



USAID
FROM THE AMERICAN PEOPLE

microNOTE 17

Opening Markets through Strategic Partnerships – Credife¹

Service Company Success

By mid-2004, CREDIFE operated in 30 locations throughout Ecuador, primarily in areas where there is a dense concentration of micro-entrepreneurs. Many of these areas were depressed, leading to branch profitability concerns, making them candidates for closure. The arrival of CREDIFE has helped generate more business for these branches, now flourishing and better meeting the needs of their communities.

March 2006

This publication was produced for review by the U.S. Agency for International Development. It was prepared by Development Alternatives, Inc.

U.S. Agency for International Development
www.usaid.gov

INTRODUCTION

As more and more commercial banks become intrigued by the idea of entering the microfinance market, the lessons learned from some of the more experienced players become crucial in evaluating requirements and potential benefits. While many banks enter the microfinance sector to meet socially responsibility requirements, be these internal or external, commitment to the sector tends to be determined by the program's contribution to bank's profitability. As a result, determining cost and revenue drivers is key to the driving the business. Once the bank is convinced that the net operating margin of microfinance products is within the bank's acceptable range, the challenge becomes growing the business to ensure long-term profitability.

The objective of this case study is to measure the profitability of a microfinance unit. CREDIFE, an Ecuadorian service company, was chosen as the subject of the study because its experience and relationship with the financial institution and majority owner, Banco del Pichincha, are straightforward and transparent. CREDIFE's success in terms of rapid growth and contribution to Banco del Pichincha's profitability show how a private commercial bank can become a significant player in the microfinance market in a relatively short time.

¹ This microNOTE is based on the Accelerated Microfinance Advancement Project (AMAP) Financial Services Knowledge Generation (FSKG) report, *Case Study on Profitability of Microfinance in Commercial Banks: CREDIFE*, prepared by Lynne Curran and Nancy Natilson. The full report is available on <http://www.microlinks.org>.

SERVICE COMPANY MODEL

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 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.

Because it follows 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 as a way to enter the microfinance arena and be positioned to take advantage of synergies between the bank and the service company.

OPERATIONS

CREDIFE works from agencies, the majority housed in Banco del Pichincha branches 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, primarily in areas where there is a dense concentration of micro-entrepreneurs. Many of these areas were depressed, leading to branch profitability concerns, making them candidates for closure. The arrival of CREDIFE has helped generate more business for these branches, now flourishing and better meeting the needs of their communities.

A small number of CREDIFE offices that operate throughout the country are not housed in branches. Once sufficient demand for bank services is generated in these areas, there is the potential for the bank to transform them into a branch.

PERFORMANCE

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. As a result, significant portfolio growth did not occur until 2001, when the portfolio grew from \$782,616 at the end of 2000 to \$3.5 million at the end of 2001. The growth continued in 2002 and 2003, with the portfolio tripling each year, to \$28 million at the end of 2003. The client base followed the same trend growing from 2,611 active clients at the end of 2000, to more than 24,000 at the end of 2003.

While Banco del Pichincha has not yet formally established profitability benchmarks for CREDIFE, its ability to be profitable has been crucial in its continued existence. CREDIFE does generate financial statements which allow it to measure performance; however, because of the relationship with the bank, these statements are not prepared in such a way to facilitate

comparison with other standalone microfinance institutions (MFIs).

Summary of Methodology

The analysis conducted focused on the profitability of CREDIFE itself as well as its contribution to Banco del Pichincha. To conduct such an exercise, the researchers reclassified the revenue and expenses related to administration of the loan portfolio as well as the balance sheet in an effort to more accurately calculate financial situation.

Revenues

CREDIFE's revenue is derived from two sources: Banco del Pichincha for servicing its loan portfolio in the form of a fixed percentage of portfolio, and commission derived from microenterprise clients and paid directly to CREDIFE. 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.

Expenses

CREDIFE pays the bank for its operating costs, ranging

from use of space and related services in bank branch offices to the salary of its general manager, 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. 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.

As the portfolio forms part of the bank's balance sheet, CREDIFE does not reimburse the bank for financial expenses such as cost of funds and provision expenses. However, beginning in 2003, CREDIFE reimburses the bank for any write-offs of microenterprise loans.

RECLASSIFICATION OF 2003 FINANCIAL STATEMENTS

Income Statement

In early 2004, with buy-in from the bank and CREDIFE's Board, an ACCION CAMEL 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 revenue and expense accounts that were affected by this reclassification were the following:

Interest revenue: Interest income was recognized under CREDIFE's income statement.

Administrative fee: The fixed percentage fee paid by the bank was removed from the income statement.

Interest paid on bank loans: Cost of funds was incorporated into CREDIFE's income statement.

Provision expense: Loan loss reserves and the related provision expenses were incorporated into CREDIFE's financial statements.

Shadow costs: Costs related to operations, such as marketing, bank staff, and the like that had not been considered in bank fees, were incorporated into the income statement.

In sum, with the shadow costs serving as a "plug," the effect of the reclassifications 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 more than \$5 million.

Balance Sheet

The only reclassification to CREDIFE's balance sheet is the inclusion of the loan portfolio and corresponding liabilities. Given that capital requirements of service companies differ from those of traditional MFIs and that capital has not been adjusted in this case, capital adequacy ratios and return on equity ratios are not presented.

FINANCIAL RATIOS

Based on adjusted financial statements, the resulting indices for CREDIFE are positive. These include:

- Portfolio yield of 30.74 percent.
- Operating expenses as a percentage of average portfolio of 22.61 percent.
- Net return on portfolio (before taxes) of 3.38 percent.
- Financial self-sufficiency of 112 percent and a return on assets of 3.3 percent.

These results can be attributed to strong portfolio growth since 2002, low levels of arrears, increased loan officer productivity, and an overall improvement in operational efficiency. Taking into consideration CREDIFE's short history, the institution's financial situation compares

favorably to that of other MFIs.

CONCLUSIONS

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.

Despite the potential of duplicating efforts, CREDIFE has elected to maintain a full head office staff. This is justified by the need to ensure staff is specialized in microfinance and therefore better able to manage the business.

Given its legal structure, CREDIFE is not permitted to hold deposits, hence the impact of those deposits on the profitability of CREDIFE is nil. If the company had the required license to capture deposits, it might result in a positive impact on profitability.

And finally, a case can be made that success depends on the MFI's ability to balance autonomy, specialization, efficiency in leveraging the bank assets, and taking advantage of the synergies derived from its relationship to the bank.

ISSUES FOR THE FUTURE

While CREDIFE and Banco del Pichincha have taken important steps in determining the financial contribution of the microfinance sector to the bank, a more detailed analysis would be beneficial in proper decision making. An activity-based costing analysis would provide a more precise picture of CREDIFE's financial results.

CREDIFE's Recommendations for Banks Entering the Microfinance Market

As many banks are analyzing the proper method through which to enter the microfinance sector, CREDIFE suggests the following be considered:

- The service company model may facilitate portfolio growth, but does not in and of itself solve all of the challenges.
- Careful planning is required to ensure efforts are not duplicated.
- Crucial to the partnership are the terms and conditions negotiated.
- The microfinance program must have a dedicated and well-positioned general manager, tied closely to and respected in the bank.
- The service company's board, if it is a separate legal entity, must be

formally linked to the bank's board.

- Management and board members must remain flexible enough to make adjustments as they learn from mistakes and as the market changes.
- In determining points of service, consideration must be given to market perception of bank.
- Growth must be carefully managed.
- The model may not have similar results in other countries because all factors must be evaluated.

DISCLAIMER

The views expressed in this publication do not necessarily reflect the views of the U.S. Agency for International Development or the U.S. Government.