresas has classified clients according to their industry or the type of activity they do, seeking to be more competent when assisting microentrepreneurs. Consequently, up to the present, there are segments specialized in Trade, Transportation, Fishing, Agrobusiness, Professional Services, and Manufacturing and Craftsmen. Each of these segments has different decision processes.

Interest rates are charged according to variables such as customer type, credit history, amount requested, and cross-selling.

In 2006, the program had 141 specialized branches, a portfolio of 211,000 clients and a number of outstanding loans worth USD 300 million. Since operations first started, 550,000 operations were undertaken amounting to a total of USD800 million. In the Microenterprises program, each account executive has 700 clients with an average rate of performance of 99%.

According to BancoEstado, the program's success factors are the commitment to work for the segment and the new job culture. The sector was intensely investigated to attend its problems properly, and comprehensive assistance was provided (end-to-end answers for the needs of the clients, their business and families: technology financing, work-related vehicles, insurances, higher education or housing loans). The success was not only due to the change that the bank implemented, but basically to the clients' commitment with the bank: 99% of the clients pay off their loan timely and 60%, due in advance.

[56] FOGAPE (Guarantee Fund for Small Entrepreneurs) is a government fund with legal status administered by BancoEstado and supervised by the Superintendency of Banks and Insurance Companies. Its major goal is to improve small entrepreneurs' access to credit by providing guarantees to the credits granted to these microenterprises by financial institutions through public tender procedures (see Chapter 5).

3.3. Service company

A MF service company (SC) is a non-financial company that provides loan origination and credit administration services to a bank. The SC does all the work of promoting, evaluating, approving, tracking and collecting loans; however, the loans themselves are on the books of the bank. The main difference between this model and the previous is that, unlike the service company, the subsidiary owns the loan portfolio it generates and recovers. Legally, an SC is a variant of the subsidiary model with the crucial distinction that it is not a financial institution.

Table 9: Implementation lessons for service companies[57]

Acción International presents the following banks and some of the lessons they have learned as SC examples —Banco del Pichincha from Ecuador and its service company, CREDIFE, and Sogebank from Haiti and its service company, SOGESOL:

- The support of a commercial bank has allowed the SCs to focus on perfecting credit methodology without worrying about obtaining funds or opening full-fledged braches. However, problems with customer service, general resistance to change, and competing priorities have slowed the growth of these operations.

- There is relatively little pressure for the SCs to begin moving up-market, since the partner banks already serve clients demanding larger loans. Low cost structures allow these companies to operate profitably at lower average loan sizes.

- External subsidy needed to launch these operations is relatively small. Most of the grant funds supported pre-project planning and specialized technical assistance and training. The banks carried most of the project costs in the form of their own staff time, payment of a significant share of technical assistance cost, and by providing the equity, loan capital and infrastructure. From a donor perspective, this cost is substantially lower than the total grant funds needed to launch brand new microfinance operations in either an MFI or a regulated financial institution.

- The best partner to launch MF services through an SC is a bank with a strategic vision to become a major retail —not corporate— bank. The most important features include a network of branches in the relevant market and a range of products already reaching down to the consumer level, such as savings, consumer lending and payment services. These features reduce start-up costs for MF operations and result in low operating costs, distributed among a portfolio of services.

- Finding an influential member of the bank's management team, who can serve as a liaison between the bank and the service company, and can help define the roles of each in the relationship.

- Banks should do what they do best, including treasury, accounting and legal functions. The MF unit should focus on its own comparative strengths, such as credit methodology and operations at branch level. Some areas will require intensive coordination, particularly human resources and information systems.

- Avoiding internal competition since SCs must compete for services with other subsidiaries or divisions of the bank. For example, congestion at branches can result in poor customer service for MF clients.

- SCs are more dependant on banks than the other collaborative models since the portfolio stays within the commercial bank. Under this arrangement, the SC cannot easily access alternative sources of

[57] Lopéz, C. & Rhyne, E. (2003).

funding or services and thus cannot pressure the bank to reduce the cost of funds or increase the quality of services. Dependency crates a "moral risk" since once the institution starts to operate, it is too costly to change strategic partners. This problem is most relevant for the external investors in an SC, who must seek protection through long-term contracts that specify all relationships and transactions transparency. Clear agreements should cover at least the following four items:

* Cost of funds, including the possibility to offset cost of funding on the basis of deposits from micro-clients.

* Fees for the clients' use of the bank's branch network.

* Fees for services provided by the bank to the SC.

* Risk sharing, especially the method of calculating provisions and how potential losses will be distributed

In return of providing credit administration services to the bank, the SC is paid a fee (and vice versa, when the bank provides services to the SC). The SC employs the loan officers and other MF program staff, while the bank in turn furnishes services to the SC which could include teller support, human resources or information technology. The SC can be a wholly-owned subsidiary of the bank or it can involve additional investors.

The SC model seeks to draw on the best elements of each of the methods discussed above, while further addressing their drawbacks. As it is not a financial institution there are important advantages: it does not require a separate banking license, is not separately supervised by the banking authorities, and does not require a large equity base. It is thus much easier and less costly to launch and operate than a financial subsidiary.

The SC model addresses several of the shortcomings of the internal unit: it establishes a long-lived structure with its own governance and staffing that gives the microfinance operation space to operate. Because transactions are between legally separate entities rather than internal, a SC provides a more transparent framework for operation than an internal unit. In this way, it is an attractive structure for involving technical partners as investors and participants in governance. Yet, as an entity that exclusively serves a single bank, the SC can take full advantage of the benefits the bank has to offer in much the way that an internal unit can, and it has less need to perform parallel tasks because the related bank can handle processes that do not require specialized MF knowledge (marketing, human resources, systems areas).

The SCs must negotiate detailed agreements with the related bank that assign cost, risk, responsibility and return to each party in an effective way, seeking to align incentives to promote the overall interest of the institution.

3.3.1. SC implementation example: CREDIFE[58]

In 1999, Ecuador was immersed in an economic crisis which highly reduced microentrepreneurs' opportunities to access financing. In this context, Banco del Pichincha (an independent bank) decided to enter the MF field and established a subsidiary to support

[58] CREDIFE and Notes to the 2004 and 2005 Financial Statements published by MixMarket.

the development of the country's microentrepreneur sector, named *CrediFe Desarrollo Microempresarial S.A.* (CDM), which became its first shareholder.[59]

CDM is supported and receives consulting services from international network organizations, such as ACCIÓN International and SALTO project in Ecuador (it is USAID's Strengthening Access to Microfinance and Liberalization Task Order project in Ecuador).

An agreement has also been signed with the Agencia Española de Cooperación Internacional to build an adequate, stable and long-term financial relationship with Ecuadorian microentrepreneurs. Moreover, CDM has granted loans to microentrepreneurs whose funds were loans granted by microcredit support organizations.

CDM has entered into an ancillary services contract with the bank. The aim of this contract is to provide professional and specialized services to the bank, accepting the commitment to perform the credit operation recovery, prospecting, assessment, and other activities related to the bank's needs in the MF field. In return of providing these services, the bank pays a monthly fee based on the value of the administered portfolio (fee of 5% in 2004 and 2005); the value of the portfolio in arrears by more than 60 days is withheld from the fee (each month the increase in the portfolio in arrears exceeding the previous month is withheld). CDM also charges the bank's microenterprise clients a fee for advisory services.

Its independence level ensures an answer to the microfinance market's dynamic changes, and its credit methodology, technology and capacity have allowed CDM to provide a range of funding sources to the microenterprise sector.

3.4. Strategic alliances

A simple and low-cost way for commercial banks to enter MF is to form strategic alliances with non-banking institutions already serving the MF market. Banks are often attracted to the concept of a strategic alliance because it allows them to claim credit for supporting MF without requiring much effort or exposing the bank to reputation risk.

The simplest way of alliance is a direct loan the bank lends to the MFI. This alternative enables many banks to increase their client portfolio; they grant loans to profitable MFIs and benefit themselves from other services these can offer, which are not directly related to the loan (means of payment, deposits, etc.) The implementation of the loan depends on the local legal and regulatory framework. The legal status of the MFI determines whether, according to the existing regulations, a commercial bank can grant a loan to the MFI, and the pledging of collaterals. MFIs typically lack liquid or tangible assets, thus banks should consider the MF portfolio as collateral or lend based on the MFIs cash flow basis. Agreements with the MFI's founders or donors and access to third-party guarantees should also be considered as possible collaterals. According to CGAP (2005), a key factor to success in this kind of relationship is the bank's ability to identify profitable MFIs and get more familiarized with the MF business. This can be achieved by referring to independent credit ratings (credit rating agencies) or by carrying out analysis to compare the MFI's performance to other local, regional or international institutions'.

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[59] In 2006, it acquired the corresponding participation from ACCIÓN, achieving 99% of the shares.

In accordance with CGAP (2005), there are a series of requirements necessary for the MFI to receive a commercial loan. Some of them are listed below:

- Readily available financial performance information.
- Proven ability to apply microfinance best practices.
- Governance and management practices with focus on results.
- High-quality loan portfolio with appropriate provisioning policies.
- Strong compromise trend for both efficiency and profitability.
- Products priced to cover full cost of delivery.
- Information systems that produce accurate and timely reports.
- Strong ratings by professional raters.
- Good prospects for growth.

However, a simple lending relationship fails to take advantage of any of the special benefits commercial banks can offer, and recognition of this gap has led some banks and MF institutions to attempt to structure more complex strategic alliances. A next level of alliance involves MFIs as deposit-collecting agents for banks, but this draws little of the potential benefits commercial banks can bring to MF.

Other possible form of alliance would have a bank and its non-bank partner enter into an agreement in which the MFI carries out some part of the credit approval and/or the credit administration process, receiving in return a share in the interest income or a fixed fee.[60] The agreement is generally structured so that the MFI receives incentives to keep a high-quality portfolio, taking part in losses derived from the administration of loans, from financing a part of the portfolio or from charging its services as a percentage of the interests of active portfolios.

This model advantage lies on the fact that the bank expands its retail operations making use of the comparative advantages of specialized organizations, such as their access and knowledge of market niches and delivery techniques for MF-related services (other than loans). This model also allows sharing the operational and credit risk with a third party and therefore avoiding costs associated with entering the MF market directly.

The key factor to success for these operations consists of ensuring an adequate selection of the MFI, based on its good reputation, strong track record of successful operations and high portfolio quality. Another crucial factor to success is the appropriate design of the agreement with the MFI, which must be clear so that it aligns incentives, responsibilities and returns between the bank and the MFI. Among other factors there appears the need to keep well-documented and standardized procedures for loan origination and approval and diversify credit risk through partnerships with MFIs operating in different markets.

In addition, the bank may provide the MFIs with access to other services, such as branch and ATM networks, cashier services and transaction processing for MFIs and their clients. In return, the bank charges a fee to the MFI or its clients, depending on the type of arrangement. This type of agreement allows the bank to increase its revenue streams, particularly on its fixed assets and systems, gaining in turn access to clients of the MFI to cross-sell products not offered by the MFI, bearing little or no financial risk. The advantage for the MFI is that it increases efficiency and reduces costs by making use of existing bank infrastructure. In this

[60] Isern, J. & Porteous D. (2005).

way, the MFI can focus exclusively on maintaining and building client relationships. It can also expand services offered to clients by referring them to bank products (deposits, transfers, etc.) One of the success factors of this type of service consists in writing the agreement clearly, including for instance clauses of non-competition for clients for a determined period, since the bank may become a competition for the MFI when it comes to offer similar services.[61]

3.4.1. Strategic alliance implementation example: Banco Sol - La Caixa

An example of these strategic alliances, involving international money transfers, is the agreement between Banco Sol in Bolivia and La Caixa in Spain.[62] With the aim of channeling savings that Bolivians who live abroad send to their country, BancoSol has signed agreements with several institutions such as La Caixa and Confederación Española de Cajas de Ahorro. These draw together more than 34 institutions, with approximately 18,000 remittance reception points only in Spain.

Among the services provided, BancoSol also facilitates the acquisition of properties in Bolivia. Bolivian people living in Spain can deposit money that is later transferred to their accounts in BancoSol to write off the credit. Unlike Ecuador, where the bank offers the properties to the potential purchasers in the cities, in Bolivia, the resident's family is in charge of looking for a property and presenting the corresponding documentation in the local bank. The bank carries out the technical, financial and legal assessments and informs the borrower, who finally decides to accept the offer or not. The borrower brings part of the money and the bank pays out the rest.

BancoSol gives Bolivians who live abroad the possibility to access to life, medical and accident insurances for their relatives who are living in Bolivia. Another service it offers is the savings account which can be opened in Spain but located in Bolivia. That money can be withdrawn with a debit card at any time from any ATM in Spain.

3.5. Considerations for choosing a model

As stated in previous sections, each of the analyzed models has advantages as well as disadvantages, and selecting one or another will depend on the organization's purpose and the bank's existing operating infrastructure. There are some decisive aspects to consider when selecting a model, including:

- When taking advantage of the bank's branch infrastructure, costs are greatly reduced and it is easier to scale up operations, even though the extent of these cost savings depends on the nature and location of the branches. One effective strategy is to locate MF branches in the same (or adjacent) physical structure to bank branches. Customer care offices must be placed separately so that the staff specializing in MF can receive clients, thus avoiding mistaking the bank's traditional businesses with this new segment. To take full advantage of the bank's network of branches, these must be located in geographical areas with a high number of potential microcredit applicants.

- MF operations can use the existing bank technology for disbursement and deposit transactions (bank tellers, ATMs and systems), eliminating the need for duplicate staffing.

[61] Isern, J. & Porteous D. (2005).
[62] Information obtained from the La Época newspaper and Banco Sol web page.

Thus, it is very important to develop an effective transactions processing strategy that works for both the bank and MF operations.

- Bank know-how in the areas of information technology, human resources, marketing, legal issues, internal audit and financial management can alleviate the need for the microfinance operation to develop full-fledged departments in these areas, substantially reducing costs. In areas where there are economies of scale in the service provision, it will always be profitable if the bank and the MF unit use them together (regarding the internal unit model as well as the subsidiary or service company).

- Depending on the development and profile of the commercial bank brand, it will be convenient to relate it to the microfinance unit, or otherwise it will be better if it has its own identity. An intermediate situation in which a new brand is developed, but still has some connection to the parent bank achieves three aims:

    - to enhance the new entity credibility;
    - to attract low-income clients who may be intimidated by a bank;
    - to keep the main branding of the traditional bank undisturbed.

It may seem that a wide range of institutions can operate in the MF market. There are different options to make the most of the institutions' internal organization strengths (state-owned banks, credit unions, independent commercial banks) The main conclusion resulting from revising international experiences is that the provision of efficient financial services to low-income people is not only determined by the institution's organizational structure, but also by a deep understanding of the clients' needs, the service provision, how consistent is the attention paid to this market compared to the main activity of the entity, the growth strategy of potential clients, and how innovative are the services and products that the entity offers.[63]

4. Downscaling under local regulations

In this Chapter the Central Bank of Argentina (BCRA) regulations are reviewed with the aim of analyzing whether it is feasible for financial institutions to apply in practice any of the four operating models described in the previous section.

4.1. Creation of an Internal Unit

Regulations allow for the possibility that local banks regulated by the BCRA create an internal MF unit. As mentioned in a previous paper,[64] regulations have established differential requirements for some of the microcredit products to be offered by financial institutions. One of these products are the so called *limited amount loans ("préstamos de monto reducido"),* in which the monthly installment - using the French system - does not exceed USD100 in the case of terms of up to 36 installments and a total amount of USD5,000[65] in the case of longer terms.[66] Regulations include the possibility that, in those credits aimed at financing

[63] United Nations (2006).
[64] Delfiner, M., Pailhé, C. & Perón, S. (2006).
[65] The approximate exchange rate during 2007 was around USD 1 = AR$ 3.
[66] BCRA. Updated Text on Credit Management, item 1.1.3.3. Loans with terms over 36 months must be guaranteed with a first degree mortgage on real estate.

microenterprises, the frequency of installments be weekly, biweekly or monthly.

Compared to other financial products, this type of loans has the advantage that less documentation is required for their granting. In general terms, BCRA regulations stipulate that whenever a financial institution grants a loan it must open a file in which all the information relating to the client will be kept. Such information includes, where necessary, a certificate of retirement contributions, registration filed with the National Industrial Registry Office and a sworn statement attesting the relationship with the financial institution, as well as all those elements that might contribute to the proper evaluation of equity, income statement and business profitability of the company or the project to be financed. In the case of *limited amount loans*, there are minor information requirements: the only requisite is that the credit file must include the data necessary to identify the client.

In addition, regulations stipulate the need to classify the client and provide the Financial System Debtors Database with this information. Under this method, the maximum amount of loans that institutions may grant is up to 10% of their regulatory capital (RC).[67]

Another way in which financial institutions may make decisions on the granting of MF loans consists in using specific evaluation methods ("screening" systems and "credit scoring" models).

As regards the content of the client file, financing granted with this method poses the same requirements as *limited amount loans*, although in this case, in addition, proof must be given of the evaluation made following the relevant procedure. Furthermore, financial institutions must develop a detailed report of the procedure chosen to evaluate the client and grant discriminate credit margins, should it be relevant, based on the type of financing. Borrower classification and provisions for loan loss risk are developed according to the length of arrears in payment.

According to these legal concepts, except in the case of those with mortgage or pledge guarantee, loans may be granted without requesting those guarantees generally used in the traditional financial system. Although this characteristic makes them appropriate to grant microfinance loans, these concepts were not conceived to that end: the scoring and screening techniques were designed to grant consumer loans, while microcredits for lower-income people are intended to finance a productive activity.

As regards the banks' customer service offices, BCRA regulations allow financial institutions, with the exception of credit unions, to set up, with the authorization of the BCRA, temporary offices in those places of the country which do not have branches of financial institutions.[68] Temporary offices can perform all transactions that branches are allowed to carry out, except offering current account services, and enjoy the advantage that, to become later permanent branches they do not need to request the authorization of the BCRA.

In short, those institutions regulated by the BCRA could grant microfinance loans with the internal unit model using two legal concepts included in the regulations, thanks to which they may overcome the main drawback of microfinance activity: the lack of those guarantees traditionally accepted by the banking system. On the one hand, through limited amount loans, a part of the banks portfolio (10% of RC) may be allocated to microcredits. On the other

[67] The regulatory capital is referred to as "*Responsabilidad Patrimonial Computable"* in local regulations.

[68] Official financial institutions from the provinces, the municipalities and the Autonomous City of Buenos Aires, each in its respective jurisdiction, may choose between these temporary offices and the mobile branches contemplated in the item 10.4 of Section 10, Chapter II, of Circular CREFI-2.

hand, they may focus their activity on microlending using statistical evaluation methods (in the case of mortgage or pledge loans, a guarantee is requested), to which end they must test the predictive power of the model and perform further verification should it exceed global limits (15% of RPC or AR$ 30 million, whichever is higher). In addition, this figure of temporary customer service offices allows financial institutions to reach some regions of the country not served by other financial institutions.

4.2. Creation of a Financial Subsidiary

As previously mentioned, the financial subsidiary model consists of a legal entity separate from the bank which the regulatory body authorizes to perform the transactions typical of a financial institution. In Argentina, any institution that acts as an intermediary in the supply and demand for funds is regulated by the BCRA; therefore, the model of financial subsidiary can only be understood within a legal concept according to which the financial institution is a shareholder in another bank or financial institution regulated by the BCRA.

In order to analyze the effects of BCRA regulations on this model it becomes necessary to consider the possibility of such relation from the point of view of the investment or shareholder bank, as well as from the perspective of the institution that will play the role of subsidiary.

As to the investment institution, according to BCRA regulations, should a financial institution want to become shareholder in another financial institution also regulated by the BCRA, there would be no impediment because it would be participating in an activity directly associated with the financial activity.[69] In that case, the institution should observe all regulations to which all the other banks are subject. If the company in which the bank intends to be a shareholder in order to perform microfinance activities cannot be considered, due to its very nature, as a provider of services related to financial activity, then their execution should be contemplated within the limits of the Updated Text on Supplementary Services to Financial Activity and Other Authorized Activities.[70]

As to the legal definition of “subsidiary”, regulations on Consolidated Supervision[71] stipulate that an institution or company is a subsidiary of a financial institution when:

- The local financial institution owns or controls, directly or indirectly, more than 50% of the total votes of any instrument with voting rights in the controlled institution or company.
- The local financial institution has direct or indirect control to determine on its own account the constitution of the majority of directive bodies of such institution or company.
- The majority of directors of the local financial institution are also the majority of directors of the mentioned institution or company.

Institutions with subsidiaries in the country are subject to BCRA supervision on a consolidated basis with their subsidiaries.
The creation or acquisition of the subsidiary by another institution should be analyzed according to the rules that regulate, respectively, the start-up of financial institutions or any

[69] Article 29 of the Financial Institutions Act.
[70] This regulation is reviewed in-depth when analyzing the service company
[71] BCRA. Updated Text on Consolidated Supervision.

modification in the shareholding structure.[72] Those rules define the requirements that should be met in each case, and the BCRA retains the power to reject, in each particular case, the request of creation or modification in the shareholding structure.

4.3. Possible relationships with service companies

As pointed out in Section 3, the service company model that commercial banks from all over the world have applied for the provision of microfinance services has been mainly organized in two different ways:

(a) the commercial bank (partially or totally) owns a non-financial company (not regulated by the banking regulatory authorities) providing certain services to the microfinance activity performed by the commercial bank;
(b) the relationship between the bank and a different company is structured by means of a contract or agreement whereby the bank receives certain services for its microfinance activity in exchange for a fee (for example, contact with microfinance customers for loan disbursements or deposit taking, analysis of risk profile and loan granting, which are recorded in the bank's own accounting).

In order to evaluate the possibility of local institutions carrying out microfinance activities by means of the service company model mentioned in (a), it is worth analyzing the BCRA regulations on Supplementary Services to Financial Activity and Other Authorized Activities,[73] which deal with the activities that may be carried out by banks.

Pursuant to the provisions of the Financial Institutions Act, these regulations establish that financial institutions are not entitled to carry out other operations than financial intermediation and, therefore, activities performed by the bank in its own name are forbidden, except those specifically authorized by the BCRA (see Table 10), which are only admitted as activities complementary to the financial institution's services and, among them, the ones which constitute an intermediation stage or an operative activity inherent to such intermediation.

Table 10: Activities (generally) authorized by the BCRA to be performed by commercial banks and finance companies[74]

1. Stock exchange brokers or dealers operating outside the stock exchange.
networks' exploitation and management.
3. Systems for electronic transmission of transactions with institutions and/or clients.
4. Pension funds management.
5. Mutual fund portfolio management (management company).
6. Issuance of credit/debit and other similar instruments.
7. Closed savings management.
8. Financial assistance through leasing transactions of capital goods, durable goods and real estate, acquired for such purpose ("leasing") or over credits arising from sales ("factoring").
9. Management of public utilities, loan, etc. collection, payment of salaries, payments to suppliers and fiscal receipt collection.
10. Services of data processing and/or transmission of information related to financial activities.
11. Services of credit information for commercial and financial use (financial record database).
12. Advice on financial and investment issues, and for mergers and/or acquisitions of companies, provided that this

[72] Art. 7 and 15 of the Financial Entities Act and complementary articles.
[73] Updated Text on Supplementary Services to Financial Activity and Other Authorized Activities.
[74] Section 2.2 of the Updated Text. All other banks, real property and other real estate savings and loans associations and credit unions will be allowed to hold such interest as long as the nature of the activity is consistent with the relevant institution type, pursuant to the operations authorized by the Financial Institutions Act.

does not imply administration or business management. Loan issuance is forbidden. 13. Mutual guarantee companies, acting as protector partner. 14. Funds management and/or trusts administration advice as regards activities consistent with the institution type. 15. Financial trusts fiduciary. 16. Transportation and/or custody of money and securities, including transport service of mailing and financial documentation of institutions and/or their customers. Associated security service for local financial institutions. In both cases, as long as it is a complement of the service provided to the owner institution/s. 17. Service of securities and book-entry mortgage bond registry officer 18. Service of liquidation of securities operations. 19. Clearing houses. 20. Temporary acquisition of interest in companies in order to facilitate their development, with the aim of selling the relevant stock holdings in the future. Financial advice on planning and managing to such companies.

Non-financial institutions rendering microfinance services that are part of any of the links in the financial intermediation activity of a bank shall be considered supplementary activities and analyzed in accordance with the provisions of the abovementioned Updated Text.

Among the activities specifically authorized in the Updated Text, the possibility that a bank may acquire stock holdings exceeding the maximum level authorized in a microfinance service company is not explicitly envisaged; this may be due to the fact that the MF activity is relatively "new". As stated at the beginning of this paper, the MF activity includes a wide range of services, some of which could be included in some of the activities listed in the Updated Text.

In the case of a company rendering services targeted to low-income people —such as data management, financial advice, credit card issuance, credit collection— such services should be specifically authorized by the BCRA. However, the BCRA does not specifically provide for the authorization of credit risk assessment and loans disbursement operations.

As pointed out before, for any other activity not defined as supplementary, the financial institution's interest shall not exceed 12.5% of its capital or voting stock. A financial institution's interest below 12.5% is not enough for the institution to control a majority of votes; therefore, the relationship with the financial institution would be only indirect.[75] In this last case, pursuant to the regulations governing activities carried out with related companies, the financial assistance to the related company (including stock holdings included) shall not exceed 5% of the financial institution's RC; this limit may be extended up to 10% if the assistance are loans backed with collateral. In aggregate, assistance to all related companies shall not exceed 20% of the financial institution's RC.[76]

If the company does not fall under the category of "related" company, the assistance without collateral (including stock holdings) can reach 15% of the financial institution's RC —or 25% of the RC, if operations with authorized collaterals are included—, but the whole of the non-listed shares of companies which do not provide supplementary services cannot exceed 15% of such RC. In turn, the sum of loans provided to any company —whether related or not— that individually exceeds 10% of the financial institution's RC must be considered as risk concentration.[77] Aggregate operations included in this category shall not exceed three times the

[75] According to BCRA regulations on "Operations with non-financial private sector persons or companies related to the financial institutions" (Communication "A" 2140, as amended), control over a company is achieved when a person or company owns or controls, directly or indirectly, 25% or more of the total votes of any instrument with voting rights in the controlled institution or company.

[76] It should be considered that institutions with a CAMEL 4 or CAMEL 5 rating cannot offer any kind of financing to its related clients.

[77] Regulations on credit risk diversification are applicable thereto.

RC of the financial institution or five times the RC of the financial institution (considering the loans to other financial institutions).

In Argentina, despite the existence of such limits, there are no impediments for shareholders to independently acquire a controlling interest in any kind of company. In such cases, the company would become a company related to the financial institution, and the limits on operations with related clients would be therefore applicable.

In order to evaluate (b), whereby banks make use of the service company model for downscaling —through a contract or agreement entered into with a company that provides them with microfinance services—, the BCRA regulations on operations outsourcing shall be considered.

Communications "A" 3149 and "A" 4609 regulate service outsourcing.[78] The former authorizes the outsourcing only of administrative or non-operative —i.e., back-office— activities upon prior notice to the BCRA. Such communication requires financial institutions to inform the address in which the outsourced activities will be carried out, as well as the nature of the activities and their starting date. A copy of the outsourcing agreement shall also be submitted. Regulations specify that the same regulatory conditions required for centralized activities shall also apply to activities performed at a third party's premises or abroad.[79] The following places are authorized by the relevant regulation for decentralized operations to be carried out:

- Premises of the financial institution or third parties, within the national territory, and with technical and/or human resources of the institution or third parties.
- Premises or subsidiaries of the head office (for branches of foreign institutions) or the foreign controlling institution (for subsidiaries of foreign institutions).[80]

Pursuant to Communication "A" 3149, financial institutions may set up promotion points to provide advice and deliver and receive requests for services and operations (including loans and credit cards), although handling of cash or securities is not allowed in such promotion points. Communication "A" 4609 sets forth the minimum operating requirements applying to information systems and information technology.

In the case of activities involving, for instance, the provision of information system or information technology services, BCRA regulations determine the requirements that the outsourcing agreements shall stipulate, as well as the functional responsibilities and control of the institution that procures such services under contract with an outside supplier. Such activities may include microfinance client data processing services or the provision of programs for the processing of information on microfinance clients, among others.

4.4. Authorized strategic alliances

As pointed out in Section 3, the simplest way of alliance is a direct loan from the bank to the MFI. In order to analyze the possibility that financial institutions regulated by the BCRA grant

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[78] Updated Text on Minimum Requirements of Management, Implementation and Control of Risks related to Information Technology, Information Systems and Related Resources for Financial Institutions.
[79] The acceptance of such condition shall be included in the outsourcing agreement; the capacity of SEFyC to audit its compliance in such buildings shall also be stipulated.
[80] With a number of requirements which must be met by head offices or controlling institutions.

loans to microfinance institutions, the BCRA's Updated Texts on Credit Policy, Credit Risk Rating and Credit Management should be considered.

As regards the possibility that a bank may provide a loan to an MFI (which can be considered a financial intermediary) that may, in turn, apply such funds to small loans intended to finance productive activities, the BCRA Updated Text on Credit Policy states the following: "*Lending assistance provided by financial institutions shall be aimed at financing investment, production, marketing, and consumption of goods and services required by both the domestic demand and national exports.*"[81] Reference is made in the Updated Text to the end use of the funds, but this would not necessarily mean that the participation of an "intermediary" is forbidden.

Due to the possible low level of capitalization of MFIs (especially foundations and NGOs), regulations on Credit Assessment may turn out to be operative in practice. The Updated Text above mentioned states that financial assistance to natural persons or legal entities shall not exceed 100% of the recipient institution's RC. This limit may be raised to 200% of the relevant institution's RC as long as the additional credit does not exceed 2.5% of the RC of the financial institution issuing the loan and with the approval of the institution's Board of Directors or equivalent governing body. Additionally, a number of requirements[82] are laid down, which banks must meet before granting a loan. Such requirements include:

- Opening of a file containing all those elements that might contribute to the proper evaluation of equity, income statement and business profitability of the project to be financed.
- Evaluations performed in order to comply with the regulations on "Borrowers Classification" and "Credit Risk Rating" shall also be included as well as data which allow verifying compliance with credit-related regulations.
- Proof of borrower's compliance with retirement contributions pursuant to the relevant regulations currently in force shall also be included.
- These regulations exclude customers who only receive financing and guarantees, performance bonds and other responsibilities issued by branches and local subsidiaries of foreign financial institutions (investment grade).

As regards the other commonly used strategic alliances (banks that provide MFIs with access to other services, such as branch or ATM networks, loan collection and MFI and customer transaction processing), local regulations pose no obstacle for the provision of such services.

5. Government policies for boosting microfinance and the banks[83]

Governments play an important role in the development of financial systems designed to offer services to the poor, which in turn has an impact on the activities of the commercial banks and MFIs that provide them. Experience demonstrates that this role can be constructive in some cases but counterproductive in others. All in all, the discussion is not focused on whether governments must intervene or not, but on what they should and should not do considering the country specific context. Governments can participate in various ways, the most important of which are:

[81] Updated Text on Credit Policy.
[82] Updated Text on Credit Management.
[83] United Nations (2006).

Table 11: The role of the public sector

Issues	Considerations
Clear policies and strategies to build an inclusive financial system	Government policies focused on both improving access to financial services and building an inclusive financial sector, thus promoting poverty reduction goals.
Interest rate liberalization (see section 2.4)	Interest rates caps established by laws or executive orders as well as implicitly through the granting of loans subsidized by state-owned banks, have usually limited the scope of financial services.
Participation through state-owned banks	Various studies focus on negative experiences of direct lending to the poor by state-owned banks, although second-tier operations or wholesale lending are less controversial. However, there are successful cases (BRI in Indonesia, BancoEstado in Chile,[84] Financiera Rural in Mexico), and emphasis has been laid on their potential to serve rural areas, which has led to renewed interest in the subject.
Mandates for the provision of targeted loans	Some government programs mandate commercial financial institutions to allocate a percentage of their loans to certain economic sectors or to the less advantaged segments of society. Many of these programs distort the market and do not produce the intended outcome. However, newer programs were successful in increasing commercial banks' participation in the provision of microfinance services.
Subsidies	Although there are some concerns about the fact that poorly applied subsidies could distort the market, by promoting the provision of inefficient services and failing to reach the target group, subsidies can help correct market failures and pursue social objectives. The trend is to apply "smart subsidies": tools that maximize social benefits and promote transparency, without generating distortions and reducing incentives for a strong development of institutions.[85]
Financial infrastructure to help reduce credit risk	There is mounting interest in analyzing financial infrastructure failures, that is, support mechanisms provided by public and private sectors in order to promote financial sector transactions. Credit bureaus and the strengthening of the judicial system play a key role in reducing credit risk.
Financial infrastructure to increase transparency	Consumer protection laws, accounting standards, external audits and independent ratings play a fundamental role in improving transparency.
Financial infrastructure to reduce costs	This item should include small financial institutions' access to financial information networks, clearing houses and payment systems, as well as the promotion of information sharing among institutions. Many participants see the design of these systems as a public good.

In several countries where the activity of commercial banks in the area of MF is considerable, or has increased in recent years, governments become involved in the implementation of policies and regulations. The observed experiences range from a mere incentive to mandates that compel financial institutions to get involved in the MF business. Below is a summary of some cases.

[84] See sections 3.1.1. and 3.1.2.
[85] For example, the provision of subsidies to MFIs during their start-up stage, when operating costs are usually very high. This would prevent costs from being transferred to creditors in the form of high rates.

5.1. Brazil

MF activity in Brazil has increased significantly in recent years. At present, microcredit institutions operate in alliance with other local and national agencies, such as local and province governments, state-owned banks, universities, trade associations, international agencies and labor unions. Many microcredit institutions outsource their training services, which are provided by the Brazilian Micro and Small Business Support Service (SEBRAE) and the National Commercial Training Service (SENAC).

Table 12: Authorities and organization of the financial sector in Brazil

National Monetary Council	
Central Bank of Brazil (BACEN)	Securities and Exchange Commission of Brazil (CVM)
Sight Deposit Taking Financial Institutions	Futures and Commodities Exchanges
Other Financial Institutions*	Stock Exchanges
Other Financial Intermediaries and Third Party Resource Administrators	

* "Other Financial Institutions" includes Microentrepreneur Credit-Granting Associations

One of the initiatives undertaken by the Brazilian government since the regulation of MF activity was the creation of the legal entity *Microentrepreneur Credit-Granting Associations* by Act No. 10194 of 2001. These associations are institutions created with the sole social objective of granting funds and guarantees to individuals —or legal entities classified as microenterprises— for making small-sized professional, commercial or industrial enterprises viable. The Central Bank of Brazil (BACEN) authorizes these associations' incorporation and operation and monitors them (see Table 12), and they can undertake the activities approved by law independently or through service contracts on behalf of institutions authorized to grant loans under the terms of current regulations. They are not allowed to capture resources from the public or issue securities for public offer. They cannot grant loans for consumption purposes either. They have to be incorporated in the form of a closed-capital company or limited company, and must use "*Microentrepreneur Credit-Granting Association*" in their denomination; the use of the word "Bank" is forbidden.

Another government initiative, aiming directly to the provision of microfinance services by commercial banks, was the implementation of the *Federal Government Act No. 10735 (9/2003)*, which specifies that commercial banks, multiple banks with trade portfolio and Caixa Económica Federal shall allot a portion of the captured sight deposits to credit transactions targeted at lower-income population sectors and microentrepreneurs. That same act regulates the effective interest rate to be charged —which is limited—, forbids charging any rate or fee other than the loan start-up fee,[86] and establishes that unapplied resources shall remain available at the Central Bank without compensation until compliance is verified. In compliance

[86] For detailed information about Act No. 10735, see Annex 2.

with the aforementioned law, the Central Bank of Brazil[87] established a minimum of 2% for the amount of sight deposits targeted at microcredit transactions with a monthly effective rate of 2%.

Credit borrowers shall be:

- Individuals with sight deposits and low-value financial applications,
- Microentrepreneurs meeting the requirements established for credit operations granted by institutions specialized in microcredit transactions, or
- Low-income individuals selected according to other criteria.

As mentioned in the second chapter of this paper, it is expected that imposed interest rate caps threaten the development of MF by commercial banks. Based on data from the Central Bank of Brazil, after two years of the implementation of the act, microfinance credits granted by banks reached 70% of the total resources that must be applied to those transactions, with heterogeneous compliance among banks. A remarkable example is Banco do Brasil, covering 100% of its obligation, while Banco Popular do Brasil reached approximately 14%.[88]

One of the most recent measures adopted by the Brazilian government as regards the microfinance activity is the implementation of Act No. 11110 of 2005, which created the National Program of Oriented Productive Microcredit (PNMPO) with the purpose of making resources available to microcredit institutions. This program makes it possible for all MFIs to access the federal resources of the Workers' Assistance Fund (FAT) and the 2% of banks mandatory deposits available at the Central Bank. This ensures these institutions a permanent and important source of resources for microcredits, which, in compensation, shall be granted at a monthly interest rate not higher than 4%.[89]

In connection with the development of the MF activity in Brazil, it is worth mentioning the participation of government through the activity of Banco do Nordeste as a first-tier bank and of Banco do Desenvolvimento Economico e Social (BNDES) as a second-tier institution.

Banco do Nordeste is a state-owned bank operating as a regional development bank in the North East region of Brazil. Through its Program of Oriented Productive Microcredit (CREDIAMIGO), the bank offers small loans to microentrepreneurs that need money and guidance to invest in their businesses.[90]

The BNDES is also a state-owned bank that, as part of its social development policies, has a program whose purpose is to broaden the productive credit offer so as to reach low-income entrepreneurs, providing funding to MF dedicated companies, many of which were also created by government laws to promote MF activity (Promotion Agencies, Public Financial Institutions, Central Credit Unions, Cooperative Banks, Microentrepreneur Credit-Granting Associations).[91] In general, loan conditions establish an 8 year term with 24-month grace period and long-term

[87] www.bcb.gov.br/MICROFIN.
[88] Source: Valor Económico. November 2005 data.
[89] Act No. 11110 of April 2005, and CEPAL-Cooperazione Italiana (2006).
[90] For more detailed information, see section 3.3.1.
[91] www.bndes.gov.br/programas/sociais/microcredito_normas.asp.

interest rate[92] (currently at 7.5% for September 2006).

In 1996, the national government allotted BNDES a special deposit of USD 150 million for the implementation of the Popular Productive Credit Program with the aim of supporting microcredit institutions. Since then, BNDES has been a central component of public policies whose purpose is to support microenterprises' initiatives in Brazil.[93] BNDES' strategy has adopted a regional and national development approach, for which it has promoted the establishment of alliances among the different participants of productive networks in order to provide technical, financial and political support for development projects.

5.2. Chile[94]

By the mid eighties, Chile was recovering from the economic crisis that had raised, between 1982 and 1983, the unemployment rate to 30%, additionally causing a considerable reduction in salaries. Microcredits appeared then as a means to support small-sized service and commercial production initiatives aimed at generating income. In that context, the first organizations that offered microcredits were born. They were solidarity-driven MFIs and private institutions that received national and foreign financial contributions.[95]

In 1990, government started considering microcredits as a mechanism for the generation of self-employment, consequently improving economic indexes. However, the inherent characteristics of microenterprises (independent units with small capital and insufficient guarantees to meet eligibility criteria of financial institutions) made it a highly risky mechanism for the traditional financial system.

In this context, with the enactment of Act No. 18989 in 1991, government creates FOSIS (Solidarity and Social Investment Fund) to subsidize part of the operating costs of small credits granted by financial institutions, thus reducing the costs of the organizations. As a result, between 1991 and 1995, MFIs and cooperatives get largely involved and grow considerably. However, between 1996 and 2000, that development declines. At the same time, banks start entering this market more aggressively.

In Chile, a major boost for microenterprises growth came from government support in the form of resources to finance micro- and small-sized enterprise promotion activities, and counseling and training initiatives through agencies such as the National Training and Employment Service, the Technical Cooperation Service, the Agricultural Development Institute, and FOSIS.

Another important driving force has been the reactivation of FOGAPE (Guarantee Fund for Small Entrepreneurs) with the aim of guaranteeing a capital percentage of the credits granted

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[92] The long-term interest rate (TJLP in Portuguese) is established by the National Monetary Council and is used as a basis for remuneration of a bank lending and borrowing transactions. Calculation methodology: http://www.bndes.gov.br/produtos/download/tjlp.pdf.

[93] CEPAL-Cooperazione Italiana (2006).

[94] www.bancoestado.cl/InformaciónCorporativa/ Microfinances at BancoEstado. Stories of Entrepreneurship and Responsibility (2004) and information obtained from a survey conducted by the BancoEstado's Regulatory Planning and Research Department.

[95] A cooperative and some NGOs were created with the purpose of granting microcredits. Only at the end of the eighties commercial banks appeared. The Banco del Desarrollo's microenterprises unit begins its operations in 1989.

by financial institutions —both public and private— to small enterprises that lack enough guarantees to apply for financing. FOGAPE was created in 1980, and is administered by BancoEstado and supervised by the Superintendency of Banks and Financial Institutions. Its resources (comprising original contributions, investments and commissions collected) are destined to guaranteeing a percentage of the credits granted by private and public financial institutions, which are selected by public tender procedures. BancoEstado plays a double role since it also participates in tenders (as a user institution, this task falls under the Small Enterprises Division, and the fund administration is the responsibility of FOGAPE's Management Unit, dependent on the bank's Financial Control Division).

With the aim of favoring micro- and small-sized enterprises' access to credit, FOGAPE currently works with 16 operators (national and international banks, public agencies and financial institutions), which participate in public tenders to obtain funding on a quarterly basis. Since 1998, this fund has grown considerably as regards number of transactions (from 200 in 1998 to 34,221 during 2004) as well as clients, currently over 38,000.

FOGAPE guaranteed loans can be accessed by individuals as well as legal entities undertaking service or productive activities with an annual sale limit of UF 25,000 (approximately USD 875,000)[96] for non-agricultural small enterprises and of UF 14,000 (USD 490,000) for agricultural small enterprises (UF: Chilean inflation-indexed, peso-denominated monetary unit). Some small entrepreneur and exporter groups are also included. They must be tax registered and there is no sale minimum, so mainly micro- and small-sized formal enterprises without unsatisfactory business history or unpaid debts can have access. Also, credits must be destined to fulfill established goals, mainly to working capital and investment projects.

In Chile, besides BancoEstado, other commercial banks have also ventured into MF: Banefe (Santander Bank) since 1993 and Banco del Desarrollo since 1991.

Both BancoEstado and Banco del Desarrollo conduct their microfinance transactions through subsidiaries. Banco del Desarrollo operates through Bandesarrollo Microempresas Asesoría Financiera de Interés Social S.A. This subsidiary places and monitors bank-owned microcredits and receives a commission from the bank in exchange.[97]

5.3. Colombia

Colombia has in place a policy[98] that establishes ceilings to interest rates charged by commercial banks. The Monetary Board[99] determines the maximum interest rates that credit institutions can charge or pay their clients as regards all lending and borrowing transactions. These rates vary based on the kind of transaction, the funds' purpose and the location.

In countries where interest rate caps have been imposed, microenterprise financing by the formal financial system has diminished. As mentioned in previous sections of this paper, in order to prevent these negative effects and to encourage financial sector's integration into the

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[96] Exchange rate: Chilean Peso / USD = 513, and exchange rate: Chilean Peso / UF = 17,975 as of December 2005.
[97] Planet Rating's report on Banco del Desarrollo rating at www.MixMarket.org.
[98] Section 6 of Executive Order 2,206 of 1963.
[99] The Monetary Board (now the Executive Board) is a public agency governing monetary, exchange rate and credit policy.

MF segment, several countries have authorized the charging of commissions that are not considered interest and have excluded certain types of loans from the imposed interest rate caps.

The mechanism used in Colombia (authorized by Act No. 590 enacted in 2000) includes the charging of commissions and fees in addition to the interest rates that financial intermediaries and microenterprise credit specialized organizations[100] are allowed to charge based on tariffs approved by the High Council of Microenterprises. That law specifies that fees charged will be used to pay specialized technical counseling provided to the microentrepreneur with regard to the economic activity or company to be developed, as well as the visits needed to check progress. Commissions shall be destined to compensate for credit transaction analysis, co-debtors references verification, and specialized collection of the obligation.

That law represented a remarkable progress in the access of microenterprises to financing from the private sector. Before the enactment of that law, microenterprises financing sources were limited to informal lenders and some non-banking entities specialized in the business segment.[101]

Another government policy intended to encourage commercial banks' access to MF is a financial sector-government agreement signed in 2002[102] by 31 commercial banks, by which banks commit themselves to contribute with an established microcredit amount from their own resources.

The figures of the banking sector-national government agreement show that during the first year and a half of transactions around USD 380 million were disbursed.[103] That figure can be divided into direct financing to microenterprises (88%) and financing to microenterprise-specialized MFIs (12%), with an estimated total of 424 benefited businesses.[104] The most active institutions as regards microcredits have been Caja Social, with disbursements of almost 27.6% of the total, Banco de Bogotá with 12.2%, and Megabanco with 12% (all private institutions).

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[100] Section 39 of Act No. 590. Microcredit activity is defined as the microenterprise funding system in which the maximum amount per credit transaction is equal to twenty five effective legal minimum monthly salaries.

[101] Avendaño Cruz, H. (2006).

[102] Ministry of Economic Development of the Republic of Colombia. Press Release. 2002.

[103] Based on average exchange rate for 2002-2004. Colombian Peso/USD=0.00037.

[104] Asobancaria (2004). The figures of microfinance credits granted by banks in Colombia differ when compared to those published by the Financial Superintendency of Colombia or by the Ministry of Trade and Industry since, for the latter, the definition of microcredit (the one adopted in the banking sector-national government agreement) is broader than the one proposed by the Superintendency. The Superintendency defines *microcredits* as "…loans and financial leases granted to microbusinesses whose total balance outstanding with the Bank does not exceed twenty-five (25) times the effective legal minimum monthly salaries," and defines *microenterprise* as "any economic exploitation unit owned by an individual or corporate entity, involved in entrepreneurial, farming and livestock, industrial, commercial or service activities, whether rural or urban, whose staff does not exceed ten (10) workers and whose total assets are under five hundred one (501) effective legal minimum monthly salaries". The figures reported in the text are based on the Agreement methodology.

6. Downscaling in Argentina

In Argentina, comparatively, a low development of microfinance activities is observed. However, the issue has become increasingly important during the last years, when the MF market became significantly dynamic, with a sustained growth of lending programs for low-income people channeled through the MFIs under the legal figures of NGOs and S.A.s[105], and more recently through financial institutions.

Commercial banks MF activity in Argentina is still fairly incipient. In all of the cases, the projects are relatively new or under an implementation process.

A first example is that of a private bank, Banco Columbia, which established a strategic alliance with ACCIÓN International to develop a microfinance services branch. The average loan granted by its microfinance unit is of USD 830, with a twelve-month term and an interest rate ranging from 30% to 40% a year, applying the method of individual rather than group loans.[106] Currently, they operate in Buenos Aires metropolitan area (Liniers, Lomas de Zamora and Quilmes).

Another private initiative is that undertaken by Grupo Supervielle —with *PlanetFinance*'s counsel—, which set up *"Cordial Microfinanzas,"* a corporation (SA) separate from the bank, to provide microfinance services. This business form provides an organizational structure and a flexible human resources model, and low-income clients feel willing to operate with specialized institutions. The average amount of granted loans is USD 430, and the average term is 8 months. Currently, they have a branch and apply individual credit methods, without requesting collateral.[107]

Another method of funding microfinance operations which is being applied by some banks is the creation of financial trusts, where the institution acts as a *trustor*. According to this method, the financial institution transfers funds to be administered by a third party and used, according to the agreement entered into by the parties, to fund MF activities. This method is being applied by two governmental institutions, and in both cases funds are channeled through different legal entities —cooperatives, civil associations, non-profit associations, *sociedades de fomento* (non-for profit organizations existing under Argentine legislation, designed to promote culture, share experiences, etc.), among others, that grant microloans.

One of the programs, "*Fuerza Solidaria,"* which has recently began its activities with the participation of Banco de la Provincia de Buenos Aires and of other governmental institutions, grants loans to microfinance institutions operating within the bank's scope of action. These institutions channel the funds to clients.

The other program is "*Fondo Nacional para la Creación y Consolidación de Midroemprendimientos* (FOMICRO)", which is funded by Banco de la Nación Argentina.

FOMICRO also works with microfinance institutions, but the latter only participate in the

105 S.A. = Spanish acronym for "*Sociedad Anónima,*" a business form similar to the American corporation which consists of an association of individuals —shareholders— with most of the rights and duties of natural persons but with perpetual existence and limited liability.
106 Lecture by Gregorio Goity during the Seminar "Microcrédito en Argentina," CEF (Centro para la Estabilidad Financiera – Center for Financial Stability), March 14, 2007.
107 Presentation by CORDIAL Microfinanzas, March 30, 2007, BCRA.

selection, submission and training of MF projects to be funded, the decision to grant the loans remaining at the bank's discretion. This program works with signature loans to fund productive ventures (non commercial) and the interest rates are subsidized by the Undersecretariat of Small and Medium-sized Enterprises and Regional Development of the Ministry of Economy and Production of Argentina.[108]

7. Conclusions

MFIs were the first to identify the unserved demand for microcredits and to develop models for the provision of credits and other financial services to low-income people. Driven by their determination to achieve their social support goals and financed by governments and donors, many MFIs expanded their activity and started experiencing growing financing needs. In several cases, due to failure to satisfy those financing needs through founder contributions or government subsidies, MFIs chose to become regulated financial entities authorized to capture deposits from the public. This gradual process known as upgrading allowed MF to reach a growing number of clients requiring microfinance services.

In contrast to this process, a new approach is emerging for the provision of microfinance services in a profitable, sustainable, unsubsidized and large-scale fashion through commercial banks, which have already detected the existence of this market and are increasingly venturing into the MF business.

Several reasons have led banks to become engaged in the downscaling process, including MF profitability and growing competition in the medium-sized and large businesses financing market.

There is not one single way in which banks become engaged in MF. On the contrary, there are several methods applied around the world without one being preferred over the other in absolute terms. The superiority of one model will depend on the bank characteristics, the purpose of the proposed business and the regulatory environment.

Downscaling models can be globally classified into *direct* or *indirect* according to the type of contact the bank has with the client. There are four downscaling models generally used: the creation of an *internal unit* in the bank developing the MF activity, the establishment of a *financial subsidiary* legally separated from the bank undertaking the microfinance activities, the creation of a *service company* that is not a financial institution and that generates bank-owned microcredits, and the formation of bank *strategic alliances* with non-banking institutions that are already engaged in the MF business (financing for MFIs, a contract to provide the bank with certain services related to the MF activity, and access to the bank branch networks, among others).

In Argentina, BCRA regulations allow regulated institutions to venture into MF through the use of some of the above mentioned models. Institutions can grant microcredits directly (Internal Unit model) using the legal figure of *limited amount loans* (whose main advantage is that documentation requirements are fewer than for other loans: only the client's ID is required) or using the credit scoring and screening systems (although these tools are designed for the provision of loans with consumption rather than commercial purposes). As regards the Financial

[108] Source BNA.

Subsidiary, in Argentina any institution serving as regular intermediary between fund supply and demand is regulated by the BCRA, so this model requires a financial institution to have equity holdings in another bank or financial institution regulated by the BCRA. In that case, the subsidiary could only target part of its activity to the MF business (same regulations covered in the Internal Unit model). The Service Company model can be used only if the activities undertaken by the company in which the bank has equity holdings are complementary to the financial activity or are expressly authorized by the BCRA (excluding credit risk assessment and loan development). These considerations apply to shareholdings over 12.5% of equity or votes; for lower shareholdings, participation is allowed but not higher than 15% of the institution's RC.[109] When a bank signs a contract with a Service Company for the provision of MF-related activities, BCRA regulations apply to the outsourcing of transactions. The outsourcing of administrative and non-operational activities is allowed, without externalization to the public. These can include MF-related activities, although the outsourcing of credit development and its risk assessment and the promotion of bank products are not allowed, provided they generate the underwriting of risks not assessed by the institution. As regards the wide range of relationships that a bank can establish with an MFI (covered under the Strategic Alliances model), local regulations do not constitute an obstacle for the provision of logistic or technical support services (access to branch networks and ATMs, credit collection, transaction processing, etc.). However, to provide financing to MFIs, the easiest and most commonly used way of strategic alliance, Credit Graduation regulations may have successful results in practice due to possible low capitalization of those institutions (mainly foundations and MFIs).

A recent study[110] conducted in Argentina estimates that there will be 440,000 potential microcredit clients in Buenos Aires metropolitan area only, which could require AR$574 million. This estimate could increase in a context of higher competition and decreasing interest rates. On the other hand, RADIM estimates that, at the end of 2006, the microcredit supply of all its members across the country reached 19,000 credits worth AR$27.3 million. To this, we should add 11,000 extra credits granted by smaller MFIs, totalizing a portfolio worth around AR$40 million.

These data would clearly indicate that there is a large unserved demand for microfinance services, which could be served by means of a rapid expansion of existing MFIs' operations. However, the magnitude of that demand could require the complementary venturing of more banks in this segment. Commercial banks could make the most of their experience in the provision of financial services, its vast network of branches and their technological infrastructure to serve the MF segment. This, plus specific training and counseling on how to best serve this sector or the establishment of strategic alliances with MF-specialized institutions under an appropriate regulating framework, would allow them to cost-effectively serve the low-income sector.

[109] The RC percentage can increase based on transactions' guarantees; Credit Risk Fractioning regulations also apply.
[110] Curat, P., Lupano, J., & Adúriz, I. (2006).

Annex 1: Indicators for commercial banks engaged in MF

No.	Bank	Country	Total Assets	Gross Loan Portfolio	Total Equity	Savings	Number of Active Borrowers	Number of Savers	Average Loan Balance per Borrower	Average Savings Balance per Saver
1	Grameen Bank	Bangladesh	646,489,830	424,439,392	98,964,539	194,707,645	5,050,000		84	
2	Banco Estado	Chile	449,290,872	397,524,702	34,362,217	191,771,297	168,829	89,738	2,355	2,137
3	BANTRA	Peru	366,867,388	315,289,203	38,142,758	228,003,540	450,182	355,956	700	641
4	Banco Solidario	Ecuador	297,622,896	207,033,940	23,740,767	197,587,178	153,452	111,468	1,349	1,773
5	MiBanco	Peru	250,504,933	207,424,921	42,953,055	147,645,770	154,541	57,142	1,342	2,584
6	Compartamos	Mexico	213,654,621	180,630,956	80,481,345		453,131	0	399	
7	Banco Los Andes P	Bolivia	181,413,306	146,448,797	18,356,929	79,205,582	7,422	38,803	1,973	2,041
8	BancoSol	Bolivia	175,651,375	130,106,000	20,037,625	96,893,500	85	76,587	1,531	1,265
9	EBS	Kenya	158,130,080	81,232,249	22,001,248	108,240,431	110,112	556	738	195
10	ProCredit SLV	El Salvador	130,564,500	102,455,400	17,522,500	64,462,200	66,617	84,246	1,538	765
11	ACLEDA	Cambodia	123,871,080	99,900,701	31,954,520	61,901,125	14,092	92,413	709	670
12	CERUDEB	Uganda	121,843,127	53,028,738	16,275,037	97,040,572	5,788	488,213	916	199
13	Banco ADEMI	Dominican Republic	97,179,643	78,131,927	13,581,892	62,071,622	33,145	36,504	2,357	17
14	ProCredit - ECU	Ecuador	83,399,582	73,318,307	9,942,591	20,133,288	29,531	14,218	2,483	1,416
15	ProCredit - NIC	Nicaragua	81,200,408	67,209,363	13,416,603	24,813,891	52,073	35,471	1,291	700
16	Bandesarrollo	Chile	61,458,279	61,786,881	1,347,462	14,168,770	54,455	28,939	1,135	490
17	CREDIAMIGO	Brazil	60,567,404	60,435,949	12,950,767		195,378	0	309	
18	K-Rep	Kenya	52,185,809	34,062,539	10,901,362	15,387,221	69,279	23,044	492	668
19	XacBank	Mongolia	48,062,265	30,007,319	7,742,876	25,062,918	50,101	65,056	599	385
20	BANGENTE	Venezuela	29,622,917	25,952,420	4,150,950	9,294,569	29,818	40,531	870	229
21	FMFB - Pakistan	Pakistan	24,295,478	6,068,138	11,514,095	10,887,046	16,931	27,932	358	390
22	FMFB Afghanistan	Afghanistan	23,147,143	7,450,809	5,831,650	95,107	8,302	156	897	610
23	MFBA	Azerbaijan	21,779,704	18,044,974	6,730,720	53,251	5,455	1,158	3,308	460
24	NovoBanco - MOZ	Mozambique	10,989,578	8,279,743	2,781,770	5,301,792	15,587	41,648	531	127
25	Nirdhan	Nepal	9,410,745	5,909,954	523,036	203,444	50,063	64,037	118	3
26	SOCREMO	Mozambique	8,061,544	5,380,658	2,913,900	806,929	6,377	3,172	844	254
27	NovoBanco - ANG	Angola	7,762,457	4,369,420	4,913,548	2,322,328	1,093	11,169	3,998	208
28	KBSLAB	India	6,494,650	4,187,415	1,251,776	1,825,425	22,814	10,434	184	175
29	SBB	Nepal	5,623,011	3,355,907	752,228	146,758	33,708	4,154	100	4
30	OMB	Philippines	5,112,897	2,840,166	2,163,074	720,452	29,516	360	96	2,001

Source: 2005 comparative tables from Microfinance Information Exchange (MIX).
The banks selected for this analysis have been rated **** and ***** in terms of their information quality (in accordance with MIX standards). Some MFIs were not considered in this analysis because microfinance represents less than 91% of their operations.

Annex 2: Government initiatives for boosting MF in Brazil

Microentrepreneur Credit-Granting Associations

Direct or indirect participation of public sector in Microentrepreneur Credit-Granting Associations' equity is prohibited.

These companies must comply with the following ceilings at all times:

-Minimum liquid net worth and paid-in capital of 100,000 Reais (USD 42,800).
-Maximum outstanding debt of five times the liquid net worth plus current liabilities obligations, loan sales and guarantee granting co-obligations, less applications in federal government bonds.
-Maximum risk diversification of 10,000 Reais (USD 4,280) per client in credit transactions and guarantee granting.

Furthermore, they must provide the Credit Risk Central System with information in agreement with current procedures established by law. Corporate participation in financial institutions or other entities authorized by the Central Bank is also prohibited.

These companies can be controlled (previously authorized by the Central Bank) by Public Interest Civil Society Organizations[111] provided that they undertake credit activities compatible with Microentrepreneur Credit-Granting Associations' purpose and that the public sector have no participation or veto power over their management.

The Microcredit Serving Point (PAM) is created for taking care of Microentrepreneur Credit-Granting Associations' credit transactions. Financial institutions can establish the PAM at any location without the need of liquid net worth or paid-in capital contribution by the institution in question; the PAM can be fixed or mobile, permanent or temporary (the Central bank must be informed of any openings and closures), owned or rented; daily fund movements must be recorded in the accounting records of the institution's headquarters or other agency; working hours can be freely determined by the institution.

Act No. 10,735 and Banco Central do Brasil's resolutions

This law specifies that the National Monetary Council (CMN) shall regulate what the law provides for, establishing at least: deposit percentage, criteria for classifying individuals and microentrepreneurs; criteria for selecting low income people; maximum interest rate for resource borrowers; credit-opening fee maximum value; credit maximum amount per person. Through an amendment, the following was added to the law: transaction minimum term; criteria for acquiring other microcredit or financial institutions' portfolio; deadline for financial institutions' adaptation to this law.

Through Resolution No. 3,310 of August 2005, the Central Bank of Brazil established that at least 2% of sight-deposit balances captured by commercial banks, multiple banks with trade portfolio and Caixa Económica Federal shall be allotted to microcredit transactions targeted at

[111] Created by Act No. 9,790 of March 1999.

low-income population sectors and microentrepreneurs. Sight deposits of government and mixed economy companies shall not be considered, in public state and federal financial institutions.

Furthermore, the resolution defines *microcredit transactions* as those conducted with individuals that own deposit accounts with a monthly average balance lower than 1,000 Reais (USD 430 approximately), individuals with small-sized enterprises of professional, commercial or industrial nature, legal entities classified as microenterprises based on current legislation, low-income people with or without low value deposits, individuals or legal entities undertaking small-sized productive activities with a gross annual income not higher than 60,000 Reais (USD 25,700 approximately).

The effective interest rate charged shall not exceed 2% per month (or 4% for transactions comprised in the National Program of Oriented Productive Microcredit created by Law No. 11,110).

The maximum credit amounts stipulated are 600 Reais (USD 255) for low income people and holders of deposits lower than 1,000 Reais (USD 430); 1,500 Reais (USD 640) for microenterprises; and 5,000 Reais (USD 2,140) for productive microcredit. The transaction term cannot be lower than 120 days and the credit opening fee ranges from 1% to 4% based on the type of credit.

The accepted microcredit transaction guarantees are: joint and several guarantees of at least three individuals; guarantee bond; other guarantees accepted by financial institutions.

Due and unpaid credit transactions can be computed towards the requirement of targeting 2% of deposits to those transactions, according to the following percentages: 100% during the first year after due date; 50% during the second year.

Computation of that requirement is based on sight-deposit daily balances of the 12 months previous to the month immediately preceding the month in which calculation is being made.

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