BANKING AT THE BASE OF THE PYRAMID:

A MICROFINANCE PRIMER FOR COMMERCIAL BANKS

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1. INTRODUCTION

Commercial banks have tremendous potential to service the microfinance market profitably. Branch networks, access to capital, and qualified human resources all provide banks with the fundamentals to launch and grow successful microfinance operations. Over the past decade, many banks have entered the microfinance market and several banks have recently shown promising results in terms of profitability and growth in this market segment. While their strategy and operations share many elements of traditional, nonbank microfinance operations, innovative practices and models are emerging.

The purpose of this primer is to provide a concise summary of the issues and options facing bankers when designing and implementing microfinance programs.

2. WHY A PRIMER?

Commercial banks began to enter microfinance in the mid-1990s. 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 of microfinance in their institution.

Fundamentally, banks must have strong leaders with decision-making authority who understand and are committed to make the changes necessary for the bank to achieve scale and service the microfinance market in a sustainable manner. Leadership and management must be clear on the organizational, product, and operational changes that need to be made to succeed in the microfinance marketplace. They must be convinced of the profitability of the product (in terms of net operating margin), have realistic growth expectations (in terms of total portfolio and, hence, absolute net income) compared with other lines of business, and make the investments required to scale up.[1]

> Microfinance represents more than a new product line or client segment; it is a new way of doing business. It requires changes in organizational culture, decentralized operations, and service that is sensitive to clients' needs.

Once the decision is made to enter the microfinance market, banks must constantly balance three pillars of successful microfinance: high volume operations, quality client service, and risk management systems. On the surface, these three pillars may appear similar to general banking practices. However, the unique characteristics of microfinance present important implications.

- Volume is achieved by reaching thousands of clients, each with numerous, small and short-term transactions.
- Service is delivered to meet the socio-economic needs of clients often living in the informal economy and traditionally marginalized from formal financial institutions.
- Risk is managed by people and systems customized to the high-volume of operations and informal nature of the clients, incorporating policies and procedures to eliminate, mitigate, off-set, and control risks.

This paper will address these issues and help bankers understand their options and the implications of their decisions when designing and implementing microfinance programs for their banks. The authors hope this document will help bankers and those advising banks on microfinance to make better-informed decisions about whether to enter microfinance and, if so, how to approach this new business endeavor to ensure success.

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[1] While most bankers quickly realize that the net financial margin on microenterprise loans is very high, they may be skeptical that the product is profitable based on the significant transaction costs involved. Moreover, even if they acknowledge that the microfinance portfolio generates a net profit, the total net income may not be sufficient to attract significant attention within the bank compared with other product lines with larger volume and larger net profits.

3. WHAT IS MICROFINANCE?

Throughout this paper, microfinance refers to financial services for the poor. Financial services include loans for business and personal use, savings and other deposit products, remittances and transfers, payment services, insurance, and potentially any financial product or service a bank can offer to this market segment. The poor include microenterprises, small farmers, low-income salaried employees, day laborers, pensioners, and poor households. The products and services can be targeted to meet the financial needs of the households as well as their income generating activities.

3.1 WHO ARE MICROFINANCE CLIENTS?

Initially, microfinance focused on microenterprises, the smallest economic units that operate in any economy. In many developing countries, these enterprises employ from 20 to 80 percent of the economically active population and make up an even greater percentage of all businesses. They include the self-employed as well as family-run enterprises. From corner grocery shops to tailors, they operate in just about any sector of the economy. More recently, microfinance has expanded to include low-income salaried employees, farmers, and pensioners. Many low-income households include more than one of these diverse sources of income. While the financial needs of these segments are similar to those of other businesses and consumers, their personal and business characteristics, as well as the relative size of their operations, diverge significantly.

Specifically, microentrepreneurs and other low-income clients tend to operate on the margins of the formal economy and society, often without requisite permits and documentation. The microenterprises have few employees, usually ranging from none, other than the owner-operator, to five, although the exact limits vary from one market to another. The enterprises and households usually have limited assets, particularly lacking fixed assets with formal titles that could serve as traditional collateral. Net incomes are on the lower end of the scale although operating margins for microenterprises in percentage terms can be significant. Formal records of sales, expenses, and incomes are scarce and unreliable. Business and household finances are mixed with income generated from diverse sources, such as multiple enterprises, farming and agricultural production activities, remittances, day labor, and salaried employment.

3.2 HOW DO CLIENT CHARACTERISTICS SHAPE MICROFINANCE?[2]

Despite this diversity, certain client preferences and needs repeatedly arise. For example, clients tend to value service, speed, and agility over price. (More sophisticated and experienced borrowers, especially those in a competitive microfinance market, will make decisions based on price as well.) In terms of loans, this means reducing and simplifying the paperwork, formal collateral, and time involved to apply for and receive a loan. For deposits, this means unhampered access to savings and low minimum balance requirements are usually more important than returns. As traditional collateral and co-signors often are not available or the costs of legally registering and executing guarantees are cost prohibitive relative to loan size, non-traditional collateral often is accepted. Like informal property rights, marital status often is not formalized, which can further complicate traditional contract enforcement. As most microfinance clients have lower levels of education than traditional

[2] For further reading on microfinance clients and their preferences, please refer to Stuart Rutherford, *The Poor and Their Money* (Oxford: Oxford University Press, 2000). Diverse market research tools for assessing microfinance clients and related articles are available on the MicroSave Web site at http://www.microsave.org.

bank clients, they require and value assistance in the application, information-gathering, and transaction processes. Even a written signature can be an obstacle for some illiterate clients.

Microfinance is part of financial sector deepening and mirrors many facets of traditional retail banking. However, it has important differences and is perhaps best described as a hybrid of small-business and consumer banking with a strong dose of understanding the clients' social and cultural characteristics. While the clients' primary sources of repayment are enterprises, salaries, pensions, and remittances, current cash flows are the best determinant of future repayment capacity. Further, family and business finances tend to be mixed. This requires specialized loan appraisal techniques and the opportunity to provide personal as well as business-oriented financial services. Given the high volume of small transactions coupled with diverse personal and business needs, microfinance approaches retail consumer finance. Unlike larger, formal businesses, microenterprises and small farmers cannot offer formal financial statements; references and financial information must be inferred from a variety of sources. Independent confirmation of income is necessary even when serving salaried workers and pensioners.

3.3 WHO SUPPLIES MICROFINANCE?

Commercial banks are relative newcomers to microfinance. Others that provide microfinance are specialized financial institutions such as finance companies and savings and loan associations, insurance and credit card companies, credit unions, consumer retailers and department stores, nonprofit development programs, pawn shops, loan sharks, and informal rotating savings and loan associations (ROSCAs). Increasingly, public and private banks are establishing microcredit operations based on the experience of these other providers that the poor repay their loans and can pay interest rates high enough to cover the full cost of lending. Moreover, microenterprises and other low-income clients demand a variety of financial services that, in many cases, only full service banks can offer.[3]

[3] For further reading on microfinance and its suppliers, refer to http://www.cgap.org/about/microfinance.html.

4. WHAT DRIVES BANKS TO ENTER THE MICROFINANCE MARKET?

Banks have been entering the microfinance market in increasing numbers over the past decade. Driven by internal and external factors, the reasons for launching microfinance operations are diverse, ranging from motivations of pure profit to social objectives.[4] Banks that are successful at microfinance, in terms of growth and profitability, have built their programs on a sound business case and operate in environments that are conducive to commercial microfinance. Nonetheless, even these banks indicate that diverse drivers shaped their decision to enter the market and their program's development. It is important to identify the real reasons for offering microfinance services in order to determine the level and kind of support the program will need and its likelihood for success.

TABLE 1: DRIVERS FOR BANK ENTRANCE INTO MICROFINANCE

Internal Factors	External Factors
• Profit • Risk diversification • Excess liquidity • Image • Cross-marketing opportunities • Bank leadership • Social responsibility • Public relations • Compatibility with bank strategy or other lines of business	• Large microenterprise and low-income market • Competition • Trend or fad • Regulations • Donor or government initiative • Market pressure on margins • Desertion of traditional clients

Likely, a combination of internal and external factors drives a bank to consider entering microfinance. Experience has repeatedly shown, however, that microfinance best succeeds in institutions that possess a sound business reason for entering the market; the declared, continued support of the bank's board and most senior management; and a group of midlevel managers who are persistent in establishing and advancing the microfinance concept. These internal drivers must be matched by an environment favorable for microfinance, with sufficient demand, freedom to set prices, and reasonable regulations. Without these essential elements—a sound business opportunity, the commitment of management, and an enabling environment—microfinance will at best flounder and likely fail within any bank.

Once the essential drivers for entering the microfinance market are identified, it is useful to examine the following questions to determine the importance of each driver and the implications of the decision.

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[4] A Harvard Institute for International Development study of 148 banks around the world making micro and small enterprise (MSE) loans found that 49 percent of the banks entered the market because of profitability reasons, 44 percent because of changing market conditions and competition, 20 percent because of social objectives, including poverty alleviation, and 17 percent because of regulations. An additional 72 banks that did not make loans to MSEs said their major reasons for not servicing the sector included high administrative costs (40 percent), a lack of networks and personnel to service the sector (32 percent), and interest rate controls (29 percent). (See "Commercial Bank Behaviour in Micro and Small Enterprise Finance," by Hatice Jenkins, Development Discussion Paper No. 741, February 2000, Harvard Institute for International Development, Harvard University.)

TABLE 2: ANALYZING THE IMPLICATIONS OF DRIVERS FOR ENTERING MICROFINANCE

If profit is the primary motive:

- Are the financial targets and timeframe for reaching profitability realistic and achievable?
- Will the bank make the investment and take on the additional costs necessary in a timely manner?
- Will microfinance eventually be at least as profitable as the bank's other lines of business? In terms of financial margin? In terms of return on investment? In terms of net income?

If risk diversification is the primary driver:

- Will the microfinance portfolio be significant enough to have an effect on the institution's risk diversification?
- How will a microfinance portfolio offset or mitigate other risks?
- Will the bank be willing to change its risk-management techniques and practices to adjust to the requirements of microfinance risk management?

If cross-marketing for other products is the driver:

- Will the bank try to use existing systems and staff to offer microfinance?
- Will the bank make the organizational and methodological changes necessary to service the sector?
- Which will take priority in decision making: existing products or the new, microfinance product line?
- Does the bank have a consumer orientation and understand the nature of microentrepreneurs with business and personal financial needs?

If internal leadership is promoting the entrance into microfinance:

- Is the internal leadership of this program in a position to garner support for microfinance from diverse areas of the bank and senior and middle management?
- Is the bank leaders' awareness in response to public pressure or a passing fad?
- Is the interest based on a firm business analysis, and do the bank's leaders intend to develop a successful business for the institution?

If public relations or social responsibility interests are important motives:

- How different is microfinance from the bank's traditional and major lines of business?
- Do senior management and the board have a sufficient understanding of the market research necessary, the sunk costs involved, and the time required to serve low-income clients adequately?
- Will microfinance remain a marginal business struggling for the necessary investment and support?
- Will bank staff be encouraged to collect on bad debts, or will the bank be troubled by forcing poor borrowers to repay or turn over collateral guarantees?

If regulatory factors or donor or government initiatives are pressuring the bank to enter microfinance:

- Do these external factors place constraints on interest rates, target markets, or other critical operational elements?
- Will microfinance remain a marginal activity established only for compliance, or will it take on a strategic role as a new line of business?
- What incentives are being offered to the bank, and how will these affect operations and performance?
- Have outsourcing or strategic alliances with microfinance institutions been explored as alternative strategies?
- Will the bank use its own funds and resources to launch and maintain the program, or will it rely on outside assistance?
- How have other lines of business established for these external reasons performed?

If competitive market pressures on margins and retention of traditional clients are driving the bank, the questions will be similar to those for the profit and cross-marketing motives.

5. THE PRINCIPLES AND OPTIONS FOR DESIGNING A COMMERCIAL BANK'S MICROFINANCE PROGRAM

If analysis of the drivers behind entering microfinance indicates that the business opportunity exists and bank management is committed to microfinance, then it is appropriate for a bank to take the next steps to design a microfinance program.

To overcome resistance to the changes required to make microfinance succeed, it is essential to outline and secure buy-in of the core principles of successful microfinance (see text box).

Based on these principles, the bank must determine its business model and define all the elements for implementation. The decisions must be consistent with the financial institution's vision and business strategy, the marketplace, the legal and regulatory environment, available financial and human resources, as well as other institutional capacities and assets. No one model will fit all circumstances. Each institution will have to formulate a business plan for microfinance with its own strategic, operating, and financial requirements.

Sustainable microfinance blends standard sound banking and business practices with techniques that have been developed specifically to conduct a high volume of small transactions with microenterprises that operate predominately in the informal sector and other low-income clients. For most banks, microfinance represents more than a new product line or client segment; it is a new way

Core Principles of Microfinance

Organization

- Autonomy necessary to uniquely service a nontraditional client segment;
- Takes advantage of the bank's assets (reputation, branch network, systems, financing, human resources, and so on);
- Point of service close to and attuned to the market; and
- Capable of achieving massive scale while controlling risks.

Human Resources

- Bank leadership who communicate the institution's commitment to microfinance;
- Manager of microfinance who believes in this business and is able and willing to implement change and innovation in the bank, motivate staff, and balance risk and growth objectives;
- Staff comfortable working with low income people;
- Appropriate staff attracted, selected, and retained;
- Training program to develop staff's skills and abilities in client service, risk management, and achieving financial objectives;
- Career path development within microfinance at the bank; and
- Compensation and incentives to reinforce and reward customer service, profitability, diverse product offering, and building a microfinance portfolio of high credit quality.

Products

- Diverse financial products;
- Appropriate to the client and market;
- Loans funded from deposits, not special funds;
- Priced for profitability;
- Simple, easy to understand, and efficient to administer;
- Loan sizes based on the capacity to repay;
- Readily verifiable client eligibility;
- Integrated borrower incentives for repayment, such as the prospect of repeat loans; and
- Acceptance of nontraditional collateral; in some cases using peer group pressure.

Operations

- Efficient, low-cost transaction processes;
- Simple application process;
- Accurate credit appraisal of cash flow, character, and repayment

of doing business. If a bank is serious about entering microfinance, it must understand and accept change and innovation.

Banks entering microfinance will need to make decisions in every area, from selecting strategic partners to designing the appropriate operating model, internal organizational structure, staffing, and product offerings. An important underlying principle, however, is that microfinance—from a product and operational perspective—is retail banking. As a result, it should have an organizational structure and a "home" aligned with the needs of retail bank customers and the bank's retail business in terms of the relationship with branch operations, the product and service models, and the volume of microfinance business. At the same time, given the characteristics of microenterprise clients, some aspects of retail banking—such as credit systems that separate the credit application, analysis, approval, and supervision processes—are not effective for microenterprise lending (see Section 5.4, Operations, for more details).

The remainder of this chapter reviews and highlights critical areas for bankers to consider microfinance's particular characteristics as they design and implement their microfinance operations.

5.1 OPERATING MODELS

Choosing the operating model for the microfinance business is perhaps one of the biggest challenges to successfully integrating microfinance into commercial bank operations. Because of regulatory changes, increasingly competitive financial markets, and new management theories and practices, operating models are continuously evolving. In many countries, regulatory changes are moving markets toward universal banks; in others, regulatory constraints, such as interest rate ceilings, encourage specialized financial intermediaries or subsidiary companies for microfinance operations.

To date, commercial banks have structured their participation in microfinance in a variety of ways with four primary models taking hold: the internal unit; the financial subsidiary; the service company; and the strategic alliance. Table 3 outlines these four models of commercial bank entry into the microfinance market.

Each model has its advantages and disadvantages and deciding on the appropriate structure depends on the bank's operating environment and business strategy. The following questions are useful in determining which model is the best fit for each bank.

- *What are the investment and cost implications of each model?* Introducing microcredit as a new product within an existing unit is generally the lowest cost way to start microfinance operations because there are no separate overhead or capital requirements. Setting up a licensed financial subsidiary implies an often-substantial equity capital base and ongoing regulatory and administrative costs. Establishing a service company requires minimal equity capital and no regulatory costs because it is not licensed by banking authorities. The internal unit and service company models are designed to take full advantage of the cost advantages the bank has to offer while minimizing duplicate staff and systems. However, these models do require careful identification and negotiation of cost recognition, in the case of the service company model, the fees the bank and service company pay one another for services, and how the risk of short-term fluctuations in the cost of funds and provisions is distributed.

TABLE 3: FOUR MODELS OF COMMERCIAL BANK ENTRY INTO RETAIL MICROFINANCE

Internal Unit

- Operates within the existing bank structure as a division or new product line.
- May be responsible for all loan processes or integrated with other bank systems.
- Often the lowest cost way to start microfinance operations. Reduces the need for—and cost of—separate overhead because many services are provided by existing departments in the bank.
- Major challenges: (1) lack of independent governance for microfinance unit so bankers with limited exposure to microfinance may make by bankers with limited exposure to microfinance; (2) difficulty in differentiating microfinance staff and policies from the rest of the bank to build distinct corporate culture and service model within the microfinance unit; and (3) maintaining good relations with support functions and branches.

Examples: Bank Rakyat Indonesia (BRI), Banco do Nordeste (Brazil), Banco Salvadoreño (El Salvador), Banco Guayaquil (Ecuador), Hatton National Bank (Sri Lanka), Banco Caja Social (Colombia)

Financial Subsidiary

- May be wholly-owned or a joint venture, which allows the bank to limit its risk in a new market.
- Conducts loan origination, credit administration, and all aspects of financial transactions.
- Loans and other operations on books of financial subsidiary.
- Licensed and regulated by the banking authorities.
- Separate staffing structure, management, and governance from bank.
- Major challenges: (1) limited access to loan capital due to restrictions on bank lending to subsidiary; and (2) likely duplication of staff functions such as parallel accounting, human resources, and information technology.

Examples: Bangente, Banco del Caribe owns 50 percent (Venezuela), Micro Credit National S.A., Unibank owner (Haiti)

Service Company

- Non-financial company that provides loan origination and credit administration services to a bank.
- Promotes, evaluates, approves, tracks, and collects loans.
- Service company employs the loan officers and bank provides support services for a fee.
- Bank funds and disburses loans and clients repay the bank; loans remain on the bank's books and are regulated and supervised according to banking laws.
- Company is not regulated or supervised by banking authorities; there is no separate banking license.
- Does not require large equity base and is less costly to launch and operate than a financial subsidiary.
- Negotiates detailed agreements with the bank that assign cost, risk, responsibility, and return to each party.
- Major challenges: (1) accurately negotiating pricing and risk sharing between bank and service company; (2) minimizing duplicate functions; and (3) maintaining good relations with support functions and branches.

Example: Credife, established by Banco de Pichincha (Ecuador) and Sogesol, created by Sogebank (Haiti)

Strategic Alliance

- Can take many forms, the most common being banks financing portfolios of specialized microfinance institutions and providing operational support for disbursements and collections through bank branches. In other cases, the microfinance institution (MFI) acts as an agent for bank products such as savings.
- Negotiates agreements that assign cost, risk, responsibility, and return to each party.
- Major challenges: (1) selecting good partners; (2) negotiating risk and cost sharing arrangements; and (3) potential competition for same clients.

Example: ICICI Bank (India), Lebanese Canadian (Lebanon)

Table based on ACCION InSight No. 6, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," September 2003, with modifications made by the authors of this paper.

- *How much risk is the bank willing to accept in starting microfinance operations?* Operating within an internal unit implies that the bank will be identified closely with the success or failure of its entry into microfinance. Creating a financial subsidiary allows the bank to limit its risk by distributing it among other shareholders, which is particularly beneficial if they have experience and expertise in microfinance. Moreover, in this model, the risk to the bank's public image and reputation is limited by the separation between the bank and the microfinance subsidiary. Similarly, establishing a service company limits the risks to a bank's reputation, although the loans and provisions remain on the bank's books. A detailed agreement between the service company and the parent bank is critical in order to assign cost, risk, responsibility, and return to each party in an appropriate way. The benefits to having a separate operating unit or company accrue if arrears increase. If the remedial strategy is to seize collateral or initiate a lawsuit, it may be easier for the bank to take such actions through its subsidiary, which acts as a firewall separating the action from the bank's image. Some banks have hired outside collections agencies to assist in seizing collateral in the case of difficult loans, even when microfinance operates as an internal unit. When microfinance operates through independent structures, collection costs are justified even though the loans are small because strong collection tactics send a clear message to borrowers of the serious consequences of non-payment, and this message in turn helps prevent a contagion effect.

- *What are the regulatory implications of each model?* Are financial sector regulations conducive to offering microfinance within the bank? As a regulated entity, banks and financial subsidiaries may be faced with legal and regulatory issues such as interest rate restrictions, taxes, documentation requirements, and other regulatory costs that could negatively affect the profitability of microfinance operations. A service company may be able to work around such controls by charging service fees or using other techniques.

- *Will the bank go it alone or establish a strategic alliance for its microfinance operations?* The decision to establish strategic alliances with experienced microfinance organizations may encourage the adoption of a service company or financial subsidiary model so the partners can participate in the ownership and governance of the microfinance operations. While such relationships may bring in immediate access to technical expertise, due diligence is required and the cost and risk sharing relationship must be discussed and defined. For a more detailed discussion on potential partners and arrangements, please refer to Chapter 7.

To avoid or reverse many of the common pitfalls encountered when implementing microfinance in a bank, consider strengthening the autonomy of the microfinance unit within the bank or setting up a separate company. If, as a subsidiary or semi-autonomous unit, microfinance can operate differently from the bank, yet take advantage of some infrastructure and specialized support services, the challenge of becoming significant enough in size relative to other areas of the bank disappears and the microfinance team can flourish within a setting it can proudly claim as its own. Comparisons to the size of the corporate, commercial, or retail portfolios and net income will not inhibit support from other departments such as IT and marketing—the microfinance operations either will pay for these services or have specialized and dedicated professionals perform these functions—and the microfinance manager will be able to focus on servicing the sector, not convincing the bank of its importance.

5.2 ORGANIZATIONAL STRUCTURE AND HUMAN RESOURCES

The operating model selected is an important factor in defining the organizational structure and human resource requirements of the microfinance operations. However, banks need to make a number of additional choices in designing and staffing their microfinance units.

Leadership. One of the most important decisions in entering the microfinance market is choosing who will head the microfinance business. The leader will need the skills and connections to design a new product line and new ways of doing business. He or she will need to network throughout the bank—in just about every area from marketing to risk management—for support and manage a geographically dispersed staff. It requires someone who can communicate well and feels comfortable with the top decision makers at the bank as well as loan officers and their clients. As the microfinance portfolio will take time to develop and reach significant size, it requires someone who is aggressive and committed to stay with the business. This person must be a leader who believes in the potential for the microfinance market segment and is able and willing to implement change and innovation in the bank. The bank must value the microfinance business and demonstrate it by naming and maintaining qualified and respected management to run it.

Designing a cooperative organization. The microfinance unit's organizational structure will depend on its relationship to and dependence on support services within the bank, the diversity of the product and service offering, and the size of operations. The costs and benefits of diverse options must be weighed when determining the organizational design. For example, will the bank opt to dedicate staff to specific functions such as systems or disbursements—and what are productivity benchmarks for each function? Will these staff members be housed in the microfinance unit or in the bank's existing departments? Will microfinance rely more on specialized supervisors, branch managers, or information systems for loan approvals and portfolio monitoring? While certain options may support more rapid growth through specialization and opening potential bottlenecks, they likely will be more costly, especially during start-up operations when volume does not justify full-time staff dedication in all functional areas. Such decisions and trade-offs will affect both the design and size of the organizational structure selected.

Where the microfinance operation is housed within the bank's organizational structure is an important decision, particularly when an internal unit is established. Several banks have launched their microfinance operations as a special unit with incubator status that reports directly to senior management. Once it becomes established, microfinance is then moved into a more permanent home and integrated more fully into the bank's organization and operations. Even in these cases, careful thought must be made when considering how different areas of the bank will work with the microfinance operations.

The organization of the bank and the location of microfinance will affect its ability to provide diverse financial services to clients while maximizing business and profit opportunities. Similar to any bank customer, microentrepreneurs and other low-income clients may initially approach a bank for either their business or personal needs. Moreover, while lending is important in relationship building, it is not the only or necessarily most important element in microfinance banking and profits. Other services—including transfers, remittances, payment and deposit services, and, in some cases, guarantees or letters of credit—may be just as important, or even more so. Many banks, however, operate with organizational structures and incentive systems that do not encourage cooperation across the consumer and business departments. The organizational alignment of microfinance within retail banking should encourage such cooperation and collaboration. In addition, explicit directives, training, and incentives for customer service staff to collaborate with this new market segment are required. New technologies, such as call centers and computer and automatic teller machines (ATMs) that can provide client account information, may be helpful if they are accessible to the new client segment (that may, for example, demonstrate high levels of illiteracy or only speak local dialects and languages) and if clients are properly introduced to and trained on how to use these services.

Staffing needs. Designating microfinance staff who service clients' full set of needs is the best way to ensure service quality. In general, microfinance clients prefer to establish a relationship with their banker; a suitable model is one in which a client service representative (a loan officer or other title as appropriate) is able to handle or coordinate all services for his or her clients, rather than sending the client around to different bank employees and departments. These loan officers must demonstrate good interpersonal and analytic skills and abilities, be highly ethical and able to work independently with little supervision. They develop a close relationship with their clients. Most interaction takes place at the clients' businesses or place of employment given the high opportunity cost to clients of leaving their business for more than a few minutes during the day and the need for loan officers to evaluate the true nature of the business. Despite the initial time investment, loan officers can be very productive, with each one often managing an average of 300 clients, or more, in urban markets after a couple of years of experience. This figure does vary based on bank systems and support, as well as population densities and competition. Knowing the clients and their businesses well and operating in a decentralized manner—with greater autonomy—the loan officer is able to make loans very quickly and cost-efficiently. A loan officer may offer a variety of credit and savings products to a microfinance client, but the product mix should make sense and linkages should exist among the products. The loan officer's responsibility for diverse products must be balanced with productivity objectives. Measures should be taken to ensure loan officers are not burdened with client requests for account balances or other information that would be served more efficiently by less expensive personnel or alternative systems.

In addition to loan officers, supervisors who are responsible for field supervision and credit approvals; credit assistants who help with data input, documentation, and contracts; and client service representatives often form part of the essential microfinance operational unit. The ratio of personnel in each of these areas will depend on productivity requirements, systems support, geographic dispersion, and integration into the bank's branch network.

Support services. Along with guaranteeing an appropriate model for client service and portfolio supervision, the appropriate organizational structure is critical to ensure microfinance has access to the required support services. These include marketing, information systems, financial analysis, risk management, legal, disbursements, deposit accounts, and human resources. Banks have the inherent advantage of enjoying economies of scale in support services since they already are in place for other products. These functions can be incorporated into or dedicated exclusively to the microfinance unit (be it a department, service company, or other) or they can draw on resources from existing departments in the bank. While the former provides a better assurance that the functions will be customized for microfinance, it is likely to increase costs significantly, perhaps to unacceptable levels, at least in the start-up phase while operations remain small. Alternatively, depending on existing functions may prove more cost-effective, but experience has shown that services may be inappropriate and/or untimely—either of which presents significant obstacles to successful microfinance. It is essential that these functions are identified and reviewed in terms of microfinance operations; the appropriate adjustments are made to ensure the staffing, processes, and policies in these areas meet the needs of the microfinance operations; and staff is familiarized with microfinance requirements and the bank's objectives in this business.

Staff selection and development. Another crucial human resource challenge comes with staff selection, training, and career development. Because microfinance deals with less sophisticated clients than other areas, banks may be tempted to use less qualified staff. Banks must remember that this is a highly labor intensive business that requires a broad set of skills and abilities, from information gathering and analysis to sales, negotiation, and problem solving. Therefore, while staff must be willing to roll-up their sleeves and get dirty in the central markets and workshops where microentrepreneurs operate and in the factories and mines where low-income salaried employees labor, these bankers also must be well skilled, trained, compensated, and retained. Some banks focus on hiring experienced loan officers and other staff from institutions engaged in microfinance, others hire and train all staff, and others promote from within. Training programs can be intensive and it often takes new loan officers months before they reach reasonable levels of productivity.

In some environments, loan officers are more effective when they are from the same community as clients, speak the local language, and know local customs. Building relationships based on trust is possible from the outset. In other environments, banks prefer to hire people from outside the local community so they can act independently and are not as pressured or tempted to make private deals and become involved in fraudulent practices. Each strategy presents pluses and minuses; the most important aspect is that the candidates meet the position requirements and demonstrate commitment to remain with microfinance long enough to recoup the training costs and become productive employees. Attractive career paths are necessary to encourage microfinance loan officers and other staff to remain loyal to the bank. Banks also need to consider the training requirements for staff in other parts of the bank that support the microfinance operations to ensure they have the required skills and knowledge, and are familiar with new policies and procedures for the microfinance operations.

Incentive systems. Implementing compensation and incentive systems for microfinance staff is another challenge for many banks. Two of the most critical factors for high performance in microfinance are portfolio quality and institutional efficiency. Staff performance drives both of these indicators. In an effort to increase staff performance in both of these areas, the microfinance industry has developed incentive plans to reward performance. These incentive schemes can be group-based (for instance, based on the profitability of the branch with each staff member's input contributing to that profitability) or individual, where the burden of responsibility is with the loan officer to maintain volume and portfolio quality. Successful microfinance programs use staff financial incentives to increase responsibility, productivity, and efficiency. If staff remuneration is tied directly to performance, appropriate behavior can be reinforced and inappropriate behavior de-emphasized.

Incentive systems also can be based on non-monetary elements, such as peer recognition, prizes, and other opportunities, although monetary incentives usually are more transparent. Regardless of what model an institution selects, banks must balance compensation and incentives to attract and retain qualified staff and managers. Performance rewards must be based on achieving efficiency, profitability, portfolio quality, teamwork, and customer satisfaction, and they must be compatible with the financial resources of the institution.

Banks tend to face two primary challenges in designing and implementing incentive systems for microfinance. First, many banks do not offer performance-based incentive systems to other staff at the same level or are resistant to offer compensation packages to microfinance staff that will result in compensation that could be higher than for staff in other areas of the bank. The second set of challenges in designing incentive systems for microfinance is to recognize the input from operations and branch staff that support microfinance but who also are responsible for other areas. Models are helpful, but it requires an integrated approach to design these programs and ongoing analysis and adjustments provide optimal results.[5]

[5] For further reading on incentive systems for microfinance, refer to the MicroSave incentive system toolkit available at http://www.microsave.org.

5.3 PRODUCT DEVELOPMENT

To achieve the volume necessary for successful microfinance operations, the bank's product offering must be relatively standardized. Differentiation lies in the packaging and service offered to clients. The appropriate packaging will depend in large part on market segmentation (merchants, farmers, pensioners, and so on) and personalized service while maintaining efficiency.

Determining which loan or savings product is appropriate for the microfinance operations of a commercial bank depends on the definition of the target market. The accompanying text box highlights some of the questions that banks should consider during product development. These questions often require banks to conduct market research to evaluate the feasibility of introducing microfinance and to design products and services for this segment. Answering these questions may require additional market segmentation after considering the bank's existing departments and products as well as external market research on clients and competitors.

Price. Once the client segment is established, the first challenge many bankers face is establishing the price for loan products—interest rates and other fees—required to cover costs. While underwriting costs decline with volume for loans, microcredit cannot operate within the financial margins of corporate loans given the difference in size and terms. Interest rates and fees must be higher than those of other product lines. While this is obvious from a profitability perspective, many bankers and outside constituencies question charging interest rates to microenterprises and poor clients that are higher than those the bank charges for other sectors. Market research and the growth of healthy microfinance portfolios in a diversity of countries, however, shows that microentrepreneurs and other low income clients can and will pay higher prices for loans and other

Fundamental Questions for Product Development[6]

- What is the target market?
  - What is the estimated market size?
  - What are its characteristics?
  - How does the bank define the microfinance market and differentiate it from small-business and consumer segments?
  - Will it target the entire segment or sub-segments?
- Who currently provides financial services to this market segment?
  - What are the terms and conditions of these services?
  - What are their comparative advantages?
- How will the bank position itself against the competition (cheaper, quicker, friendlier, less cumbersome, more points of service, greater product offering, and so on)?
- What will be the bank's product strategy?
  - Does the bank already service this segment with existing products?
  - Will it design and roll out products specifically for this segment or concentrate on cross-selling existing products?
  - Will it offer clients both business and personal products?

6 For further reading on market research and product developm technical notes on new product development written by Monic available at http://www.microlinks.org, and the MicroSave market research and product development tools and case studies, available at http://www.microsave.org.

banking services (based on what they pay moneylenders and other sources of financing, as well as the profit margins many microenterprises generate with their businesses). In most cases, banks and other lenders develop pricing schemes that combine interest rates, commissions, and fees to cover costs and generate a profit. Because the highest costs are associated with client acquisition and first-time borrowers, pricing schemes usually incorporate incentives for loyalty, such as reduced interest rates and fees for repeat clients.

Collateral. For many banks, collateral—especially real estate and salaried co-signers—plays an important role in lending. However, many microenterprises lack acceptable security for loans, and when available, the costs of legally registering and executing such collateral are not justified by the loan size. In addition, it can be very difficult if not impossible for a microenterprise to present a salaried co-signer. This does not mean that collateral is not used; it does imply that nontraditional collateral and non-salaried co-signers should be accepted in lieu of conventional collateral. The use of such security has real implications for loan policies and procedures because the legal frameworks for moveable asset guarantees are weak or nonexistent in many countries and collection mechanisms tenuous. Some microlenders make loans to groups that mutually guarantee the loans. Most banks focus on individual lending and do require collateral although its role is primarily for moral suasion rather than realizable security. Instead of relying on collateral, microlending primarily depends on good loan analysis of a client's character and capacity to repay, positive incentives for on-time repayment, and effective supervision and collections procedures. In some countries, banks are able to secure loan repayment through payroll or pension deductions and do so when targeting the salaried employee and pensioner market segments. However, as continued salaried employment is not guaranteed, banks usually search for and require alternative sources of repayment.

Loan size. Microcredit by definition implies smaller loan sizes than other bank products. In some countries, such as Ecuador, the maximum loan size is determined by microcredit regulations.[7] Combined with short terms, this issue of loan size presents a challenge to portfolio growth. To accelerate growth, banks may increase loan sizes while simultaneously extending loan terms, resulting in smaller installments that appear to meet a client's repayment capacity. However, this can be a recipe for disaster if funds are diverted from the business and clients become over-indebted. Micro lending must match loans to business cycles and repayment capacity. Second, some micro credit methods work to establish a credit history and incentives to repay through stepped lending. As initial microenterprise loans are usually for working capital, they are for shorter terms (less than one year) than for other loan portfolios. Successful lenders also have been diversifying loan products to meet clients' investment and personal needs, such as housing, while maintaining strict underwriting criteria appropriate for the microfinance sector. In this way, they are able to gain a larger share of the overall market segment as well as each client's potential demand for financial services. Both strategies help achieve portfolio growth.

Product segmentation. When it comes to client and product segmentation, as financial services clients, micro and small enterprises differ significantly from each other and consequently require distinct products, services, and underwriting criteria. Many banks consider microenterprises as a source to generate small business banking and lump the two together. However, while most small enterprises will come from the microenterprise segment, the vast majority of microenterprises will never become small enterprises. Moreover, while some salaried employees and pensioners want loans for business purposes, they may be for risky start-up enterprises and are often for consumption purposes. Understanding the needs of these diverse segments has important implications for the

[7] At the time this Primer was written, microcredit regulations in Ecuador allowed for loans up to $20,000 to microenterprises. These loans have less stringent documentation requirements than the larger commercial loans and stricter provisioning requirements, based on number of days in arrears, than consumer or commercial loans. Despite the established maximum, the average microcredit loan of regulated institutions in the country was under $2,000.

product offering (which is likely to be more limited for consumers and microenterprises than for small businesses) as well as bank organization and operations.

Microfinance options. Unique characteristics for deposits and other financial services are relevant for microfinance. For example, the rapid growth in remittances to many developing countries in recent years, and their relationship to low income communities, have made this financial service increasingly important for microfinance.[8] Likewise, domestic transfers are also important for low-income communities, particularly in countries with a mobile work force. Payroll and pension payment services are often a bank's first contact with microfinance clients. Offering to convert these payment services into direct deposit savings accounts, banks have diversified and grown their deposit base and built the foundation for offering diverse financial services to clients who previously only came to the bank to collect payments or cash their checks. To make deposit services available to low-income clients, they must offer no or low minimum balances and provide for access through frequent withdrawal and minimum fees as it tends to be more important than the amount of interest paid.

With the growth of telecommunications technologies, particularly cellular, satellite, and Internet technologies that do not depend on traditional landlines, the expansion of automatic tellers and mini-branches that make deposit, transfer, and payment services more accessible are breaking the boundaries for innovative financial service offerings to low-income communities. The poor also value and purchase insurance policies. In many traditional communities, funeral societies, a type of savings and insurance policy to cover funeral expenses, are a standard financial service. Some formal financial intermediaries have adapted and incorporated funeral insurance policies linked to a client's savings account, providing added incentives to save. Likewise, low-cost health and life insurance policies have been developed and rolled out to low-income communities.[9]

5.4 OPERATIONS

Microfinance is a volume business and clients require quick and timely service. Efficient, decentralized, and standardized operations are essential for profitability, risk management, and client satisfaction. However, banks must often overcome cumbersome policies and processes to integrate microfinance into their operations effectively while maintaining rigorous internal control over operating risks. From an operational standpoint, microfinance is retail finance, but some important differences exist between microfinance and consumer or traditional business banking, particularly in terms of credit operations (see Table 4).

Credit technology. The credit methodology or technology for microfinance usually has loan officers responsible for the full loan cycle from new business promotion to analysis, monitoring, and collection; whereas, in consumer lending, the credit process usually is segmented, with a different person responsible for each step. The microfinance approach encourages loan officers to promote and recommend high-quality loans as they are also responsible for collecting those loans and their performance bonus depends on a combination of portfolio growth and on-time repayment.

Loan officers are accountable for the success of the full loan cycle while administrative and operational functions, such as contract and check preparation and data processing, are done by administrative and operations staff to optimize internal controls and productivity. Most disbursements and repayments are carried out through bank branches and in some cases through direct deposit into or debit (standing order) from the client's savings account. Sometimes, if volume reaches a high

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8 For more information on remittances, please refer to the Remittance Newsletter published by DAI under USAID's Financial Services Knowledge Generation Project and available at http://www.microlinks.org/.

9 For more details and examples of products for microfinance, please refer to http://www.microsave.org/.

level, a new loan officer may be dedicated full-time to sourcing new business. Likewise, when significant volume is achieved, some officers may be dedicated to collecting the most difficult loans. Some banks, particularly those that come from a consumer finance background, have developed or contracted a specialized sales force and/or collections agents to support loan officers. While these models may demonstrate higher growth and productivity, they also tend to generate higher rates of arrears than the more traditional model. In all models, targets and incentives for portfolio quality, as well as lending, must be clear for all involved in the credit process.

TABLE 4: MAJOR DIFFERENCES BETWEEN MICROFINANCE AND CONSUMER FINANCE

Operation	Microfinance	Consumer Finance
Credit Technology	Loan officer responsible for full cycle from sales to collections.	Separation of sales, appraisal, and collections functions.
Loan Application	Bank staff assists with preparing loan application.	Client prepares and presents completed loan application.
Loan Appraisal	Loan officer visits business and residence, prepares basic financial statements, calculates ratios, and evaluates qualitative factors. Primary references are neighbors and business relations, with credit bureau use where available. Increasing reliance on parameter-based lending; move toward credit scoring limited.	Reliance on employer confirmation and payroll deductions. Reference checks conducted via telephone, formal documentation, and credit bureaus (where available). Increasing reliance on credit scoring.
Collections	Primarily site visits conducted by loan officer. Specialized collection personnel for difficult cases with late payments over specified number of days. Focus on administrative collections procedures. Legal proceedings limited.	Primarily phone calls and letters. Legal proceedings to secure co-signor repayment, collect collateral, and conduct foreclosures.
Internal Controls	Separation of functions and management information systems are important. High reliance on loan officers to provide reliable information for appraisal and approval. Increasing use of computerized loan application and approval systems to integrate credit policies and compliance into approval process. Reinforced through ex-post compliance checks.	Separation of functions and management information systems are important. With more objective appraisal parameters and reliable information than microfinance, as well as increasing use of credit scoring models, compliance integral to approval systems.
Decentralization	Clients serviced in branches. High level of delegation to loan officers and branch staff. Back office operations centralization depends on systems.	Clients serviced in branches. Centralized decision-making facilitated through automation,

Loan appraisal. Loan appraisal for microfinance also differs substantially from that deployed for a typical bank customer. A microfinance client does not have the formal documentation and physical assets required for a traditional bank loan. Credit technology for microfinance is designed to be simple, straightforward, and efficient to minimize the transaction cost to the client. By spending time on-site at the prospective borrower's business and home, the loan officer becomes familiar with all aspects of the business and develops a strong personal relationship with the client. The personal nature of the loan officer-client relationship engenders a greater level of trust and allows the officer accurately to assess the borrower's character, cash flow, and repayment capacity. This assessment is carried out through on-site interviews that allow the loan officer to analyze the client's inventory, sales cycle, and business demand. The loan officer also obtains informal client references by speaking to neighbors and other nearby businesses. Since loan officers generally operate in geographically defined zones or territories, they are familiar with other local businesses and have other clients in the same area.

In some countries, the existence of a credit bureau can provide additional support to the decision-making process by revealing a prospective borrower's repayment history and level of indebtedness with other financial institutions or commercial entities. Although public and private credit bureaus are being established in a growing number of countries, in many cases they do not yet exist, are weak, or lack data on microfinance borrowers. In these instances, banks often begin by developing information networks through which they can check client references and credit histories. These systems include calling other financial and commercial institutions for references, checking payment of public utilities and other services such as telephones, and reviewing public records. In some countries, the superintendence of banks, or other supervisory authority, maintains a credit database for supervisory purposes which may be helpful, although these systems often do not include small loans or many of the unregulated institutions that offer loans to microentrepreneurs. Development of full service credit bureaus that include data on all microfinance clients significantly facilitates market entry, reduces costs associated with credit analysis, and provides an incentive for repayment while improving risk management of microenterprise lending.

In addition to drawing on the resources of credit bureaus, a bank—especially one with consumer lending operations—may use technology such as credit scoring to help control repayment risk. Credit scoring in microfinance is in its very early stages (implemented by only a few sophisticated MFIs) and its use has been hampered by a lack of consistent historical household data. A bank interested in applying credit scoring to its microfinance clientele should determine at the start what information it will need to create a database enabling it to determine patterns about client behavior that are standardized, comparable, and valid. More common for microlending in banks is to establish a clear loan policy and standardized parameters for analysis and lending based on the five Cs of credit, with emphasis on capacity (financial ratios) and character (personal and business references and credit history if available), followed by capital, collateral, and conditions.

Collections. A loan officer is accountable for any loans he or she makes that fall past due. When this occurs, the officer must initiate immediate action. Microfinance operations take a staged approach to collections. First, the responsible loan officer must make persistent attempts to collect the loan from the first day a payment is missed. At a specific point in time—usually 30 to 60 days after the date on which the payment was due—the branch manager or other supervisory staff also will become actively involved. Only after the loan officer and branch manager, or supervisor, make repeated and ultimately unsuccessful attempts to collect is a collections agent brought in to take over the collections activity. The collections agent may be an employee of the financial institution or an independent agent. The original loan officer remains accountable for the loan, and his or her monthly compensation and lending authority will be affected (adversely) by the nonperforming loan. In addition to the personnel responsible for collections, a necessary component for effective delinquency management is a management information system (MIS) capable of accurately identifying on a daily basis when payments are due and when they become past due. This system must generate the reports necessary for effective collections and make them available to collections staff in a timely manner.

Decentralization. Another important characteristic of successful microfinance operations is decentralization, particularly with respect to credit decisions. Banks are not accustomed to delegating authority to individual loan officers, nor to holding frequent and relatively informal meetings to approve loans. Most microcredit decisions are carried out at the branch level through committees made up of loan officers and supervisors who meet frequently and informally, sometimes daily.

Depending on the organizational structure of the microfinance operations, sometimes a loan officer may only need a supervisor's approval for a credit decision. This level of decentralization of the credit process can be challenging to the bank's culture, especially when microfinance operations are conducted as an internal unit of the bank, which may operate in a very centralized manner with other loan products. Some banks, such as Banco Agricola in El Salvador and Banco Wiese in Peru, have established specialized credit centers to review and approve microenterprise loans in a centralized or regional manner while placing loan officers in branches. Other banks have invested in new technologies that allow credit appraisal, approvals, contract preparation, and disbursements to take place centrally while loan officers and clients can be located throughout the bank's network. Banks must recognize that quick decision making is a core operating principle of microfinance and results in reduced operating costs, decreased wait times for clients, and enhanced accountability of loan officers. With technological advances, it is possible to have decentralized client service while maintaining more centralized credit approval and processing, but it is critical to ensure that credit quality remains high and processing time brief. Usually, a decentralized service model is fundamental to client satisfaction and retention in what is becoming an increasingly competitive environment for microfinance in many countries.

Internal controls. Rigorous internal controls such as the strict collections procedures described above are essential to successful microfinance operations because of the decentralized credit process. Given a loan officer's greater autonomy and self-supervision, the lack of hard collateral, and the more informal nature of microfinance documentation, a bank must understand and control its risks, particularly with respect to fraud, which can occur in the form fake clients or loans. A bank's compliance personnel and internal audit department must be trained to understand the specific characteristics of microfinance to ensure proper procedures and methodology are followed.

Supportive branch network. Branches must be located in areas where microentrepreneurs work and reside, and must be staffed by employees who understand, respect, and communicate effectively with the clientele. Staff members at the branch must understand the potential profitability of deposits and loans to the microfinance sector. Where loan officers and their portfolios are assigned to branches, branch mangers must be trained in microfinance policies and procedures and their targets and incentives must be aligned with those of microfinance in the bank. Visiting a traditional branch of a bank can be a very intimidating experience for a microfinance client who may not receive the same level of customer service that wealthier clients receive. Commercial bank tellers must be trained properly to service the microfinance sector even if they are providing other services and products to diverse clients. There is a risk that when microfinance is not a major product line in the bank, the staff will not receive the necessary support and incentives to provide high-quality service to the microfinance clientele.

Back office operations. The back office operations that support the lending and deposit activities of the microfinance clients often are not given enough attention in the initial planning and implementation stage but are important for the long-term success of bank's microfinance operations. These activities include MIS, internal audit, customer service, loan administration, contracts, cashier services, staffing, and training. Banks must plan carefully in the front and back office to ensure they can manage the large transactions volume generated by microfinance, which can surpass the volume from its traditional customers. Microfinance operations may use bank tellers, ATMs, and other systems for disbursement and deposit services, so having an effective transaction processing strategy in place is essential to ensuring good customer service, sustaining employee morale, and facilitating overall operational efficiency. It is important that the contract and disbursement procedures are consistent with the quick and decentralized client service model.

Ideally, the bank will design and program the MIS before the launch of operations. It must determine what client information should be captured and analyzed and where that data should be stored.

Without extensive knowledge of and experience in microfinance, the bank will face challenges in answering those questions and making the best decision about the most appropriate MIS. Depending on the organizational model chosen to implement microfinance operations and the capacity and ability to customize the bank's systems, a decision will have to be made between developing or buying a separate system and modifying the bank's existing system. If a separate system is created, the bank must consider how the data will be consolidated and reconciled because data migration and interface pose big challenges. The bank must be aware of the level of effort and financial costs involved and ensure that the work remains a priority for the members of the MIS department, who will likely have little understanding of microfinance operations.

New technologies—such as software to facilitate and integrate work-flow processes for loan appraisal and disbursement, opening deposit accounts, and conducting other financial service transactions—are revolutionizing operations and risk management systems at traditional banks that adopt them as part of their microfinance and broader retail banking businesses. At the same time, these technologies allow banks to improve client services by reducing transaction time and allowing centralized processing and decentralized client service. Although banks are increasingly automating loan appraisals, loan officers spend most of their time in the field meeting with clients, so desktop computers are not usually a main tool in their work. To take advantage of automation, and keep loan officers in the 'street' with their clients, some banks have begun to use handheld technologies such as Palm Pilots that permit loan officers to gather client information in the field and later "hot sync" it to an office computer. Whether information is gathered on paper or using handheld technologies, other staff members can carry out administrative functions such as entering data, preparing contracts, and processing checks, so it is not necessary to have one desktop computer per loan officer.[10] Advances in telecommunications, smart cards (imbedded chip technology), automatic teller machines, and even cellular phones are revolutionizing the way deposit, transfer, and payment services are offered, and are particularly promising in expanding financial services to remote regions and marginalized areas—where the majority of microfinance clients live and work—where traditional bank infrastructure is not cost effective.

[10] For more information on information systems for microfinance, please refer to the CGAP information services resource center at http://www.cgap.org/iss site/.

6. GETTING TO PROFITABILITY

Profitability plays an important role in a bank's decision to initiate and sustain its microfinance operations. As with any new product or investment, there are different aspects of the business case to consider and different methodologies for measuring profitability and return on investment. Determining the costs and revenue drivers of microfinance operations is critical to ensuring that resources are available and properly allocated; that costs, both actual and imputed, are fairly assigned; and that pricing strategies accurately reflect profitability goals. When a bank is not already allocating costs fully and accurately for other lines of business, the introduction of microfinance can be a driving force in getting it to implement a full cost and revenue allocation system. The main questions for many bankers follow:

- How does microfinance contribute to the bank's overall profitability?
- Are microfinance operations profitable on their own?
- What are the core drivers of that profitability?[11]

In terms of the ease with which it may start up and succeed in microfinance, a bank's extensive branch network, access to ample and low-cost funds, existing IT, and overall low operating costs provide it with advantages over other institutions such as smaller, specialized financial intermediaries. Given the preponderance of fixed costs in the operation of a financial institution (such as buildings, information systems, and managements salaries), the marginal cost for a bank to introduce a new product can be relatively small. For example, banks have succeeded in microfinance when they have added microfinance services in underutilized branches, particularly those branches located near where microentrepreneurs work and live. Banco del Pichincha of Ecuador added microcredit to its array of financial services as a way of reaching profitability in its underutilized branches. The bank established a service company, Credife, which required little capital, had a lean structure, and could capitalize on a branch network in low-income areas. For 2003, the net return on the microcredit portfolio before taxes was 3.38 percent.[12] The legal structure chosen by the bank for microfinance operations will have an important impact on the cost structure and net profitability (see Section 5.1 Operating Models for a description of the most common models and implications for profitability). The bank should also analyze how profitability may change depending on the legal and operating structure chosen. With the service company or subsidiary models, profitability also means that dividends will be paid to the shareholders, which will reduce the bank's overall return if it does not hold 100 percent of the shares.

Regardless of the model, a bank will want to know if its microfinance operations are profitable even if the results are consolidated into the bank's overall financial performance. Understanding all of the costs involved in setting up and maintaining a microfinance operation is crucial to understanding its profitability, including the time estimated to achieve profitability. This understanding will facilitate analysis of the bank's microfinance operations in comparison to the bank's other lines of business. Important costs include staff recruitment, training, salaries, and benefits; cost of funds and loan loss provisioning; design, programming, and installation of IT; transaction costs; promotion and public relations; and development of products and services for the microfinance sector. In some cases, new branches or other types of points of service will have to be established to serve this market.

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[11] For a detailed analysis of the profitability of microfinance in two commercial banks, see the Accelerated Microenterprise Advancement Project (AMAP), Financial Services Knowledge Generation (FSKG) case studies on Hatton Bank of Sri Lanka and Credife/Banco del Pichincha of Ecuador by Lynne Curran and Nancy Natilson available at http://www.microlinks.org.

[12] For details on the profitability analysis at Banco del Pichincha and Credife, please see the AMAP/FSKG case study by Lynne Curran and Nancy Natilson available at http://www.microlinks.org.

Another important cost often overlooked is that of the technical assistance and training that the bank may receive to support its entry into microfinance. Although the cost of this assistance may be covered partially or totally by funds from donor agencies and other multilateral financial intermediaries, it is a subsidy and should be included in determining the profitability of this line of business. Moreover, to ensure that such outside support is taken seriously by the bank, it is recommended that cost sharing be incorporated into the arrangement.

As part of analyzing profitability, a bank will ideally carry out a full cost allocation of its microfinance operations; that is, all direct and indirect costs are allocated to each division, product, or process (depending on the model chosen), ensuring each activity carries its share of the overhead burden. It is relatively straightforward to determine the direct costs that can be specifically linked to microfinance, such as loan officer salary expense. Allocation of indirect costs—those costs not directly related to a specific product, branch, department, or customer—can pose a challenge because it is likely that some of the functions of microfinance, such as human resources, technology, finance, and administration, will be carried out by staff and systems not exclusively dedicated to microfinance. For example, branch tellers may serve microfinance and non-microfinance clients in the same location and may perform both disbursement and deposit activities, rendering a detailed profitability analysis of microfinance operations difficult unless the bank has sophisticated information and costing systems.

While difficult, successful allocation of indirect costs will allow the bank to analyze the efficiency of the chosen operating model or individual branches. For example, while the service company model can facilitate fast growth and absolute income, its margins may not be as profitable due to duplication of efforts in some functions (such as human resources and marketing). Having information about the degree to which individual products and services contribute to or detract from the overall profitability of microfinance operations can help the bank to identify sources of inefficiency and opportunities for additional revenue generation.

Cost control is one approach to achieving profitability in microfinance operations and ultimately is essential to an institution's competitive positioning. Bank branch infrastructure can make it easy to scale up operations and increase volume quickly, thereby achieving profitability sooner. Revenue generation is the complementary approach several banks have taken since they already operate with a lower operating cost structure than other nonbank MFIs. Khan Bank of Mongolia found that by rolling out microcredit products throughout its branch network it could quickly generate enough revenue to make even its smallest rural branches profitable.[13] Pricing is crucial to that profitability goal, but bankers may be faced with regulatory constraints, such as interest rate caps or usury laws affecting microfinance. Bankers usually consider pricing higher for microfinance products, similar to or even higher than interest rates charged for consumer lending.

The extent to which the bank may be able to cross-sell other products and services to microfinance clients may be an important factor in its decision to enter microfinance. For example, banks can earn fees on transactions such as cash transfers, a staple in the informal economy that operates primarily on a cash-only basis. By offering an array of products and services, the bank can boost the profitability of microfinance operations compared to its other lines of business. Although these cross-selling opportunities increase the bank's overall profitability, they will be attributed to microfinance only if the management information systems can segregate the relevant data.

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[13] For information on Khan Bank, which was privatized and formerly known as the Agricultural Bank of Mongolia, please refer to the summary case study on this bank prepared under the FSKG research on state-owned retail banks available at http://www.microlinks.org. For a more detailed case study, see Morrow, J. Peter, Jay Dyer and Robin Young, "Agricultural Bank of Mongolia," in *Small Customers Big Market* edited by Malcolm Harper and Sukhwinder Singh Arora, ITDG Publishing, Warwickshire, 2005.

Bankers must be cautious in their estimates of the time it will take for microfinance operations to become profitable. If reaching profitability is the overarching and short-term goal, the bank may opt not to hire the most qualified individuals or to train them properly, or may push up loan sizes to increase disbursements and portfolio volume. Red flags such as deviations from credit processes may not be recognized on a timely basis and can result in delinquency and loan losses. Well-designed policies and incentive systems that emphasize both growth and credit quality will lead to strong volume and avoid the risks inherent in a "growth at all costs" approach.

7. CONSIDERING STRATEGIC ALLIANCES

Before launching into program development, banks should answer the following questions:

- Should the bank go it alone or get outside assistance?
- If opting for outside assistance, what kind? An alliance? A merger or acquisition? Consultancy and training?
- Who are possible partners?
- Are donor or government programs available? Do their benefits outweigh the costs?

While banks may decide to develop the business on their own, establishing an alliance with another organization could prove highly beneficial. These alliances can range from an advising or training relationship to a full-fledged joint venture, merger, or acquisition.

For technical assistance, several consulting firms and nongovernmental organizations (NGOs) specialize in microenterprise finance. Based on their years of experience with diverse institutions in diverse environments, their assistance can be valuable in designing and implementing microfinance operations, helping banks to learn from others' mistakes, and incorporating tried and true best practices solutions with the latest options. Their relationships with banks vary from those in which they provide technical assistance on a consulting basis and those in which they hold management contracts to run the bank—or an aspect of its operations—to becoming equity investors in specialized microfinance banks and subsidiary service companies. The level of commitment may increase with the level of financial involvement and associated risks (from consultants to contracted managers to equity investors) as will the level of control and governance over strategic decisions and operational issues.

Many of these organizations have headquarters in the United States or Europe, with operations worldwide, although some local organizations do exist, such as Environmental Quality International (EQI) in Egypt and ECIAfrica in South Africa[14], particularly in countries where microfinance has roots in the local development and financial communities. ACCION International has assisted several banks, including Banco de Pichincha in Ecuador and Sogebank in Haiti, the largest banks in their respective countries, to establish specialized microfinance service companies. ACCION, through one of its investment funds, is a shareholder in these companies as well as a technical advisor for the microfinance operations. DAI holds management contracts with the recently privatized Khan Bank of Mongolia (and is a minority shareholder in this bank), the (still public, but soon to be privatized) National Microfinance Bank of Tanzania, and Commercial Microfinance Limited of Uganda, all of which focus on microfinance as a major line of business. Both ACCION and DAI hold consulting contracts with banks and donor organizations such as USAID to provide technical assistance and training to banks around the world to develop and expand their microfinance operations. DAI's London, U.K.-based subsidiary, Bannock Consulting, and the German consulting firm, IPC each have held a number of contracts financed by the European Bank for Reconstruction and Development (EBRD) to assist banks in Eastern and Central Europe and Central Asia to develop micro and small enterprise finance programs. IPC also has established a network of commercial banks and finance companies specializing in micro and small enterprise finance recently branded as Procredit. Some of these have been established jointly with local banks. See Chapter 8 for a list of the Web sites of organizations that assist banks to develop and run microfinance programs.

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[14] ECI*Africa* is part of the DAI global network of companies.

For operational alliances, innovative relationships can be established between banks and specialized microfinance organizations. These include many examples of banks lending to MFIs that on-lend to microenterprises, specialized NGOs organizing microentrepreneurs to prepare for loans or other bank services, and banks contracting with specialized microfinance organizations for loan promotion, underwriting, and portfolio supervision services. In these cases, the banks' level of risk and operational responsibilities vary significantly. These options imply less direct involvement in retail microfinance. Evaluating and selecting the partner organization and establishing a relationship that ensures appropriate profit and risk sharing helps lead to success.[15]

[15] For a more detailed discussion of an innovative example of a Bank/MFI linkages, see the forthcoming publication from the AMAP/FSKG, "Opening Markets Through Strategic Partnerships: An Analysis of the Alliance between FIE and ProMujer". See also the CGAP short profiles and forthcoming focus notes on this topic.

Banks can both operate in the local market and ensure total control of future operations, by considering the acquisition of the portfolio of a specialized microfinance organization, or perhaps the entire institution. As with alliances, evaluation, selection, and valuation are critical. This strategy may be used to launch or expand operations. Given the personalized nature of most microfinance services—that is, the fact that clients identify closely with their loan officers or other institutional personnel—it is critical that special attention be paid to managing clients during the time of transition to ensure their compliance with existing contracts and to encourage an ongoing relationship with the bank. A clear benefit of this strategy includes a jump-start on developing the portfolio, and if the acquisition includes staff, systems, or infrastructure, it may provide an extra burst to institutional learning and capacity in this new line of business.

If looking for funding and other types of outside assistance, in many countries, donor agencies, including the World Bank, the Inter-American Development Bank, and other multilateral financial intermediaries or bilateral donors such as USAID or the Department for International Development (DFID), provide funding for technical assistance and other support for banks entering and expanding operations in the microfinance market. The technical and financial support and connections these programs provide can be extremely useful in establishing and refining microfinance programs. However, they will require a certain level of reporting and disclosure and may have other operating requirements regarding regions or target markets serviced. It is worthwhile for banks to weigh the financial and transaction costs of such a relationship.

Bank/MFI Linkages

Banks from Guatemala to India to Russia lend to specialized MFIs and provide deposit and payment services for clients. In some cases, the banks start by providing loans to the MFIs that may be guaranteed by third parties but then expand lending once a good relationship is established. In some cases, such as ICICI Bank in India, such relationships can develop to the point where the bank contracts the specialized MFI to provide all loan servicing functions while the loans remain on the bank's books—much like a service company model. In places where high-performance MFIs operate, these linkages are a viable option for banks interested in entering the microfinance market without developing all the specialized capacities required to succeed at microfinance.

In addition to funding, banks may participate in the microfinance operations of MFIs by providing disbursement and payment support, including use of branches and automatic teller machines. Some banks charge for these services while others simply benefit from the significant deposit balances the MFIs and their clients maintain in the bank. These relationships allow banks to become more familiar with the local microfinance market and participate with lower risk while requiring little or no organizational and operational changes.

8. RESOURCES AND REFERENCES FOR MORE INFORMATION AND ASSISTANCE

8.1 DOCUMENTS

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8.2 WEB SITES

TABLE 5: WEB SITES WITH INFORMATION ON MICROFINANCE

Location	Description
http://www.accion.org	ACCION International is a nonprofit organization based in the United States and operating in Latin America, the Caribbean, Africa, and the United States through associated MFIs. ACCION provides training, technical assistance, and investments to MFIs. The mission of ACCION International is to give people the tools they need to work their way out of poverty. ACCION's publications and statistics on microfinance are available on its Web site.
http://www.cgap.org	The Consultative Group to Assist the Poorest (CGAP) is a consortium of 28 public and private development agencies working together to expand access to financial services for the poor, referred to as microfinance. CGAP's staff, working from World Bank offices in Washington, D.C. and Paris, serve donor agencies, financial service providers, and government policy and regulatory bodies. To each of these client groups, CGAP provides technical advice, training, research and development, information dissemination, and funding for innovations. The Gateway section of this Web site provides significant resources on microfinance, including links to the Microbanking Bulletin and the Mix Marketplace.
http://www.dai.com	Development Alternatives, Inc. is an employee-owned, international consulting firm that helps business, government, and civil society solve economic development problems. DAI has a global banking and finance practice with bank technical assistance, training projects, and management contracts around the globe.
http:www.dfid.gov.uk	The web page for the British Government's Department for International Development (DFID). New papers on the role of guarantees and case studies on the business rationale of five commercial banks in microfinance will be posted shortly. Papers on the role of financial sector development in economic growth and poverty alleviation available through the following two links: http://www.dfid.gov.uk/pubs/files/finsecworkingpaper.pdf http://www.dfid.gov.uk/pubs/files/fsdbriefingnote.pdf
http://www.iadb.org/sds/mic/index_MIC_e.htm	The Web page for the Inter-American Development Bank's micro and small enterprise division.
http://www.microlinks.org	USAID's Microenterprise Learning Information Sharing and Knowledge Sharing Web page.
http://www.microsave.org	A project that promotes the development of savings and other client-responsive financial services among MFIs. Market research and incentive system tool kits available to provide guidance for banks in these critical areas.