BANKS IN MICROFINANCE: GUIDELINES FOR SUCCESSFUL PARTNERSHIPS

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Development Alternatives, Inc.

BANKS IN MICROFINANCE
Guidelines for Successful Partnerships

This microNote is written primarily for USAID staff and others who may consider approaching banks to develop microfinance programs. It is intended to help donors, bank advisors, and other strategic partners to make better-informed decisions about whether and how to approach a bank to offer support for implementing or expanding a microfinance program, and how to ensure success for such an endeavor.

Some of the best-known microfinance institutions (MFIs) in the world have transformed into banks to take advantage of the benefits a bank structure offers for microfinance. At the same time, in an increasing number of developing countries, existing commercial banks present tremendous potential to profitably service the microfinance market.[1] Branch networks, access to capital, diverse financial products, and qualified human resources all provide banks with the fundamentals to launch and grow successful microfinance businesses. Over the past decade, banks have entered the microfinance market, and recently a number of them have shown promising results in terms of profitability and growth. In several of these more successful cases—in countries as diverse as Ecuador, Haiti, Mongolia, the Philippines, and South Africa—USAID has supported the banks' entry and expansion in microfinance.

Working with banks is different from collaborating with traditional microfinance institutions (MFIs). The organization, operations, and product offerings of commercial banks entering the microfinance market often vary from those of specialized microfinance institutions. Innovative practices and models are emerging, including more centralized operations and greater reliance on technology. Given their business priorities and organizational culture, banks present a unique set of challenges and needs for donors and development professionals. In particular, keeping microfinance a priority and making the organizational and operational changes required for growth and profitability are important areas in which outside support can be critical for banks entering microfinance. Therefore, the approach to working with commercial banks in microfinance must be tailored to their reality.

It is important to assess why a bank is interested in entering the microfinance market in order to determine its commitment to scale and sustainability. Although a mix of internal and external

[1] Prepared by Robin Young, drawing on *Banking at the Base of the Pyramid: A Microfinance Primer for Commercial Banks,* by Robin Young and Deborah Drake, a deliverable under USAID's Financial Services Knowledge Generation Project implemented by Development Alternatives, Inc.

factors often drives a bank to consider entering the microfinance market, without a clear business case, it is unlikely microfinance will receive the attention and resources necessary to succeed.

Market indicators can help determine the business potential for microfinance in banks. Increased or excess financial sector liquidity, or downward trends in interest rates and margins, are positive signs of the potential for bank interest in developing new markets such as microfinance. Not all environments are conducive to banks entering the microfinance market, however. If banks enjoy large margins on traditional business and are not pressured by competition to search out new markets, they are unlikely to enter the microfinance market in a serious way. In a relatively uncompetitive environment or one in which price controls and other regulations constrain bank operations, it is unlikely that banks will enter this market for purely business reasons, although they may do so because of social or public relations concerns or government mandates.

A review of key internal factors will help determine the feasibility and commitment of a bank's entrance into microfinance. Banks with higher potential to succeed at microfinance will demonstrate specific characteristics such as an underutilized branch network located near microentrepreneurs, retail banking operations and culture, and internal leadership that understands and is committed to microfinance. Most important is to approach senior decision makers in the bank to discuss the potential returns of microfinance and secure their commitment to a sustainable microfinance strategy.

Banks that do decide to enter microfinance usually require some form of outside technical assistance to design and launch a microfinance program. This assistance is necessary so the banks can learn from best practices and others' mistakes and to help them keep microfinance a priority during the critical start-up and initial expansion phases. The most common areas in which banks require assistance are business planning for microfinance; evaluating and establishing the appropriate legal structure and organizational design; developing loan product, policy, and procedures manuals; business process reengineering of operating processes; evaluating legal options for nontraditional collateral and contract enforcement; customizing existing products; selecting and training staff and developing the appropriate organizational culture for microfinance; and customizing information and risk management systems.

Careful thought regarding the design of outside assistance and the provision of consulting and training services is essential. Although banks have financial resources and capacity that can be beneficial to significant expansion with a relatively low investment by USAID, outside assistance (such as that provided in USAID projects) helps to keep microfinance a priority within a large bank whose managers and directors have to oversee a variety of issues and businesses and helps to ensure the program is designed to maximize outreach and sustainability. To ensure bank buy-in to outside assistance, it is important to structure the relationship in such a way that the bank is accountable for performance and demonstrates commitment by covering operating expenses (such as branch costs and personnel) and assumes risk by providing loan capital. Ongoing discussions with knowledgeable experts, including USAID and project-supported in-house advisors, help banks recognize successes, challenges, and potential solutions. Organizing study tours to other specialized MFIs, and especially to banks that offer microfinance, is another way external support has helped banks refine their operations and succeed at microfinance. Technical assistance in planning and initial implementation, conducting feasibility studies, customizing financial products, developing policy manuals, designing and evaluating pilot programs, training staff, and system specifications and customization have been useful in helping banks establish a strong basis from which to grow. In a few markets, banks have been able to hire experienced professionals from other successful MFIs, as in Peru. However, the number of such environments and professionals is limited.

Support for development of an enabling legal framework and market infrastructure facilitates entrance and expansion of banks in microfinance. Whereas unregulated institutions have found ways to work around legal constraints, banks operating under supervisory structures require clearer and more consistent laws and norms. Improvements to the financial sector's legal framework—appropriate loan classification and provisioning, loan file documentation, requirements for rural branch infrastructure and hours of operations, reserve requirements, collateral registries, and contract enforcement, among other issues—encourage and facilitate bank entrance and expansion in the microfinance market. Market infrastructure that includes such elements as credit bureaus that work with microfinance clients encourages competition and risk management, both of which facilitate entrance of diverse institutions, including banks, into the microfinance market.

CHALLENGES

Banks continue to face challenges in designing and implementing microfinance programs. *Banking at the Base of the Pyramid: A Microfinance Primer for Commercial Banks* presents a detailed discussion of the decisions banks face in designing and implementing microfinance. Following is a summary of the areas that have presented the greatest challenges thus far for banks and those assisting them in designing and implementing microfinance programs.

DEFINING THE TARGET MARKET

Although banks usually do not begin by serving the poorest microentrepreneurs and day laborers, they can provide an important array of products and services for many low-income clients as part of the financial services network in any economy. It is not uncommon, even before it has initiated a microfinance program, for a bank to service some microentrepreneurs or salaried workers through existing consumer or small enterprise products. Hence, it is useful for the bank to conduct a client and product segmentation process to define microfinance and avoid unnecessary internal competition for the same clients with other products or departments in the bank. Defining and perhaps reassigning client segments among diverse areas of the bank likely will take some business away from existing areas and, therefore, may cause internal conflicts and power struggles.

With traditional MFIs, USAID usually counts the entire portfolio for reporting purposes; a multiservice bank, however, will clearly serve segments of the population—such as corporations and high income individuals—that are not considered when monitoring project results. Therefore, parallel to the internal segmentation process, USAID and the bank must clarify their definitions of client and product keeping the USAID project monitoring system and results indicators in mind. As part of this discussion, it is important to consider the diverse ways the bank may service clients, through different products, departments and channels. A second consideration is the capacity of the bank's management information system to identify and track these clients, loans, deposits, or other performance indicators. If the bank's systems cannot easily meet USAID's reporting requirements, project resources may be required to support tracking and verification of indicators.

PRICING AND COSTING

Some banks find it difficult initially, from a public relations standpoint, to increase the price of loan products for poorer segments of the economy. In some countries, interest rate ceilings and usury laws limit banks' ability to set interest rates. However, without appropriate pricing, microfinance will not be profitable and therefore will not grow within the bank. In many cases, banks do not have detailed costing systems and their traditional methods for cost allocation may not correspond to the microfinance operations that typically feature small transactions. Therefore, the costing systems may distort the true profitability of microfinance. To correctly price a microfinance product, it is important to understand the market prices for microfinance (from moneylenders and other microfinance providers) as well as the microfinance product's cost structure.

LEGAL AND OPERATING MODEL

Choosing the operating model of the microfinance operation is one of the biggest challenges of successfully integrating microfinance into commercial bank operations. The model must establish the autonomy necessary to uniquely service the nontraditional client segment. At the same time it should take advantage of the bank's assets in terms of reputation, systems, financing, and human resources. The model chosen also must consider the appropriate participation of strategic alliances and outside investors in the governance structure. To date, commercial banks have structured their participation in microfinance in a variety of ways; four models have predominated: the internal unit, the financial subsidiary, the service company, and strategic alliances with specialized microfinance institutions. Each model has its advantages and disadvantages—including cost, risk, regulatory requirements, and partnering options—and deciding on the appropriate structure depends on the bank's operating environment and business strategy.

ORGANIZATIONAL STRUCTURE

Clearly, microfinance is more similar to retail than to corporate banking and, therefore, should have a structure that facilitates a decentralized client service model, taking advantage of branch infrastructure. In the initial stages, it is recommended that the bank develop a limited pilot program with an operating structure relatively independent of regular operations in order to test and adapt products and processes while limiting the burden of the bank's other operations. Microfinance can be integrated it into the bank's operations as appropriate in the roll-out stage.

DECENTRALIZATION

A key characteristic of successful microfinance operations is decentralization, particularly with respect to customer service and 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 require 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. New technologies, such as work flow software, credit scoring, and computerized loan application analysis systems, help to ensure lending policies are followed, facilitating centralized loan approvals and back-office operations while allowing loan officers and their clients to operate in a decentralized fashion throughout the bank's network.

HUMAN RESOURCES

The three essential elements in terms of human resources are: finding the right leader, selecting and training loan officers and other personnel, and crafting appropriate compensation and incentive packages.

The leader of the microfinance unit must have the confidence of and access to the bank's most senior decision makers, and must have the support and oversight of a senior decision maker in the bank who champions microfinance to ensure that the organizational structure is implemented and that microfinance operations, staff, and clients receive the necessary attention. In addition, the microfinance leader must have knowledge of and commitment to microfinance and the ability to manage a large staff of widely dispersed personnel. A management team must support this leader, in terms of both supervision of field-based staff and provision of support services from the bank. This second level of management helps anchor the microfinance operations and provides options for future leadership succession.

Staff must be qualified and motivated to stay in microfinance to recoup the training costs and help to generate sufficient volume and maintain portfolio quality. During the pilot program and initial expansion phases, training is critical to ensure that staff, who may be new to microfinance, are grounded in the techniques, policies, and procedures of microfinance and the bank's culture and operating standards. Although the focus is on those staff directly involved in microfinance operations, such as loan officers, staff throughout the organization require ongoing, practical training in a variety of topics. Qualified staff may be lured away to other areas of the bank, which can be good for the bank and the individuals but detrimental to the microfinance program.

Incentive systems, a critical factor for productivity and portfolio quality in microfinance, are often difficult to implement in banks for two primary reasons. First, many banks do not offer performance-based incentive systems to other staff at the same level, and/or they are resistant to offering incentives to microfinance staff that could result in compensation that is higher than for staff in other areas of the bank. Second, there is the challenge of recognizing and rewarding the input from operations and branch staff who support microfinance and who are responsible for other areas. Although models to quantify this input exist, using parameters such as number of microfinance transactions processed, designing and implementing such an incentive model requires care and an integrated approach.

CONCLUSIONS

The areas discussed above highlight the key issues and challenges of working with commercial banks to launch and grow successful microfinance operations. An increasing number of banks are demonstrating how to successfully address these issues and overcome the challenges to establish sustainable and substantial microfinance programs that extend diverse financial services to previously marginalized and underserved clients. Private banks that have succeeded in microfinance include Banco del Pichincha and its service company Credife (Ecuador), Khan Bank (Mongolia), Capitec Bank (South Africa), and Hatton Bank (Sri Lanka); successful public banks include Bank Rakyat Indonesia (BRI) and Banco do Nordeste (Brazil). In many of these cases, support from USAID and other donors was an important factor in helping the bank design and implement its successful strategy.