Downscaling Institutions and Competitive Microfinance Markets: Reflections and Case-Studies from Latin America

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I. Summary:

This research, conducted from May to August of 2004, began with the hypothesis that commercialization of microfinance through downscaling is happening and that it is only a matter of time before large financial institutions come to dominate the microfinance market. The objective was to understand what, if anything, could be done to facilitate downscaling so that it increases poor communities’ access to appropriate financial services. To gain insights on downscaling, interviews were conducted to document the experiences of consultants, financial supporters and direct practitioners of microfinance.

This report first defines microfinance and discusses the key elements of commercialization and downscaling to give readers a common starting point. As the focus is on downscaling, Section IV also presents the types of institutions entering microfinance and their downscaling strategies.

Section V synthesizes the thoughts and ideas of those who have seen the downscaling trend from a cross-country and Latin American perspective. This section is a result of interviews with, and a survey of literature from, some leaders of the institutions that promote commercial microfinance. The report compiles their generalized responses to the major questions about downscaling in Latin America:

- Is downscaling really the future of microfinance?
- What is motivating banks to downscale?
- What is holding up downscaling?, etc.

Many of the answers to these questions have been expressed elsewhere, but needed recapitulation before the subsequent analysis of downscaling institutions. The interviews additionally provided insights and perspectives into downscaling that until now seem to have received little attention.

Next, in Section VI, the paper provides in-depth case studies of various Latin American commercial microfinance institutions and downscalers. The bulk of that section results from first-hand observation of such institutions in Peru and Ecuador and discussions with their managers. The paper analyzes the competitive microfinance marketplace of each country based on direct observation. Brief reports on downscaling institutions in several other countries provide added depth. The paper then compares the different processes the various institutions use to develop and maintain their microenterprise loan portfolios.

The effects of the commercialization of microfinance were also discussed with clients of the institutions in Peru and Ecuador (Section VII), providing grounds for some general observations about how commercialization and downscaling actually affect the people microfinance is supposed to help.

Section VIII then presents the major conclusions about downscaling drawn from the interviews and market analysis:

- Downscalers already have significant share of microfinance market in several countries
- Current downscalers are adopting more appropriate microenterprise loan practices
Consumer finance companies are entering microenterprise loan market
“Demonstration effect” may encourage new entrants
Existing specialized commercial institutions are reacting to competitive pressure from downscalers
Current microfinance clients receive better service and access to more credit

Finally, based on these conclusions, we suggest future options for those involve in promoting the growth of the microfinance industry and downscaling.
II. Hypothesis:

The idea that commercial institutions are best equipped to provide for the financial needs of traditionally underserved low-income individuals and businesses is not new. However, many question whether institutions that have traditionally serviced other clients or provided services other than credit for the self-employed can and will provide access to appropriate financial services for the poor. This paper investigates the differences between the various types of large financial institutions downscaling into microfinance to determine whether they will ultimately serve the social objectives of microfinance in Latin America.

The hypothesis of this study was primarily drawn from the extensive experiences of Profund International and its investors in Latin American microfinance. This paper’s \textit{a priori} hypothesis was that downscaling is happening in many Latin American countries and that downscaling institutions would soon control a significant segment of the microenterprise lending market. It was also expected that research would show that:

- Downscaling institutions would reveal purely commercial motivations for their entering microfinance.
- Downscalers are driving the competitive microfinance market, expanding client outreach and improving prices and service levels.
- In today’s economic environment, those who had historically supported the social objectives of microfinance needed only to step aside to let the downscalers accomplish their goals.
- Downscaling institutions would nevertheless need non-financial support of various kinds from donor agencies and investors that have mastered the intricacies of microfinance.

Institutions that have downscaled in the past have had mixed levels of success – and failure. However, as commercial microfinance begins to come of age, many larger institutions are starting to recognize it as a potential business opportunity. Economic, historical, cultural and other factors will continue to drive banks into this industry. The purpose of this paper is to document some of the factors most significantly affecting the downscaling movement.

We did not expect to show downscaling or microfinance as an ultimate solution to poverty in Latin America. However, downscaling was expected to appear as major step toward providing many communities with equitable and sustainable access to financial services. We expected to see downscaling by large financial institutions as vital to the long-term goals of microfinance.
III. Defining Microfinance:

The term “microfinance” means many things to different people, particularly in the Latin American context. This paper will use the following general definition of microfinance, which will then allow us to address commercialization and downscaling.

Microfinance entails providing non-exploitive financial services to poor and economically disadvantaged communities not served by formal financial institutions. Services can include but are not limited to:

- Credit for micro- and small enterprises
- Consumer credit
- Insurance
- Savings
- Remittances
- Business advice

A financial service institution will be classified with the prefix “micro-” depending on the clients it serves. Determining whether a financial institution is actually “doing microfinance” requires establishing first that its clients are poor, and second that the institution provides appropriate services.

As microfinance has evolved over time, its practitioners’ drives and motivating factors have also changed. Initially, altruistic non-profit and social service institutions provided microfinance. The focus of many of these microfinance institutions (MFIs) soon shifted to the creation of self-sustaining institutions that would serve their communities over the long-term, without relying on foreign donors. Once many MFIs reached the goal of sustainability, they were restructured to create operating surpluses in order to access different sources of funds, reach more clients and further their mission. Today, under certain circumstances, it is possible for MFIs to generate surpluses not only for growth but also to provide a financial return to their equity investors.

This latest stage in the evolution of MFIs – with the potential for financial gains through microfinance – is one of the driving forces behind the proliferation of commercialization and downscaling.
IV. Defining Commercialization and Downscaling

As the microfinance industry has matured, it has become increasingly relevant to discuss the degree to which its services can or should be commercialized. The commercialization of microfinance can happen three major ways:

1. **Downscaling:** A bank or other formal financial institution expands its services to work with clients traditionally served by MFIs. Such an expansion can mean serving microfinance clients in one or many financial areas.

2. **Commercial Investing:** Driven primarily by the promise of financial returns, private funds are placed into institutions already profiting from microfinance. Funds may be invested in MFIs directly or through an intermediary.

3. **Transformation:** An NGO or socially motivated MFI changes its organizational and legal structure to become self-sufficient and profit driven.

This paper will focus primarily on evaluating the current practices of Latin American banks as they downscale into microfinance.

**Institutions:**
Most Latin American countries have several types of formal and regulated financial institutions. In a given country any or all of these may participate in microfinance, depending on their specific circumstances.

**Small Private Retail Banks:** These for-profit banks are primarily funded locally and provide traditional financial services to the middle and higher income communities. What they lack in reach and operational efficiency they often make up for in more customized client service. They are also more in touch with local clients and issues and are likely to be more flexible in the products they offer. As they downscale, they are often forced to dedicate more of their resources to their microfinance which can often make up a significant part of their portfolio.

**Large Private Retail Banks:** These institutions typically have a wide client reach in their country. They are not constrained by capital needs because they have sufficient deposits and equity to move into microfinance. In general, these institutions are the most technologically advanced and operationally efficient. They also offer the widest variety of products to their current clients. These banks however have a large cultural gap to overcome when considering downscaling. Their loan products and processes may not be flexible and customizable enough to meet the needs of the typical microfinance client.

**State Banks:** Several Latin American countries have a state bank as a dominant financial institution. As public entities, these banks often have a mandate to serve the financial needs of the country’s people, including microfinance clients. However, these state banks often fall far behind the private banks in terms of efficiency and technology. Also, as these are state enterprises, it becomes unclear to what extent they can be considered “commercial.”
Defining Commercialization and Downscaling

**Multi-National Banks:** MNBs are similar to large domestic retail banks, but with a few differentiating factors. They have better access to capital markets and technology than domestic banks, but in general their management is less aware of cultural needs in providing microfinance. This lack of awareness is partly due to the fact that many of their business decisions are made from the home country of the bank. These institutions are not displaying significant interest in working directly in microfinance, and even their indirect participation has been very limited.

**Consumer Finance Companies:** Latin America has many commercial financial institutions specialized in providing wide-scale consumer credit. These offer credit cards and other consumer credit services but usually do not take savings or deposits. They tend to have a wide reach, though, and often serve relatively low-income individuals. Their clientele are traditionally salaried employees and not self-employed microentrepreneurs. Their usually large number of clients and the fact that they process small loan amounts make them somewhat similar to traditional MFIs. Some now offer credit to entrepreneurs, effectively bringing them into the realm of traditional MFIs.

**Specialized Banks:** These are institutions established in some Latin American countries expressly to reach out to micro- and small entrepreneurs and/or low-income clients. They focus on that market niche and are not complicated by having to serve high-income clients. They often began as NGOs, later transformed into regulated financial institutions and are culturally prepared to work in microfinance. These institutions are not technically downscaling, as they have always worked in microfinance, but are major commercial participants in microfinance in some Latin American countries. Therefore, understanding these institutions is extremely important in an analysis of the competitive environment facing downscalers.

In our research we have contacted some of these types of financial institutions to explore how they are approaching microfinance. We have also analyzed the competitive interaction between them as they downscale. Of primary concern in our discussions with them were the different strategies and operating structures that would allow these different types of institutions to successfully enter into microfinance.
Defining Commercialization and Downscaling

Strategies:
Since there are different types of organizations that are implementing microfinance operations in various economic circumstances it is not surprising that we find several different strategies for downscaling. Here are brief descriptions of the characteristics of the most common strategies:1

Internal Unit: This involves the financial institution creating the infrastructure and methodology for working in microfinance through its current institutional framework. They often create a specific division for microfinance that is managed on the same level as its other commercial divisions. This structure makes it more likely that the bank acknowledges microfinance as a commercial activity and thus dedicates the appropriate resources to its success. Through this approach the bank bears all of the risk and return associated with pursuing opportunities in microfinance. A drawback of this strategy is that because of cultural and human resource constraints banks are often not able to focus the necessary energy on this unit. A risk of not creating a microfinance unit outside of an institution’s traditional structure is that microfinance may lose the attention of a management team that is accustomed to financially larger and more traditional practices.

Subsidiary: Some institutions establish a separate subsidiary to conduct microfinance activities. This subsidiary is a legally independent entity maintaining and managing the capital requirements and ownership of its lending portfolio. Creating a subsidiary often costs more than establishing an internal unit, but its costs may be justified when the subsidiary can better service microfinance clients and generate more business. Also, this structure can mitigate some of the bank’s risk if it is not the subsidiary’s sole owner. A drawback is that this structure may limit how much the bank can invest in microfinance, because most countries have limits to the amounts banks can lend to subsidiary organizations.2 Also, this structure could lead to inefficiencies because it costs more to transfer funds to a subsidiary than to an internal microfinance unit.

Service Company: “A microfinance service company is a non-financial company that provides loan origination and credit administration services to a bank. The service company does all the work of promoting, evaluating, approving, tracking and collecting loans; however, the loans themselves are on the books of the bank. In return for providing these credit administration services to the bank, the service company is paid a fee.”3 This model is an attempt to combine the best aspects of an internal unit (low transfer and infrastructure costs) and a subsidiary (independent management and risk mitigation).

Partnership Approach: This approach – often referred to as “bank linkage” – is the one most often used by multinational banks. For the purposes of this paper it will not be considered downscaling. In such a linkage, a financial institution makes a relatively hands-off debt investment or donation into a MFI. This is operationally simple for the financial institution but provides none of the benefits of improved efficiency or lower funding costs of commercialization strategies. However, the MFI does often receive the benefits of using the

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1 A more detailed explanation of these different strategies is available in ACCION International’s Insight, No. 6.
2 Campero, Fernando, IADB, Interview
3 Lopez, Cesar, Rhyne, Elisabeth, ACCION International Insight, No. 6
bank’s operational infrastructure and other services.\textsuperscript{1} Also, the MFI often receives consulting or technical support from the partner bank. This is not commercialization because the bank is not approaching the MFI as a business opportunity. However, such a partnership may eventually lead to an MFI becoming more commercial.

Each financial institution presented in the case-studies section of this paper has unique features in its structure, history and context that may have led its management to adopt one of these strategies over others. As Latin America’s microfinance industry is still in its infancy in many countries – or at most, its adolescence – we expect to see even more operational structures, or at least some hybrids of the ones presented above.

\textsuperscript{1} Young, Robin, Interview
V. Current Views on Downscaling in Latin America

Major contributors to the microfinance industry have included international consultancies (ACCION, IPC, DAI), quasi-private investors (Triodos, Profund) and multilateral agencies (IADB, USAID, CGAP/World Bank, IFC, CAF). We interviewed various representatives of these institutions – people who have watched the microfinance industry develop over a long period and across countries – about their current understanding of microfinance as a whole and also their ideas about its commercialization and downscaling. This section synthesizes their views, providing an appropriate lens through which to view the various examples. (See Appendix for a complete list of interviewees.) This section will discuss in detail what factors are generally thought to be most encouraging to banks as they look at microfinance as a business opportunity. Also, the paper will describe what have been identified as major obstacles for banks entering into microfinance. The interviews also tackled some other issues related to downscaling.

Downscaling: The Future of Commercialization?

We asked microfinance professionals whether the commercialization of microfinance through downscaling banks is indeed the “inevitable and irreversible trend in Latin America” that some have predicted. Almost all the interviewees felt that some commercial players would take strong positions in microfinance in most Latin American countries. However, the general consensus was that this movement would not be homogenous across countries. For instance, in countries where regulatory and other constraints hamper the progress of financial institutions, downscaling will proceed more slowly, if at all. Also, commercial institutions may not work successfully in all market segments, as not all microfinance services and clients may be viable business opportunities.

In fact, commercial financial institutions already provide some financial services to microentrepreneurs on an ad-hoc basis, and other institutions are seriously beginning to enter this market. In a 2001 IDB/CGAP survey, 20 of 176 MFIs were categorized as downscalers¹ and accounted for 29% of the total lending portfolios. Between 1999 and 2001 the portfolio of the downscalers responding to both surveys grew by 45%, compared to a decrease in 5% in the portfolio of unregulated institutions in the same countries. (See Table 1)

Most interviewees concluded that while commercial downscaling is already happening in a few areas, most Latin American countries would not see widespread, systemic downscaling for at least a few years. This is not to say that banks – specialized or downscalers – will not be the dominating force in the market. It is impossible to predict how successful or replicable current efforts will prove in future economic environments. Several interviewees also noted that changes in microfinance rarely take place as fast as market indicators suggest that they should. Despite this skepticism, many interviewees pointed out that a large number of factors are driving commercial financial institutions to develop a microfinance business practice.

¹ Many of the institutions considered downscalers by IDB/CGAP would not fit the definition given by this paper, as most of them are specialized microfinance institutions.
What is encouraging commercial players to enter the microfinance markets?
In most of Latin America, relatively low recent growth in major sectors of the economy have left banks with high levels of underutilized liquidity and few mainstream investments opportunities. The banks are being forced to look to smaller-scale businesses and markets to place their funds. With global financial markets, multinational banks have come to dominate servicing the financial needs of the upper strata of the economy. Increased competition due to privatization and the recent stability of interest rates have also reduced profit margins for groups serving the same “high-end” clients.

With margins decreasing, commercial financial institutions have had to turn to new market niches in order to grow, or in some cases, survive. Banks that are less competitive in the high-end market are also looking to other markets, including microfinance, for profitable growth. Many consumer finance banks and small retail banks have already begun providing capital to microentrepreneurs. It remains to be seen if and how larger retail banks will move into the market, which in many instances has proven to be profitable.

Regardless of the rate at which commercialization through downscaling is happening, it is clear that the number of commercialized microfinance institutions is growing. Currently, 27 of the 32 Latin American MFIs tracked by Microrate, Inc. are commercial institutions. Their combined portfolio grew by about 30% over the past year. None of these institutions are downscalers, but larger commercial banks are now noticing that these institutions have had an average return on assets of 4.8%. They do not want to be left out of markets where others are beginning to reap profits. (See Table 2) In addition, “demonstration projects like Profund have contributed to the increased interest of commercial players in microfinance.” The ability of traditional MFIs and microfinance intermediaries to demonstrate profitability has and will cause a wide range of institutions to consider entering into microfinance. The increased interest in pursuing

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1 Some expect is that many banks will skip over the medium-size entrepreneurs that have already proven to be a difficult market and start working further down in the proven microfinance market.
2 Crawford, Gil, Microvest, Interview
opportunities in the microfinance markets because other institutions have proven it to be profitable is commonly called the “demonstrations effect.”

It was also often mentioned that commercial institutions are motivated to enter into microfinance in order to diversify their portfolios. Interviewees mentioned two types of diversification that occur when commercial institutions enter into microfinance:

1. Microenterprises are thought to have little correlation with traditional business cycles and to be more resilient during economic downturns.
2. A portfolio of microenterprise loans spreads the risk over thousands of businesses, at least theoretically unrelated, throughout the economy, so called “atomization.”

These aspects of diversification may appeal to larger downscaling institutions already operating in parts of the economy with different risk profiles.

Another potential commercial benefit is that microfinance could greatly increase the number of clients a financial institution serves. Most large banks in Latin America generate a significant portion of their revenue from non-credit related businesses, such as currency exchange, remittances, insurance, etc. Several interviewees suggested that commercial institutions often see microfinance clients as way to increase their income through cross-selling products they already offer to their traditional clients.

Microfinance presents an opportunity for Latin American consumer finance companies to expand their product offerings. These profit motivated institutions already work in high volume and often with clients that have similar income levels as the microentrepreneur. This is in a sense more of a “sidescaling” than a downscaling, but as it involves purely commercial institutions reaching into the microenterprise market it is equally relevant to this study. These companies are motivated by the fact that their systems are geared to handle a similar type of high-volume/low-value loans that microenterprise lending generates.

However, many people remain skeptical of the ability of these consumer credit companies to work in this segment because their credit technology is completely different from what has been proven to work in microfinance. Consumer finance companies are also often accused of simply re-categorizing their smaller consumer loans to claim they are working in microfinance while not actually reaching low-income individuals and communities. These institutions often do this when they are facing political or regulatory pressure to enter microfinance, but do not want to actually change their business practices. A great deal of the skepticism stems from the Bolivian experience of the late 1990s that involved a rush of consumer finance companies into microfinance seriously damaging the market. If consumer credit companies do not properly modify their strategies to make the shift from evaluating salaried people to the potential cash flows of microenterprises they will have difficulty maintaining a profitable portfolio. However, it is possible that they can appropriately modify their credit evaluation technology and in combination with their efficient operations can be successful in this market. It will be important for these consumer finance companies to understand why their predecessors failed in their attempts to “sidescale.”

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There are some often-mentioned non-commercial reasons that could mobilize a commercial institution into the microfinance segment. Some banks may think that there is value in appearing to be socially responsible. By publicizing microfinance as a social opportunity the banks could hope to improve their public image, especially in countries where banks have a tainted image due to misappropriations or financial crises. Another factor that could make otherwise uninterested commercial financial institutions enter into this market would be government or political pressure and incentives. “If banks do not enter the microfinance market with serious long-run commercial intentions they could ruin the entire microfinance market.”¹ It was universally expressed by those that were consulted during this study that the entrance of commercial institutions will not be a positive development for the industry if it is spurred by solely noncommercial motives.

### Table 2: Statistics from 27 Commercialized Microfinance Institutions in Latin America

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
<th>Average</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Period:</strong> December-2003</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Except if noted otherwise figures are in:</td>
<td>Thousands</td>
<td>Thousands</td>
<td>Thousands</td>
</tr>
<tr>
<td><strong>Loan Portfolio</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Loan Portfolio</td>
<td>$2,714</td>
<td>$32,078</td>
<td>$93,148</td>
</tr>
<tr>
<td>Number of Borrowers</td>
<td>2,505</td>
<td>33,915</td>
<td>217,454</td>
</tr>
<tr>
<td>Average Loan Balance (per borrowers)-Actual Amounts</td>
<td>$290</td>
<td>$982</td>
<td>$2,126</td>
</tr>
<tr>
<td>Portfolio at Risk / Gross Loan Portfolio</td>
<td>0.7%</td>
<td>5.2%</td>
<td>14.3%</td>
</tr>
<tr>
<td><strong>Productivity Indicators</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total operating expense / Average gross portfolio</td>
<td>10.7%</td>
<td>19.7%</td>
<td>65.7%</td>
</tr>
<tr>
<td>Number borrowers per credit officer</td>
<td>101</td>
<td>256</td>
<td>443</td>
</tr>
<tr>
<td>Number of borrowers per staff</td>
<td>48</td>
<td>102</td>
<td>213</td>
</tr>
<tr>
<td><strong>Financial Ratios</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income / Average equity(ROE)</td>
<td>-11.5%</td>
<td>22.4%</td>
<td>52.1%</td>
</tr>
<tr>
<td>Net Income / Average assets(ROA)</td>
<td>-2.1%</td>
<td>4.8%</td>
<td>18.0%</td>
</tr>
</tbody>
</table>

Source: Microrate, Inc.

**What is holding up downscaling?**

Whether anything is in fact holding up downscaling depends on one’s expectations about how fast it should be moving. The recent increase in the number of downscalers and their rapidly growing portfolios have led some to conclude that nothing can slow this trend. Others look at the millions of clients still unserved or being served by social institutions and say that commercialization has not even begun. Even those who claim that downscaling is happening agree that both endogenous and exogenous factors can impede it.

¹ Hamman, Jacinta, LA-CIF/Cyrano Management, Interview
Current Views on Downscaling in Latin America

For those interviewees concerned that downscaling was not happening as fast as it could, one hypothesis about why Latin American banks are not entering into microfinance—or any new business, for that matter—was that they were preoccupied with other structural and internal issues. Over the last few decades, banks in Latin America have gone through many mergers and acquisitions, and banks rarely enter into new businesses while in the throes of structural reorganization. For a bank to expand into a new product line—especially one perceived as high-risk, like microfinance—its traditional line of business must be operationally stable. Large Latin American banks have dramatically increased the number of products they offer, from credit cards to mutual funds. Now many realize they have overextended themselves and are scaling back to find their niche. Until they reach organizational stability again, and consistency in their products for upscale clients, many will not dedicate resources to microfinance initiatives.

Also, large banks may perceive that it is a better use of their time and resources to invest in different products for their high-end clients, that the effort and opportunity costs required to successfully downscale into microfinance could yield much larger returns directed elsewhere. While the returns on an investment in microfinance may be high relative to the assets invested, the size of that return relative to other bank activities may be insignificant to the bank’s bottom line. For a large downscaler, microfinance will likely make up a relatively small portion of its portfolio; in which case the bank may be unable to use that investment to significantly diversify away the risk of its main portfolio. For very large institutions, even a relatively large microfinance portfolio may not provide enough incentive to downscale.

The most frequently mentioned constraint for banks opening operations in microfinance is a misalignment of their culture with the needs of microfinance clients. Large commercial banks in Latin America generally have a very conservative culture which permeates their business strategy. Therefore, it is not easy to convince the board and shareholders of a bank that entering in a new line of business will be in their best interest. The staff and management of these banks are not well-equipped (culturally, technologically and physically) to deal with the needs of large numbers of potential clients who are running low-income enterprises. For many banks, especially corporate banks, it will take an extremely high investment of time and human resources just to begin to understand the microfinance market, let alone develop products and provide it with appropriate services. This cultural divide has created an environment where the microenterprise segment is the last place that many banks will look for profitability. Even if they do eventually enter microfinance, if they do not understand the culture and are not successful banks will be quick to abandon this market. However, as noted earlier the high returns of microfinance, growth

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1 “[From] (June 1998 to March 2000), there were eighteen mergers or acquisitions, ten of which involved foreign banks [in Argentina]… In Colombia and Peru, there were seven mergers or acquisitions, four of which involved foreign banks. Chile had six such transactions, half involving foreign banks,” Clarke, G., R. Cull, M. S. Martinez Peria, and S. M. Sánchez, 2001, “Bank Lending to Small Businesses in Latin America: Does Bank Origin Matter?” Mimeo, World Bank, Washington DC.

2 de Sousa-Shields, Marc, Enterprise Solutions Global Consulting, Interview

3 To the contrary for some of the banks analyzed in this report (Banco del Pichincha and Sogesol) although microfinance is a small part of their overall portfolios, it makes a significant and disproportionately large contribution to their net profits.

4 Young, Robin, Interview
opportunities, new downscaling strategies and market saturation is beginning to make it very difficult for profit squeezed banks to continue to ignore the sector for “cultural” reasons.

Another issue impeding downscaling is the limited patience of the outside shareholders in large financial entities. Many institutions take a year or two after commercialization of their microfinance operations to reach a break-even point and operational self-sustainability. Especially during uncertain economic times, under immediate pressures to returns, financial institutions lack the flexibility to pursue long-term strategies. In theory, larger banks, with their lower cost of funds, should be able to realize returns more quickly, but if they do not, this could and does discourage others from entering the market.

Some think this demonstration effect has been hindered by the fact that many commercial banks already profiting from microfinance either do not or cannot identify which of their profits are generated specifically by their microfinance operations. Some serve microfinance clients as part of their personal or small enterprise banking divisions, but usually these transactions are so small that they are not separately accounted, making it difficult to use them as examples of successful downscaling. Even commercial institutions that do measure the profitability of their downscaling efforts often withhold that information to avoid encouraging competitors from entering the market.

With their lower costs of funds and better infrastructure, commercial institutions have the potential to displace NGOs and other socially driven institutions, including government sponsored ones, in the MFI market. However, as long as donor and other “soft” funding are available for microfinance, noncommercial MFIs may be able to thrive. This has led some to conclude that the existence of subsidized funding for NGOs is discouraging potential downscalers from entering the market, because they may believe it is not viable without soft funding.

Microentrepreneurs and other microfinance clients often operate in a sector of the economy that provides minimal information about their credit history or debt level. In many Latin American countries there is no cost-effective way for formal financial institutions to gather information about potential client indebtedness. The lack of proper credit bureaus also keeps large banks and other institutions, which typically rely on such bureaus, out of the microfinance market. However, such institutions may be more willing to downscale as technologies and information systems improve their access to client credit information.

Finally, political interference, poor governance and weak regulatory frameworks were mentioned as issues keeping commercial institutions out of microfinance in certain countries. For instance in countries with interest rate ceilings, such as Colombia and Venezuela, it was thought that it would become increasingly difficult to generate returns from microfinance. Also, the general political instability of many Latin American countries makes banks unwilling to enter the often politicized business of microfinance for fear of interference by public authorities.

**How will competition from downscalers affect the microfinance industry?**
For ardent believers in classical economic forces there are no arguments against the idea that in the long run increased competition can only improve the service microfinance clients receive.
However, many NGOs and other traditional MFIs feel threatened by downscaling institutions. This impending threat causes many incumbent practitioners to criticize commercial entrants to the market as “not really doing microfinance”. In particular, they feel that downscaling banks are not a threat to “real” microfinance because of their lack of understanding of microfinance clients. This lack of understanding is also thought to keep downscalers from maintaining a high-quality portfolio and reaching to clients further down-market. In the marketplace, the effect of downscalers’ competition will ultimately be determined when clients decide which institution’s products best meet their needs.

“Competition improves efficiency and puts pressure on banks to come down-market. Consolidating will definitely begin to happen in many areas, as it will be impossible for many players in such small markets to compete.”¹ As consolidation and competition change the microfinance market, client services may be disrupted. A very important issue for those promoting downscaling will be to minimize short-term instability as the microfinance becomes subject to the forces of market-based competition.

The other general conclusion of those interviewed is that if downscaling succeeds, even if specialized institutions and NGOs are not driven out of the market, they will have to operate much more efficiently in order to maintain their level of self-sufficiency and provide services for the marginal clients the banks do not reach.

A potential ill effect of competition may be that as commercial microfinance players move in and margins shrink, institutions will no longer be able to sustain serving their poorest clients. “Those practices that are profitable will be skimmed off [by downscalers], but less profitable ones will have to continue being operated by non-profit or niche institutions.”² This skimming could leave once profitable and sustainable institutions with only their high-cost, low-return clients. The resulting inefficient and over-subsidized institutions would then be driven out of the market, leaving marginal and smaller scale entrepreneurs with no one to provide them credit. Which leads to a philosophical/political contemplations beyond the scope of this paper, including such questions as “Should those ‘low-return’ clients have been commercial microfinance clients in the first place?”

It was also discussed that client over-indebtedness could be a negative result of increased competition from downscalers. As competition increases the difficulty of disbursing funds to new clients and decrease profit margins there is a potential for several institutions to give credit to the same individual or enterprise. Institutions may make loans to the microentrepreneur based on their total capacity to make a repayment and thereby the client is indebted several times higher than their capacity to pay. Without proper information sharing of client debt levels an increased level of competition could correspondingly decrease the overall quality of microfinance portfolios.

¹ Castello, Carlos, ACCION International, Interview
² Dileo, Paul, Scion Associates, Interview
With downscalers entering microfinance, what will happen to the microfinance NGOs? When considering the effect of downscalers on noncommercial MFIs there was a wide range of responses, from “The days of NGOs in microfinance are numbered” to “There will always be room for NGOs in niche markets.”

Some interviewees felt that client over-indebtedness could be another negative result of increased competition from downscalers. As competition increases, the difficulty of disbursing funds to new clients and decreasing profit margins may lead several institutions to give credit to the same individual or enterprise. Each institution may make loans to the same microentrepreneur based on his or her total capacity to repay, thereby creating a debt load several times higher than it should be. Without proper sharing of information about client debt levels, increased level competition could correspondingly decrease the overall quality of microfinance portfolios.

As has been the trend for a decade, many NGOs will be forced to transform into commercial institutions, especially if, as is predicted, donor funding for traditional microfinance becomes less available. As discussed earlier, the financial success of the transformed NGOs will entice yet more large institutions to downscale.

Most often it was mentioned that NGOs will be able to serve markets that commercial players will find too costly to approach. These markets include rural areas and the smallest of microenterprises. However, NGOs or other public institutions may demonstrate that these segments are commercially bankable. Once this happens downscalers are likely to move into these markets as well. Theoretically, this cycle of NGO demonstration followed by downscaling will continue until the NGOs are working solely with clients whose needs cannot be supported by commercial institutions.

How will downscalers fund their microfinance portfolios? If the future of microfinance is in downscaling commercialized institutions, the future of microfinance funding can be summed up in one word: deposits. Throughout the development of the microfinance industry there has been a shortage of capital for MFIs to support their lending portfolios. Many have spent large portions of their resources trying to mobilize this funding, often from international investors. Commercial institutions, especially large retail banks, will generally have enough capital in the form of deposits to not need to struggle to fund a microfinance portfolio.

“Costs of funds can be significantly cheaper for commercialization through the service company model because it is deposits-based, therefore [the commercial MFIs] do not have to borrow from other institutions.”¹ In this model, the parent bank supports the microfinance portfolio through its own deposits. Despite the low-cost and availability of capital, some large commercial institutions are looking to outside funding for their portfolios anyway (See Case Studies), since they may still be uncertain about financing microenterprises solely with their depositors’ capital. Another theory suggests that banks are still using multilateral financial assistance for their downscaling efforts “because it is there.” However, the general sentiment of those interviewed was that in the

¹ Campero, Fernando, Inter-American Development Bank, Interview
long-run institutions that borrow from outside investors or rely on donor funding will not be able to compete on a cost-of-funds basis with those financed through deposits.

Depending on the speed at which commercial players enter this market and decrease the need for outside capital, it could be some time before traditional investors run out of opportunities to provide social or financial support to microfinance. “There will still be room for international investors to place funds with a few pro-poor-focused financial institutions that can be profitable."¹

**What will be the roles of investors and donors in downscaling?**

There are a variety of institutions that are willing to invest or donate to MFIs and their roles may change as downscalers are willing to finance their microfinance portfolios with their own resources. Also, as some large financial institutions are downscaling they are still looking for outside sources types of low-cost funding to support these activities. These funding sources, public, social and commercial all have their advantages and disadvantages.

**Foreign public investors:**

About 89% of foreign funding for microfinance worldwide comes from public, bilateral or multilateral agencies.² This funding actually makes up less than 10% of the total capital in microfinance, but MFIs leverage it to mobilize local funding for their lending portfolios.

Many banks often inquire with multi-lateral and foreign investors about assistance in entering into microfinance. However, very few of them actually apply for funding and decide to downscale once they learn about the complexities of microfinance. One conclusion from this observation is that multi-lateral funding alone is not a sufficient incentive to give some banks a reason to enter into microfinance and that there must be another driving force. A more pessimistic analysis would say that banks expect multi-lateral funding to facilitate their entry into microfinance and when they find it difficult to obtain this funding they decide to stay away from an otherwise lucrative market. Several of the commercial institutions that are discussed in the case studies are recipients of this type of public funding.

**Donors:**

Many of the professionals interviewed expressed great concern that donor agencies have distorted and will continue to distort the commercial market for microfinance. When international or domestic donors with specific social agendas give funding to NGOs for microfinance activities, they are considered to be subsidizing inefficient operations and sometimes even taking clients away from locally self-sufficient organizations. Some interviewees, however, argued that donors should continue to play a roll in supporting innovation and pushing microfinance to reach out to clients not served by commercial MFIs. Also, donors may play a role in communicating the success of downscaling institutions to markets and institutions that remain skeptical of the lucrative opportunities in microfinance. However, it is generally expressed that the direct involvement of donor agencies in microfinance will be limited as commercial institutions increase their market presence. According to one interviewee, “The

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¹ Crawford, Gil, Microvest, Interview
² CGAP, Focus Note No. 25
current trend of increasing commercialization in the financing of microfinance is progressively diminishing the suitable range of action for donor agencies.”

**Purely commercial investors:**
Just as it is hard to find an MFI with no social component, it is a challenge to find microfinance investors seeking only monetary returns from their participation. However, the lack of commercial investors in microfinance may not be so surprising given the region’s overall investment atmosphere in Latin America. Many mature Latin American industries are attracting few local investors, so it is no surprise to find a lack of commercial investors in microfinance. (See chart) Another reason there may be relatively few purely commercial investors actively involved in this market is that in some cases they are not allowed in. The institutions that control microfinance are not willing to allow profit-motivated investors to gain financial and operational control of MFIs.

![Foreign Direct Investment Inflows to Latin America](http://stats.unctad.org/fdi/)

However, just as the diversification argument might provide a sound financial reason for a bank to enter microfinance, it may also apply to a traditional investor. “For commercial investors, the risk-return profile of microfinance can diversify their portfolio, as it may not be correlated with the rest of their other holdings.”

The main investors in fully commercial downscaling banks in Latin America are primarily seeking a commercial return from their investment in these institutions. A downscaler’s shareholders will influence whether a bank is able to pursue microfinance practices. Purely commercial investors will only consider whether a bank’s investment in microfinance is in their financial interest. Reliance on commercial shareholders and capital may expedite or impede downscaling, depending upon these parties’ perceptions and reactions to developments in microfinance.

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1 Janson, Tor (2003).
2 Castello, Carlos, ACCION International, Interview
3 Dileo, Paul, Scion Associate, Interview
Do commercial downscalers serve the social mission of microfinance?
The general sentiment among those interviewed was that in the long-run commercialization and
downscaling will improve peoples’ access to credit and other financial services. This is very
much in line with what has always been the mission of traditional microfinance practitioners.

There was no consensus on whether downscalers would have a commercial incentive to serve all
of the market segments that are currently served by more socially conscious institutions. Some
believe that for-profit institutions will experience “mission drift” and will work further up-
market than traditional microfinance institutions. However, in the constantly changing
microfinance markets it is difficult to establish empirically whether commercial institutions are
really drifting or merely responding to market forces.

At first blush, the significantly larger loan balances of regulated—and therefore commercial—
microfinance institutions seem to suggest that the push towards commercialization has driven
microfinance institutions off their initial mission of serving poorer clients. However, there seems to be
no compelling argument that this represents mission drift. Rather, larger loan sizes could simply be the
function of different factors, such as choice of strategy, period of entry into the market, or natural
evolution of the target group.¹

However, if downscalers serve any clientele formerly served by social institutions, they are
essentially freeing up resources for the social institutions to use with other clients. In this way
downscalers may make a second-order contribution to the expansion of microfinance.

This is not a black-and-white issue, and it becomes difficult to separate the social and
commercial missions of organizations downscaling into microfinance. “There are still very few
purely commercial MFIs, as most of them have social motivation.”² As commercially-based
institutions move into the field motivated by the high returns realized by others, it will be
interesting to see whether the emphasis they put on microfinance will also have a corresponding
social side.

Several interviewees indicated that, regardless of why a commercial institution gets into
microfinance, it ought to have a thorough understanding of the field’s social component in order
to optimize its returns. Microfinance has a significant positive social impact on its clients and
others in the poorer sectors of an economy. Downscaling institutions may best be able to realize
commercial benefits from microfinance if they understand that delivering social impact is also an
important part of the business from the standpoints of marketing, employee satisfaction and
customer service.

What organizational structures will work best for downscalers?
In order to enter into microfinance successfully, a commercial institution must consider carefully
how this new business will fit into its organization. Most of those interviewed felt that a structure
that places microfinance outside of the main bank can more efficiently manage a microfinance
operation. However, as the case studies show, several banks, such as Banco de Crédito de Peru,
Banco Caja Social and Banco Mercantil have decided to establish internal microfinance units.

¹ CGAP, Occasional Paper No. 5
² von Stauffenberg, Damian, Microrate, Interview
The institution’s “culture, strategy and operating environment dictate whether [an internal or external structure] is best for the bank in the medium term.”

Each institution has the ability to choose its own organizational strategy. However, certain elements were seen as vital to a downscaling operation’s success. First, the microfinance operations should have some level of autonomy, to make strategic decisions that may not always be directly in line with the parent company’s policies. As part of this independence, the institution must also be allowed to modify its structure as the microfinance business matures or it faces a changing competitive environment. In addition, it was suggested by interviewees that the management of a microfinance division should not be relegated to a position of secondary importance. A bank must be able to calculate the microfinance business’s contribution to its bottom line. This will allow it to evaluate and manage downscaling efforts more appropriately, with a full understanding of whether its microfinance activities are commercially viable or not. The organizational structure must allow the parent institution to adapt to the particular cultural tendencies of the microfinance marketplace. The supervisory entity (board of directors) and the owners of the firm must also be comfortable with how microfinance is incorporated into the business practices of the institution. It is important for downscalers to have “owners and board that are nuanced enough and have a long term perspective.”

The controlling owners’ and the boards’ relationship with the management structure will also have an influence on the relative success of the downscaling operation.

**Which type of commercial financial institution will dominate this market?**

As noted previously, several types of commercially orientated financial institutions can move into microfinance. To date there have not been enough examples of each type of institution successfully entering the microfinance market in Latin America to conclude that any one of these types of institution is better positioned to do so.

There is a case for believing that the different types of commercial institutions within a given market will service a particular niche clientele. For instance in a microfinance market that is being penetrated by both specialized banks and consumer finance companies; “Specialized banks cannot compete with consumer finance companies as they move up market. The specialized banks will have to settle on a niche that has a lower loan size further down market.” In this type of scenario different types of commercial institutions would gain control of various levels of the microcredit segment.

However, there is a consensus that in a given market *if a large bank seriously commits to downscaling, it will be very hard for any other type of institution to compete for the same clients.* Large commercial banks have major competitive advantages in the cost of funds, technology, infrastructure and administrative efficiency. Banks will, however, have to modify their culture and operational strategies appropriately to attract and retain microfinance clients. Contrary to expectations, earlier empirical studies have shown that larger banks have not always been able to use their strengths to succeed in microfinance. “Both the 1997 and 2001 studies found that small

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1 Young, Robin, Interview
2 Crawford, Gil, Microvest, Interview
banks generally integrate microfinance better than large banks. This may be because microcredit is a more significant part of the portfolio of such banks and garners more resources and attention.”¹ However, since strategies for downscaling have since improved, large banks may now be better positioned to use their competitive advantages.

Many interviewees also indicated that for long-term success in this market there is a need for an understanding of the social component of this market. Even if a MFI is driven by commercial goals (profits, market share) they will not be able to profit and grow in the long-term unless they properly meet the different needs of the microfinance clients. This is where specialized banks and consumer finance companies have the advantage. “Consumer credit agencies may have an easier time [than large banks] entering into microcredit as they are closer to the small scale customer, they are used to processing smaller loans and their culture is more appropriate.”² In contrast to the consumer lenders, the specialized banks usually are operating with technology that has historically proven to be more appropriate in evaluating the credit risk involved with financing microenterprises.

Several of those interviewed mentioned institutions developed by IPC-GmbH/Internationale Micro Investitionen (IMI) as well positioned to dominate commercial microfinance in some countries. A German consulting firm, IPC-GmbH, established IMI to create microfinance institutions with the goal of achieving financial returns using standardized and proven methodologies. IMI is a majority owner and operator of five microfinance institutions in Latin America. Although IPC-GmbH worked briefly with downscaling banks, it has abandoned this practice to focus on developing its own institutions. When asked why, Gabriel Schor, of SFE (Ecuador) responded “Because of our views on development, it is not easy to find patient banks that share the same long-term commitment and perspective.” These IMI-sponsored institutions particularly specialized, with equally particular advantages and disadvantages. (See Case Studies for a description of SFE)

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² Fajury, Lizbeth, Consultant, Interview
VI. Case Studies:

To understand downscaling and the competitive microfinance marketplace we interviewed the managers of commercialized MFIs throughout Latin America. We talked with specialized microfinance banks, consumer finance companies expanding into enterprise lending and larger banks that are downscaling. We looked to gain information on what was driving these institutions to work in this sector, how their microfinance operations differed from their other business practices, what the constraints were to their success in microfinance and the overall competitive environment they were facing.

The development and complexities of the competitive commercialized microfinance industry can be seen in the Peruvian and Ecuadorian economies. In these two countries major commercial entities are downscaling into microfinance with different strategies. This section also presents case-studies of MFIs downscaling in other countries and their strategies. We also conducted field visits to get a glimpse of the reaction of the “traditional” MFIs and their clients’ reaction to this market shift. We evaluated these institutions to highlight the various issues that concern the financial institutions, their clients and their investors. Then, there is a brief analysis of the different systems being used by the various downscalers to manage their microenterprise lending portfolio.
Table 3:  
Key Indicators for Downscaling MFIs in Case Studies (December 31, 2003):

<table>
<thead>
<tr>
<th>Institution</th>
<th>Country</th>
<th>Type</th>
<th>Assets</th>
<th>Micro-enterprise Portfolio</th>
<th>Clients</th>
<th>% of Portfolio in ME</th>
<th>ROA</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mibanco</td>
<td>Peru</td>
<td>Specialized</td>
<td>114,000</td>
<td>75,680</td>
<td>116,695</td>
<td>69%</td>
<td>5.2%</td>
<td>23%</td>
</tr>
<tr>
<td>Banco de Crédito de Perú (Solución)</td>
<td>Peru</td>
<td>Downscaler</td>
<td>6,378,000</td>
<td>131,247</td>
<td>4%</td>
<td>1.3%</td>
<td>14.5%</td>
<td></td>
</tr>
<tr>
<td>Banco del Trabajo</td>
<td>Peru</td>
<td>Consumer</td>
<td>184,000</td>
<td>90,265</td>
<td>79,735</td>
<td>41%</td>
<td>12%</td>
<td>36%</td>
</tr>
<tr>
<td>Banco Solidario</td>
<td>Ecuador</td>
<td>Specialized</td>
<td>181,583</td>
<td>55,892</td>
<td>46,789</td>
<td>46%</td>
<td>1.9%</td>
<td>21.8%</td>
</tr>
<tr>
<td>Banco del Pichincha (CREDIFE)</td>
<td>Ecuador</td>
<td>Downscaler</td>
<td>1,749,666</td>
<td>33,123</td>
<td>24,040</td>
<td>3.5%</td>
<td>1.14%</td>
<td>12.1%</td>
</tr>
<tr>
<td>Sociedad Financiera Ecuatorial</td>
<td>Ecuador</td>
<td>Specialized</td>
<td>26,100</td>
<td>20,733</td>
<td>11,195</td>
<td>56%</td>
<td>5.2%</td>
<td>18%</td>
</tr>
<tr>
<td>SOGEBANK (SogeSol)</td>
<td>Haiti</td>
<td>Downscaler</td>
<td>343,851</td>
<td>4,831</td>
<td>7,070</td>
<td>4.3%</td>
<td>1.72%</td>
<td>40.1%</td>
</tr>
<tr>
<td>Visión</td>
<td>Paraguay</td>
<td>Downscaler</td>
<td>36,890</td>
<td>10,680</td>
<td>50,462</td>
<td>43%</td>
<td>1.6%</td>
<td>14.9%</td>
</tr>
<tr>
<td>Banco Mercantil</td>
<td>Venezuela</td>
<td>Downscaler</td>
<td>3,639,000</td>
<td>27,554</td>
<td>&gt;3000</td>
<td>3.2%</td>
<td>4.9%</td>
<td>38.7%</td>
</tr>
<tr>
<td>Banco del Caribe (Bangente)</td>
<td>Venezuela</td>
<td>Downscaler</td>
<td>594,690</td>
<td>5,794</td>
<td>7,558</td>
<td>1.7%</td>
<td>11.4%</td>
<td>38%</td>
</tr>
<tr>
<td>Banco Caja Social</td>
<td>Colombia</td>
<td>Downscaler</td>
<td>537,900</td>
<td>23,300</td>
<td>23,228</td>
<td>6.0%</td>
<td>2.1%</td>
<td>17.1%</td>
</tr>
</tbody>
</table>
**Case Studies: Peru**

**Peru**

Peru has one of the largest potential markets for microfinance in South America, with over three million enterprises having fewer than 10 employees.\(^1\) There are various estimates of what percentage of these businesses lack financial services and are potential microfinance clients. According to the Bank Superintendency of Peru, only 540,000 or 17.5% of these enterprises have received formal credit. “This market [of Peruvian microcredit] is not saturated, and there are different market segments for microfinance.”\(^2\) Although the Cajas in Peru currently provide much of that country’s microcredit, they are not generally considered likely to expand significantly.

The past several years have seen a general lack of economic opportunity, which has slowed investment in Peru. The total credit market is only about 20% of the economy, so the lack of penetration of credit applies not only to microfinance. Peru’s microfinance environment is one of the most mature and yet dynamic in all of Latin America, with a wide variety of financial institutions competing, including downscalers, specialized institutions, NGOs, Cajas and consumer finance providers.

**The Players**

**Banco del Trabajo**

Banco del Trabajo (Bantra), a subsidiary of the Chilean Grupo Altas Cumbres, was founded at the end of 1994 as a consumer lending bank to work with the lowest-income salaried customers segments. Bantra saw potential profits this market segment despite the fact that it was a business that would require high-volumes, low-margins and relatively high-arrears. Grupo Altas Cumbres first entered into the business of making loans for microentrepreneurs through Financiera Condell in Chile, also originally a consumer lending company. Grupo Altas Cumbres eventually sold this operation in 1999, with over 750 thousand customers.

As the strategy for Banco del Trabajo’s development was to replicate the success of Financiera Condell, it began making loans to microentrepreneurs in 1997. In early 2000, Bantra refocused its efforts in microenterprise lending portfolio by bringing on in new managers. By 2003, with microenterprise lending making up 41% of its lending portfolio and 36% of its income, Bantra had the highest ROE of any bank in Peru. Through 2003, Bantra’s microenterprise portfolio averaged a total of over $79 million and was by far the largest segment of its business. It could be argued that even Bantra’s consumer finance and credit card issues to its low-income clients fit the definition of microfinance. However, for comparison purposes we will focus on the impact and results of microenterprise lending.

Bantra is business ventures are driven by private shareholders looking for high-yield projects. This completely profit-driven culture comes directly from its parent company, Grupo Altas-Cumbres, which has many investments that do not necessarily work in microcredit markets. The

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1 Mibanco, Investor Presentation
2 Hamman, Jacinta, LA-CIF/Cyrano Management, Interview
Group is now trying to replicate the success in lending to microentrepreneurs in its other operations in Latin America, such as Banco Centro Mundo (Ecuador) and Corporacion Financiera Miravalles (Costa Rica). Asked why Bantra got into microenterprise lending, its General Manager of Business, Claudio Vettier, said, “It was simply the evolution of our business; we had started as a bank to meet the underserved credit markets for consumer. We saw that there were no other banks, only NGOs, serving this [microenterprise] market.” Bantra also seems to have recognized the social importance and public image effects of microenterprise lending. Over the last two years Banco del Trabajo has conducted a microenterprise competition and awarded a “National Women’s Microenterprise Prize.”

**Banco de Crédito de Perú (BCP)**

BCP is the largest commercial bank in Peru, with a total asset value at the end of 2003 of more than US$6-billion. In 1995 BCP partnered with Banco de Crédito e Inversiones of Chile to create the subsidiary Solución Financiera y de Crédito del Perú (Solución). Solución was created to reach out to the underdeveloped consumer credit markets in Chile and Peru. In 2001 Solución began to lend working capital to microentrepreneurs, and this portfolio soon grew into a large and profitable part of its business. Until that point, BCP’s involvement in microenterprise lending was through an investment in Mibanco (See Below). As Solución entered the microenterprise market, BCP divested its share in Mibanco to avoid a conflict of interest. By December 2003 Solución had more than 14% of Peru’s formal microenterprise loans in its portfolio, and those loans constituted more than 80% of that portfolio.

From Solución’s inception, BCP maintained 55% ownership in the subsidiary. This investment was originally made to realize the profits from the untapped consumer credit market. In 2001 Solución consolidated its microenterprise lending at the national level and formalized this businesses operations and strategy. In March 2003 BCP bought the remaining 45% of Solución and one year later it absorbed it entirely into the structure of the bank and dropped the Solución name. “The main motivation behind this move was that we are the Number One bank in Peru in all market segments except this one [microenterprise]. We want to be the Peruvian bank that is for everyone and do not only want to be a bank for the elite,” says Carlos Morante, BCP’s Vice President of Microfinance. This idea, that market dominance would be a motivating factor for banks to enter into microfinance, was not mentioned by the microfinance professionals interviewed during the general survey for this report.

BCP has now absorbed all of Solución’s employees and has created a division for PYMES (small- and micro- enterprises) that is part of its personal banking division. BCP is merging its approximately 300 small business officers with the 1000 Solución loan officers to create a team that will cover small and microenterprise markets. It has also set up more than 30 sales offices, often in old Solución locations, which are designed to attract and service small and microenterprise clients. The structure of these Service Centers is very similar to the “service company” structure, in which a center is responsible for the client interaction, but none of the actual financial transactions take place in these offices. All microfinance clients have access to BCP’s widespread branch network, the largest in Peru, and its other products and services.

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BCP had only absorbed Solución several months prior to the completion of this study, so many
of its processes and systems for dealing with this “new” business were still in flux. BCP was
facing some operational and cultural difficulties with this merger. Only time will tell whether the
BCP management has the controls, organizational structure and commitment to overcome these
issues and succeed long-term in the microfinance market.

Mibanco is a commercial bank that grew out of the experience of the microfinance NGO Accion
Comunitaria del Peru (ACP). ACP was transformed in Mibanco in 1998 with the assistance of
ACCION International. We classify Mibanco as specialized commercialized microfinance
institution, because of its NGO roots and its complete focus on providing services to
microentrepreneurs. Mibanco has grown into a profitable (ROA of 5.2% for 2003) institution
that had a total portfolio of over US$114 million at the end of 2003. Most of Mibanco’s 180,000-
plus clients are from Lima and its environs, as are 25 of 29 of its agencies.

“Currently our strategy is focused on defending our current client base from the competition,”
says Rafael Llosa, General Manager of Mibanco. To help it understand how to best operate in
this increasingly competitive environment Mibanco has hired an external management consulting
firm to analyze its processes. Mibanco intends to make its banking processes more efficient and
reduce its operating costs. One of Mibanco’s disadvantages is its higher cost of funding relative
to other mainstream Peruvian commercial banks, and it is putting a major emphasis on finding
strategic ways to reduce this cost. Mibanco’s management feels it can compete with other
institutions through quality of service and product offerings that are more aligned with the
microentrepreneur’s needs.

When it started operations, Mibanco had a very secure position in the market, and its loan
officers claim they had no difficulty finding and attracting clients. Now, however, a variety of
commercial competitors threaten Mibanco’s market share. This increased competition has
affected Mibanco’s lending activities in at least two ways:
1. As recently as two-years ago, 80% of Mibanco’s clients had formal loans only with Mibanco.
   Today, approximately 55% of Mibanco’s clients have formal loans from other institutions.
2. A large number of its clients are now approaching Mibanco with loan offers from other
   banks. Mibanco is often forced to change its loan terms to match the competitors’ in order to
   retain their clients.

Although the bank is visibly changing – opening more branches, advertising, expanding to other
cities – there is no evidence of any dramatic change in its philosophy. Although Mibanco had its
roots as an NGO, commercial success became a key priority the moment it converted into a
bank, although it continues to maintain its original balance between its social mission and the
drive for increased profitability. It is changing to become more efficient to meet the goal of
remaining commercially profitable without reducing its emphasis on strategies such as the loan
officers’ personal relationships with clients.

Conclusions about Commercialized Microfinance in Peru:
With its purchase of Solución, BCP, a downscaling commercial institution, has become the leader\(^1\) in Peru’s formalized microfinance market, with approximately 20% of the country’s microenterprise loans. (Before BCP entered the microfinance market, Banco del Trabajo was the regulated microenterprise lending market leader in terms of portfolio size.) BCP has not entered this market for social purposes but with this clear commercial objective as described 2003 annual report: “The operation [the merger] will improve the overall performance of BCP and increase our participation in segments with higher margins and adequate levels of risk.”\(^2\)

Compared to Mibanco and Bantra, however, BCP lacks a focus on the microenterprise market. In April 2004, Mibanco’s microenterprise lending represented more than 68% of its portfolio; for Bantra the figure was over 40%. These two institutions have made serving the needs of the microfinance segment of the economy their primary business concern. For BCP, on the other hand, microenterprise lending is a mere 4% of its total loan portfolio. BCP claims it will be able to focus on its microenterprise lending segment because it has the highest growth potential of all its divisions. However, if the market becomes saturated and growth opportunities and margins decrease, or if other parts of Peru’s banking sector pick up, BCP’s management may no longer give adequate attention to its downscaling operations.

Mibanco, as a specialized institution with NGO roots, clearly uses a different model than the other two commercial institutions to deal with loan processing. (See Comparison of Loan Processes Chapter) Each party claims that its model gives it a significant advantage in working with microfinance clients. The three institutions’ portfolio quality and their ability to grow offer some indications of the relative merits of their different approaches. In 2002 and 2003 Bantra and BCP experienced more growth than Mibanco, but Mibanco has consistently had a lower portfolio at risk. (See Table 4 and 5) Most MFIs achieve long-term financial and social goals by focusing on portfolio quality and long-term client relationships; by focusing on volume, downscalers may gain short-term profitability, but possibly by sacrificing long-term sustainability. A comparison of Mibanco with the two recent Peruvian downscalers seems to justify concerns about the long-term success of volume-driven downscalers.

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\(^1\) This analysis does not consider the municipality-owned Cajas as the market leader, although if one were to aggregate these institutions they would have 35% share of the microenterprise loan volume

\(^2\) Translated from Spanish.
In Peru and elsewhere, client retention will be an important measure of how successfully commercial institutions engage in microfinance. For these institutions, client acquisition is very costly in terms of human resources, so retaining clients can create major cost efficiencies. The competition experienced by Mibanco indicates a changing marketplace where client acquisition and retention can no longer be taken for granted. In the past, Mibanco’s loan officers did not have difficulty finding new clients, but the long-time loan officers we spoke to claimed that new client generation had become much more challenging. Also, current Mibanco clients were beginning to realize the benefits of having commercial entrants in this market. Client retention and its attendant lowering costs will likely become more challenging as the microenterprise lending practices of BCP, Banco de Trabajo and possibly others begin to offer clients alternatives.

Mibanco is working to become as operationally cost efficient as possible, but the management does not feel that it can compete with large commercial players such as BCP on costs. The management feels that its best strategy for client retention and to remain relevant in the marketplace is to offer more products to its microenterprise clients. One may wonder: Are the added products really a reaction to the clients’ needs or are they a reaction to the

### Table 4:

<table>
<thead>
<tr>
<th>Year to Year Absolute Growth (Thousands of Nuevos Soles)</th>
<th>Microenterprise Portfolio</th>
<th>Total Loan Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mibanco</td>
<td>56,736</td>
<td>54,686</td>
</tr>
<tr>
<td>Banco del Trabajo</td>
<td>112,823</td>
<td>60,747</td>
</tr>
<tr>
<td>BCP + FS</td>
<td>119,067</td>
<td>124,196</td>
</tr>
</tbody>
</table>

### Table 5:

<table>
<thead>
<tr>
<th>Year to Year % Growth of Portfolio</th>
<th>Microenterprise Portfolio</th>
<th>Total Loan Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mibanco</td>
<td>35.4%</td>
<td>25.2%</td>
</tr>
<tr>
<td>Banco del Trabajo</td>
<td>81.2%</td>
<td>24.1%</td>
</tr>
<tr>
<td>BCP + FS</td>
<td>48.8%</td>
<td>34.2%</td>
</tr>
</tbody>
</table>

Source: Mibanco based on information from Superintendencia de Banca y Seguros de Peru.
Case Studies: Peru

competition? And, if it focused its resources on lowering its costs of funds and operation instead of expanding to other products would it eventually be able to compete on price? Whether this product diversification strategy is successful depends on the answers to these questions. Unfortunately, only the success or failure of this strategy will answer them.

From the perspective of those trying to extend financial services to underserved markets, it is not clear that the entrance of downscalers increased competition will significantly increase the number of clients served in Peru. Competition instead seems to be creating an environment in which clients receive better services and more advantageous loan terms. A number of long-time clients at Mibanco and Banco del Trabajo all claimed that the level of service they received, in particular the speed of service had improved during their tenure as clients. (See Client Discussions Section) One positive development in terms of possibly reaching more clients is that the consolidation of Solución and BCP will work “to eliminate the competition [for the same clients] between both arms of the business.”

There is not yet sufficient evidence, though, that competition is forcing any institutions to focus on a smaller segment of the market. None of the institutions had any intention of reducing their minimum loan amounts to reach clients with even smaller businesses. This indicates that commercial viability of microfinance activities is a primary concern for all the institutions. There is no indication which of them, if any, will reach out to the many unbanked microentrepreneurs and low-income individuals that remain in Peru.

BCP is not planning to compete for the lowest segment of the client population as its minimum microenterprise loan size is $400, compared to $100 at Bantra and Mibanco. Loans under $400 represented more than 25% of Mibanco’s loans, but less than 5% of its portfolio. If BCP or other downscalers drive Mibanco and Bantra out of the upper part of the market, they will have to greatly improve their operational efficiency and process many times more clients to continue growing in terms of asset size.

Commercial institutions, BCP and Bantra, currently dominate the formal private microcredit market in Peru (even more so if consumer credit markets were considered). As of the publication of this paper, BCP was still going through major adjustments to its operational processes and organizational structures to accommodate the absorption of Solución. If its management has the patience and focus to understand this segment and communicate that understanding to its microfinance staff, BCP could be a real model for downscaling. It has the resources to put behind this business and has not used any outside funding, technical assistance or subsidies to absorb Solución. However, as a commercial entity, BCP could abandon the microfinance market if it proves unprofitable. For BCP, microfinance will, for the foreseeable future, remain a relatively minor part of its business portfolio in terms of assets and therefore not necessary for its survival. By contrast, Banco del Trabajo and Mibanco cannot afford to abandon their focus as microenterprise lenders nor lose too many clients to downscalers or others. Understanding the importance of personal contact with microfinance clients is a major competitive advantage for these institutions, but only as long as BCP and other downscalers are not able to internalize that client focus.

1 Banco de Crédito de Perú, Annual Report 2003.
Case Studies: Ecuador

Ecuador:
After suffering one of the world’s worst banking crises in 1999/2000 and the tumultuous process of dollarization, Ecuador’s economy has only recently begun to stabilize, and its economic prospects remain uncertain. Ecuador is home to more than 1.3 million microentrepreneurs meaning that in some manner more than half its people rely on microenterprises for their livelihood.1

Ecuador was the birthplace of one of the world’s first commercialized microfinance institutions (Banco Solidario in 1996), but has only recently begun to see other commercial entities enter the market. One consequence of the banking crisis is that Ecuadorian banks face great difficulty growing in traditional higher-end markets. As these downscaling entities have turned to microfinance as a business opportunity, the strategies needed to compete in that market have begun to change dramatically. In general, Ecuador’s microfinance industry seems to be going through a strong expansion stage, as the total volume of loans from more than doubled in the last year (May 2003-04) to US$171 million.2

The Players:
Banco del Pichincha
Banco del Pichincha at the end of 2003 was Ecuador’s largest bank, with assets of more than US$1.75 billion. In 1997 Pichincha began working with ACCION International, and by 1999 it had established a service company, CREDIFE, to reach into the microenterprise sector. At the end of 2003 almost US$28 million of Pichincha’s US$1.2 billion loan portfolio (2%) was in microenterprise loans generated through CREDIFE.

The primary service CREDIFE offers its microentrepreneur clients is working capital credit of between US$300 and $5000. After a first loan, as necessary, clients can apply for fixed-asset loans ranging from US$300 up to $10,000, which can be used to buy equipment or otherwise remodel their business. In addition, microfinance clients are set up with accounts at Pichincha, in order to service their loans. CREDIFE’s clients can conduct their financial transactions its increasing number of agencies throughout the country and also at Pichincha’s branch network, the most widespread in the country.

According to Carlos Viteri, General Manager of CREDIFE, “Before microenterprise was thought to be a risky market and this was thought of as a more socially motivated project. Now the paradigm has shifted and the bank is beginning to pay more attention to CREDIFE.” The demonstration of consistent profitability of microfinance clients that CREDIFE has brought on board has given Pichincha management reason to pay its subsidiary significant attention. From May 2003 to May 2004 Pinchincha’s microenterprise portfolio grew by 147% to over $34 million.3

As a stand-alone entity, CREDIFE’s net income for 2003 grew by 140% from the year before, to $460 thousand. Pichincha realizes income from CREDIFE as a shareholder as well as from fees

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2 Superintedencia de Bancos y Seguros de Ecuador, http://www.superban.gov.ec/
3 Superintedencia de Bancos y Seguros de Ecuador, http://www.superban.gov.ec/
Pichincha receives for administration and loan processing. This income, together with income generated from Pichincha’s direct microfinance loans, accounted for more 16% of Pichincha’s net income in 2003. (See Table 6)

### Table 6:
**CREDIFE’s annual contribution to profitability of Banco del Pichincha for 2003**

<table>
<thead>
<tr>
<th>Description</th>
<th>US$ (Thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIFE Net Income after taxes</td>
<td>461</td>
</tr>
<tr>
<td>Share of CREDIFE Net Income paid to Pichincha (79%)</td>
<td>364</td>
</tr>
<tr>
<td>Transaction and infrastructural fees paid by CREDIFE to Pichincha</td>
<td>1,082</td>
</tr>
<tr>
<td>Financial revenue earned by Pichincha from Microlending operations</td>
<td>2,973</td>
</tr>
<tr>
<td>Portfolio management fee paid to CREDIFE by Pichincha</td>
<td>(1,012)</td>
</tr>
<tr>
<td><strong>Total contribution from microlending operations to Pichincha</strong></td>
<td><strong>3,407</strong></td>
</tr>
<tr>
<td>Pichincha Net Income before taxes</td>
<td>20,503</td>
</tr>
</tbody>
</table>

| % Pichincha Net Income from Microcredit Operations                         | 16.6%            |
| % Pichincha Loan Portfolio devoted to Microcredit Operations               | 2.5%             |

Source: CREDIFE

### Sociedad Financiera Ecuatorial (SFE)

Sociedad Financiera Ecuatorial (SFE) is a commercial MFI created in Ecuador in 2001, when the German microcredit investment company, IMI, bought Financiera Alterfinsa. At the end of 2003 SFE had over US$26 million in assets and a client base of more than 11,000. In addition to credit for small- and microenterprises, SFE offer its clients housing loans.

SFE’s venture into Ecuador’s microfinance market was triggered by the opportunity presented in the post-crisis banking environment. Many banks attempting to serve this market had failed, while NGOs and Banco Solidario were able to survive and grow. IMI management felt there was an ample “micro” market still unserved, and the weak banking sector left an up-market business opportunity for small and medium enterprise loans as well.

SFE is implementing microcredit technology that IPC –Gmbh has used to develop many other commercial microfinance institutions in Latin America, Africa and Eastern Europe. The investment into SFE is already proving to be a viable commercial venture, as it posted an ROA of more than 5.2% for 2003. SFE currently supports a large portion of its loan portfolio through loans from such development organizations as the IFC, CAF, LA-CIF, and IADB. “We believe that we can grow and become commercially viable faster than it would take a bank to integrate microfinance,” commented Gabriel Schor, Manager IPC-Gmbh.
Banco Solidario was transformed in 1996 from a Financiera into a fully commercial bank with the mission of serving Ecuador’s underdeveloped sectors. Banco Solidario falls under the category of specialized financial institutions, as its sole focus is working with microentrepreneurs who have no access to formal credit. Although, technically a commercial bank, Banco Solidario’s culture is thoroughly dominated by its social mission. At its inception Banco Solidario’s clientele was approximately 80% mainstream, but this strategy was soon abandoned early on, as serving the microenterprise sector was found to be commercially viable and more aligned with the bank’s social goals. Banco Solidario is now stable and profitable, posting returns on equity of more than 30% in 2002 and 24% in 2003. At the end of 2003, Banco Solidario’s total assets were US$181 million of which US$62 million was invested in microenterprises and US$92 million in microcredit.

Currently facing competition from the other commercial actors, the bank is expanding into other products and services to retain clients. Microentrepreneurs usually need financial services beyond the standard working capital offered by other organizations. The management’s believes traditional commercial banks will not dedicate appropriate resources and attention to develop products that truly fit the needs of microfinance clients. “Specialized banks have an advantage in this sector, as we understand our clientele [more than mainstream banks],” claimed Santiago Ribadeneira, President of Banco Solidario. To this end Banco Solidario has internally developed several unique products to serve what it perceives to be its clients’ needs.

While actively taking deposits, Banco Solidario relies heavily on international funding. As of June 2004, it had about US$28 million in international equity and $5 million in international debt on its books. In December 2003, international shareholders represented around 49% of its equity base. The bank spends much of its resources mobilizing this international funding, sometimes on ‘soft’ terms, because it has found it difficult to raise the deposits it needs locally.

Consumer Finance Companies in Ecuador:
Unibanco is a consumer lending company formed from the Banco de Cooperativas del Ecuador in 1994. At the end of 2003, Unibanco had more than 350,000 credit clients and total loan disbursements of more than US$80 million. Unibanco looks to serve Ecuador’s underserved consumer credit market through various credit card offerings and affiliations with consumer goods retailers. Its clients generally belong to the lower-income strata but are not financing microentrepreneurial activities and thus not eligible for traditional microfinance loans. Unibanco is unique in the cases presented here because it has no short- or long-term plans to provide credit for enterprises. “We have confidence in our strategy and are not fighting for the same [microenterprise] market. We also understand consumer credit and think it would be a bad idea to go into a business that we do not understand,” say Andres Jervis, Unibanco’s President. The Unibanco business model runs on high-risk and high-cost loans but succeeds through economies of scale and technology. The bank services a market niche traditionally not served by Ecuador’s larger retail banks.

Banco Centro Mundo (Centro Mundo) is a subsidiary of the Chilean Grupo Altas Cumbres. This bank was started to mimic the strategies of Banco del Trabajo in Peru and the Group’s other previous successful institutions. Centro Mundo is one of Ecuador’s dominant consumer finance companies, with a total credit portfolio of over $73 million. Although it only began developing
its microenterprise portfolio in 2003, microenterprise lending already accounts for more than 10% of its loan portfolio.

**Conclusions about Ecuadorian Commercialized Microfinance Market:**
Despite its long history of successful commercial microfinance (Banco Solidario and SFE) the movement towards commercial downscaling in Ecuador is still in its infancy. A variety of institutions with at least quasi-commercial structures are beginning to compete in this market. However, since for the most part the Ecuadorian financial services market has been focused on recovering from the crisis of several years ago, it is too early to decide whether downscaling institutions such as Banco del Pichincha will dictate the market dynamics and push the market to reach more clients.

When Banco Solidario began operations, it did not put branches near the offices of microfinance NGOs because there seemed to be enough unserved high-quality clients that it did not need to compete for the same few clients already getting credit from other socially-focused institutions. However, in the current market Pichincha/CREDIFE’s agencies are sometimes approaching clients who already have credit with Banco Solidario or other MFIs. Some of these clients are beginning to switch institutions or take loans from places. This kind of competition, although making more credit available to current microfinance clients, does not necessarily accomplish the goal of reaching those not served by existing financial systems. In addition, this competitiveness is threatening to create a problem of over-indebtedness among microfinance clients.

Unlike Solidario, SFE is not changing its strategy in the wake of increased competition. IMI/IPC has a set of standard procedures and techniques that have allowed it to grow its institutions successfully. Competition for microenterprise clients has not reached a level where SFE has needed to add or change its offerings. This unwillingness to modify its strategy may at some point cost SFE its ability to attract or retain particular types of clients. Currently, while Solidario has lost significant market share, SFE’s portfolio continues to grow.

One may question how committed Pichincha was when it initially created CREDIFE, as the initiative was in-part driven by outside institutions (ACCION International and USAID)\(^1\). Despite Pichincha’s extreme liquidity its microfinance lending portfolio is still partially funded by CAF, AECI -ICO, BlueOrchard Finance, Triodos, and CFN. Outside/international technical assistance has also been useful and important to this downscaler’s strategy. “ACCION’s support has and will be very important to us. They allowed us to quickly get the ‘know-how’ of their industry. They helped us understand that we had to understand our clients and adapt our business to them and not the other way around. In addition, it gave us peace of mind to have partnered with an international network,” commented Carlos Viteri, General Manager, CREDIFE.

CREDIFE has seen profits and significant growth over its three years in operation, which will likely increase Pichincha’s interest in this market. Several managers of institutions discussed above also mentioned that the Banco de Guayaquil, Ecuador’s second largest bank, is developing

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\(1\) Lopez, Cesar, Rhyne, Elisabeth, **ACCION International Insight**, No. 6
a microenterprise lending program and could be a new competitor. The “demonstration effect” may be increasing the interest of banks in Ecuador to downscale.

SFE has also experienced rapid growth in its microfinance portfolio, and IMI is committed to investing and making this business grow. There is a question, however, whether Pichincha will continue to invest in CREDIFE if the market changes and investments in other parts of its business show more favorable returns. On the other hand, Solidario and SFE are focused primarily on growing their microfinance portfolios and serving microenterprise clients. However, there is a risk in today’s competitive environment that they may sacrifice portfolio quality to grow their microenterprise loan placements.

Banco Solidario is looking to maintain competitiveness by offering new products, such as consumer finance credit. However, the existence of other commercial providers of these services may make it hard to generate predicted yields. Other banks in consumer finance, such as Unibanco, have focused on particular products and developed the appropriate credit technology and economies of scale to operate profitably. Institutions like Unibanco already provide microentrepreneurs and other low-income clients with the services the specialized institutions are adding to their offerings. Therefore, these may not be the competitive advantage predicted. As competitive pressures increase, there is nothing to prevent a client from using the services of these other institutions. As a strategy for product and client expansion, downscaling institutions may purchase consumer lending technology from the specialized institutions, or even acquire the institutions altogether. Such product-specific competition could come not only in consumer finance but also in such areas as housing finance and insurance. It is not clear what value the microfinance client puts on the ability of one institution to meet a variety of financial needs. In the consumer credit market, Unibanco currently has little competition aside from Banco Centro Mundo. However, as traditional microfinance institutions like Solidario begin to look for different services to offer their micro client, this may change.

Although competition is increasing between downscalers and specialized banks in Ecuador, the microfinance market is still not saturated. This is in part due to the past failures of the banking system. But the entry and rapid growth of CREDIFE, SFE and potentially other commercial institutions point to a strengthening of the sector driven by commercial institutions. However, it is still too early to claim whether Banco del Pichincha or some other downscaler will be the most important contributor to this growth.
Table 7:

<table>
<thead>
<tr>
<th>Microenterprise Loan Portfolio ($US Thousands)</th>
<th>Market Share #</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-02</td>
<td>Dec-03</td>
<td>% change</td>
<td>Dec-02</td>
<td>Dec-03</td>
<td>Change</td>
</tr>
<tr>
<td>Banco del Pichincha</td>
<td>8,846.01</td>
<td>27,379.50</td>
<td>210%</td>
<td>14.8%</td>
<td>26.3%</td>
</tr>
<tr>
<td>Banco Solidario</td>
<td>43,851.10</td>
<td>59,789.09</td>
<td>36%</td>
<td>73.6%</td>
<td>57.4%</td>
</tr>
<tr>
<td>SFE</td>
<td>6,894.12</td>
<td>16,936.86</td>
<td>146%</td>
<td>11.6%</td>
<td>16.3%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>59,591.23</strong></td>
<td><strong>104,105.45</strong></td>
<td><strong>75%</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

# Does not include share of the market controlled by cooperatives.
Source: Banco Solidario based on information from Superintendencia de Bancos y Seguros de Ecuador.

Table 8:

<table>
<thead>
<tr>
<th># of Clients</th>
<th>Average Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-02</td>
<td>Dec-03</td>
</tr>
<tr>
<td>Banco del Pichincha</td>
<td>16,438*</td>
</tr>
<tr>
<td>Banco Solidario</td>
<td>65,339*</td>
</tr>
<tr>
<td>SFE</td>
<td>5,254</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>87,031</strong></td>
</tr>
</tbody>
</table>

* ACCION International
**Venezuela**

Relative to most Andean countries Venezuela has an underdeveloped microfinance market. Political and economic instability have severely hampered the growth of even the formal banking sector. Nonetheless, Banco Mercantil and Banco del Caribe, large commercial financial institutions, have begun downscaling. The evolving strategies of these two institutions will show how downscalers can continue to grow as a microfinance market matures and becomes more competitive.

**Banco Mercantil:**

Banco Mercantil (BM) is Venezuela’s largest bank, with, at the end of 2003, a 15% share of the formal credit market and more than US$ 3.6 billion in assets. In 1999 BM began to consider downscaling after strategic discussions with CAF. “NGOs had been working in this segment since 1986. From watching their success and the growth of this market [Banco Mercantil] decided it needed to look at this important segment,” commented Jose Llovera, Banco Mercantil’s General Manager of Microfinance.

As a large bank with a great deal of history in Venezuela, BM had to undergo major cultural changes to work with microenterprise clients. It modified its management structure to accommodate the new microfinance business and put its management on the same level as its other divisions. Its microfinance management office is strategically located in a neighborhood that is close to many microentrepreneurs. This was to ensure that this division was able to have the focus on the clients that it needs. However, unlike in many other cases of downscaling BM has not created separate branches or institutions for its microfinance clients.

In addition, BM developed lending manuals and procedures to enable the microenterprise division to adopt the “best-practices” of the NGOs that were working in the market. Another important element in modifying the culture of Banco Mercantil was to bring in managers, loan officers and other staff that had previous experience in microfinance.

BM’s microenterprise lending process reflects its understanding of and commitment to the sector. BM adopted the process used by socially motivated MFIs in which the client has a one-to-one relationship with the loan officer from loan origination to repayment. This strategy was adopted not as a social response but as an important business strategy; BM’s management felt “it is the only way to hold onto clients.” Also, BM has both solidarity group and individual loans, allow it to be more responsive to client demands than local NGOs offering only group lending.

In addition to interest income from microenterprises credits, BM expects to generate other revenue from microfinance clients through the wide variety of products available to all its clients. According to management, it is working to make sure that microentrepreneurs become fully bankable by preparing them to use those other services.

One important force that could be driving BM’s downscaling effort is the Venezuelan government’s recent legislations. Starting in 2002 Venezuela required that all banks invest at

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least 1% of their portfolio in microenterprise lending, a requirement that has now been pushed to 3%. Banco Mercantil has continually exceeded required levels of credit disbursement in both microfinance and the agricultural sector.

**Banco del Caribe/Bangente:**
Banco del Caribe, a large Venezuelan commercial bank, began its involvement in microfinance in 1997 by taking a 25% ownership stake in Bangente. Bangente is a separately licensed bank specializing in microenterprise lending and at the end of 2003 had a loan portfolio of US$ 5.8 million. Other original investors in Bangente included Profund International, IADB and CAF. Banco del Caribe has now increased its commitment to this microfinance entity and taken a majority share of 52% in Bangente.

According to the Bangente management, Banco del Caribe’s original investment was primarily socially motivated and did not look at microfinance as a profitable business venture. Therefore, in the early stages of Bangente’s development Banco de Caribe made a relatively small commitment to the entity. Although Bangente is currently profitable (ROA of 11.4% for 2003), and Banco del Caribe has increased its financial commitment in Bangente, it has still not adopted microfinance as a major part of its business. Banco del Caribe has not changed its management or organizational structure to accommodate its Bangente investment.

Bangente has a separate physical infrastructure for its major business operations and client interaction. However, in an arrangement similar to the service company model, Bangente has a contract with Banco del Caribe for financial transactions and other administrative processes. The major difference is that Bangente is not a service company but a formal bank with its own license and its own portfolio on its books. The cultural and physical separation of the two entities and their administrative interaction make them a sort of a hybrid of the service company model and the partnership model.

Bangente follows the traditional microfinance lending model, which it adopted with assistance from ACCION International. It offers clients both group and individual loans, primarily for working capital. It has not moved into products other than credit for microenterprises and does not link its clients to other Banco del Caribe services. Its concentration on microfinance allows it to continue to try to reach new clients and maintain its portfolio quality.

Venezuela’s government has become highly involved with the promotion of microfinance which has had a direct effect on Bangente. Since Venezuelan banks must now have 3% of their portfolio in microcredit, many banks place deposits with Bangente. Currently more than 50% of its lending capital comes from banks trying to meet their legal obligation. This, along with the resources of Banco del Caribe, has given Bangente more than enough capital to finance its microlending portfolio.

**Conclusions from Banco del Caribe and Banco Mercantil:**
Although all banks in Venezuela are required to have a portion of their assets in microfinance, there is still limited competition and minimal saturation of the country’s microfinance market. This is due to the fact that most banks simply reclassify some of their existing portfolio as microfinance or place deposits in other MFIs. The government is further becoming involved in
the microfinance market by opening state-managed banks focused on microfinance, and there are fears that these institutions could damage the microfinance environment. NGOs are not deemed to be a competitive threat to downscalers, because they lack the capacity to meet the market demand. The NGOs are even referring some clients to the downscalers and learning how to access capital markets from them.

There are long-term ideas about Bangente converging with Banco del Caribe and even being absorbed by Banco del Caribe. This would most likely occur only when Banco del Caribe sees microfinance as a legitimate commercial activity. If Banco Mercantil’s (or some other downscaler’s) microfinance business grows and becomes profitable, it could trigger such an event. The expansion of Banco del Caribe’s involvement in microfinance depends on whether it can see Bangente as more than just a self-sustaining social project.

Banco del Caribe/Bangente has and will likely remain in microfinance because of a strong social commitment. However, it seems that Banco del Caribe has made the commercial success of this downscaling a secondary objective. Its low level of interest in Bangente may prevent the microfinance institution from growing and operating efficiently. Banco Mercantil’s interest in the market is primarily commercial, meaning that it will expend the resources needed to grow its portfolio and increase its operational efficiency. Although it currently has no intention of leaving the market, Banco Mercantil, as a large bank, could close its microfinance operations and continue to survive should the government change its requirements and/or the management decides that microfinance was not in the bank’s best interest.

To date, Banco Mercantil’s use of an internal division to conduct microfinance activities has been successful. All indications are that this unit has been methodically developed and given attention sufficient to enhance the quality of its loan portfolio. The major concern is whether having microfinance as an internal unit will limit its ability to reach deep into the micro sector of the economy. Microfinance is only one of several businesses that fall under Enterprise and Personal Banking at Banco Mercantil. Over the long term, it is impossible to predict whether the bank will continue to dedicate resources to downscaling as the Venezuelan microfinance market matures and its marginal returns decrease.

At present these two Venezuelan downscaling institutions are positioning themselves to be strong microfinance practitioners. As large commercial institutions, they will have the resources to provide wide-scale access to financial services for underserved segments of the economy. The potential constraints for them in expanding their microfinance operations are the lack of adequate human resources, lack of internal commitment to this business and political interference.
**Banco Caja Social (Colombia)**

Caja de Ahorros was founded in the early 1900s as a self-sustainable savings institution for Colombia’s poor by the mission-driven Círculo de Obreros de Bogotá (now Fundación Social). Since by Colombian law only banks can offer checking accounts, in 1991 this savings institution was converted into a bank, Banco Caja Social (Caja Social). This conversion allowed it to offer its clients a more complete line of financial products. Caja Social has expanded to providing credit to the micro, small and medium-size enterprises. Over the last decade it has consistently been in one of the country’s top five banks in terms of return on equity. At the end of 2003, Caja Social had $538 million in assets and 86,757 microenterprise loan clients. Although it works with the lower income segments of the population it is not a “specialized” microfinance institution, because microenterprise lending is just one of its many business segments and not its initial focus.

Since 1999, Caja Social’s structure for its microenterprise loans was to have one person at a bank branch meet and initiate the loan process with the client. Then, the application process, risk assessment and back office processing have been done by different functionaries. This goes on in 44 cities, in 122 Caja Social offices. This process is similar to that used by consumer credit companies when they enter into microfinance. The average of these “micro” loans is about $2500.

Recently, Caja Social started a pilot project to reach out to Colombians needing much smaller amounts of capital, with loans of approximately $300. Management spent resources and time to learn about the microfinance operating procedures of NGOs and other institutions that work with such clients. It decided to implement a similar microcredit model to these institutions, with one officer responsible for a client from origination to repayment. To more appropriately implement this program, Caja Social has engaged ACCION International to assist in hiring and training loan officers.

Despite its social roots, Caja Social receives no subsidized funding, and all its projects are done seeking a profit. When asked their reasons for further downscaling, although they were already serving small entrepreneurs, Eulalia Arboleda, President of Caja Social, responded, “There is an extremely large market not being attended by the banks, and our current services did not meet the needs of these clients. We will start this project small and once it has proven to be profitable we can expand it very rapidly. This is a growth opportunity.” For Caja Social to expand this project, its largest investment will likely be in human resources, as it already has an extensive physical infrastructure that can service this new client segment.

Although Caja Social is determined to enter the microfinance market, certain Colombian government policies could constrain it from profitably moving its operations further down-market. Mandated caps on the interest rates it can charge its clients could keep its margins so low as to render this business unprofitable.

Caja Social has a separate microenterprise lending division that should allow management to focus on this new initiative. It is an interesting example of a financial institution attempting to reach further down into the microfinance market motivated by a commercial opportunity. All
indications are that it is proceeding cautiously, with a relatively sound strategy for approaching this new client segment.

The question remains, though, whether Caja Social is truly a commercial institution. Its major shareholder is the Fundación Social, a not-for-profit institution. Its other primary shareholder is the IFC. Also, Caja Social’s management notes, “microfinance is not only a business case for Banco Caja Social; as part of the Fundación Social Group, it has a strong aim for corporate social responsibility, which in the financial activity toward its clients, it understands as its ability to provide down-market financial services.” This is another case of an institution downscaling into microfinance that is blurring the line between a commercial and a social mission. However, Caja Social’s methodical approach to further downscaling and the fact that it is investing its own resources in this initiative make it an important institution to monitor for those championing downscaling.
Case Studies: SOGEBANK

SOGEBANK (Haiti)

SOGEBANK is the Haiti’s largest bank and at the end of 2003 it had more than $340 million in assets. It is a commercially motivated entity that entered into microfinance in 2000 by establishing a service company, SogeSol, with the technical assistance of ACCION International and funding from several international agencies. At the end of 2003, SOGEBANK’s microenterprise portfolio generated through SogeSol amounted to more than US$4.8 million, with more than 7,000 active clients.¹

Although on the demand side the environment was ripe for SOGEBANK to enter the microfinance market at a much earlier time, until 1995 there were interest rate ceilings and other restrictions in Haiti that made it virtually impossible for a commercial bank to downscale. In 1995 the Haitian government began to change banking regulations to create a more competitive, commercial and efficient banking system. It was after these changes that SOGEBANK could seriously consider downscaling and decided to begin work with international partners that had had previous experience in microfinance.

On whether SOGEBANK could have delved into microfinance without such international assistance, Pierre Marie-Boisson commented, “Theoretically it could have happened, but we needed to develop a lot more technical expertise [about microfinance]. This would have taken significantly more time on our own. Also, having multinational partners assured the institution [SOGEBANK’s board] that it was okay to go into microfinance.” It was not easy for the controlling powers of SOGEBANK to see the reasoning behind downscaling, as it was not the cultural norm for the bank to work in this market segment. Thus, the service company model and the creation of a separate institution allowed SOGEBANK to downscale without significantly disrupting its internal culture or putting its mainstream business at risk.

The success of SOGEBANK’s microfinance efforts has encouraged other Haitian financial institutions to consider entering the field, including Capital Bank, the country’s fourth largest bank. Banks in Haiti are very liquid, with technology and infrastructure currently underutilized on high-end clients. In addition, due to political and economic circumstances, an ever growing segment of the Haitian market is self-employed and in need of financial services. As a matter of commercial survival, the major Haitian banks have seen the need to downscale to diversify their portfolios and to fully utilize their lending capacity.

Despite the disruptive political circumstances in Haiti, SOGEBANK has shown that a commercially driven institution can downscale profitably. SogeSol and its microfinance business have made a significant contribution to the bank’s bottom line. Despite representing only about 4% of SOGEBANK’s lending portfolio, SogeSol’s operations are estimated to contribute between 27% and 36% of SOGEBANK’s net income. (See Table 9) The SOGEBANK/SogeSol management attributes its current success to having the proper technical assistance and a balance between those concerned for the success of microfinance and those who view the bank as a commercial entity. Several large commercial banks from other countries have recently visited SOGEBANK to learn how it has used microfinance to improve its bottom line. After seeing the

¹ ACCION International, http://www.accion.org/about_where_we_work.asp
service company model in practice, these institutions have implemented similar microfinance projects.

**Table 9:**
SogeSol’s approximate contribution to SOGEBANK per month*

<table>
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<th>Haitian Gourde (Thousands)</th>
<th>US$ (Thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SogeSol’s Net Profit less taxes</td>
<td>2,700</td>
<td>67</td>
</tr>
<tr>
<td>SOGEBANK’s share of profit</td>
<td>945</td>
<td>23</td>
</tr>
<tr>
<td>SogeSol Transaction fee to SOGEBANK</td>
<td>1,300</td>
<td>32</td>
</tr>
<tr>
<td>SogeSol rental of SOGBANK Infrastructure</td>
<td>600</td>
<td>15</td>
</tr>
<tr>
<td>SogeSol payment for SOGEBANK’s professional services</td>
<td>375</td>
<td>9</td>
</tr>
<tr>
<td><strong>Total contribution of SogeSol</strong></td>
<td><strong>3,220</strong></td>
<td><strong>79</strong></td>
</tr>
<tr>
<td>SOGEBANK Income</td>
<td>9,000 -12,000</td>
<td>222 – 296</td>
</tr>
<tr>
<td>% Contribution to SOGEBANK’s Income</td>
<td>27%-36%</td>
<td>27%-36%</td>
</tr>
<tr>
<td><strong>SOGESOL portfolio as % SOGEBANK total portfolio</strong></td>
<td><strong>4.3%</strong></td>
<td><strong>4.3%</strong></td>
</tr>
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</table>

*This analysis was done according approximating monthly income figures, because some of the actual data are not representative of the “normal” levels of income and operations, because of the current situation in Haiti.
Visión de Finanzas (Paraguay)

Visión de Finanzas (Visión) began operations as a small savings bank in Paraguay in 1992. In 1996 the Inter-American Development Bank (IADB) offered Paraguayan institutions a line of credit and technical-assistance funding to enter into microfinance. Some Visión board members decided that Visión should take advantage of this program. The bank started with a pilot project, using IADB funding to access the microcredit technology of IPC-Gmbh. Visión has now turned its business focus completely toward microfinance. As of the end of 2003, it had a loan portfolio (excluding credit cards) of almost US$25 million of which 43% was allocated to microenterprises.

Besides the financial incentives provided by the IADB, Visión was motivated to downscale by the business opportunity in “banking the unbanked” in Paraguay, and by the potential benefits of diversifying its loan portfolio’s risk profile. In order to convert completely into a microfinance bank it had to significantly change its strategies for generating and processing loans. In order to modify its structure, Visión drew on the resources of the IADB and the expertise of international microfinance consultants from CGAP. Its investment and change in business strategy has been reflected in positive financial performance, as it has consistently generated returns, even in difficult economic times in Paraguay. In 2003, Visión posted an ROA of 1.6%.

Although microenterprise lending remains a profitable business for Visión, it does not rely solely on its microenterprise loan portfolio to generate income. Shrinking margins and Paraguayan limits on interest rates are decreasing its opportunities for profitable growth. “It is impossible to survive on financing income alone,” commented Luis Maldonado, Visión’s President. The bank is using other products and services to enhance profitability. As Paraguay’s economy depends heavily on trade with its neighbors Brazil and Argentina, Visión generates income through a currency exchange business launched in 1999. It gains additional revenues from its credit card business, fees on its cash machines and its partnership with Western Union. In addition, it brings in non-finance income as Paraguay’s major provider of bill-payment and credit-collection services for both public and private industries.

Visión funds most of its microfinance portfolio through savings accounts and time deposits. Most of this deposits-based funding is not from the market segment that produces its microenterprise borrowers. According to management, in order to operate successfully, it has to make both its higher-wealth depositing clients and its “micro” borrowers comfortable with its culture. To attract one market segment without alienating the other takes an extremely sensitive and balanced strategy. Visión has recently faced competition from multinational banks for its large depositors while successfully attracting international loans from CAF and other institutions to service its loan portfolio.

Besides growing through increasing its internal capacity, Visión is also purchasing the consumer credit portfolios of other Paraguayan Financieras. These efforts allow Visión to expand its client base and gain incremental profits through cross-selling other products and services to these new clients.
Visión is an example of a bank that needed to find a niche market to survive because competition in higher-end markets, government regulations and a declining economy were limiting profits. Influenced by international advisors and the commitment of its management, Visión turned to the microfinance segment to improve its prospects. In recent times, when most Paraguayan financial institutions serving only higher-income segments of the market failed, Visión, with its focus on microfinance, was able to survive. This may bring the importance of the microenterprise segment of the economy to the attention of other institutions in Paraguay and possibly drive more entrants into microfinance. Although Visión’s mission is to be “the Leader in Microfinance,” its management claimed that it is increasingly difficult to generating profits through traditional microfinance activities alone. Visión’s evolving business strategies in microfinance, as it becomes a less significant portion of its business, will be of significant interest to other downscalers.
Comparison of Loan Processes

The key elements of a microfinance operation are its loan generation and recovery processes. Through our interaction with various downscalers, we were able to compile a basic overview of the operational procedures they use for microenterprise lending.

Mibanco, Banco Solidario, SFE, SOGEBANK, Visión, Bangente, Banco Mercantil and CREDIFE all follow more or less “traditional” microfinance model. In this model, a single loan officer generates client interest in the loan product and evaluates the client’s business and creditworthiness; the agency then processes the loan, and the loan officer is responsible for recovery. In this approach, the time between client identification and loan disbursement averages five to six days. For renewals, the client works with the same loan officer, and if the loan amount is the same, it requires minimal paperwork. At some of the institutions, however, the client’s capacity to pay is reassessed if the loan amount increases. There is a strong emphasis on the loan officer-client relationship. Often the loan officer visits the client’s home or business and advises the client on issues beyond just their credit capacity. Loan officers usually work in a single geographic area and are not specialized in a particular type of business. On average, a loan officer is able to work with 300 to 500 clients. Due to particular cultural and economic circumstance, the institutions analyzed that used this traditional model had slight variations in their lending processes. However, they all adopted the definitive elements: the one-to-one loan officer-client relationship and a focus on client’s ability to repay the loan based on cash-flows from their microenterprise.

Banco del Trabajo (Bantra) uses a modified version of its consumer lending structure to process microfinance loans. A sales force, paid on commission, generates interest among potential clients. If a client is interested in a loan, a salesperson collects information on the client and the microenterprise, based on checklist of requirements. According to Guillermo Arancibia, “The most unique element of our process is the checklist to evaluate the client business.” If client satisfies the list’s requirements, a second officer, trained to evaluate informal microenterprises, then forecasts cash flows and income based on informal documentation and/or non-traditional business indicators, such as size of the stock, type of merchandise or rotation of inventory. A CPA then finalizes and evaluates all documents and, if approved, sends them to central processing. A separate functionary handles collection and client management. Bantra management estimates that once it identifies a potential client, it takes around 4-5 days to process and disburse the loan. Compared to their consumer loan products, which usually have a turnaround time of less than 48 hours, this seems slow, but it is comparable to the microfinance industry in general. It is likely that this is the model that will be used by Banco Centro Mundo in Ecuador.

Banco Caja Social in Colombia had been using a functionalized approach to “micro”enterprise lending similar to that of Banco del Trabajo. However, Caja Social is now developing procedure to use a more “traditional” approach to work with entrepreneurs with much smaller businesses and loan requirements. This newly adapted strategy is still in its pilot stage, but if successful it will be interesting to note if other downscalers mimic this approach.
Banco de Crédito de Peru, has only recently incorporated microenterprise lending fully into its structure and is still modifying its loan processes. In the past, it did not have a sales force in the field and would contact potential clients indirectly through advertising and mailings. However, it is now making a concerted effort to “knock on the client’s door,” with the kind of sales force traditional to the microfinance world. BCP has established special centers to both attract and service their microfinance clients. Once a client expresses interest, the sales team collects the requisite paperwork and passes the information on to a business analysis team. This team visits the client’s business and evaluates the client’s capacity to repay the loan. The loan is then sent for processing to whichever BCP branch is most convenient for the client, and the receives a card that can be used to draw the funds at any BCP branch. Another BCP team handles collections. The client is also assigned an account manager for any future issues with the bank.

Microentrepreneurs who repay loans in a timely fashion, automatically get a revolving line of credit. BCP’s strategy has been to combine what it has deemed to be the most successful strategies of Solución and its small-business lending strategies.

Many recent downscalers are adapting MFI loan processes that have been proven to enable institutions to be profitable. It is important to note that these downscalers now evaluate the potential loan based upon the potential cash generated by the microenterprise. This is an indication that they maybe beginning to understand and profit from the strategies that traditional MFIs have used to evaluate the repayment potential of a microentrepreneur. However, a few are developing and modifying their own strategies for client generation and loan processing. These usually have the advantage of economy of scale and are easier to teach to less select employees. The traditional model requires intensive and costly selection and training of loan officers. However, the traditional MFI model seems to produce higher-quality loan portfolios and higher client retention rates. The downscalers with novel approaches that were part of this study are still adapting their loan processes. It is too early and there is insufficient data here to conclude whether the “newer” methods will yield better or worse results than the traditional microfinance methods. It should be noted that these results could be evaluated on a social (client outreach/size of loan) or a commercial (contribution to the bottom-line of the institution) basis. Over the period analyzed, the portfolios of all of the types of institutions in this study experienced growth and profitability.
VII. Client Perspectives on Downscaling and Commercialization

During the course of this study we met with several microfinance clients in Peru and Ecuador to gain a better understanding of their perspective on how commercialization and greater competition is changing microfinance. Although these discussions were informal, and only a small sampling, we believe we can draw some general conclusions.

The primary observation is that clients do not feel service has gotten any worse as their microfinance provider grew in size and focused on profitability and efficiency. This was despite the fact that some borrowers had become clients when their lender was a small NGO (ACP) and before it commercialized (Mibanco). In fact, all of the borrowers claimed that the institutions they were working with had become more efficient. This may be a result improved operational procedures, but it is also likely that their subsequent transactions required less processing than their initial loans.

In microfinance markets, client loyalty is an indicator of both the level of competition and quality of service. It seems that clients with smaller loans and often fewer options (or less awareness of options) are extremely loyal to whatever institution first offered them a chance to prove their creditworthiness. Although these clients now know about other institutions in the market, they have developed a comfortable relationship with one lender and do not foresee working with anyone else. As well, these smaller clients generally do not want additional funding and therefore have no need for a loan from a new entrant. There is a second category of microfinance client, usually with a little larger loan size, that is quite aware of the price differences between the different local microfinance providers and often already has loan products from two or competing institutions. These clients are much more likely to switch service providers based on price difference because their businesses are often larger and corresponding marginal profits are smaller. For these clients small differences in costs of capital can significantly affect the bottom line of their microenterprise.

It may threaten the sustainability of some microfinance institutions that their higher-end clients (with larger and more profitable loans) may be the very ones most willing to switch institutions based on price. This could leave some institutions with only clients who require extremely small loans and do not generate sufficient profits. It will be important in the future for commercial microfinance institutions to develop strategies to retain higher-end clients while at the same time deriving additional income streams from smaller ones. The case studies in this report show that several institutions are beginning to operate along these lines.

Our client discussions reconfirmed the value of the emphasis traditional microfinance has put on the client-loan officer relationship. Many clients placed a high value on the services and demeanor of their loan officers. However, slightly larger entrepreneurs, while appreciating their loan officers, were much more willing to find credit elsewhere as their needs and the market changed. This loyalty to an MFI based on the client-loan officer relationship has lead many to conclude that institutions that separate the lending process by function (e.g. Banco del Trabajo) may limit their ability to serve smaller microfinance clients appropriately. Such a strategy could
work, as long as there is some way for the client to build a personal relationship with the institution itself and not a particular loan officer.

Regarding marketing and outreach, downscalers and other new entrants into microfinance would be wise to maintain a good reputation with their early clients. Many clients and loan officers indicated that new clients are strongly influenced to work with a particular institution based on “word-of-mouth” recommendations from peers. The cost of client acquisition, a major expense for MFIs, can be significantly reduced if early users of the institution’s services spread the word about their satisfaction. To this, end some commercial MFIs have begun rewarding clients who recommend other creditworthy clients.

In order to succeed, downscaling institutions have to understand the particular nuances and needs of microfinance clients. Better terms and more efficient processes are not enough. For instance, one client noted that he used with his institution (Banco del Trabajo) because when he needed a loan, “they knocked on my door, while the other [competing institution] just sent a letter.” If downscalers do not take client reactions like that seriously, they may have a hard time attracting and retaining clients at a profitable rate.

Another issue that was indicated by the interviews was that because of increased competition some clients are getting access to significantly more credit than they felt that they need. Several of the clients talked about being offered additional credit from their current lender or other institutions that they did not want. The clients did not feel they could effectively use or repay the additional loan. As long as clients do not accept this overextension of credit there may not be a problem, but competition is creating an increased threat of client over-indebtedness. The idea of the microfinance clients’ credit needs and thus their profitability for the MFI growing significantly as time goes may be overemphasized. If commercial players think that all clients starting with smaller sized and unprofitable loans will eventually grow and take on larger loans they may be overestimating the potential profitability of these clients.

In general, it currently appears that microfinance clients are now noticing that they have more options and are receiving higher quality microfinance services due to increased market competition from downscalers. It is not clear that the clients, however, have any preference or tendency to work with downscaling institutions. The clients in the long-run will work with the institutions that they perceive as best servicing their needs. This brief study indicated that there may be at least two if not more different segments in the microfinance market. It may be that as the competition for clients increases with the entrance of downscalers different types of institutions will specialize in serving the different segments of the microfinance market.
VIII. Conclusions

Downscaling banks are increasingly becoming providers of microfinance in those Latin American markets that were investigated (Peru, Ecuador, Venezuela, Haiti, and Colombia). The commercial institutions analyzed in this study appear to be approaching microfinance as a serious business opportunity. In all cases, their microfinance portfolios have contributed to institutional profitability and have grown in the last year or more. The past growth of this sampling of institutions allows us to be cautiously optimistic about the future contribution of downscalers to the progress of microfinance. There seem to be benefits to both clients, through efficiencies driven by market competition, and to the downscalers themselves, through improved bottom lines.

Most managers interviewed claimed they currently regard microfinance as commercially profitable. However, not all institutions entered this field for commercial reasons. For some (e.g. Banco del Pichincha, Visión, Banco del Caribe), the idea of microfinance as a source of profit has only recently caught the attention of management and boards. In some of these cases (Visión, Banco Mercantil), political pressures or public incentives were an initial factor that moved the institution into microfinance. Although many microfinance professionals appeared skeptical of downscalers driven by noncommercial factors, the institutions observed do not seem any less likely to succeed commercially for having been “pressured” into the field. There is a subtle mix of social and commercial forces driving institutions to downscale. It will be important for their managers, shareholders and boards to understand and react appropriately to these different and often opposing factors.

As expected, most downscaling retail banks studied face no major capital constraints; they can a fund their microfinance portfolios through deposits. Even specialized MFIs are making capturing deposits a central part of their funding strategy. All institutions in relatively competitive microfinance markets will likely experience pressures to reduce funding costs. Some downscalers in this study have drawn funding from public and quasi-private financial resources. This public financing does not seem to be creating market “distortions” as much as it is providing some additional confidence in microfinance markets for hesitant financial institutions. Also, as this type of funding often brings with it technical expertise, it may have ancillary benefits for downscalers and their clients. At the same time, institutions like Banco de Crédito, SOGEBANK and Banco del Trabajo have committed their own internal resources to downscaling. MFIs that cannot efficiently access deposits or mobilize other low-cost funding for their portfolios may have difficulty competing with downscalers.

A few years ago, the microfinance industry experienced a setback when consumer finance companies tried to become microenterprise lenders in Bolivia. This occurred in part because the entrants did not fully understand the microfinance market and did not adopt the appropriate technology for making loans to microentrepreneurs. However, it seems now that commercial institutions are entering into microenterprise lending with more sound methodologies. The lending technologies being used by these consumer finance companies and other large downscalers seems to have been adopted more appropriately to the needs of the microentrepreneur. The competitive entry of downscalers analyzed in this research has not
shown any evidence of having caused major market instability or over-indebtedness of their clients. However, since the entrance of these institutions is a relatively recent phenomenon, any negative impact on the microfinance market from the competitive presence of downscalers will be more evident over the long-term, especially in times of economic hardship.

If these downscaling institutions, especially those that are more commercially oriented, continue to succeed financially even as the microfinance market becomes more saturated, it is likely that others will try to mimic their downscaling efforts. This demonstration effect may be even more influential if the relative impact of microfinance on the downscalers’ bottom lines is sufficiently publicized and other constraints to downscaling are removed.

A serious concern for the managers of most of the institutions studied was the human resource constraint on potential institutional growth. They felt their growth would be hindered by their inability to find enough loan officers. Others talked about the lack of funding for training and building capacity of their existing human resource. Other constraints mentioned included unstable regulatory environments and potential government interference. These issues will continue to concern downscalers as they decide how to start or continue working in microfinance. However, despite these constraints, it seems that microfinance markets in many Latin American countries are becoming more formalized, and there are now noticeable downscaling participants.

The impact downscalers are having on the commercial microfinance market should be taken seriously by those who feel that improving access to financial services is an important part of poverty alleviation. In several Latin American countries downscaling has had a competitive impact on incumbent MFIs and increased choices in the products and pricing available to microentrepreneurs. Downscaling will continue to be a major force in the microfinance market, and in general it is increasing the industry’s capacity to provide financial services to the poor. However, it is still early days and it is not entirely clear whether downscalers have enough long-term commitment and understanding of the industry to make them the most significant institutions in the microfinance market.
IX. Ways Ahead

Even with the advent of downscaling and increased competition in microfinance markets, noncommercial promoters still have a role to play in helping downscalers to serve microentrepreneurs more effectively. Based on the findings of this research, initiatives that would encourage downscalers to further pursue microfinance opportunities could include:

**Consulting services that:**
- Facilitate changes in the culture of the downscaling institution, enabling it to conduct microfinance activities more effectively.
- Advise and support institutions shifting from one organizational structure to another (e.g. a large bank absorbing a microfinance subsidy).
- Developing microfinance operations that are appropriately designed to meet the downscalers’ structure and objectives.
- Manage the perception and image of the downscaling institution to allow it to appeal to both large-scale depositors and microentrepreneur borrowers.
- Evaluate the social impact of downscalers in a way that encourages institutions to disclose accurate information about their microfinance business.
- Educate downscaling institutions’ shareholders and boards on the importance of patience in developing microfinance initiatives.
- Develop strategies for downscalers to absorb NGOs and other noncommercial MFIs that are acceptable to both parties.
- Advise governments and regulatory bodies on more appropriate regulations for microfinance.

**Investors/donors could play a role in:**
- Providing partial subsidies for technical assistance to enable downscalers develop appropriate microfinance structures and processes.
- Promoting stability in the microfinance market by creating mechanisms to keep downscalers from abandoning microfinance clients, even during difficult economic times.
- Allowing commercial institutions to reach out to less profitable clients (e.g. in rural areas)
- Supporting the creation of effective credit bureaus to allow institutions to share client credit information
- Alleviating human resource constraints by creating or supporting institutions to train microfinance professionals.
- Developing a forum for downscaling institutions to share best practices and publicly promote their accomplishments in microfinance
- Funding watchdog institutions to monitor whether downscalers are involved in exploitive lending practices.

**Further areas of study into downscaling:**
- Conduct specific studies of the Mexican and Brazilian markets, which are significantly different from the rest of Latin America in terms of size and the development of their respective microcredit markets.
- Undertake a more comprehensive examination of the direct effect of downscaling and commercialization on client outreach and quality of service.
Ways Ahead

- Further analyze the role of cajas, cooperatives and similar institutions in competitive microfinance markets.
- Analyze the different consumer finance technologies being used by traditional MFIs and the consequences of product diversification.
- Study in-depth the appropriate microenterprise lending technology for downscalers.
- Report on regulations and legal structures that best support stable microfinance environments.
- Collect information on client retention and profitability related to downscalers’ cross-selling other financial services to microfinance clients.
- A report on regulations and legal structures that best support stable microfinance environments.
- A study of client retention and profitability related to downscalers’ cross-selling other financial services to microfinance clients.
Appendix: Glossary

X. Appendices

Glossary and Acronyms:

Bandra – Banco del Trabajo
BCP – Banco de Crédito de Perú
BID – Banco Interamericana de Desarrollo (IADB)
CAF- Corporación Andina de Fomento
CGAP – Consultative Group to Assist the Poor (World Bank)
Financiera – Non-bank regulated financial institution
IADB – Inter-American Development Bank (BID)
IFC – International Finance Corporation
IMI – Internationale Micro Investitionen
IPC-Gmbh - International Projekt Consult
ME – Microenterprise
MFI – microfinance institution
NGO- Non-Governmental Organization
ROA – return on assets: net income over average total assets
ROE – return on equity: net income over average total equity
SFE – Sociedad Financiera Ecuatorial
List of Interviewees:

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* Interviewed in person, all others interviewed over the phone
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All data and statistics provided are from publicly available sources, banking supervisory agencies, annual reports, financial statements, etc. unless otherwise noted.