Commercial Bank Downscalers in Latin America

Introduction
Traditional commercial banks in Latin America are entering the field of microfinance in greater numbers than ever before. What was once a timid exploration of a new market by a few pioneers has transformed into a more committed entry of over twenty banking institutions and finance companies. In many countries of Latin America, one to three banks or finance companies are either offering microloans or are in the process of planning an entry into the market.¹ The implications are far reaching. Not only is the financial sector landscape in each country changing, but the new exploration and competition are encouraging a new wave of product innovation and a fresh look at operating systems.

This brief report highlights some elements of this relatively new trend. It is anecdotal rather than empirical, as the research on this topic is still young. Most of the views expressed here are based on direct conversations with bankers attending two USAID-sponsored conferences (Washington, D.C., November 1996 and Santiago, Chile, March 1998), and the 1997 report, Commercial Banks in Microfinance: New Actors in the Microfinance World, which was based on a survey of bankers at the first of those conferences.²

¹ Conventional banks and other regulated finance companies in Latin America and the Caribbean that have a microlending unit include: Banco Económico, Banco Unión, and FASSIL in Bolivia; Banco do Noreste in Brazil; Banco del Estado, Banco Santander and Banco de Desarrollo in Chile; Caja Social in Colombia; Banco de Comercio in Costa Rica; Banco Solidario in Ecuador; Banco Agrícola Comercial and Banco de Desarrollo in El Salvador; Banco Empresarial in Guatemala; Bank of Nova Scotia in Guyana; Bank de L’Union Haitienne and Banque InterContinentale in Haiti; Banco de Comercio and Financiera Industrial y Agropecuaria (FIA) in Honduras; Banco del Café, Interbank and Banco del Campo in Nicaragua (using "brokers"); Banco Wiese in Peru; Multicredit Bank in Panama; Financiera Familiar in Paraguay; Bangente in Venezuela. There may be others.

 spécialisé microfinance banks or financieras, dedicated exclusively to microfinance, include: BancoSol, Caja Los Andes and Fomento de Iniciativas Económicas (FIE) in Bolivia; Finamérica in Colombia; Financiera Calpiá in El Salvador; and MiBanco in Peru.

² This document was written for USAID's Microenterprise Best Practices project by Mayada Baydas, Douglas Graham and Liza Valenzuela. It can be downloaded from the www.mip.org web page.
This document will explore seven questions:

- Why are commercial banks and finance companies entering the microfinance market?
- What products do they offer and how?
- What issues do they face and how do they resolve them?
- What innovations are they bringing to the microfinance field?
- Are they profitable?
- Do these banks and finance companies reach poor microentrepreneurs?
- What is the future of commercial bank downscaling in Latin America?

**Why Are Commercial Banks and Finance Companies Entering the Microfinance Market?**

The simple answer appears to be competition. Latin American countries have experienced a decade or two of macroeconomic stabilization efforts which have had three important effects:

- A reduction in the role of the state and an increase in private sector economic activity;
- Lower rates of inflation; and
- Financial sector liberalization, which has freed interest rates and reduced barriers to the entry of new banks and finance companies.

These important changes have led to an increase in the number of private banks, which most typically originated as a means to finance the activities of emerging business groups. Spanish and Chilean consumer finance banks have also entered various Latin American countries. As banking systems have become more competitive and corporate profit margins are squeezed, many banks have begun to look at new niche markets.

Why the microenterprise market? Microfinance has been publicized in various Latin American countries, and the word is out that non-governmental organizations (NGOs) are able to lend money at cost-covering interest rates and get it back, with repayment rates often higher than banks'. Most of the banks that have entered the microfinance market thus far draw on these experiences. Some bankers have visited the more stellar programs, and many have even hired personnel from the successful non-governmental programs.

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3 For purposes of this brief, the term commercial banks is used to represent private corporate banks as well as finance companies.
A number of the institutions entering microfinance today have come from the consumer finance market. While this is a different market, it shares many similarities with microfinance, and the leap from one product to another is less formidable. The consumer and microenterprise markets are high volume businesses with small loans and high transaction costs. This contrasts sharply to corporate lending, with its sizable loans, lower interest rates, and lower operating costs.

**COMPARISON OF LOAN PRODUCTS**

<table>
<thead>
<tr>
<th></th>
<th>MICROFINANCE</th>
<th>CONSUMER</th>
<th>MEDIUM-LARGE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Client</strong></td>
<td>individual</td>
<td>individual</td>
<td>firm</td>
</tr>
<tr>
<td><strong>Client activity</strong></td>
<td>self-employed</td>
<td>mostly salaried employee</td>
<td>enterprise</td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td>solidarity group; co-signers, cash-flow</td>
<td>co-signers</td>
<td>fixed assets</td>
</tr>
<tr>
<td><strong>Delinquency</strong></td>
<td>lower - tracked closely</td>
<td>high - not tracked closely</td>
<td>low - not tracked closely</td>
</tr>
<tr>
<td><strong>Loan analysis</strong></td>
<td>business and household cash flow; character-based</td>
<td>based on salary; credit scoring and credit bureau; technology-based</td>
<td>business cash flow</td>
</tr>
<tr>
<td><strong>Loan Size &amp; Term</strong></td>
<td>small, short-term</td>
<td>small, short to medium term</td>
<td>large, medium to long term</td>
</tr>
<tr>
<td><strong>Marketing</strong></td>
<td>word of mouth</td>
<td>media advertising</td>
<td>media advertising</td>
</tr>
<tr>
<td><strong>Transaction Costs</strong></td>
<td>high</td>
<td>high</td>
<td>low</td>
</tr>
<tr>
<td><strong>Volume of Loans</strong></td>
<td>high</td>
<td>high</td>
<td>low</td>
</tr>
</tbody>
</table>

**What Products Do They Offer?**

Latin American banks and finance companies entering the microenterprise credit market are by and large offering small individual loans, based on the repayment capacity of the enterprise. Loans do not require fixed asset collateral, but are usually backed up by a co-signer. Terms appear to be longer than those of NGO programs, usually closer to a year, and repayment installments are frequent, often weekly.

A number of banks are experimenting with group lending – a practice that stems directly from
NGO experiences. Group lending approaches are usually found in banks that have organized an independent structure to handle microfinance, as in the subsidiaries of the Bank of Nova Scotia in Guyana and the Banco de Desarrollo in Chile, or in those which have hired NGO staff -- as in the case of the Banco Empresarial in Guatemala and the Banco Económico in Bolivia.

Two other modalities have been observed: a bank microlending unit that lends to NGOs which then onlends through group mechanisms (Banco Wiese in Peru); and microlending through private “brokers” who organize the client groups and bring them to the bank, a modality found among three Nicaraguan banks.

**Issues Bank Downscalers Face and How They Solve Them**

**Staffing.** Experience has shown that loan officers, who have the main contact with the client and represent the bank in the client's eyes, must have strong people skills and a genuine desire and ability to work with low-income people. Since most conventional banks don’t have personnel with a social services vocation, microfinance units usually recruit from the outside. Many, such as Banco Empresarial in Guatemala and Banco Económico in Bolivia, have recruited NGO staff, who bring with them a sense of social mission, a more modest salary history, and a knowledge of methodologies to reach out to a special clientele. For back-office jobs and middle-management, the story is different. A number of bankers at the Santiago conference reported recruiting staff from within their banks for these jobs.

**Commitment.** Without commitment at the highest levels of the bank, these incursions in microfinance do not last. Those banks whose entry is principally motivated by a desire to improve their public image or those merely responding to laws requiring them to dedicate a percentage of funds towards small business appear to have the smallest, least aggressive programs. On the other hand, those whose entry is motivated by a search for a new profitable market, regardless of whether their motives are purely economic or also social, appear to be expanding at a faster pace and with stronger financial results. While the long term interest of the banks and finance companies is not yet proven, most banks are utilizing their own deposit base for on-lending (as opposed to donor resources), and a few are making important investments in technological innovations. If sufficiently profitable over the medium term, it appears likely that many banks may stay in the market.

**Administrative Structure.** A critical issue is how the bank is organized to provide microfinance. Conventional corporate banking is very a different business from microfinance, and the structure necessary to support large transactions is inappropriate for the microfinance business. Conventional banks often have many departments to process and administer their loans (e.g. loan initiation, underwriting, legal, issuance, accounting, collections). Facilities are usually elegant and close to major business centers, staff are financially-minded and sophisticated, and rewards are based on placing large loans. Microfinance institutions require more simple offices, convenient for the client, staff who feel comfortable with a poorer clientele, and a simple operating structure.
wherein the loan officer tends to be the loan initiator as well as the collection agent. Banks that have simply opened a new microfinance window by offering a smaller sized loan, while maintaining the same corporate loan process, have found it difficult to mesh the two cultures and many have withdrawn from the market. Others have had more success by simply installing a separate, specialized organizational unit within the larger bank. The idea of using subsidiary, or in its less dramatic form a specialized microenterprise department to deal exclusively with the microentrepreneur has been a more successful organizational innovation. All systems and procedures close to the client are unique to the microfinance operation, and clients do not interact with the larger bank. In the case of two Chilean banks, a special window with a trained teller located next to the banks’ other windows is used for the microenterprise client.

**Innovation**

Microfinance innovation in Latin America is clearly in the commercial banking sector. What can be observed thus far among the banks committed to microfinance is a strong emphasis on systems and technology to reduce the costs of processing thousands of tiny loans. From sketchy evidence, it appears that bank microenterprise units have operating expenses ratios similar to the strongest specialized microfinance institutions (in the 10% to 20% range). While that may sound acceptable to observers of the microenterprise development field, they are not acceptable to many microfinance bankers who still compare themselves with traditional banking industry ratios. At the USAID-sponsored bankers conference in Santiago, Chile, bankers described a variety of cost-reduction strategies, including credit cards, smart cards, credit scoring techniques, staff recruitment methods, consumer lending adaptations, and subsidiary arrangements. The outside observer is struck by this dedicated search for technique, a search reminiscent of the days when non-governmental organizations pioneered micro lending methodologies.

**Are They Profitable?**

All of the banks interviewed for the *Commercial Banks in Microfinance* report as well as those participating in the Santiago conference opined that the microfinance market is profitable. Data to confirm this is scarce, but more is becoming available. Three regulated financial institutions which emerged from non-governmental organizations (BancoSol, Caja Los Andes in Bolivia and Financiera Calpiá in El Salvador) have return on equity figures in their twenties and thirties -- higher than the returns of most corporate banks (generally in the teens). It is also common knowledge that the Unit Desas of the Bank Rakyat Indonesia have been the money makers for the larger BRI. A new study of one commercial bank in Latin America also confirms strong levels of profitability for the bank’s microfinance product, stronger in fact, than any other division of the bank. While anecdotal, the “mood” of the conferences is telling. In the November 1996 conference, the parting words of a Jamaican banker voiced one of its principal conclusions: “we are sitting on a gold mine.” By the second conference in Santiago, 18 months later, the

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sentiments of the group were best expressed by a Paraguayan banker who said: “I wouldn’t want to have any of you as my competitors.” From the point of view of the bankers in Santiago, profit was no longer an issue, but rather competition. Whether this high profitability and hence continued interest will persist in a time of economic crisis, as experienced in Asia, only time will tell.

**Do the Banks Reach the Poor?**

The *Commercial Banks in Microfinance* authors interviewed 17 bankers and derived information on average loan sizes. If we exclude the BRI, which has phenomenal numbers (2.3 million borrowers with loans outstanding of $1.42 billion), the rest of the banks had an average of 8,500 clients, an average loan size of $1,400 and a portfolio of about $10.2 million. Two banks in the sample had average loan sizes under $300, a figure that has been generally regarded as the upper limit for lending to the poorest people, and two banks had loan sizes above $3,000. The chart below presents the distribution by average loan size of the 17 banks.

### AVERAGE LOAN SIZE
**Banks Participating in Microfinance Conference, Nov. 1996**

<table>
<thead>
<tr>
<th>Average Loans</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>under $300</td>
<td>2</td>
</tr>
<tr>
<td>$301 to $1,000</td>
<td>7</td>
</tr>
<tr>
<td>$1,001 to $2,000</td>
<td>4</td>
</tr>
<tr>
<td>$2,001 to $3,000</td>
<td>2</td>
</tr>
<tr>
<td>$3,001 to $4,000</td>
<td>2</td>
</tr>
</tbody>
</table>

Traditional banks will probably never be able to reach the poorest of clients, who by their condition require additional services, such as basic literacy, sanitation and health. Banks will also probably be unable to serve clients in remote rural areas which have limited economic dynamism or rural infrastructure. Unless governments solve these urgent problems through education, improved health services, rural roads, telecommunications, and improved agricultural sector policies, these clients will probably remain on the fringes of the national economy.

**What is the Future of Commercial Banks in Microfinance?**

Commercial banks entering the microfinance market are principally offering loans for microentrepreneurs, and not microsavings or other financial services. There are a few exceptions, mostly from outside the Latin America region: the Worker’s Bank in Jamaica, the Standard Bank in South Africa, and the BRI and Bank Dagang Bali in Indonesia. As Latin American banks become more comfortable dealing with a lower-income market and as competition increases, they
are likely to begin offering a diversity of products to the low-income client. Two Spanish banks (Bilbao y Vizcaya and Santander) which are heavily invested in the consumer finance market in Latin America, have amassed voluminous small savings. Observant local banks will likely follow the lead as the current consumer finance wave sweeps through Latin America.

It is likely that commercial institutions will become the dominant actors in microfinance in the Latin America region. In some countries, such as Bolivia and Chile, banks have more loans and larger volumes than all of the NGOs combined. In countries with strong credit union movements (Guatemala, Ecuador, and to a lesser extent Honduras and Bolivia), these banks will be competing head to head with credit unions for the microfinance market. NGOs which wish to compete on a larger scale will probably best do so by transforming themselves into regulated banks or finance companies. It is yet to be seen whether other countries in Latin America will institute a specialized non-banking institution license, as have Bolivia and, to some extent, Peru.

It appears donor investments in microenterprise over the years are beginning to pay off, as the field is becoming increasingly commercialized. Given that these banks are using their own resources, it is likely the role of donors will begin to change. How donors can best support the commercialization process without creating market distortions is a critical new question.

This brief was written by Liza Valenzuela, Deputy Director, Office of Microenterprise Development.