

Conclusions

A large proportion of the 2495 million people in low-income countries, and even many of the 2738 million in middle-income countries, still lack effective continuous access to banking services. It can be argued that financial services will follow increased prosperity, so that people without such services need to be richer and more accessible before banks and other financial institutions can consider serving them. We would argue, however, that improved access to banking services is a cause as well as an effect of economic development. Research has confirmed how access to financial services helps reduce vulnerability and enables people to seize economic opportunities. But we have met many economically active individuals, poor and non-poor, who live very close to bank branches but have no dealings with them. In the past 30 years, there have been enough initiatives in different locations to confirm that the bigger issue is how this market of small customers is perceived and served by banks. There is no longer any doubt that low-income consumers represent a large and growing market, and that very many of these customers who are currently un-served by banks have both the ability and willingness to pay for the banking services they need.

This book contains 18 case studies describing how existing banks have re-oriented themselves, or new banks have been set up to serve low-income customers and their enterprises. While development agencies and subsidies have played some part in this and have helped with the initial experiments, most banks are pursuing this market because it makes commercial sense. Many of these initiatives are recent but Bank Rakyat Indonesia (BRI), the subject of the first case study in the book, started offering such services 20 years ago. While many of the other case studies are nowhere near the scale of BRI, their results are as dramatic. It is clear that more bankers, investors and policy makers in many more countries are recognizing the market potential to serve large number of un-banked and under-banked people and are re-engineering financial institutions to serve this huge market.

Once the promoters' conviction and capital are combined with the right skills and systems, it does not take very long to make profits out of this market. The case studies have shown how each institution evolved its approach to microfinance. The remainder of this chapter draws some key conclusions from the case studies and shows what they mean for bankers, policy makers and others.

Table c.1 in the annex at the end summarizes some critical development indicators for the 15 countries where the banks are located, and it also includes some summary data from the 18 case studies themselves.

The sample of nine public sector and nine privately owned banks is neither representative nor random, and there are many other banks in the same and other countries, which are working in microfinance. The case studies cover a wide range of low and middle income countries, including some of the poorest nations in Africa, the poorest nation in Central and South America, as well as Bangladesh, Pakistan and India, which are together home to by far the largest concentration of poor people on Earth. Poverty and a predominantly rural population is no bar to commercial banks' entry to microfinance.

The figure for domestic credit provided to the private sector is a useful indicator of the level of formal financial intermediation. This relates the amount of credit to the private sector, in the form of loans, trade credit and other obligations, to the total GDP. It is significant that this ratio is well below even the 27 per cent average for all low-income countries in six of the countries represented in our case studies. The banks in question have been able to reach out to large numbers of un-banked people in spite of the abysmally low level of formal financial activity in general. This shows that banks can intervene in the microfinance market even when formal financial transactions are at a very low level nationally.

Small customers are a large and profitable market

The Microbanking Division of Bank Rakyat Indonesia today serves almost 30 million savers and three million borrowers through 4185 outlets. The US\$3bn savings mobilized from savers are more than adequate to finance the substantial loan portfolio of US\$1.7bn. During the 20 years from 1984 to 2003, the long-term loan loss ratio, calculated as total overdue by one day or more, including amounts written off, divided by the total which had fallen due during the period, was only 1.9 per cent. The micro-banking unit has made consistent profits and during the past five years (1998 to 2002), the average annual profit was US\$139m, translating into an average annual return on assets of 5.8 per cent. This performance was achieved despite the fact that during the 20 year period, the Indonesia Rupiah exchange rate against the US dollar fluctuated between 1074 and 10 446. As the case study says: 'BRI has demonstrated that in a de-regulated policy environment, a public bank is capable of serving vast numbers of micro-savers and micro-borrowers at competitive interest rates: mobilizing resources internally, covering its costs, and financing its expansion from its profits. BRI has proven that institutional viability, sustainability and outreach to low-income people are compatible.'

The success of BRI is not a recent phenomenon. By 1989, BRI had demonstrated that it was possible to transform an ailing public sector development bank into a viable, competitive and growing financial intermediary.

If the lessons from BRI were evident by 1989, why was the example not followed more widely elsewhere? Was the BRI success dependent on its particular context, or were other policy makers and private investors unable or unwilling to implement its lessons elsewhere?

Fortunately, BRI is no longer an isolated case. In Kenya, five private entrepreneurs set up Equity Building Society in 1984. The case study shows how Equity's focus on efficiently serving small customers helped an almost insolvent institution to revive and grow. Today, Equity serves 252 000 depositors and 66 000 borrowers from 15 branches and 24 other outlets. The numbers reached have grown dramatically in the past few years. Equity has also made growing profits since 1994 and, in 2003 it delivered a return on equity of 30 per cent and a return on assets of 3.6 per cent.

In Mongolia, a country over 10 times the physical size of Bangladesh with a population of only 2 million, a creative arrangement of private management working within the framework of public ownership was used to revive AgBank. As the case study says: 'The bank has disbursed 878 000 loans between late 2000 and February 2004 while maintaining an arrears rate consistently below 2 per cent and becoming the most profitable bank in Mongolia, with return on equity of 44 per cent in 2003. AgBank has shown that financial products can be created and delivered gainfully in even scarcely populated areas, if they truly meet the needs of the customers.'

As some of the above numbers indicate, the microfinance market is not just profitable, it is also enormous. Other case studies also report substantial growth and market potential:

- ICICI Bank in India only entered the market in 2001, by offering wholesale finance to other institutions, as well as direct service delivery. In two years, its microfinance portfolio grew from US\$16m to US\$63m, and the bank envisages a potential portfolio of US\$4bn from this market.
- State Bank of India now allows informal self help groups (SHGs) of 10-20 women to open bank accounts and borrow from the bank. SBI was lending to 174 666 such SHGs in March 2004, against only 12 200 SHGs four years earlier, and the bank aims to be doing business with one million SHGs, with approximately 15 million mainly women members, by 2008.

- In Guatemala, Banco del Cafe's portfolio grew from US\$0.02m in 1999 to US\$0.9m in 2001, and by 2003, it had reached US\$16.9m.
- Banco Solidario is the microfinance market leader in Ecuador and has grown from less than US\$30m portfolio in 1997 to more than US\$ 130m in 2003.
- Banque du Caire estimates that only 7 per cent of the 2.4 million small entrepreneurs in Egypt have access to microfinance.
- Only 3 to 4 per cent of Georgians have a bank account.
- Bank of Khyber quotes a Pakistan microfinance network study that potential demand for microfinance services in Pakistan is around US\$2bn per annum.
- Equity estimates that 6.7 million under-banked and un-banked Kenyans require comprehensive financial services.

Microfinance involves diversified risks, high loan repayments and customers who are concerned more with service quality than interest rates. Many commercial banks are discovering that the returns from this market are high in spite of the higher transaction costs.

Not all the case studies include complete data for the profitability of the banks' microfinance business because microfinance is sometimes a small and relatively new part of the overall portfolio, and the banks' product and activity costing procedures may not be very rigorous. But where microfinance is housed in a subsidiary such as Sogesol and Finadev, or makes up a significant part of the institution's business, as in BRI, Equity, or Banco Solidario, or where ownership has recently been transferred to private investors such as AgBank or American Bank of Kosovo, the numbers are more rigorous and profitability is substantial and sustained. What is more, most of the institutions in the case studies have substantial expansion plans for microfinance. They do not regret their entry to this market.

Profitability can be quickly achieved

Some bankers are initially exasperated as to why development practitioners make so much fuss about microfinance. After all, they say, they have been disbursing micro-loans and accepting micro-deposits even before the word 'microfinance' was coined. Most eventually appreciate that the excitement is about doing it profitably, with large numbers of customers who cannot offer collateral, with high loan repayment and manageable operating costs.

The BRI units achieved breakeven point 18 months after the inception of reforms in 1985. Sogesol in Haiti, despite being a new company and working in difficult circumstances, broke even in its twentieth month and achieved full profitability within two years of starting. Even though most commentators had written off the AgBank as recently as 1999, the bank was successfully turned around and sold to a private investor in less than three years. American Bank of Kosovo was set up from scratch and in two-and-a-half years it had attained breakeven.

In many cases, the investors provided the initial commitment, and they may have entered into partnerships with international and/or social investors. Each case study shows how this commitment emerged and was institutionalized. Even though Sogebank in Haiti was an experienced retail bank, its managers realized that they did not internally have the expertise to build an effective microfinance operation. The bank decided to set up a service company in partnership with socially responsible investors.

International Micro Investments, a private investment company, are so confident of their business model that they have already invested in 18 microfinance banks around the world.

In India, with support from the National Bank for Agriculture and Rural Development, NGOs and donors have encouraged the public and private sector banks to experiment with informal self-help groups. The encouragement of the Central Bank, political support, positive experiences from the pilot programmes, and growing staff skills and confidence have helped to scale up the programme in the last few years. However, the scale is still small when compared to the potential customer demand or the banks' overall portfolio. Over 12 years, for example, the SBI has disbursed US\$137m loans to the SHGs, but this is only 0.4 per cent of the bank's current loans outstanding of US\$31bn.

In case of AgBank, the commitment to reform a public sector bank emerged through an agreement between the government and international donors. The initial trigger for the chairman of Banque du Caire, another public sector bank, was the doubtful quality of the existing loan portfolio and the large and partly under-employed workforce. Carefully selected managers, along with external technical assistance for systems and staff development, helped convert these aspirations into a functioning programme.

Commercial banks not only have to have good systems but also constantly keep them under review. This is especially important with rapid growth of customers, staff and portfolio. Producers Bank portfolio quality deteriorated when its value tripled during 1996-97. During 2002, ProCredit Bank discovered that a number of employees had committed a fraud in the Gold Pawn loan department and had to write off US\$1.55m during the year, compared against US\$0.15m loan write-off the previous year. ProCredit Bank had to strengthen its internal controls and procedures.

Some technical assistance providers are themselves investing in microfinance banks, such as ACCION, IMI and CARE. This is a healthy trend and should be welcomed. Donors have made significant contributions to the initiatives in many of the banks described in the case studies. A few banks such as United Georgian Bank, Tbiluniversalbank, Sonali Bank and Bank of Khyber have received credit lines from concessional sources such as the European Bank for Reconstruction and Development (EBRD), International Fund for Agricultural Development (IFAD) or elsewhere. Most of the development grants have been used for capacity building such as staff training, systems design or product development. In the case of Equity, the total subsidy is estimated to have been US\$1.73m, excluding loans and equity. This amounts to less than US\$7 per customer being served today. Operating cost support was provided by donors for the AgBank turnaround, but this was more than justified by increasing annual profits and the enhanced value of the bank.

It is clear that the benefit to cost ratio for assistance to banks in microfinance is much more favourable than for similar support to microfinance institutions for which both the loan capital and operating cost support has been much higher in relation to the numbers of customers served. Moreover, if the Co-operative Bank of Kenya, the Kenya Commercial Bank and even Barclays Bank are beginning to learn lessons from Equity's success just in Kenya itself, the larger benefits of such catalytic donor grants can go far beyond the original recipients.

Small customers strengthen banks' capacity to cope with big crises

This book is not about political and economic stability. We present the case studies from the perspective of the institutions, but the wider political, economic and social environment in which the institutions operate is, of course, critical to their success.

There are some indications that microfinance can materially assist a bank to weather severe economic and even political crises. Several of the countries from which the case studies are drawn have recently had crises or indeed still are in turmoil:

- In Zimbabwe, GDP has been declining since 1997, registering a 7.3 per cent drop in 2003. Inflation has fluctuated between 100 and 600 per cent over the period 2001-03 and the Zimbabwe/US dollar exchange rate has fallen from 40:1 in 2001 to 800:1 in 2003, and is still falling. Unemployment is estimated to be 60 per cent.
- Kosovo suffered from a decade of discrimination and neglect and was ravaged in 1999 by the Serb occupation and ethnic cleaning.
- Haiti's underdeveloped economy is the result of decades of political instability. The country has suffered severe political unrest during most of the past 15 years and the situation continues to be unstable.
- Georgia's independence in 1991 was followed by a brief civil war and massive economic disruption caused by the break-up of the Soviet Union.

Political stability has a vital impact on economic opportunities and performance. Economic disruption can also emerge from other factors. The Ecuadorean economy performed poorly for some 10 years and faced the worst financial and economic crisis in its history in 1999. The crisis in the financial sector led to devaluation of the Sucre, rapid inflation and capital flight, and 20 banks closed, representing 45 per cent of the financial system.

The financial institutions in the countries described in the case studies are coping with these difficult circumstances very effectively, and it is clear that their microfinance portfolios have played an important part in enabling them to do this. Banco Solidario, the only private bank in Ecuador focused on microfinance, was able not only to remain open during the most difficult period but even to post modest profits. The liquidity of the microenterprise portfolio, and the risk diversification facilitated by many small loans and different financial products, helped the bank to weather the crisis. Microenterprises mainly use local inputs and supply to local markets and are thus better placed to deal with external shocks. At the peak of the financial crisis, micro-entrepreneurs lined up to repay their loans rather than to withdraw their money.

A year earlier, the microfinance division of BRI also showed that the impact of crisis could be positive. During June to August 1998, after Indonesia had been hit by both drought and an economic crisis, 1.29 million new saving deposit accounts were opened in BRI units. During the crisis year (August 1997 to August 1998), savings deposits increased by 90 per cent and loans outstanding by 5 per cent, when the inflation rate was 56 per cent. Because of the uncertain future, people were reluctant to take new loans, but they continued their loan repayments. The loan loss ratio during this period was 2.16 per cent, which was virtually the same as the long term 2.17 per cent loss ratio experienced since 1984. Due to expanding deposits and an almost stable loan portfolio, the division's excess liquidity increased by 195 per cent during this period. This was extremely valuable, since confidence in the banking system was falling and might have triggered a run on the bank. Financial institutions with significant exposure to small customers seem to have better capacity to deal with such crises.

Small customers demand appropriate products and service delivery

Commercial banks have learned that small customers are no different from other customers in one respect - the onus is on the supplier to understand the location, the needs and the preferences of the customers and then to design and deliver products that best meet these needs. It is not more of the same - most small customers do not want complex product features, procedures or paperwork, and cannot afford frequent visits to the bank. They do not have balance sheets or securities and they have to work within very short time horizons. Microfinance can be a low margin, high volume mass market for the bank.

No matter where and how the idea to serve this market originates, the bank often has to redesign or refocus the financial products, the type of staff employed and their training, the management information systems and the incentives for both customers and staff.

When loan officers' and tellers' responses at the point of customer contact are effectively integrated with efficient back-office systems, such as credit manuals and management information systems, the results can be spectacular both in efficiency and customer response.

Equity conducted detailed process mapping to optimize the speed and efficiency of its customer service and introduced a new computerized system to improve its turnaround time from 30 to 40 minutes to about five minutes at the counter. Banque du Caire provides automatic approval in 10 minutes for repeat loans. The AgBank study reminds us that "the intent is not to compete with international banks going after high-end customers, but appropriately to serve rural and low-income market segments. Money should be spent to make local branches adequate and comfortable, but they do not have to be the best in town. Occasionally, only two people are needed in a location, and hand ledgers and a calculator may be adequate technology.'

Several case studies mention efforts at branding and promotion, such as CBZ, Sogesol, ProCredit and Equity, including lottery prizes to mobilize deposits. The Equity case study shows that customers can be influenced by observing other people's experiences. Product take-up grows rapidly once the customers discover the quality of the services being provided. Ninety per cent of FINADEV's clients got to know the bank through relatives or friends.

In 2000, AgBank discovered that large numbers of pensioners would crowd into the banking hall on a fixed day to collect their pensions, which was a problem for them and for the bank. In response, AgBank offered saving products to the pensioners, and their pension payments were automatically deposited in their accounts. The pensioners were able to withdraw these deposits when they wanted; this reduced pressure on the branches and led to a larger proportion of deposits remaining with the bank. The bank was also able to develop a loan product for these pensioners. Other customers, such as nomadic herders, had different needs but they also appreciated the new products.

Producers Bank in the Philippines was able to draw on Grameen Bank Bangladesh methodology to offer a standardized set of financial products, which were relatively easy for the management to understand, for the field staff to sell, and for low-income clients to access. As members of solidarity groups, poor women and men could access a loan of US\$100 without any need for collateral. These loans are repayable in six months and customers can then access larger amounts. The bank started with less than 3000 such clients in 1999, and had reached 44 000 clients by 2003.

Even after offering the full range of banking services, including micro-loans of US\$1000 to US\$10 000, ProCredit introduced an express micro-loan ranging between US\$100 and US\$1000 and with simpler requirements and shorter repayment period (12 months), than the regular micro-loan. Banque du Caire is negotiating a micro-insurance product for its individual borrowers and sees the potential for bulk purchase of other products needed by its large customer base.

Bancafe and Bank of Khyber mention changes in banking hours. While many banks offer financial services to individuals, others work only through groups, and yet others serve both groups and individuals. Some banks offer a large range of microfinance products, but BRI successfully serves its large customer base with two basic products, SIMPEDES savings and KUPEDDES loans. The needs of microfinance customers also evolve and change and their bankers have to respond to this. Bancafe introduced community loans first in 1999 and individual loans only in 2001. By 2003, 88 per cent of its loans were to individuals.

Small customers pay back their loans and make substantial deposits

When formulating their initial plans for their entry into microfinance, Banque du Caire sought the reassurance of a 90 per cent guarantee for their micro-loans. When this was not forthcoming, the bank started cautiously with a more modest portfolio than they had originally planned. Three years later, and with the portfolio at risk at only 0.49 per cent, the bank planned to set up 150 new micro-lending branches, to employ 1000 new staff and to introduce new products.

Table c.1 in the annex shows that majority of banks have portfolio at risk (PAR) of only 2-4 per cent of their loan portfolio. The loans are not secured with physical collateral, and are thus considered as unsecured loans by the regulators. The reasons for this good performance are a combination of the following:

- Small customers value ongoing access to responsive financial institutions and go to great lengths to maintain or improve their credit record.
- In addition to the incentives of continued access and bigger loans, some banks offer interest discounts on prompt payment.
- With extremely large numbers of small customers, one customer getting into difficulty represents only a very small fraction of the overall portfolio
- Regular contact with customers, and effective internal monitoring and information systems promptly spotlight problem cases for follow-up action.
- Prompt follow-up and recovery efforts ensure that other borrowers learn that wilful default is unacceptable.
- In some group-based methodologies, existing group members use their local knowledge to assess potential members while forming groups and when sanctioning loans.
- Bank staff are aware that their performance is being regularly tracked and compared against other staff. Some banks link staff compensation and incentives directly to the size and quality of portfolio managed. Often the loan officers disbursing the loan are also responsible for collection and thus build, and if necessary can use, their close relationships with clients to apply moral pressure on defaulters.

Institutions offering appropriate and diversified savings and loan products have found that saving depositors outnumber the borrowers and the deposits mobilized are more than adequate to fund loan demand. Table c.1 also shows that in six of the ten institutions which have specialized micro-savings products the total savings balances exceed the loans outstanding by a wide margin, and in every case the numbers of depositors exceed the numbers of borrowers. Equity found that even with 96 per cent of its depositors depositing less than US\$50 each, it could still mobilize deposits of US\$50m.

Similarly 71 per cent of the AgBank depositors operate current accounts with an average balance of only US\$8. Because the bank also offers a range of useful savings products, the savings mobilized increased from US\$13m in 2000 to US\$64 m in 2003.

All poor people cannot immediately become bank customers

In Table c.1, Producers Bank of the Philippines has one of the lowest average sizes of loans and deposit balances. The average loan outstanding is US\$74, which is 7 per cent of per capita gross national income and the average savings balance is US\$20, or 2 per cent of per capita income. The bank acknowledges that in spite of these very small amounts, it is

difficult to target the poorest segment of the population and very remote areas. BRI is in the same situation, in that distant villages, particularly on the outer islands of Indonesia, are sometimes totally un-served.

In countries with large numbers of very poor people, who tend to live in dispersed locations with inadequate roads, it is very hard for banks to cover the costs of reaching all the poor.

Strategic choices to serve small customers

In our Introduction, we indicated the different strategies pursued by the different institutions. The most common strategy for a commercial bank is to go down market, or downscaling, that is to reach out to poorer customers and neighbourhoods and to design and deliver appropriate products suitable for these customers. Existing banking licenses, staff, infrastructure and resources mean this can be done quickly. Seven of the nine public sector institutions in our case studies decided to take this route. These institutions face many challenges.

- Being public institutions they already have mixed experiences of this market, from earlier and often badly designed welfare programmes. It difficult to ensure that staff realize that this market segment is large and can be profitable, and that these customers need appropriate products and good quality services. The whole approach is totally different from the low-price, poor-quality services which they may have been used to providing in order to meet social obligations or satisfy government requirements.
- They have to develop the necessary culture and systems and to improve the motivation and skills of their existing staff. Many Banque du Caire staff were unwilling to spend time outside their offices developing business; they were used to waiting for customers to come to them.
- Staff have to accept that they are accountable and that transactions must be transparent AgBank management had to protect staff from external pressures.
- Management have to sustain the focus over time and draw the right lessons. Bank of Khyber had various phases of centralization and decentralization in their efforts to deal effectively with microfinance customers.

Financial Bank, Benin and Sogebank, Haiti, two private commercial banks, decided to pursue microfinance through a subsidiary. This enabled the banks to partner other investors who contributed both technical skills and financial resources. Sogesol was set up as a non-financial subsidiary, which did not require a separate banking licence or central bank supervision. The loans remain on the books of the parent bank, Sogebank, and the subsidiary earns fees based on the size and quality of the portfolio it has developed. Both subsidiaries leverage the reputation and systems of the parent. The subsidiaries are dedicated to microfinance and can thus remain totally focused on it.

This service company approach also presents a number of challenges. The interests of minority investors have to be protected; the tasks, costs, risks and remuneration have to be allocated carefully between the parent and the subsidiary; the back-office operations have to be integrated properly; and the senior staff of the parent bank have to ensure that the subsidiary has the access it needs to legal and other shared resources. State Bank of India, Producers Bank, and others are doing business with informal groups rather than individual customers. In India, this has received significant policy support and is currently the dominant microfinance model. In some cases, these groups are promoted by the bank, but in most cases other promoters are involved. Oriental Bank of Commerce now uses facilitators who are paid from a 1 per cent levy on loans. The advantage of this model is

that groups help to identify customers and the groups also reduce the transaction costs per customer served. It is not easy, however, to reach out to the poorest people since they are often excluded from groups, and the costs of group promotion, support and supervision have to be covered.

ICICI Bank and Sonali Bank work through existing NGOs and MFIs to reach large numbers of customers. ICICI Bank has also bought out MFIs' existing portfolios. This enables MFIs with limited capital to extend their outreach. ICICI Bank does not have to develop its own retail delivery channels, and also benefits from first-loss guarantees. The bank hopes to develop a secondary market for microfinance receivables. The success of this policy will depend on there being sufficiently strong and substantial microfinance institutions that can offer the necessary retail delivery capacity and can also provide satisfactory guarantees.

The financial sector policy environment

Commercial banks are controlled by central banks. It is more expensive to handle large numbers of very small transactions than to work with more familiar corporate and middle-class personal accounts, and it may be necessary to charge microfinance customers higher interest rates. This can be politically difficult, even though the new customers' only alternative may be moneylenders who charge far higher rates.

The whole village unit microfinance system of BRI was only possible after interest rate deregulation in Indonesia in 1983. The Philippines deregulated interest rates in 1999, and most central banks now allow banks to fix their own interest rates, service charges and product features. As the Ecuador case study mentions, however, the threat of central bank intervention remains.

Similarly, the regulations usually only allow banks to have a certain limited proportion of their loan portfolio unsecured. The turnarounds of Equity and Agbank, both of which were insolvent, would have been impossible without sensitive handling by their respective central banks. The authorities in most countries are putting greater pressure on banks to improve the rigour and disclosure standards of asset classification, but there is still insufficient appreciation that short-term micro-loans are in fact more secure than many so-called secured loans, and that micro-loans can and should be judged by tougher norms than larger longer-term loans. Central Banks are also allowing increased competition, which will drive banks to improve the efficiency and quality of their services and also to keep charges down. This will lead some banks to concentrate on their core business, which is probably not microfinance, but the case studies show that liberalization is leading many others to reach out and to serve the enormous unmet demand.

Overall, the commercial banks have fewer regulatory problems than specialized non-bank microfinance institutions. Most MFIs still have to deal with many issues relating to the choice of act under which they should incorporate and how to access to equity finance in order to have sufficient capitalization to be allowed to mobilize deposits from savers. Banks are in a much stronger position, and the successes described in the cases demonstrate that they can profitably take advantage of this.

The way ahead

The case studies contain many messages for the many different stake-holders, and every reader will draw her or his own conclusions from the material. We attempt below to draw together some of the most important action implications for bankers, policy makers, donors, microfinance practitioners and their customers.

Bankers

The main message of this book is for bankers. There are of course many different types of banks; in the public and the private sectors, large and small, local, national and multinational. There are also many postal banks, and co-operative banks, and some MFIs which have become banks. This book focuses mainly on existing commercial banks, but many of the lessons from the case studies are equally applicable to these other types of financial institutions.

All the case studies show how both the banks and their clients have benefited from their entry into the new market of microfinance. Every bank will have different reasons for entering the microfinance market, and the cases show that there are many different ways in which banks can become involved. The following arguments, however, played an important role in most of the cases in this book:

- The financial services market is becoming globalized and many national banks which earlier had a major share of local corporate business are losing out to international banks. One advantage that the national banks have is their extensive branch networks. Some treat this as a burden, and are trying to reduce their branch numbers, but previously unprofitable branches can be made viable with new microfinance business.
- Banks, like most kinds of business, aim to maximize their market shares, to grow, and to spread their risks; microfinance can provide an ideal way of achieving all three of these broad goals.
- Microfinance can be profitable in its own right, but some micro-customers will also grow into big ones who can be profitable and loyal customers in the future. They will be unlikely to change their banking relationships if they have received good service when they were saving and borrowing only very small sums.
- Large private and corporate clients will shop around and are becoming more price sensitive and more willing to shift for small differences in interest rates. Poorer people need products which suit their needs, good service and convenient access; they will not move their accounts for a few percentage points in interest charges or returns on savings.
- It costs money to develop new customers, of whatever scale, but in many places NGOs and MFIs have promoted groups or other forms of intermediation to enable poorer people to be economical customers for financial services. The NGOs have in effect done the banks' customer development work for them, and banks can pick up ready-made customers at little or no cost to themselves.
- In some of the countries covered in the case studies, such as Bangladesh, Georgia, and Kenya, some MFIs have grown very rapidly and are obtaining full banking status. Existing banks are being threatened by these new competitors, and they may have to compete with them in the microfinance market in order to pre-empt competition for their own traditional customers.
- Microfinance should be seen primarily as a profitable long-term business opportunity, and not as an act of social responsibility for public relations' purposes. Nevertheless, banks are more dependent than most businesses on public opinion and government approval; they can enhance their image and their balance sheets at the same time by effective microfinance initiatives.

There are, of course, also many good reasons why commercial banks should not become involved in microfinance:

- Loans are unsecured, the clients and delivery channels are unfamiliar in social, gender and economic terms, both to bank staff and to their existing customers who may have to mingle with them at branch bank counters. Earlier misguided poverty alleviation programmes may have destroyed any credit culture among the poor, at least in the opinion of bank employees.
- Large numbers of small accounts require highly efficient accounting and management information systems, and aggressive follow-up of defaulters may create bad publicity for the bank as a whole. Similarly, the transaction costs of microfinance business may require a bank to charge higher than normal interest rates. These are unlikely to create problems for the clients, but journalists, the general public and particularly politicians may misinterpret these rates as usurious exploitation of the poor.

The case studies include examples of all these problems, and they show how banks have successfully overcome them. Direct entry into the microfinance market may also not always be appropriate for every institution. The case studies show how collaboration can, in some situations, be more appropriate than competition.

Donors and policy makers

Foreign donors can claim much of the credit for recognizing and supporting the various new institutions which came up in the 1970s and 1980s and which have pioneered most innovations in microfinance. Governments have responded more slowly, but in many countries they are now successfully encouraging rather than frustrating microfinance.

The principles of 'new paradigm microfinance' are now fairly well established, but the major task now is to extend the availability of micro-financial services to a larger proportion of the potential market, that is, the people who can benefit from them.

The examples in this book demonstrate that, in many if not most circumstances, existing commercial banks offer the most effective and efficient way of doing this. The main arguments for this proposition can be summarized as follows:

- It is less expensive, and quicker, to reach more poor people through the existing banks, rather than trying to do it by creating and developing entirely new institutions.
- Sound inclusive banking systems are a necessary component of economic development. Microfinance can strengthen and legitimize existing banks, and thus benefit both the 'un-banked' and the economy as a whole.
- New microfinance institutions usually owe their origin and survival to donor or other assistance, but commercial banks have their own independent existence. If microfinance is firmly embedded into a bank's profitable operations, it is likely to continue after external assistance is withdrawn.
- Most countries, quite rightly, insist that all banking institutions, and particularly those which mobilize small demand deposits, should conform to quite stringent regulations. Existing banks already do conform, and are usually already taking savings from potential micro-borrowers. There may be a need for some changes to regulations relating to unsecured loans, or to the location of banking transactions, before a bank can offer financial services, but there are far less regulatory hurdles to overcome than when setting up a new institution.
- Commercial banks do not need new equity to enable them to offer micro-financial services, and because they are usually flush with funds they do not need more finance. Encouragement, persuasion, training and some temporary operational support is all that is likely to be needed, and the case studies show that such assistance can often be highly cost-effective.

- New institutions need new infrastructure and, most critically, they need new managers. It has been suggested that competent managers are the scarcest resource in most poor countries. It makes sense to use institutions which are already being managed, even if imperfectly, than to identify and build the capacity of completely new management teams.

We believe that our case studies demonstrate by example that these arguments are valid. There are of course some situations where there are no commercial banks, or they are so weak or hidebound by tradition as to be unwilling even to consider this new market, or when bank management take a perfectly reasonable strategic decision not to become involved. It may also still be necessary, in an ever-reducing number of countries, to test and demonstrate the viability of microfinance to the banking community as part of the process of introducing the new market to them. In such circumstances, it may be necessary to start or expand specialist MFIs but this should not be the automatic response. If micro-financial services are needed, the existing banks should be the institutions to provide them unless there are compelling reasons why they cannot.

There are also some common but less legitimate reasons why both donors and governments may sometimes be reluctant to take this route. They may prefer to work with institutions which are more pliant and more grateful, and to look for 'projects' where they can claim credit for a complete new institution, rather than for a relatively minor component, in financial terms, of a large business portfolio. It is also difficult to nail a commemorative plaque to a new group of outstanding loans, or to ask an ambassador or minister to inaugurate a quite modest new department. It is important that these issues should be recognized, so that they can be avoided.

Microfinance practitioners

Some MFI staff may read this book in order to appraise the competition, or perhaps to help them in thinking about their own future. Some MFI staff in India and elsewhere have already moved to commercial banks, and this trend is likely to increase, as banks increase their market share.

Such moves are obviously excellent for the banks, in that they acquire ready-made expertise in what may for them be an unfamiliar market segment, which needs new types of financial products. There are also many reasons why MFI staff should think seriously of making such a move. There are likely to be more promotion opportunities, and a wider variety of work; and employment may be more secure, if sometimes less well remunerated, than in a donor-dependent 'project' or NGO. Work in the harsh commercial world may be less comfortable and more constrained by hierarchy and bureaucracy than in a socially-oriented NGO or MFI, but banking staff working in microfinance should be able to take satisfaction from the fact that they will probably be able to reach far more needy people, in a more sustainable way, than they ever could from most MFIs.

Some banks such as Sonali and ICICI Bank are also forging effective and mutually profitable partnerships with MFIs, rather than competing directly with them. Bank staff with experience of working for MFIs are already playing a vital role in initiating and managing these relationships.

Customers

Finally, we must briefly consider the customers' interests. These must of course be paramount, both from a social point of view but also to ensure that micro-financial services are properly marketed. If they are not, they will be unprofitable for the banks and useless to their clients.

For the poor, secure and accessible savings are at least as important as loans. Commercial bank deposits must usually be insured, by law, at least up to the likely level of most microfinance client's balances. Many MFIs do not offer savings facilities at all, or, if they do, they are uninsured. By mobilizing savings the MFIs may be putting savers' funds at risk, and they may be operating against or at least outside the law.

Many MFIs are critically dependent on donor or government subsidy of various kinds, and are likely to remain so. When this support is withdrawn, the institutions may go out of business. This is disastrous if they cannot repay savings deposits, and it can also be a serious blow to a poor household if they lose their main source of credit. Banks, on the other hand, are above all long-term institutions. Central banks ensure that banks do not get into trouble or at least that customers are 'rescued' in the interests of the credibility of the nation's financial system as a whole.

It is surely to be hoped that microfinance itself will become redundant, sooner rather than later, because most people will no longer need it. They will be able, like most of the readers of this book, to choose their own financial service providers and to do business with them individually, or in groups, as and when they wish. In individual cases this is already happening, and some microfinance clients have 'graduated' to regular client status. It is clearly much easier for a client to do this within the same institution than to have to establish her reputation from scratch with a new and unfamiliar bank.

The United Nations has designated 2005 as the International Year of Micro-Credit, and has invited governments, the private sector and other institutions to join in raising the profile and building the capacity of microfinance. This book addresses the experience and potential of one type of institution that can provide microfinance services - the commercial banks - but which has to some extent been neglected by comparison with specialized institutions. We believe that commercial banks alone have the potential to deliver micro-financial services in the volume and variety that are needed. We hope that this book will lead more banks to extend their outreach to greater numbers of poorer people who presently lack access to formal financial services.

ⁱ Malcolm Harper and Sukhwinder Singh Arora (eds) Small Customers, Big Market 2005
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Table c.1 Development indicators and summary data from the case studies

Development indicators	Indonesia	Philippines	Pakistan	Bangladesh	India				Egypt
					State Bank of India	Canara Bank	Oriental Bank of Commerce	ICICI Bank	Banque du Caire
GNI/capita US\$	710	1 030	420	380					1 470
% Urban population 2002	43	60	34	26					43
Domestic credit to private sector 2002 (% of GDP)	22	36	28	29					61
Case study indicators for microfinance activities	BRI	Producers Bank	Bank of Khyber	Sonali Bank					
Number of outlets	4 185	3	18	16	2 250	1	31		96
Number of depositors ('000)	29 869	51	*	*	5 100	7	12	*	*
Number of current borrowers ('000)	3 100	44	5		2 600	3	12	282	65
Deposits outstanding (US\$ million)	3 527	1			73	1	1		
Loans disbursed (US\$ million)			14	11	137		2		50
Loans outstanding (US\$ million)	1 678	3	4	7		1	1	63	17
Deposit per account (US\$)	118	20			14	189	53		
Average loan amount (US\$)	541	77	825	n.a.	53	457	83	223	500
Average deposit as a % of GDP per capita	17	2	0	n.a.	3	40	11	n.a.	
Average loan as a % of GDP per capita	76	7	196	n.a.	11	97	18	48	34
Portfolio at risk (PAR)	0.0	0.0	0.0	2.5		1.0			1.5

Table c.1 (cont)

Development indicators and summary data from the case studies

Development indicators	Zimbabwe	Kenya	Benin	Ecuador	Guatemala	Haiti	Kosovo	Georgia	Mongolia
GNI/capita US\$	n.a.	360	380	1 490	1 760	440	...	650	430
% Urban population 2002	37	35	44	64	40	37	...	57	57
Domestic credit to private sector 2002 (% of GDP)	37	23	12	28	19	16	...	8	19
Case study indicators for microfinance activities	Commercial Bank of Zimbabwe	Equity Building Society	Finadev	Banco Solidario	Bancafé	Sogesol	American Bank of Kosovo	ProCredit Bank	AgBank
Number of outlets		39		23	70	7	17	18	379
Number of depositors ('000)		296	14	91		*	77	32	377
Number of current borrowers ('000)	3	75	14	90	12	7	2	28	128
Deposits outstanding (US\$ million)	1	49	1	127			65	18	76
Loans disbursed (US\$ million)			43				74		211
Loans outstanding (US\$ million)	0.3	27	10	92	17	5	32	48	49
Deposit per account (US\$)		166	91	1 308			844	549	200
Average loan amount (US\$)	97	360	656	1 484	1 500	685	30 833	1 667	382
Average deposit as a % of GDP per capita	n.a.	46	24	88			...	84	47
Average loan as a % of GDP per capita	n.a.	100	173	100	85	156	...	256	89
Portfolio at risk (PAR)	1.5	8.0	1.0	4.3	0.5	7.4	2.6	1.6	