Focus Note
NO. 28 JUNE 2005

COMMERCIAL BANKS AND MICROFINANCE: EVOLVING MODELS OF SUCCESS

The authors of this Focus Note are Jennifer Isern, lead microfinance specialist, CGAP; and David Porteous, consultant.

The authors would like to extend their thanks to several individuals and institutions that made valuable contributions to this paper. This paper includes case studies gathered through CGAP research led by Jennifer Isern including Matthew Brown, Tiphaine Crenn, and Gautam Ivatury in 2003–04. Elizabeth Littlefield, Jeanette Thomas, and Ousa Sananikone, all of CGAP, made thoughtful and helpful comments. The authors would also like to thank the representatives of all the institutions cited in this paper for their willingness to share their experiences.

There is a vast potential market for retail financial services among low-income clients, and a growing number of commercial banks have successfully entered this market. These are the findings of recent research undertaken by CGAP, the global resource center for microfinance supported by a syndicate of 30 multilateral, bilateral, and private donors.

Microfinance is the category of financial services offered to lower-income people, where the unit size of the transaction is usually small ("micro"), typically lower than the average GDP per capita, although the exact definition varies by country. Starting in the 1970s, well-known pioneers, such as Grameen Bank in Bangladesh and ACCIÓN in Latin America, demonstrated that poor people can be creditworthy. Today, microfinance covers the full range of financial services—credit, savings, remittances, insurance, and leasing, among others—which are increasingly provided by a diverse set of financial service providers. In 1998, CGAP described commercial banks as "new actors in the microfinance world."[1]

Seven years later, it is not surprising that commercial banks are playing an increasingly important role in many financial services markets across the world. Compared with many existing providers of microfinance, commercial banks have potential competitive advantages in a number of areas, such as recognizable consumer brand names, existing infrastructure and systems, and access to capital.

The commercial opportunity in microfinance is catching the interest of mainstream banking. The February 2005 issue of *The Banker* carried a special feature on microfinance. The editorial of this issue stated: "Bankers are only just realizing that the poor have needs just like anyone else and that giving them the opportunity to help themselves not only works, but can open up the global financial markets to an entirely new customer market and asset class."[2]

This Focus Note highlights recent CGAP research about the different ways in which commercial banks have successfully entered the microfinance market.

[1] Baydas, Graham, and Valenzuela, *Commercial Banks in Microfinance: New Actors in the Microfinance World*, 1998, www.cgap.org/publications/focus_notes.html

[2] *The Banker*, February 2005, p. 6

Why Enter the Market?

In a number of countries, banks have been compelled by their governments to provide financial services, especially credit, to sectors such as small or agricultural enterprises that are considered social priorities. Using moral or legal compulsion generally has not led to sustainable models of service provision.

However, increasingly, commercial banks are investigating for themselves, and some are entering the microfinance market because they see sustainable profit and growth opportunities.

Commercial banks face increasing competition in their traditional retail markets. This is causing margin squeeze. It is also leading forward-thinking banks to explore new potential markets that can generate growth in client numbers at acceptable profit margins.

CGAP estimates that there are up to 3 billion potential clients in the microfinance market.[3] Some 500 million people are currently being served by socially-oriented financial institutions, ranging from cooperatives to postal savings banks that extend financial services beyond the traditional clients of commercial banks. Nonetheless, a significant number of potential clients remain unserved.

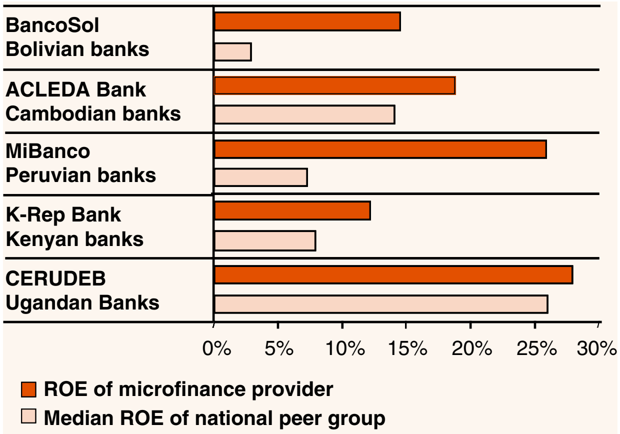
A recent CGAP survey identified over 225 commercial banks and other formal financial institutions that are engaged in microfinance.[4] For some, microfinance has been highly profitable. Certain microfinance-specialized banks are now more profitable than the banking sector average in their country (see figure 1).

Success is not guaranteed, however, as some banks have attempted to serve this market and failed because they did not understand the market or tried to move too quickly. Those that have succeeded offer a number of lessons to those now considering this market.

[3] Christen, Rosenberg, and Jayadeva, *Financial Institutions with a "Double Bottom Line,"* 2004

[4] Isern, Ritchie, Crenn, and Brown, "Review of Commercial Bank and Other Formal Financial Institution Participation in Microfinance," 2003.

Figure 1



All data as of end of 2003. *Source:* Bankscope

How to Enter the Market

The CGAP survey of banks in microfinance reveals that there is no single approach to entering the market for microfinance. For one thing, different banks will have different business goals, and the competitive and regulatory environment will vary. Banks have a wide range of approaches to choose from when entering the market.

The current approaches can be divided into two main categories—direct and indirect—based on how the bank makes contact with the client. Some banks enter the market directly by expanding their retail operations to reach the "micro-level" by creating an internal unit or launching a separate company, such as a service company or specialized financial institution. Others take an indirect approach by working with existing microfinance providers. CGAP has identified six discrete approaches banks use to enter the microfinance market.

Provide services directly through:

- an internal microfinance unit, or
- a specialized financial institution, or
- a microfinance service company.

Work through existing providers by:

- outsourcing retail operations, or
- providing commercial loans to MFIs, or
- providing infrastructure and systems.

Choosing the approach that fits both the bank and the circumstances at the outset is an important factor in future success. Each approach has its particular rationale, risk profile, success factors, and costs. The section that follows sets out the basic model and variations in each case, together with selected examples of banks following each approach. The decision tree in figure 2 shows how different factors may give rise to a different choice of model.

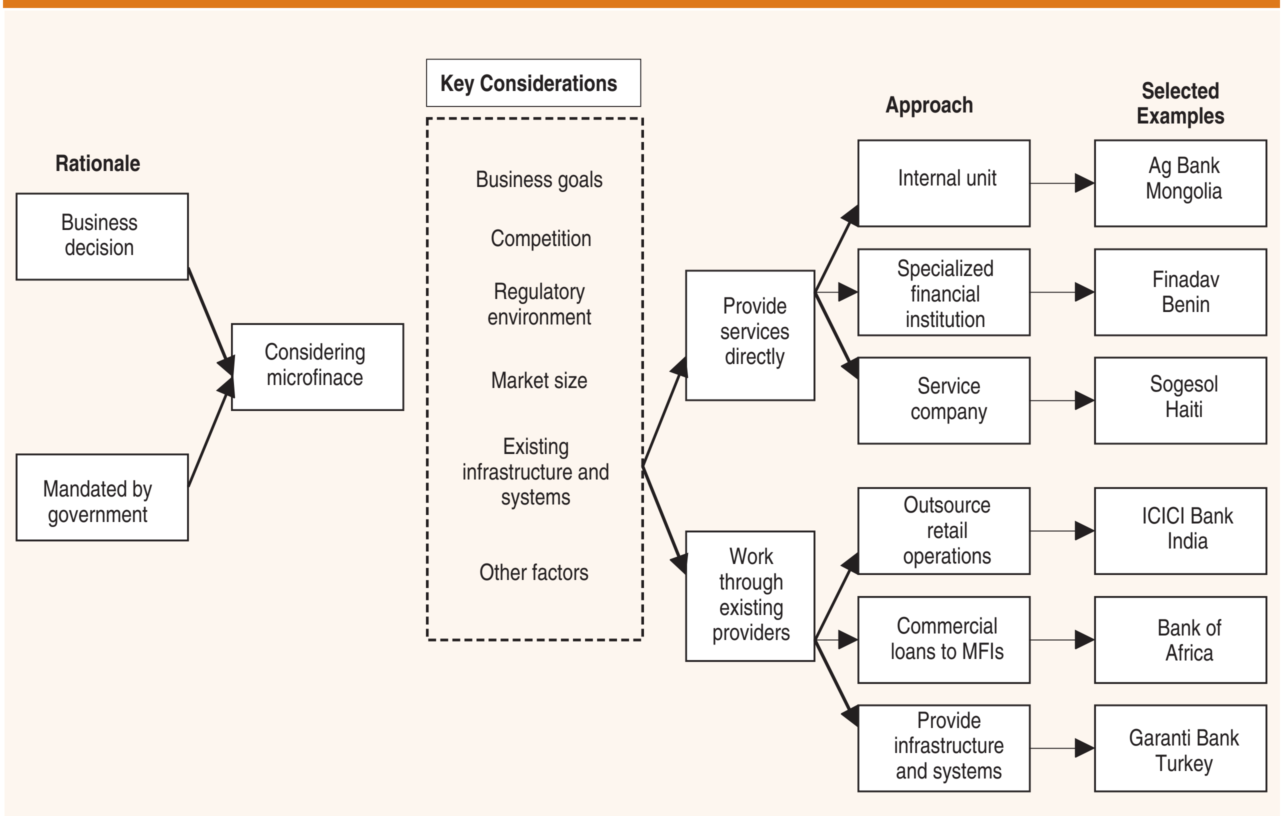
Providing Services Directly

Internal Unit

Under this model, the bank provides microfinance services within its existing institutional structure. It may form a specialized unit within the bank (the internal unit) to manage microfinance-related operations. The microfinance unit is neither a separate legal entity nor regulated separately from the bank. The microfinance operations leverage existing staff and systems of the bank. An internal unit requires adaptations of the bank's systems and procedures to the specialized requirements of microfinance-related operations. Banks may give further autonomy to the internal unit by creating separate systems, loan procedures, staffing policies, and governance. The unit can be linked with various bank departments such as retail or consumer finance departments.

The Agricultural Bank of Mongolia, which chose an internal unit, has the largest branch network in Mongolia with 379 locations (93 percent in rural areas). It successfully emerged from state ownership following an ambitious turnaround strategy launched in 1999. Once the new management team took over, the first loan product they proposed was a working capital loan for micro and small businesses. Since then, the bank has added other products, including transfer payments; an array of savings products; loans for medium entrepreneurs, pensioners, and herders; payroll deduction loans; and agricultural loans. The bank

Figure 2 Decision Tree for Commercial Banks in Microfinance



Summary two-page profiles for each of the six models are available online at www.cgap.org/commercialbanks/profiles.html developed products specifically for a large segment of the market to diversify their client base. All products were designed to be integrated into the branches by existing staff. As of February 2004, the bank reported the following operations:

- Micro and small loan portfolio of $19 million, with more than 13,400 outstanding loans (39 percent of total). The bank's total loan portfolio is $50 million with more than 128,200 outstanding loans. The average outstanding loan is $382.
- $75.5 million in 377,400 savings accounts. The average deposit account balance is $200.
- More than 15,400 domestic transfers for the month representing $260,000. The average transfer is $17.
- A return on equity of 44.2 percent in 2003 and an arrears rate consistently below 2 percent.[5] The Agricultural Bank is one of the most profitable banks in Mongolia.

The internal unit model is seen throughout the world, including in Akiba Commercial Bank, Tanzania; Bank Rakyat, Indonesia; Banque du Caire, Egypt; Banco Solidario, Ecuador; Cooperative Bank, Kenya, and Banco do Nordeste, Brazil.

Specialized Financial Institution

Rather than set up an internal unit, the bank may decide to form a separate legal entity (the specialized financial institution, or SFI) to undertake microfinance activities. The SFI is licensed and regulated by the local banking authorities, usually as a finance company or other non-bank financial institution, and may be wholly-owned or a joint venture with strategic partners and investors. The SFI provides retail microfinance services, including loan origination, disbursement, and collection as well as other financial services as defined by its charter. The SFI maintains separate corporate identity, governance, management, staff, and systems from those of the parent bank. As a variation on the model, the new institution may use parent-bank infrastructure (office space, information technology, accounting, treasury, etc.) or be more independent and stand alone.

In 1995, Financial Bank in Benin started microfinance operations by offering retail housing and consumer loans to salaried workers and by wholesaling loans to microfinance institutions (MFIs). During this time, it began to offer free cashier services to MFIs that borrowed from the bank. This experience allowed Financial Bank to learn more about a microfinance client base and the patterns of their transactions. In November 1998, the bank decided to expand operations and create an internal unit to manage its microfinance operations. Building on its growing success, the bank spun off its internal microfinance unit as Finadev, a specialized financial institution. The new institution began operating in July 2001 with these shareholders: Dutch FMO, LaFayette Participations, Financial Bank Benin, and Financial Bank Holding.

Finadev rents offices in five of six Financial Bank branches and has two independent branches. While the top two managers are seconded employees of the bank, the rest of Finadev staff are specially recruited. Initially, many procedures were similar to the bank's, but over time Finadev developed its own procedures for loan review, information services, human resources, etc. As of December 2003, Finadev served 14,000 loan clients with an outstanding loan portfolio of US $9.8 million; Finadev reached a return on equity (ROE) of 5.2 percent while maintaining high portfolio quality with portfolio at risk (PAR) > 30 days of 1.05 percent.[6]

A number of other specialized financial institutions have been created in the past few ears, such as Jordan National Bank's AHLI Microfinancing Company; Jamaica National Building Society's JN Small Business Loans, Ltd.; Banco del Estado de Chile and Banestado Microempresas; and Teba Bank and Teba Credit, South Africa.

Service Company

In a service company model, the bank forms a non-financial legal entity (the service company) to provide microloan origination and portfolio management services. In contrast to the specialized financial institution,

[5] Dryer, Morrow, and Young, "Case Study: The Agricultural Bank of Mongolia," 2004.

[6] Interviews with the Finadev chairman in May 2004, and deputy director in April 2004; Finadev 2003 financial statements and performance reports; and Finadev web site, www.finadev.org.

the service company usually undertakes more limited operations and is not regulated separately by the banking authorities. Loans and other financial service products (savings, transfers, payment services, etc.) offered to service company clients are registered on the books of the parent bank. The service company typically maintains separate corporate identity, governance, management, staff, and systems (although the information systems are usually linked directly with those of the bank). The service company may be wholly or partly owned by the bank. However, the service company structure offers the bank the ability to involve technical service providers with expertise in the delivery of microfinance and other interested investors as equity partners, which it cannot do with an internal unit. The service company may operate in designated areas within bank branches or in separate offices close to the bank.

In late 1999, SOGEBANK, one of the largest commercial banks in Haiti, embarked on its management-driven venture to enter the microfinance market. SOGEBANK cites several reasons for launching services, including improved regulatory conditions with the elimination of interest rate ceilings and reduction in required legal reserves; demonstration effect from other successful commercial institutions; the threat of losing customers in an increasingly competitive environment; and an enhanced reputation as a socially responsible actor.

SOGEBANK was strategically positioned to enter this market because it held a significant share of savings from small savers and had developed capacity to process high transaction volume. To reduce risk, SOGEBANK created SOGESOL as a joint venture with strategic partners. The first loans were disbursed to clients of SOGESOL in November 2000. (SOGESOL does not need its own bank license, avoiding arduous reporting requirements.) Besides credit, through similar arrangements, SOGESOL can offer its clients savings, payments, and remittance-related services. Under the SOGEBANK-SOGESOL service agreement, SOGEBANK disburses all loans and maintains the loans on its books. For its loan origination and portfolio management services, a net fee is paid to SOGESOL representing the difference between all income accruing to the loans originated by SOGESOL from interest and fees, and all costs and risks accruing to the managed portfolio, including loan loss expense, market cost of funds, a support service commission (contractual), and an *ad valorem* transaction fee. At the end of three years of operations, SOGESOL was serving over 6,000 active clients and managing an outstanding portfolio valued at close to US $3 million. Average ROE was over 30 percent for those three years.[7]

Other examples of the service company model include Banco del Pichincha's Credife in Ecuador and Banco ABN-AMRO Real's Real Microcredito Asessoria Financiera in Brazil.

Working through Existing Providers

Outsource Retail Operations

In this model, the bank contracts a high-caliber MFI to originate microfinance loans that are registered on the bank's books, to make credit decisions, and to service the loan portfolio in return for a share of the interest income or fees. The arrangement is similar to banks outsourcing transaction processing to ATM network operators. The microfinance products, including loans, insurance, and money transfers, may be branded by the bank or the MFI, or be a joint brand. The bank may restrict the MFI from servicing other banks. The bank may delegate credit decisions to the MFI if the MFI has a history of maintaining a high quality loan portfolio on its own, or the bank may structure a joint review process. However, this model requires that the bank and MFI share risks and incentives to maintain high portfolio quality. Hence, the bank may ask the MFI to finance a portion of the microfinance loan portfolio or provide a first loss guarantee on a portion. Insurance companies may follow a similar agency model with an MFI. In other cases, non-MFI NGOs may provide training or personal finance education to the bank's clients on the basis of an informal relationship with the bank.

[7] Lopez and Rhyne, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," 2003; and Boisson, "Commercial Banks and Microfinance: Strategic Choice or Temporary Distraction: The Case of SOGESOL," 2003.

ICICI Bank contracts MFIs in India to source microfinance loans and continuously monitor and service these loans. As one example, Spandana, an MFI based in Guntur, Andhra Pradesh, has acted as a service agent for ICICI Bank since November 2003, and has disbursed nearly US $3 million to over 20,000 clients under the arrangement through the end of March 2004. Spandana's field staff help borrowers complete loan applications and promissory notes in the name of ICICI Bank, make disbursements, collect repayments, and monitor the loan over its entire life. The cost to the borrower on the one-year term loan is a flat 15 percent (about 30 percent effective p.a.), the same rate that Spandana charges when it is the lender of record. Of this charge, 9.25 percent is interest income and fees for ICICI Bank, and the remainder (about 20.75 percent) is a service charge collected by Spandana.

To share the credit risk, ICICI Bank requires Spandana to deposit a fixed deposit with the bank in the amount of 12 percent of the total committed amount. As an alternative, Spandana may take an overdraft from the bank for this amount and pay a 1 percent fee upfront. If losses occur, ICICI Bank will draw from this overdraft, charging Spandana 19 percent interest on the amount drawn. ICICI Bank gains from a highly profitable, rapidly-growing microfinance portfolio and links to organizations that have strong track records but lack sufficient equity to borrow directly.[8]

In Lebanon, Credit Libanais, Jammal Trust Bank, and Lebanese Canadian Bank all outsource their lending operations to the microfinance institution AMEEN. MFIs in India manage some client relations for AIG, Aviva, MetLife, ICICI Lombard Royal Sundaram; and transfers companies, such as Western Union, Vigo, and MoneyGram, link with MFIs to provide customer support.

Provide Commercial Loans to MFIs

Banks can provide a term loan or line of credit to an MFI for working and/or lending capital. This is one of the most common models since it is closest to standard commercial bank lending. The loan may be unsecured, secured by the pledging of assets as collateral or a cash deposit, or by a third party guarantee. The bank may stipulate covenants with respect to the provision of periodic financial statements, rights to inspection, as well as other financial covenants.

Many banks around the world provide commercial loans to MFIs. Several factors indicate whether an MFI is ready for commercial funding:

- Readily available financial information
- Sound governance and capable management, with focus on profitability and efficiency
- High-quality loan portfolio with appropriate provisioning and write-off policies
- Information systems that produce accurate, timely, and relevant reports
- Good prospects for growth

Provide Infrastructure and Services to MFIs

In some cases, the bank provides access to its branch or ATM networks, front office functions (including cashier services), or back-office functions, such as IT services and transactions processing, to a microfinance institution and/or its clients. In return, the bank receives fees, commissions, and/or rents from the MFI and its clients, depending on the terms of the contractual arrangement. Transactions processing is the most basic and common form of this link between banks and MFIs, and is generally the lowest risk approach. As variations on the model, MFIs can place their own staff in the bank branch to serve MFI customers or can rely on bank infrastructure (e.g., ATMs and cashiers) for loan disbursements and repayments, domestic and international transfers, and foreign exchange transactions. Clients can have accounts with the bank directly or receive loan disbursements and repay loans to the MFI's account at the bank. Back-office functions can be processed by the bank if MIS systems are compatible.

Garanti Bankasi, a private commercial bank, is the third largest bank in Turkey in terms of assets. It has 329 domestic bank branches and a network of over 800 ATMs; it offers internet and phone banking services; and

[8] Interviews with ICICI senior management October 2003 and April 2004.

it is known for its customer service. In late 2001, Garanti began providing services to Maya Enterprise for Microfinance as a small business client. Given the bank's highly developed infrastructure, Maya negotiated with Garanti to offer a variety of services, and the business link proved mutually advantageous. Garanti provides branch network banking and electronic banking for all loan disbursements, payments, and reporting to Maya's clients, who receive preferred service by Garanti staff. Maya invests any dormant capital in the bank and processes its payroll through the bank. Maya's loan officers help clients fill out forms to establish checking and savings accounts and ATM cards with Garanti.[9]

Examples of this model are prevalent throughout the world, including Banamex and Banco Bital serving Compartamos in Mexico, Alta Bank serving FINCA Tomsk in Russia, and Procredit Bank serving Constanta Foundation in Georgia.

Next Steps

Commercial banks that wish to take advantage of the opportunities in microfinance should carefully evaluate the considerations listed in the decision tree above, specifically their own goals, the potential market size and competition, the regulatory environment, and their current infrastructure and systems.

Given the differences between classic banking and microfinance, commercial banks need to view microfiance as a new business line and conduct the same kind of research that any company would entering a new market. For one thing, the clients and products may pose different risks from the risks of traditional banking. The different models outlined offer a range of risk levels for banks, and ways of managing them. Any bank looking to get into the market will need to take into account the bank's own interests and institutional capacity, competition, and other market factors. Secondly, banks getting involved in microfinance will need to develop new products appropriate to their target clientele. To deliver the products effectively, banks usually need to adapt their systems and procedures and provide specialized staff training and incentives on the new clients and products.

While a variety of models are evolving for commercial banks to enter the microfinance market, none is doing it successfully without board and management vision and commitment. Without this vision and commitment, it is unlikely that a bank will apply the resources—human and financial—necessary to make microfinance a profitable part of the business.

Entering this market is a long-term business proposition. No bank should expect to make a "quick buck" from microfinance. But the evolving models and profit records of successful players are encouraging more banks to see the long-term business rationale. There is a massive potential market for banks that approach these clients successfully.

[9] Email correspondence with Catholic Relief Services technical advisor and the director of the Maya Foundation, May 2004. See the Garanti Bankasi web site at www.garanti.com.tr.

Box 1 Serving the Underserved—What Makes for Success?

- **Commitment** from board and management, strong internal champions, and alignment with the bank's core commercial strategy
- **Knowledge** of microfinance best practices and how to serve micro-clientele
- **Infrastructure** located conveniently for clients
- **Products** especially adapted for low-income and informal markets
- **Systems and procedures** adapted to the microfinance operations, e.g., systems that support immediate follow-up on missed payments
- Appropriate staff **training** and incentives on new clients, products, and delivery systems

Suggestions for Further Reading

"Banks Can Reach Out to the Poor," *The Banker* (2 February 2005): 6.

"Microfinance Joins the Mainstream," *The Banker* (2 February 2005): 12.

Pierre-Marie Boisson, "Commercial Banks and Microfinance: Strategic Choices or Temporary Distraction, The Case of Sogesol," paper presented at the AFRICAP seminar "Financing Growth in Africa through Commercial Capital," Dakar, Senegal, April 25, 2003, www.africapfund.com/site/rubrique.php3?id_rubrique=45.

Robert Peck Christen, Richard Rosenberg, and Veena Jayadeva, *Financial Institutions with a "Double Bottom Line": Implications for the Future of Microfinance,* CGAP Occasional Paper, no. 8 (Washington, DC: CGAP, July 2004), www.cgap.org/docs/OccasionalPaper_8.pdf.

Jay Dryer, Peter Morrow, and Robin Young, "Case Study: The Agricultural Bank of Mongolia," paper presented at the World Bank Institute conference "Scaling Up Poverty Reduction," Shanghai, China, May 2004, www.worldbank.org/wbi/reducingpoverty/docs/newpdfs/case-summ-Mongolia-Agricultural-Bank.pdf.

Jennifer Isern, Anne Ritchie, Tiphaine Crenn, and Matthew Brown, "Review of Commercial Banks and Other Formal Financial Institution Participation in Microfinance," November 2003, www.microfinancegateway.org/content/article/detail/19104.

Jennifer Isern, Anne Ritchie, Tiphaine Crenn, Tamara Cook, and Matthew Brown, "Banks Entering Underserved Markets—Factors for Success," November 2003, www.microfinancegateway.org/files/18155_Success_Factors_of_FFIs.pdf.

Cesar Lopez and Elizabeth Rhyne, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," *ACCIÓN Insight* 6 (September 2003), www.accion.org/micro_pubs_list.asp.

Liza Valenzuela, "Getting the Recipe Right: The Experience and Challenges of Commercial Bank Downscalers," Chapter 3 in *The Commercialization of Microfinance*, ed. Deborah Drake and Elisabeth Rhyne (Bloomfield, Conn., USA: Kumarian Press, 2002).

Liza Valenzuela, Doug Graham, and Mayada Baydas, *Commercial Banks in Microfinance: New Actors in the Microfinance World*, CGAP Focus Note, no. 12 (Washington, DC: CGAP, July 1998), www.cgap.org/docs/FocusNote_12.pdf.

For More Information on Microfinance

The Microfinance Gateway (www.microfinancegateway.org) is a global microfinance portal with a large searchable archive of documents, links to case studies, and a consultant database.

The MIX (www.themix.org) provides information on microfinance institutions, funds, and other support organizations, as well as specific benchmarking data to compare performance based on peer groups according to geographic region, institutional size, and other distinguishing characteristics.

CGAP, the Consultative Group to Assist the Poor, is a consortium of 30 development agencies that support microfinance. More information is available on the CGAP web site, www.cgap.org.

CGAP
1818 H Street, NW
MSN Q4-400
Washington,DC 20433 USA

Tel: 202-473-9594
Fax: 202-522-3744

Email:
cgap@worldbank.org

Web:
www.cgap.org