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CASE STUDY ON PROFITABILITY OF MICROFINANCE IN COMMERCIAL BANKS

CREDIFE

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DAI

Development *Alternatives,* Inc.

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CREDIFE

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EXECUTIVE SUMMARY

OBJECTIVE

Although an increasing number of specialized microfinance institutions have shown that microfinance can be profitable (usually following years of subsidies for start-up and innovation) and an increasing number of banks have entered the microfinance market, literature and data on the profitability of microfinance in commercial banks are essentially nonexistent. This is due to the limited number of banks that offer microfinance on a commercial basis, the difficulty in obtaining proprietary information on banking operations, and difficulties in accurately costing and measuring the profitability of a specific product within multiservice finance intermediaries. However, if microfinance is to continue to expand and attract private, commercial investors, including banks, the profitability case must be explicitly demonstrated in a variety of institutions and environments.

The objective of this case study is to measure the profitability of a microfinance unit related to a private commercial bank, regardless of the business model chosen. CREDIFE, a service company in Ecuador, was selected as the subject of this case study because of its relatively straightforward and transparent relationship with Banco del Pichincha (the bank), its majority shareholder and parent company, for which it services the microenterprise loan portfolio. CREDIFE's apparent success, in terms of both rapid growth and contribution to bank profitability, demonstrates how a bank can become a significant player in the microfinance market in a relatively short time.

MICROFINANCE OPERATIONS

In the late 1990s, Banco del Pichincha decided to enter microfinance, which it determined was a "good fit" for its needs at the time. The service company model was attractive to the bank because the microenterprise operations would be able to function somewhat autonomously yet be positioned to take advantage of synergies with the bank, including the bank's name recognition and its image as one of the most solid banks in Ecuador.

Although CREDIFE, the service company established by Banco del Pichincha and its strategic partners, began lending to microentrepreneurs in July 1999, the project began on a much smaller scale than originally anticipated because of the economic and financial crisis in Ecuador that year. Significant growth in the portfolio managed by CREDIFE was not seen until 2001, when the portfolio grew from $782,616 at year-end 2000 to $3.5 million at year-end 2001. The steady, yet explosive, growth continued in 2002 and 2003, with the portfolio tripling each year—to $28 million at year-end 2003. The client base also has grown significantly, from just 2,611 active clients at December 31, 2000, to more than 24,000 at year-end 2003.

PROFITABILITY

CREDIFE's strong portfolio growth has resulted in the economies of scale necessary to enable it to efficiently manage its portfolio and attain profitability. However, since CREDIFE's financial statements are ultimately consolidated into those of Banco del Pichincha, the bank, as 79 percent shareholder, is concerned about overall profitability of the consolidated entity rather than the

allocation of profits between companies and has never performed a complete cost analysis of CREDIFE's contribution to its bottom line. Although CREDIFE has continually monitored its bottom line with the preparation of monthly financial statements and breakeven analyses, it does not impute profitability of its operations to reflect an operation that owns its portfolio. However, in early 2004, with buy-in from the bank and CREDIFE's Board, an ACCION CAMEL assessment of CREDIFE was conducted and CREDIFE's financial statements were reclassified. Although the reclassification's effect on CREDIFE's bottom line is nil, the cost structure and net profit of the microcredit operation become more transparent. The reclassification performed as part of the ACCION CAMEL assessment has been used as the basis of analysis for the present case study.

According to the analysis, CREDIFE reached financial self-sufficiency in 2003, covering all costs and subsidies with financial revenue generated by the loan portfolio, and its contribution to Banco del Pichincha's net income in 2003 was calculated at $1.44 million or 7.63 percent of the bank's net income for the year. Overall, CREDIFE's return on assets (ROA), using the reclassified balance sheet and income statements that include the loan portfolio managed by CREDIFE and corresponding interest revenue, compares favorably to that of the bank. The primary cost allocation method used in this paper results in an ROA in 2003 for CREDIFE of 3.21 percent compared to the bank's ROA of 1.17 percent.[1] CREDIFE's portfolio, on the other hand, represents a mere 3.63 percent of the bank's total portfolio, which implies that CREDIFE is more profitable than some other business/market segments of the bank. Depending on the indirect cost allocation, the ROA for CREDIFE would most likely be even higher.

SUCCESS FACTORS

In addition to its recent rapid expansion, CREDIFE's profitability can be attributed to many factors, including but not limited to:

- Its relationship with Banco del Pichincha—specifically, its ability to leverage the bank's existing infrastructure and liquidity;
- Its controlled operating expenses;
- Its high portfolio quality; and
- Its ability and willingness to charge interest rates and commissions higher than other product lines.

In addition to the direct profit contribution of the microcredit operations, the bank benefits from higher utilization of its fixed assets such as branches and systems, cross-selling of other financial services such as deposits, and graduation of clients into other bank products.

Although CREDIFE and Banco del Pichincha both certainly have benefited from their relationship, the success of a microfinance unit associated with a commercial bank depends on a variety of factors, including the ability to balance autonomy, specialization, and efficiency of microfinance while leveraging the bank's assets (infrastructure, liquidity, reputation) and taking advantage of the synergies derived from its relationship to the bank. CREDIFE's rapid ascent in becoming an important and profitable provider of microfinance in Ecuador serves as an inspiration to other commercial banks sharing the same vision.

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[1] The ROA figure for 2003 for the microcredit operations could be even higher depending on the allocation of the bank's indirect costs to this portfolio.

1 INTRODUCTION

As more commercial banks become intrigued by the idea of entering the microfinance market, the lessons learned from some of the more experienced players become useful in the decision-making process. Even if a bank enters the microfinance market for socially responsible reasons, the long-term viability of the microfinance program is eventually defined by its contribution to the bank's profitability. Determining cost and revenue drivers is key to ensuring that resources are available and properly allocated; costs, both actual and imputed, are fairly assigned; and pricing strategies accurately reflect profitability goals. Once the bank is convinced that the net operating margin of microfinance products can be high relative to other products in the bank, the challenge becomes growing the volume so that the absolute net income is also significant.[2]

The objective of this case study is to measure the profitability of a microfinance unit, regardless of the business model chosen (see Box 1). As with any profitability analysis, one needs to understand the costing method used and, although it is not the focus of the case study, the details of the methodology are described in the text. Of the two primary options for product costing, allocation-based and activity-based, the former served as the foundation for this analysis because of its relative simplicity and because CREDIFE was already using the cost-allocation methodology to calculate its profitability.[3] In addition, the researchers have reclassified some accounts on the financial statements to enable more transparent analysis of CREDIFE's performance.

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[2] For a more detailed discussion of the drivers of bank entrance into microfinance and factors for success, refer to Robin Young and Deborah Drake, *From Best Practices to Alternative Options: A Primer for Banks Entering the Microfinance Market*, AMAP/FSKG publication, available at www.microlinks.org.

[3] For a description and discussion of these models, refer to Monica Brand and Julie Gerschick, *Maximizing Efficiency: The Path to Enhanced Outreach and Sustainability*, ACCION Monograph Series No. 12, Washington, D.C., September 2000; and the CGAP Product Costing Web site at www.cgap.org/productcosting.

Box 1: Models of Commercial Bank Entry into Retail Microfinance[4]

Internal Unit

- Operates within the existing bank structure as a division or new product
- Loans and other operations are on the bank's books

Examples: Bank Rakyat Indonesia (BRI), Banco do Nordeste (Brazil), Banco Salvadoreño and Banco Agrícola (El Salvador), and Hatton National Bank (Sri Lanka)

Financial Subsidiary

- May be wholly owned or a joint venture with other investors
- Conducts loan origination, credit administration, and all aspects of financial transactions
- Loans and other operations are on the books of a financial subsidiary
- Licensed and regulated by the banking authorities
- Separate staffing structure, management, and governance from the bank

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

Service Company

- Nonfinancial company that provides loan origination and credit administration services to a bank
- Promotes, evaluates, approves, tracks, and collects loans
- Service company employs the loan officers and the bank provides the support services (human resources, IT) for a fee
- Bank funds and disburses loans and repayments are made directly to the bank; loans remain on the bank's books and are regulated and supervised according to banking laws
- Company is not regulated or supervised by banking authorities; there is no separate banking license
- Negotiates detailed agreements with the parent bank that assign cost, risk, responsibility, and return to each party

Examples: Credife, established by Banco de Pichincha (Ecuador); Sogesol, created by Sogebank (Haiti)

Strategic Alliance

- Can take many forms; some of the most common are banks financing portfolios of specialized microfinance institutions and providing operational support in terms of disbursements and collections through bank branches
- Negotiates agreements that assign cost, risk, responsibility, and return to each party

Example: ICICI Bank (India)

There are many challenges in any cost-allocation exercise, such as which costs should be allocated (only marginal costs, or indirect costs, too?) and how to allocate costs (based on number of loans, size of portfolio, staff time?). As commercial banks develop more sophisticated management information systems (MISs) and understand the importance of measuring product profitability, an in-depth analysis using activity-based costing becomes appropriate. If the bank's institutional vision is that microfinance must contribute to the bank's net income like any other product line, then a costing exercise becomes a priority. Ironically, the necessity to prove that microfinance is a profitable business sometimes provides the impetus to the bank to measure the profitability of all of its products.

CREDIFE was chosen as the subject of this case study because, as a service company, CREDIFE's experience and its relationship to Banco del Pichincha are relatively straightforward and transparent. CREDIFE's apparent success in terms of both rapid growth and contribution to Banco del Pichincha's

[4] Based on ACCION InSight No. 6, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," September 2003; and Young and Drake, *A Primer for Banks Entering the Microfinance Market.*

profitability show how a private commercial bank can become a significant player in the microfinance market in a relatively short time.[5]

[5] In addition to the clarity of costs and CREDIFE's success in terms of outreach and sustainability, the bank and service company were willing to participate, share confidential information with the researchers, and publish the findings. This willingness to participate was the result, in part, of the established relationship between the Development Alternatives, Inc. (DAI)/ACCION research team and the bank because of ACCION's participation in CREDIFE and DAI's management of USAID's Strengthening Access to Microfinance and Liberalization Task Order (SALTO) project in Ecuador.

2 BACKGROUND

2.1 EXTERNAL FACTORS

2.1.1 MACROECONOMIC SITUATION

Ecuador, located on the equator in South America, has a population of approximately 13 million, and some estimates place up to 65 percent of the population below the poverty line. The economy is primarily based on oil; agricultural production is the secondary source of export and public sector revenues. In the late 1990s, natural disasters and sharp declines in world petroleum prices led to a severe economic crisis, reducing real gross domestic product (GDP) by more than 6 percent. After the currency depreciated approximately 70 percent in 1999, the government dollarized the economy. Dollarization has stabilized the economy somewhat, and growth is just returning to precrisis levels.[6]

The Ecuadorian banking system also collapsed during the economic crisis. Many of the existing banks in 1999 failed, and many investor funds fled the country. Banco del Pichincha survived the crisis and remained stable; it is now the largest bank in the country. Today, the banking sector has excess liquidity and is searching for new business opportunities, including microfinance.

A World Bank study[7] shows that poverty increased in Ecuador during the period 1990–2001. The increase is more evident in urban areas than in rural areas as a result of increased migration to urban areas during the period and the 1999 crisis, which particularly affected middle-class households, who banked with many of the financial institutions that did not survive the crisis. Many Ecuadorians who were impacted by the crisis turned to the informal sector for a means of survival, and the availability of microfinance in the country has helped them to get back on their feet and strengthen their microenterprises as a source of family income. A study sponsored by the USAID Strengthening Access to Microfinance and Liberalization Task Order (SALTO) project found 592,000 people nationally whose primary income came from self-employment or owning a microenterprise; 45 percent of these had started their business since 2000.[8]

2.1.2 SUPERVISION AND REGULATION OF MICROFINANCE IN ECUADOR

The Central Bank and Superintendence of Banks of Ecuador first included microcredit as a type of credit for loan classification purposes and review in periodic analyses in 2002. The definition of a microloan is a loan that finances a microenterprise whose source of repayments is sales from production, commerce, or

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[6] CIA *World Fact Book*.

[7] World Bank, Poverty Reduction and Economic Management Sector Unit Latin America and the Caribbean Region, *Report No. 27061-EC Ecuador Poverty Assessment.* April 2004.

[8] USAID/SALTO, *National Study of Microenterprises in Ecuador*, forthcoming. This figure is likely to be considered a conservative estimate because it excludes farmers, many of whom are smallholders and may also run a microenterprise as a secondary activity. The national census conducted in 2001 found approximately 1.5 million people who owned microenterprises or were self-employed (69 percent) or farmers (31 percent).

service activities, and the maximum size for a microloan is $20,000.[9] For these loans, formal financial statements are not required; rather, the bank must prepare and utilize an appropriate credit policy that ensures good risk management.

With technical assistance from the SALTO project, the Superintendence of Banks in Ecuador has implemented prudential norms for microloans classified based on the definition provided above. Such norms include:

- Loan loss provisioning must begin when a loan is five days in arrears.
- Loans that are 90 days past due must be provisioned at 100 percent and written off when they are 180 days past due.
- Financial institutions can voluntarily provision above specific provision requirements set by the Superintendence.

Credit bureaus have facilitated credit screening for the microenterprise sector in Ecuador. While the Superintendence maintains a database on loans (central de riesgo) that regulated institutions use as part of credit screening and analysis, Ecuador recently established a comprehensive credit bureau law and has issued licenses to six credit bureaus that have begun operations over the past year. The government also publishes statistics related to the microfinance sector, including the Boletin de Cooperativas de Ahorro y Crédito y Microempresa (Bulletin of Savings and Loan Cooperatives and Microenterprise). The Superintendence's interest in the sector is also evident in its participation in microfinance events in 2003, both national and international. In addition to various local workshops and conferences on microfinance, Central Bank staff participated in specialized management training programs for microfinance and Bank Superintendence staff participated in international microfinance seminars and the Inter-American Development Bank forum on microfinance.10 At the same time, potential threats to regulated microcredit operations have arisen in terms of controls on interest rates and laws proposed in Congress that would restrict commissions and financial margins. However, at the time this paper was written, the market effectively set the price for microcredit in Ecuador.

2.1.3 MICROFINANCE SUPPLIERS

According to the statistics of the Superintendence of Banks in Ecuador, as of March 2004, the institutional suppliers of microcredit included three private commercial banks, 27 cooperatives, and one finance company. This represented an 82 percent increase over the previous year in the number of regulated institutions reporting credits for microenterprises. The other banks, in addition to Banco del Pichincha through CREDIFE, were Banco Solidario and Banco Centro Mundo. The finance company, Procredit (formerly Sociedad Financiera Ecuatorial), is the fastest growing of the institutions. Banco de Guayaquil, with USAID-supported technical assistance through the SALTO project, is preparing to launch a microfinance program in 2004.

During the same 12 months, the total microcredit portfolio of these entities increased 133 percent, from $80.6 million to $187.6 million. Most of the growth came from the banks, as can be seen in Table 2.1. In terms of market share, as of March 2004, the banks had 55 percent of the total regulated microfinance

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[9] Espinosa, Rodrigo (Superintendence of Banks), Alexander Shapleigh, Fernando Fernandez, Marina Mutchler, and Jorge Daly (SALTO Team Members), *Regulation for Expanding Rural Financial Services*, Supervision and Regulation of Microfinance Industry in Ecuador, USAID SALTO Project.

[10] Central Bank Annual Report.

portfolio outstanding; the cooperatives, 35 percent; and Sociedad Financiera Ecuatorial, 10 percent. Banco del Pichincha/CREDIFE accounted for $32.2 million of the total microfinance portfolio as of March 31, 2004 which represented 31 percent of the private banks and 17 percent of the total regulated market.

TABLE 2.1: MICROCREDIT PORTFOLIOS IN US$ MILLIONS

Type of Institution	March 31, 2004	March 31, 2003	Annual growth
Private banks*	102.6	52.4	96%
Cooperatives	65.2	16.5	295%
Finance company	19.8	8.9	123%
Housing finance companies	0	1.0	- 100%
Government bank	0	1.8	- 100%
TOTAL	187.6	80.6	133%

* According to the presentation, Banco Solidario had an additional $22 million in loans that do not technically fit within the Central Bank definition of microcredit but are disbursed using traditional microcredit methodologies; this brings the total microcredit portfolio managed by private banks up to $124.6 million at March 31, 2004. Source: Presentation by Rodrigo Espinosa, National Director of Studies and Statistics, Superintendence of Banks and Insurance of Ecuador, May 2004.

The number of microcredits outstanding as of March 31, 2004, was 131,460, of which CREDIFE had 25,953, or some 20 percent of the total market. A number of unregulated microfinance programs also operate through nongovernmental organizations (NGOs).

The national microenterprise survey conducted under the SALTO project estimates that the total number of microentrepreneurs is 592,000, and 16 percent of respondents reported having requested and received a loan during the past year. Given the number of microenterprise loans outstanding relative to the number of microenterprises, only some 21 percent of the demand is satisfied as of year-end 2003. Both the 16 and 21 percent figures suggest that room remains for microfinance to grow significantly in the coming years.[11]

2.2 INTERNAL FACTORS

2.2.1 ORGANIZATION AND LAUNCHING OF MICROFINANCE

Banco del Pichincha is today the largest bank in Ecuador. Founded in 1906, the bank's total loan portfolio reached $856 million by December 31, 2003—26.3 percent of the market share of banks in Ecuador. At the same time, it held over 28 percent of deposits in the banking system. The bank's total assets reached $1.7 billion at December 31, 2003, and the bank and its subsidiaries had $2.4 billion in assets. Banco del Pichincha has Ecuador's largest branch network, with more than 200 offices in over 75 cities and towns, as well as international offices in the Bahamas and the United States.

[11] For details on the microenterprise sector in Ecuador, refer to the national microenterprise study *Microenterprises in Ecuador*, available on the SALTO Web page at http://www.salto-ecuador.com

In the late 1990s, Banco del Pichincha made the decision to enter microfinance, which it determined was a "good fit" for its needs at that time. Ecuador was in the midst of an economic crisis, which had limited the demand for consumer lending and caused the bank to have excess liquidity. After studying a number of options, including closing branches and introducing new products, the bank identified microentrepreneurs as potential customers who could grow into future consumers, small and medium businesses, and even, eventually, corporate customers. The socially responsible leaders within the bank, including the Chairman of the Board of Directors, saw microfinance as a means of satisfying the needs of an underserved market. At the same time, microfinance was identified as a profitable way to take advantage of unused branch infrastructure and excess liquidity. Simply stated in the words of Ernesto Dávalos, CREDIFE's Chairman and member of the Banco del Pichincha's Board, "CREDIFE is the future of the bank; microfinance is the future of the country."

2.2.2 THE SERVICE COMPANY MODEL

A microfinance service company is a nonfinancial company that provides loan origination and credit administration services to a bank. The service company does all of 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 (and vice versa, when the bank provides services to the service company). The service company employs the loan officers and other microfinance program staff, and the bank in turn furnishes services to the service company that could include teller support, human resources, or information technology. The service company can be a wholly owned subsidiary of the bank or it can involve additional investors.[12]

Under the service company model, CREDIFE is the main interface with clients, with full responsibility for all credit evaluation and loan approval, collections, delinquency management, and recovery of overdue loans. Loans are disbursed by Banco del Pichincha and remain on the bank's books; interest therefore accrues directly to the bank.

The service company model was attractive to Banco del Pichincha for a variety of reasons—most importantly, in the words of Dávalos, the bank could experiment in the microfinance arena using a service company, allowing the operations to work "juntos pero no revueltos" (loosely translated: "together but not mixed up"). In this way, CREDIFE would be able to function somewhat autonomously, yet it still would be positioned to take advantage of synergies with the bank, including the bank's name recognition and its image as one of the most solid banks in Ecuador.[13]

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[12] For more information on the service company model and CREDIFE's experience with the model, see ACCION InSight No. 6, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," September 2003, available at http://www.accion.org/.

[13] Given the banking crisis and the failure of several banks in Ecuador in 1999–2000, the reputation of the surviving banks has been important for their image and operations in the market.

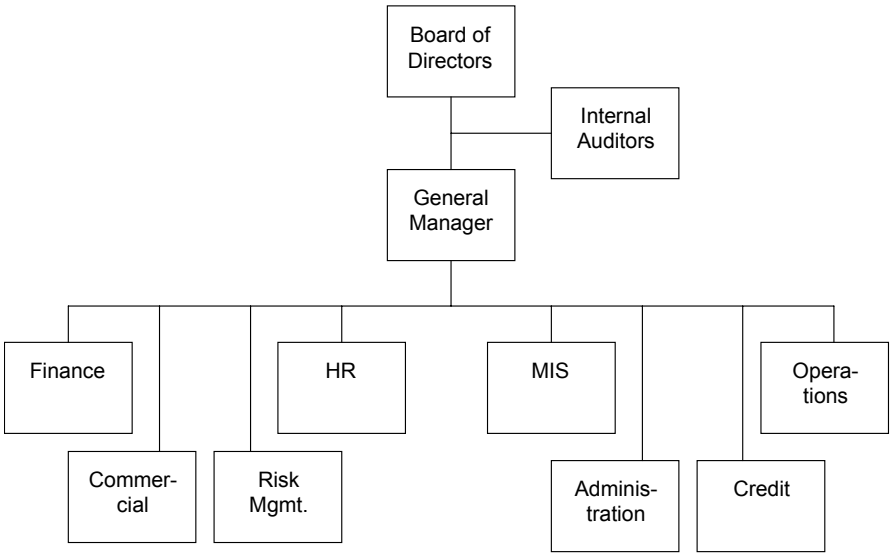
2.2.3 OWNERSHIP, GOVERNANCE, MANAGEMENT

CREDIFE is a subsidiary of Banco del Pichincha, which is the majority shareholder of the service company with 79 percent of all shares. There are two other strategic investors in the company: ACCION International, with 20 percent ownership, and Fundación Pichincha, the bank's foundation, with 1 percent.

CREDIFE's Board of Directors is composed of five directors and four alternates. Because it is a subsidiary of Banco del Pichincha, CREDIFE's governance parallels the governance of the bank, although Ernesto Dávalos, the Chair of CREDIFE's Board, is the only overlapping member between the two boards. The Chair of Banco del Pichincha's Board is very interested in CREDIFE's performance and personally designates the bank representatives on CREDIFE's Board. Therefore, the bank staff who participate on CREDIFE's Board—the Vice President of Personal Banking and the Vice President of Risk Management—dedicate several hours per week to CREDIFE, overseeing operational aspects. In fact, the responsibility for CREDIFE's performance falls within the Personal Banking Division of the bank. The other two strategic investors also have one seat each on CREDIFE's Board and actively participate in monthly Board meetings.

CREDIFE has a fully staffed management team, responsible for the operations of the service company and accountable to CREDIFE's Board of Directors.

FIGURE 2.1: CREDIFE ORGANIZATIONAL STRUCTURE



2.2.4 PRODUCT RANGE

Since its inception in 1999, CREDIFE has offered an individual loan product for working capital purposes. Loan sizes range between $300 and $5,000, with terms ranging between 3 and 12 months. In 2003, a fixed asset product was also introduced, with loan sizes ranging between $500 and $10,000 and

terms up to 3 years. Management is currently analyzing other potential products, including home improvement loans.

Clients who qualify for larger loans are automatically "graduated" to Banco del Pichincha loan products. This mainstreaming effect was one of the original goals of the bank when it entered microfinance. Although CREDIFE does not accrue income generated from these graduated clients, both the bank and the clients benefit from the graduation process, because the clients now have access to traditional commercial bank products.

CREDIFE clients are required to open a savings account with the bank, and loan proceeds are disbursed into that account. To date, no in-depth analysis of the amount of savings mobilized by CREDIFE clients has been conducted. However, CREDIFE management has begun to monitor the movement in the company's clients' savings accounts; the account maintenance fees that CREDIFE was paying the bank for 2003 could be reduced once average account balances are calculated. Currently, CREDIFE pays the account maintenance fee as if all clients maintain just the minimum required balance in their accounts at all times.

2.2.5 OPERATIONS

CREDIFE's head office is not located in the financial district of Quito, where Banco del Pichincha's head office is. Instead, CREDIFE's management team works downtown, where they come into daily contact with microentrepreneurs. There is a CREDIFE agency on the ground floor of the CREDIFE head office, and a bank branch next door.

CREDIFE works from agencies that are staffed by an administrator, credit officers, and assistants. The agencies depend on bank branches for teller services. By mid-2004, CREDIFE operated in 30 locations throughout Ecuador. The majority of its agencies are housed in Banco del Pichincha branches located in areas where there is a dense concentration of microentrepreneurs. Many of these areas were depressed, which caused the branches to be unprofitable and candidates for closure; with the arrival of CREDIFE, however, these branches now are flourishing because they are serving the needs of their "neighbors." Four CREDIFE agencies are located outside of bank branches because of space constraints. In addition, a number of small CREDIFE offices operate throughout the country and depend on agencies operationally. When there is sufficient demand for bank services in the zone served by these CREDIFE agencies and offices, they may be transformed into a bank branch.

3 PERFORMANCE ANALYSIS

3.1 OUTREACH BREADTH AND DEPTH

Although the original projections developed in 1998 showed a breakeven operation after three years of project launch and an attractive rate of return on equity, external factors quickly proved these projections to be overly optimistic. In early 1999, just as the bank and its strategic partners were preparing to launch CREDIFE, the economic depression that had been felt for the previous few years intensified and turned into a severe economic and financial crisis. This led to the resignation of Ecuador's President Jamil Mahuad and the eventual dollarization of the economy. With the severe crisis on hand, CREDIFE was not able to follow the original business plan. Although it did begin lending to microentrepreneurs in July 1999, the project began on a much smaller scale. Significant portfolio growth was not seen until 2001, when the portfolio grew from $782,616 at year-end 2000 to $3.5 million at year-end 2001. The steady, yet explosive, growth continued in 2002 and 2003, with the portfolio tripling each year, to $9.4 million at year-end 2002 and $28 million at year-end 2003. The client base also has grown significantly, from just 2,611 active clients at December 31, 2000, to more than 24,000 at year-end 2003. As is evident in Figure 3.1 and 3.2, the average loan size at CREDIFE increased significantly from 2002 to 2003, with average disbursements doubling from $731 to $1,469, which is similar to the average loan disbursed for the regulated Ecuadorian microcredit market in 2003, according to statistics from SALTO and the Superintendence.

FIGURE 3.1: CREDIFE LOAN PORTFOLIO

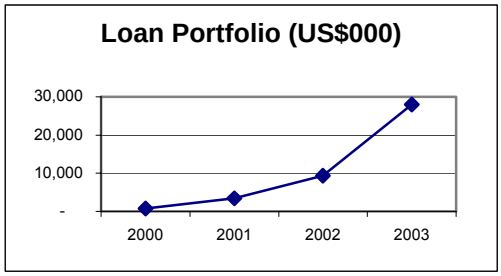
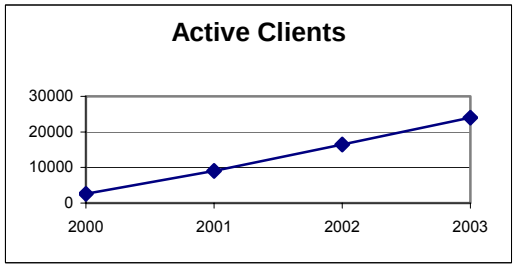


FIGURE 3.2: CREDIFE ACTIVE CLIENTS



3.2 PROFITABILITY "CULTURES" OF CREDIFE AND BANCO DEL PICHINCHA

CREDIFE's profitability has long been an important factor in its existence. However, Banco del Pichincha has not formally established profitability benchmarks for CREDIFE, nor does it compare CREDIFE's performance with other subsidiaries or bank products. Since CREDIFE's financial statements are ultimately consolidated into those of the bank, Banco del Pichincha, as 79 percent shareholder, is more concerned about overall profitability of the consolidated entity than about the allocation of profits between companies. Although CREDIFE has continually monitored its bottom line, with the preparation of monthly financial statements and breakeven analyses, it does not impute profitability of its operations to reflect a standalone microfinance institution (MFI) that owns its portfolio and accrues interest (to facilitate comparisons with other MFIs or bank lines of business).

More than product profitability, Banco del Pichincha focuses on branch performance, and its branch managers have extended an enthusiastic welcome to CREDIFE; one branch manager called it "super excelente." The reasons for the popularity of CREDIFE among branch managers is simply that it increases the loan portfolio of the branch, an indicator for which branch managers are responsible in terms of business targets, along with portfolio quality and number of clients, although they are not linked explicitly to bonus or incentive payements. CREDIFE's loans represent as much as 80 percent of the portfolios of some branches. Branch managers, however, estimate that they only spend about 30 minutes to one hour per week on CREDIFE so the increased portfolio is essentially "free" to them. Because branch managers do not have any formal responsibility for CREDIFE's portfolio, staff, or operations, the cost of their time is not allocated to CREDIFE when calculating profitability. Previously, an additional bonus to the branch managers was that CREDIFE's loans were not even in the branch targets, so managers were easily exceeding projected loan portfolio volumes. However, as of 2004, CREDIFE's loans are included in branch projections and targets. Branch managers are more concerned with increased portfolio than with the net effect on the branch's bottom line, given the current method of establishing branch goals and objectives within the bank.

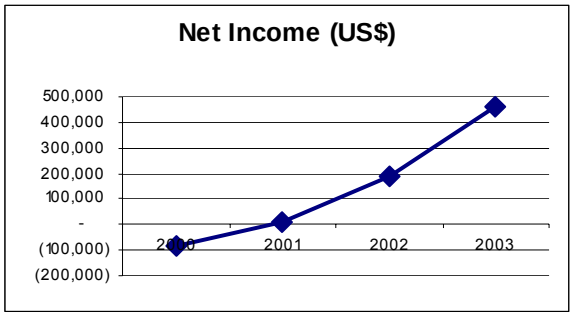
One might expect that branches experience an increase in deposits as well because of CREDIFE's presence. However, since deposits held by CREDIFE clients are not tracked separately, the impact of CREDIFE on branch deposits has not been measured and the branch managers do not consider the increased deposits as an advantage of having CREDIFE in their branches.

CREDIFE has begun to analyze its agency performance every few months. Its direct expenses include real personnel costs (CREDIFE staff) and expenses reimbursed to the bank, including transaction costs. CREDIFE then allocates the overhead of its head office to each agency according to the number of outstanding credits, because it is assumes that it takes the same amount of head office administrative time to manage a large loan as it does a small loan.

3.2.1 PROFITABILITY IN CREDIFE

Although Banco del Pichincha and its partners agreed not to expect such rapid returns as originally projected for CREDIFE, the importance of profitability in the decision-making process surrounding CREDIFE and its operations must not be underestimated. All parties involved readily agreed that losses are reasons to exit the market more than small profits are reasons to stay. CREDIFE made a very small profit for the first time in 2001, but it had not yet achieved the economies of scale necessary to sustain and increase returns. In fact, in mid-2002, when small losses were reported, shareholders determined that the service company would be given just six more months to show significant profits and then a decision would be made to either close it down or expand its outreach. The challenge was met and CREDIFE's sustainability has renewed the Board's commitment to microfinance. CREDIFE's audited net income over its first four full years of operations is illustrated in Figure 3.3.

FIGURE 3.3: CREDIFE NET INCOME



In mid-2002, when small losses were reported, shareholders determined that the service company would be given just six more months to show significant profits and then a decision would be made to either close it down or expand its outreach.

3.3 PROFITABILITY FACTORS

3.3.1 SUMMARY OF METHODOLOGY

CREDIFE's profitability is a result of its costs and revenue as determined by market factors and its agreement with Banco del Pichincha. The analysis conducted for this paper focused on the profitability of CREDIFE itself as well as its contribution to Banco del Pichincha. In order to conduct such an exercise, the researchers reclassified the revenue and expenses related to administration of the loan portfolio and incorporated them into CREDIFE's income statement. This included adjustments to consider the interest revenue earned directly by the bank, the administrative fee the bank pays CREDIFE and the interest CREDIFE pays the bank, provision expenses, and other indirect costs. The researchers also reclassified the balance sheet to incorporate the loan portfolio in order to more accurately calculate financial ratios. While these initial reclassifications do not have an effect on CREDIFE's bottom line, they do indicate more clearly the composition of costs and revenues and allow for a more accurate profitability analysis of the microcredit operations. A secondary level of analysis, which would be beyond the scope of this paper, would require a more detailed activity-based costing exercise for the bank to determine the exact level of the bank's indirect costs that should be allocated to CREDIFE's microcredit operations. Preliminary assumptions for reallocating these indirect costs are applied to demonstrate the possible effect such an exercise could have on the profitability of the microcredit operations. The following sections walk through the reclassification process and resulting financial statements and ratios.

3.3.2 REVENUES

CREDIFE's revenue mainly comes from two sources: Banco del Pichincha and the microenterprise clients. Banco del Pichincha compensates CREDIFE for servicing its loan portfolio in the form of an administrative fee, which is a fixed percentage of the loan portfolio. According to the agreement between the bank and CREDIFE, the fee will be reduced if delinquency in the microfinance portfolio increases above certain levels, which has yet to occur. The service company absorbs the risk of fluctuations in its own operating costs and those for which it reimburses the bank, plus extreme delinquency.[14] In addition to the interest clients pay to the bank, they also pay a commission directly to CREDIFE.

The interest rate charged to CREDIFE clients is established by the Banco del Pichincha's ALCO (Asset & Liability Committee). The present policy is to charge microfinance borrowers the same rate charged to the bank's consumer credit clients—the maximum allowed by the Central Bank. The commission paid by clients to CREDIFE varies based on the amount and term of the loan and is established according to a market study of effective rates charged by competing MFIs. Interest rate ceilings are established by the Central Bank on a monthly basis in Ecuador and are based on average rates charged in the financial system the previous month. Commissions charged to clients are not regulated by the Central Bank, however, so in essence the effective interest rate is regulated more by the market than by the Central Bank.

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[14] ACCION InSight No. 6, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," September 2003, available at http://www.accion.org/.

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3.3.3 EXPENSES

Until CREDIFE reached cumulative breakeven on a direct cost basis in November 2002, many indirect costs were subsidized by Banco del Pichincha. However, once it was determined that the service company was sustainable, a reimbursement scheme was put into place. Since 2003, CREDIFE pays the bank for operating costs ranging from use of space and related services in bank branch offices to the salary of its general manager, who is technically a bank employee. In most instances, costs reimbursed reflect actual expenses incurred by the bank; in the case of office space in branches owned by the bank, CREDIFE pays the same rate charged to other subsidiaries, which is a flat rental by square meter. However, CREDIFE is currently conducting market studies of costs for similar spaces to ensure that the price reflects fair market value. Other branch expenses are calculated as follows: telephone and cafeteria expenses are based on the number of CREDIFE employees in a branch compared to the number of bank employees in the branch; all other expenses (other utilities, depreciation, cleaning, insurance, security guards) are allocated based on the relative percentage of space used by CREDIFE personnel. Additionally, CREDIFE pays the bank "transaction costs," which include costs incurred to open an account (loan proceeds are disbursed into client savings accounts), loan disbursement, and repayment, as well as account maintenance fees.

Because the portfolio actually belongs to the bank, CREDIFE does not reimburse the bank for financial expenses such as cost of funds and provision expenses; rather, these costs are covered by the interest clients pay on loans directly to the bank. However, beginning in 2003, CREDIFE reimburses the bank for any write-offs of microenterprise loans. Certain other expenses, such as use of telecommunication lines and goodwill (use of the Banco del Pichincha name), as well as time dedicated to CREDIFE by Banco del Pichincha's Personal Banking staff, have not been calculated and continue to be covered by the bank.

Table 3.1 is an example of how some of the costs are divided between Banco del Pichincha and CREDIFE:

TABLE 3.1: DIVISION OF COSTS BETWEEN BANCO DEL PICHINCHA AND CREDIFE

Costs	Absorbed by or Paid by Banco del Pichincha	Directly Paid by or Reimbursed to the Bank by CREDIFE
Cost of funds	●	
Provision expenses	●	
Write-offs		●
Personnel		●
Transaction costs ($4.00/opening + $2.00/month)		●
Telecommunication lines	●	
Communication and other utilities expenses		●
MIS	● (software)	● (IT staff)
Collections		●
Rent ($8.00/sq. meter)		●

As of 2003, CREDIFE's audited income statement includes the income it actually earns (the administrative fees paid to it by the bank and the commissions paid to it by clients, as well as investment income); all direct CREDIFE expenses, including staff and head office expenses; and all costs it reimburses to the bank, including branch expenses and transaction costs. CREDIFE considers the portfolio and any reserves or write-offs as contingent liabilities on its balance sheet.

3.4 RECLASSIFICATIONS OF CREDIFE INCOME STATEMENT, 2003

In early 2004, with buy-in from the bank and CREDIFE's Board, an ACCION CAMEL[15] assessment of CREDIFE was conducted. The performance and profitability of the service company were analyzed, with all revenue and expenses related to the administration of the loan portfolio incorporated into CREDIFE's income statement. The exact revenue and expense accounts that were affected by this reclassification were the following:

Interest revenue: All interest earned on the microenterprise portfolio and registered on the bank's income statement was incorporated into CREDIFE's revenue on its own income statement.

Administrative fee: The fixed percentage fee paid by the bank to CREDIFE has been removed from CREDIFE's revenue because it technically is generated from the full interest revenue incorporated above.

Interest paid on bank loans: Cost of funds that correspond to financing the CREDIFE loan portfolio has been estimated and incorporated into CREDIFE's expenses on its own income statement. Financing for CREDIFE's loan portfolio comes primarily from deposits mobilized by the bank. A small percentage is also financed by international and development loans received by the bank and restricted to the CREDIFE portfolio, which actually carry a slightly higher interest rate than the bank's overall weighted average cost of funds, based solely on the interest rate paid to depositors.

Provision expense: Loan loss reserves are created by the bank for the CREDIFE portfolio, and the related provision expense was estimated (based on the portfolio quality at the end of 2003 and 2002 and the bank's provisioning policies) and incorporated into CREDIFE's financial statements.

Shadow costs: After covering the above expenses, Banco del Pichincha earns a net profit on the CREDIFE loan portfolio. This profit to the bank may be reduced by additional expenses that are not specifically allocated to CREDIFE operations, such as Personal Banking Division staff time, use of telecommunication lines, and other general cost allocations such as marketing. For this analysis, this entire value—the indirect costs and the residual profit received by the bank from CREDIFE—is considered a cost on CREDIFE's reclassified income statement.

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[15] ACCION International, a minority shareholder in CREDIFE through its ACCION Gateway Fund, has been interested in a complete analysis of the service company operations. The ACCION CAMEL assessment conducted in 2004 was financed by USAID/SALTO. For further information on the ACCION CAMEL, see Sonia B. Saltzman, Rachel Rock, and Darcy Salinger, *Performance and Standards in Microfinance: ACCION's Experience with the CAMEL™ Instrument*, ACCION International, 1998.

TABLE 3.2: RECLASSIFICATIONS OF CREDIFE INCOME STATEMENT, 2003 (US$)

	Debit	Credit
Interest revenue (Interest revenue received and registered by the bank.)		2,972,632
Administrative fees (Reversal of fees paid by the bank to CREDIFE.)	1,012,521	
Cost of funds (Weighted average cost of funds paid by the bank to finance the CREDIFE loan portfolio.)	651,441	
Provision expense (Provision expense incurred by the bank to maintain sufficient loan loss reserves on the CREDIFE portfolio.)	234,387	
"Shadow costs" (Difference between interest revenue received and other direct costs incurred by the bank on the CREDIFE portfolio (administrative fees, cost of funds, provision); includes indirect costs and residual net profit received by the bank from the CREDIFE portfolio.)	1,074,283	
TOTAL RECLASSIFICATIONS	$2,972,632	$2,972,632

TABLE 3.3: EFFECT OF RECLASSIFICATIONS ON CREDIFE'S INCOME STATEMENT, 2003 (US$000)

	AUDITED	Reclassifications	RECLASSIFIED	Reclassification as % Average Portfolio
Interest earned	0	2,973	2,973	15.9%
Commissions from clients	2,773	0	2,773	14.8%
Administrative fees from bank	1,012	1,012	0	0%
Financial expenses	0	-651	-651	3.5%
Provision expenses	0	-234	-234	1.3%
Operating expenses	-2,458	-1,074	-3,532	18.9%
Administrative expenses	-760	0	-760	4.1%
Investment income	64	0	64	0.3%
Net income before taxes	631	0	631	3.4%
Taxes & employee profit sharing	-170	0	-170	1.0%
Net income	461	0	461	2.5%

In sum, with the shadow costs serving as a "plug," the effect of the reclassifications shown in Table 3.3 on CREDIFE's bottom line is nil; net income both before and after reclassifications is $461,000. However, the reclassifications make it easier to see the true contributors to the service company's profitability. For example, after the reclassification, the true return on the portfolio is evident: interest earned plus commissions from clients is over $5 million.

In 2003, CREDIFE registered net operating income before taxes of $631,014, compared with 2002 net operating income of $246,000. However, in 2002 CREDIFE was not reimbursing the bank for any expenses incurred (transaction costs and operating costs). For comparative purposes, 2002 financial statements have been adjusted to include the cost of unreimbursed expenses, resulting in an adjusted net operating loss of $164,565.

3.5 RECLASSIFICATIONS OF CREDIFE BALANCE SHEET, 2003

The only reclassification to CREDIFE's balance sheet is the inclusion of the loan portfolio, as illustrated in Table 3.4. Because it is fully funded by deposits and international loans designated for CREDIFE, the corresponding entry increases liabilities. If CREDIFE were a standalone financial institution and not a service company, it would need to have more capital. Therefore, no capital adequacy ratios or return on equity are calculated because there is no relevance given the reclassification used in this exercise.

TABLE 3.4: EFFECT OF RECLASSIFICATIONS ON CREDIFE'S BALANCE SHEET, 2003 (US$ 000)

	AUDITED	Reclassification	RECLASSIFIED
Cash	39		39
Portfolio	0	27,988	27,988
Investments	1,175		1,175
Net fixed assets	158		158
Other assets	0		-
TOTAL ASSETS	1,414	27,988	29,402
Accounts payable	376		376
Other liabilities	276	27,988	28,264
TOTAL LIABILITIES	652	27,988	28,640
Capital	410		410
Retained earnings	352		352
NET WORTH	762		762
TOTAL LIABILITIES & NET WORTH	1,414	27,988	29,402

3.6 FINANCIAL RATIOS

Using the reclassified financial statements, the resulting financial ratios for CREDIFE indicate attractive returns. With a portfolio yield of 30.74 percent and operating expenses as a percent of average portfolio of 22.61 percent, the net return on portfolio (before taxes) was 3.38 percent. As a result, CREDIFE's financial self-sufficiency was 112 percent and its return on assets (ROA) was 3.3 percent. If the amount of Banco del Pichincha's indirect costs allocated to CREDIFE were reduced from what was considered

for this analysis, the operating efficiency ratio would be lower, raising the financial self-sufficiency and ROA indicators to even higher levels. Such a calculation may be appropriate but an accurate value cannot be determined without a more thorough costing exercise at Banco del Pichincha. As it stands, the net contribution of CREDIFE to Banco del Pichincha in 2003 was $1.44 million, or 7.63 percent of the bank's net income for the year.

TABLE 3.5: NET RETURN ON LOAN PORTFOLIO (2002 AND 2003)

	2003	2002	
		Adjusted	Unadjusted
Operating income	631,014	-164,565	246,000
Average loan portfolio	18,691,040	6,425,704	6,425,704
Net return on loan portfolio (before taxes)	3.38%	-2.56%	3.83%

The strong growth experienced at CREDIFE in 2003, along with a very healthy loan portfolio (that is, low arrears), allowed the service company to reach financial self-sufficiency in 2003, covering all expenses and shadow costs with operating revenue.

TABLE 3.6: FINANCIAL SELF SUFFICIENCY (ADJUSTED 2002 AND 2003)

	US$000	
	2003	2002
Adjusted revenue	5,810	2,291
Adjusted expenses	5,177	2,459
Financial self-sufficiency	112%	93%

Financial self-sufficiency was achieved despite a fall in the financial margin (net financial income/average loan portfolio) from 29.81 percent in 2002 to 25.97 percent in 2003, reflecting a decrease in the effective interest rate. The portfolio yield (interest & fee revenue/average gross portfolio), which closely approximates the effective rate at CREDIFE, given the high loan portfolio quality, fell from 35.65 percent in 2002 to 30.74 percent in 2003; the interest-only portfolio yield fell from 17.89 percent in 2002 to 15.90 percent in 2003 as a result of decreasing interest rate ceilings established by the Central Bank. Fee income relative to the average outstanding portfolio also fell from 2002 to 2003, from 17.76 percent to 14.84 percent. This fall is not related to any change in the commission structure; rather, it is a result of increased disbursements along with a slight extension in loan term from an average of six to seven months in 2002 and 2003, respectively.

TABLE 3.7: FINANCIAL MARGIN AND PORTFOLIO YIELD (2002 AND 2003)

	2003	2002
Financial margin	25.97%	29.81%
Portfolio yield (interest & fees)	30.74%	35.65%
Interest	15.90%	17.89%
Fees	14.84%	17.76%
Portfolio at risk > 30 days	1.09%	2.12%

A key contributor to the achievement of financial self-sufficiency was CREDIFE's operating efficiency during the period. Once the above-mentioned operating expense adjustments are made, the adjusted operating efficiency ratio (measured as total operating expenses/average gross loan portfolio) is 22.61 percent in 2003, compared with 32.37 percent in 2002. The strong portfolio growth led CREDIFE to the economies of scale necessary to efficiently manage its portfolio. At December 31, 2003, CREDIFE's loan officers were managing an average of 256 clients each, compared with 213 at December 31, 2002. The increased productivity was achieved despite the need to increase the number of loan officers (from 77 at December 31, 2002, to 94 at December 31, 2003) to handle the portfolio growth. The more mature loan officers at CREDIFE were handling up to 400 clients each at December 31, 2003.

TABLE 3.8: OPERATING EFFICIENCY (2002 AND 2003)

	2003		2002	
	Original	Reclassified	Original	Reclassified/ Adjusted
Operating expenses/ Average portfolio	16.86%	22.61%	19.80%	32.37%

Another important factor contributing to the improvements in the operating efficiency ratio is the increased loan size mentioned previously. The average loan portfolio managed by CREDIFE loan officers at December 31, 2003, was 140 percent larger than the previous year, and the average outstanding loan balance was double that at December 31, 2003.

TABLE 3.9: PRODUCTIVITY (2002 AND 2003)

	US$	
	12/31/03	12/31/02
Average outstanding loan balance	1,164	571
Loan portfolio/Loan officers	297,746	121,999

3.7 CHALLENGES THAT AFFECT PROFITABILITY

Like any microfinance institution, CREDIFE faces external challenges with increased competition and government regulations on interest rates. Internal challenges include maintaining productivity and efficiency while maintaining portfolio quality.

Because of its service company status, an interesting dilemma facing CREDIFE as it attains high levels of profitability is what to do with earnings. Traditional MFIs would usually have no choice but to invest the bulk of their earnings into growing their loan portfolios. However, because CREDIFE is not the owner of the loan portfolio, it cannot invest in this directly. Instead, CREDIFE's only options are paying dividends, capitalizing some earnings, and utilizing earnings for fixed assets and investments. In order to make more profitable investments, CREDIFE may need to make changes to its legal status and bylaws; it has already begun preliminary discussions with supervisory agencies in Ecuador to explore such options.

Finally, it is interesting to consider the profitability of the microfinance operation if CREDIFE were a standalone entity that allocated all costs and revenues directly to the microcredit operation. This involves using the reclassified figures from the CAMEL analysis and conducting an indirect cost allocation exercise for the bank's other costs to consider some portion of the $1,074,000 of "shadow costs" as actual costs and the remainder as contributing to the net income of the microfinance operation. This adjustment obviously increases the profitability of the microfinance operation substantially. The analysis conducted above with 100 percent considered operating expenses is the most conservative option; 100 percent considered as profit would overstate the returns. Only a detailed cost allocation or activity-based costing analysis of Banco del Pichincha would provide an exact figure. For the purposes of this exercise, 80 percent of the shadow costs will be considered net income to the microfinance operation, and the remaining 20 percent—senior management time, use of telecommunication lines, and other bank overhead not already allocated directly to CREDIFE—will remain costs. The results of this analysis are shown in Table 3.10.

3.7.1 PROFITABILITY COMPARISONS

When CREDIFE's short history is taken into account, the profitability levels it has demonstrated compare favorably to other microfinance institutions. Experience has shown that traditional start-up MFIs take a minimum of three to five years to reach breakeven, and CREDIFE was no exception, achieving breakeven on an adjusted basis in April 2003.

TABLE 3.10: PROFITABILITY COMPARISONS, DECEMBER 31, 2003

	CREDIFE (Reclassified, including 20% allocation of bank's estimated indirect costs)	CREDIFE (Reclassified, including 100% allocation of bank's estimated indirect costs)	Average Ecuadorian MFIs*	Average of financially self-sufficient Latin American MFIs**
ROA (before tax)	7.6%	3.2%	4.4%	4.4%
Financial self-sufficiency	135%	112%	114%	122%
Operating efficiency	18.4%	22.6%	16.4%	20.7%
Portfolio at risk > 30 days	1.1%	1.1%	1.8%	3.7%
Loans/Officer	256	256	419	398

* Proyecto SALTO's eight MFIs include four cooperatives that operate very differently from banks, so comparisons must be made cautiously. ** MicroBanking Bulletin Issue #9. Data are from 2001 and 2002.

To date, Banco del Pichincha's entrance into microfinance via the service company CREDIFE appears to be a win-win situation for both parties as well as the overall microenterprise sector in Ecuador. CREDIFE's estimated contribution to the bank's net income is illustrated in table 3.11.

TABLE 3.11: CREDIFE'S CONTRIBUTION TO BANCO DEL PICHINCHA'S BOTTOM LINE, 2003

	US$000
Financial revenue	2,973
Financial cost	(651)
Provision for loan loss expense	(234)
Portfolio management fee	(1,012)
79% net income of CREDIFE	364
Net contribution	1,440
BP net income	18,884
CREDIFE's contribution/BP net income	7.63%

Note: Transaction and infrastructure fees paid by CREDIFE to the bank are not included as revenue to the bank because it is assumed that CREDIFE is reimbursing actual costs incurred by the bank. However, it could also be assumed that these were underutilized resources and therefore have no marginal cost or little marginal cost to the bank. If this assumption is used, then the net contribution is even greater.

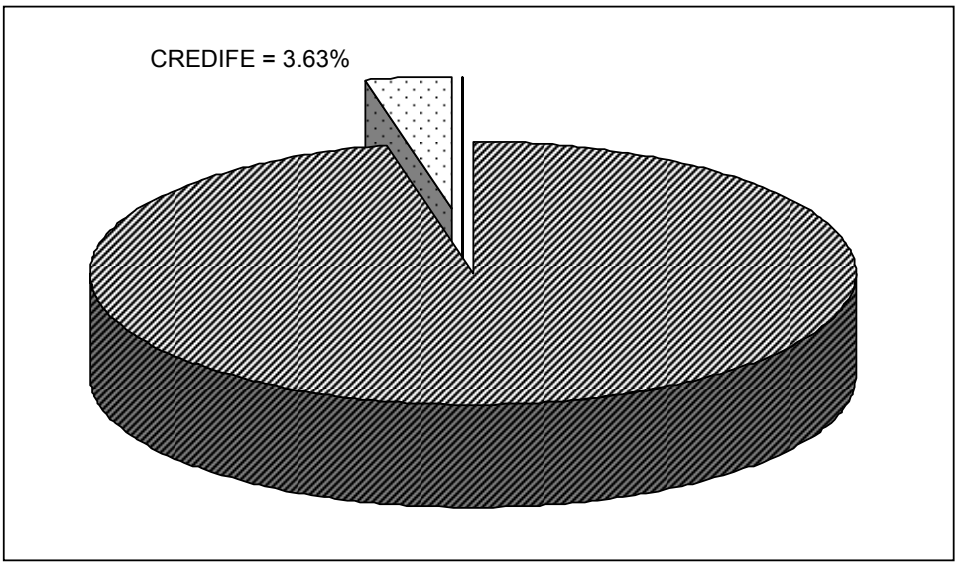
CREDIFE's portfolio, on the other hand, represents a mere 3.63 percent of the bank's total portfolio, implying that CREDIFE is more profitable than some other business/market segments of the bank. Overall, CREDIFE's ROA (using the reclassified balance sheet) compares favorably to that of the bank: 3.21 percent and 1.17 percent in 2003, respectively. Moreover, if CREDIFE's net contribution to the bank of $1.44 million (from the above table) were considered as earnings, the returns would more than double.

TABLE 3.12:

	CREDIFE	Banco del Pichincha
Return on assets, before taxes and employee profit sharing	3.21%	1.17%

Note: Banco del Pichincha data from the Ecuador Bank Superintendence Web site: www.superban.gov.ec.

FIGURE 3.4: CREDIFE'S PORTFOLIO WITHIN BANCO DEL PICHINCHA'S LOAN PORTFOLIO



4 CONCLUSIONS

CREDIFE's profitability can be attributed to many factors, including but not limited to:

- Its relationship with Banco del Pichincha; specifically, its ability to leverage the bank's existing infrastructure and liquidity;
- Its controlled operating expenses (other new microfinance institutions have registered operating efficiency ratios of upwards of 100 percent during the first three to five years);
- Its high portfolio quality;
- Its recent expansion; and
- Its ability and willingness to charge interest rates and commissions higher than other product lines.

How much of CREDIFE's success can be attributed to the service company model? As a separate legal entity, CREDIFE enjoys a certain degree of autonomy in its operations, allowing for timely decision making and definition of strategies and objectives. On the other hand, if a bank's board can delegate governing authority to an advisory group or committee, perhaps an internal unit can enjoy the same autonomy. Ultimately, a service company of which 50 percent or more is owned by the bank is a subsidiary of the bank and the bank's board is responsible, which, from a governance perspective, makes it not so different from a unit operating within the bank.

Despite running the risk of duplicating efforts, CREDIFE has a full head office staff, including finance and accounting, MIS, human resources, credit, and risk management departments. This could appear to be an unnecessary increase in expenses, but CREDIFE's staff are specialized and trained in microfinance. However, under the model of an internal unit, a bank could still have specialized personal who understand the intricacies of microfinance and who may or may not be centralized in the same department. The costs related to such staff in a service company are transparent and easily identifiable; if, on the other hand, an internal unit relies on bank staff outside of the unit, allocation of personnel and overhead becomes a challenge when trying to fully allocate costs to the microfinance business.

Another advantage to CREDIFE of its status as a legal entity separate from the bank is its image, both in the bank and in the marketplace. It is viewed as an institution dedicated to microfinance. Staff can dedicate 100 percent of their efforts to growing the microfinance portfolio, without having to justify the institution's small size relative to the overall bank.

Given its legal structure, CREDIFE is not permitted to hold deposits. Because CREDIFE is viewed as a portfolio management company, Banco del Pichincha is not concerned with identifying deposits mobilized by its customers. Instead, the bank credits deposits to the branches. Thus, the impact of those deposits on the profitability of CREDIFE is nil. The impact could be imputed if the MIS were capable of easily segregating these deposits, which is not the case in Banco del Pichincha. If, on the other hand, CREDIFE were able to hold deposits, impact of deposits on profitability would be obvious.

CREDIFE's profitability is directly related to the agreement it negotiated with Banco del Pichincha, which gives the majority of the net profits generated from the microfinance portfolio to the bank. As a result, dividends and employee profit sharing are lower. If CREDIFE were a unit within the bank, all of the interest earned would be attributed to the unit. In the end, profits of both the service company and an internal unit are consolidated into the bank's earnings, so the bank's focus on its overall

bottom line is understandable. Moreover, during the first four years of operation, the bank subsidized CREDIFE's operations and bore the greatest risk.

In conclusion, it is not necessarily the model that dictates the profitability of the microfinance business within a commercial bank. Instead, success depends on the MFI's ability to balance autonomy, specialization, and efficiency with leveraging the bank's assets (infrastructure, liquidity, reputation) and taking advantage of the synergies derived from its relationship to the bank.

4.1 ISSUES FOR THE FUTURE

While CREDIFE and Banco del Pichincha have taken important steps in determining the profitability and contribution of microcredit to the bank, a more detailed analysis could provide important data for future decision making. An exercise to more accurately determine the full cost and contribution of CREDIFE to the bank should include an activity-based costing analysis to estimate the level and amount of indirect costs and bank overhead that should be attributed to CREDIFE.. In addition, the analysis should include the contribution of CREDIFE to generating clients for other bank services, including deposit mobilization, small enterprise borrowers, etc. Finally, the exercise should calculate CREDIFE's contribution to covering the bank's fixed costs, such as rent for space CREDIFE uses in branches.

4.2 CREDIFE'S RECOMMENDATIONS FOR BANKS ENTERING THE MICROFINANCE MARKET

CREDIFE's rapid ascent in becoming an important and profitable provider of microfinance in Ecuador serves as an inspiration to other commercial banks sharing the same vision. CREDIFE's recommendations to other banks contemplating entering microfinance, and to banks struggling with making microfinance a significant contributor to the bank's profitability, include the following:

- The service company model may facilitate portfolio growth, but does not in and of itself solve all of the challenges.
- The service company model facilitates growth and therefore absolute income, but may not have as profitable margins as a unit within the bank due to duplication of efforts.
- Great care must be taken in negotiating the formal agreement between the bank and the service company because it will determine how the risks and profits are distributed between the two entities.
- The microfinance program must have a dedicated and well-positioned general manager, tied closely to and respected in the bank. (CREDIFE's present general manager previously worked in Banco del Pichincha's retail division and managed 13 branches, so he came to CREDIFE with a good working relationship with the branch employees.)
- The service company's board, if it is a separate legal entity, must be formally linked to the bank's board, with at least one common member. Other board members should represent key areas from bank operations on which the microfinance subsidiary will depend.
- Management and board members must remain flexible enough to make adjustments as they learn from mistakes and as the market changes.

- Management and board members must know whether the bank's name is perceived positively or negatively by the microentrepreneur market segment and position the microfinance outlets accordingly.
- Caution must be taken regarding uncontrolled/unplanned/too rapid growth.
- Caution must be taken in replicating CREDIFE in other countries; the model must be adjusted to reflect the external environment and the internal reality of each bank.