Microfinance Enters the Marketplace

by
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ABSTRACT

The past few years have seen an acceleration in the creation of commercial microfinance programs. The demonstration effect of profitable microfinance institutions (MFIs), combined with market forces in newly-liberalized financial markets, created the conditions for this rapid expansion. Bolivia, Chile, Paraguay, Uganda and Bangladesh are the focus countries for this paper, although the authors draw examples from other countries as well.

In these countries, new commercial entrants, such as consumer lenders, commercial banks, and state banks, are changing the microfinance industry. With growing numbers of clients, service providers are now in direct competition with each other, often for the first time. In response to commercial entry and increased competition, microfinance programs are seeking to improve services, develop new products, introduce cost-saving technology, and lower prices. While these changes can benefit the customers, they also bring risks for institutions and their clients, including the risk of overindebtedness by customers and the likelihood that not all current providers will survive.

This paper considers the implications of these changes for clients and for the institutions that helped create the field of microfinance—non-governmental organizations (NGOs), governments, and donors. The authors contend that these groups will need to rethink their microfinance strategies in light of the rapidly changing marketplace.

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Acronyms

ABSA	Amalgamated Banks of South Africa
ASA	Association for Social Advancement
ADEMI	Asociacion para el Desarrollo de la Microempresa
ATM	Automated Teller Machine
BRI	Bank Rakyat Indonesia
BURO	Buro Tangail
FFP	Private Financial Funds
FIE	Centro de Fomento a Iniciativas Economicas
FINCA	Foundation for International Community Assistance
IDB	Inter-American Development Bank
IPC	Interdisziplinare Projekt Consult
MFI	Microfinance Institution
PRODEM	Fundacion para la Promocion y Desarrollo de la Microempresa
PROPESA	Corporacion de Promocion para la Pequeña Empresa
SEEP	Small Enterprise Education and Promotion Network
SEWA	Self Employed Women's Association
USAID	United States Agency for International Development

Introduction

MICROFINANCE ENTERS THE COMMERCIAL STAGE[1]

In the past few years, powerful changes have been taking place in microfinance, setting the stage for a fundamental transformation of the field. These changes are opening the sheltered domain of microfinance, once the preserve of donors and development organizations, to the broader financial marketplace.

In a handful of countries, a competitive market is emerging in the provision of financial services to the poor. Low-income clients in Bolivia, Chile, Paraguay, Bangladesh, parts of Uganda, and several other countries can now choose between a number of high quality microcredit options and soon may be able to open passbook savings in a variety of microfinance institutions. Although many or most of the institutions providing these services were created by organizations focused on development, some recent entrants have primarily commercial motivations in reaching low-income clients. These new entrants are bringing with them new skills, technologies, and comparative advantages. The competition between microfinance service providers is sparking innovation at a fast pace.

The emergence of the broader microfinance market offers several exciting prospects for those involved in development finance. It suggests that the challenge of scale (reaching the enormous potential demand), may be met in the foreseeable future, as the market develops in new countries. It suggests that, once there is a competitive marketplace in a given country, services will continue to expand with fewer or no further public subsidies. It also suggests that low-income clients will be given a wider range of more convenient, lower cost services.

For the development professionals who have identified themselves as microfinance practitioners or supporters, the emergence of the market for microfinance has serious implications, which have not yet been fully explored. Donors, governments, and NGOs will need to reconsider their strategies in new circumstances. Until now microfinance has been driven fundamentally by development concerns, most importantly higher incomes for the poor. Increasingly, microfinance will be driven by the twin concerns of the competitive marketplace: market share and profits. The microfinance community has yet to fully come to terms with the implications of such a shift.

This paper seeks to describe the dimensions and the nature of the changes now taking place, with a focus on Bolivia, Chile, Paraguay, Bangladesh and Uganda, where the emergence of the microfinance market is relatively advanced—although trends described here are also evident in a number of other countries. The paper introduces new entrants, including consumer credit institutions, private commercial banks, and transforming state-owned development banks. It examines how MFIs respond to newly-competitive conditions and new technologies. Finally, it offers some reflections on the implications of these changes for clients, NGOs and other microfinance providers, governments, and donors. First, however, it may be helpful to lay the groundwork by describing the forces that have created the current situation.

[1]This paper is largely based on the authors' direct experience and observation, supplemented by interviews with key people in several countries. We would like to thank those people who gave us their insights and helped us collect information: Stuart Rutherford (Bangladesh); Ann Ritchie, Michael McCord, and Jim Gohary (Uganda); and Roland Pearson (South Africa). Jennifer McDonald provided nearly all the input on Paraguay. We would also like to thank Kate McKee and Liza Valenzuela of the USAID Office of Microenterprise Development for their support at all stages in preparing this paper.

Part 1

THE CHANGING ENVIRONMENT FOR MICROFINANCE

The microfinance community and the mainstream financial sector were largely separate throughout the 1980s and early 1990s, but are now converging to create the conditions that are transforming microfinance. The self-defined microfinance community once operated largely outside the larger mainstream financial sector. During the past 15 years, however, both have changed in ways that have brought them closer together and now make their confluence inevitable.

The Microfinance Community Demonstrates Financial Viability

The microfinance community began to identify itself as a distinct development field in the early 1980s, when its pioneering institutions—such as Grameen Bank, Bank Rakyat Indonesia (BRI), and the early ACCION International affiliates—began to produce surprisingly positive results. These institutions demonstrated products and service delivery methods that reached the poor, generated high repayments, covered costs, and could be taken to significant scale. Ever since, the microfinance community has focused on building institutions to deliver these products and services, and spreading microfinance methods around the world.

Important parts of the community focused on the search for mechanisms to attract commercial funding and investment into microfinance. The "financial systems approach" stressed the ultimate goal of integration with the financial sector as the only way to ensure that microfinance could achieve large-scale outreach without continued donor dependency.[2] As a result of the efforts of organizations which adopted this approach, many of today's leading microfinance institutions operate as fully commercial entities that serve microfinance clients. They mobilize loan funds from commercial sources and/or savings deposits. Some are structured as for-profit entities, or as parts of for-profit entities, with shareholders who aim to profit from their investments. Their operations are in fact profitable, and they serve significant numbers of clients. Examples include: BancoSol and Caja de Ahorros y Préstamos los Andes in Bolivia; Asociacion para el Desarrollo de la Microempresa (ADEMI) in the Dominican Republic; Financiera Calpia in El Salvador; Banco Solidario in Ecuador; Association for Social Advancement (ASA) and Buro Tangail (Buro) in Bangladesh; the Cooperative Bank of Uganda; Self Employed Women's Association (SEWA) Bank in India; and BRI. At present, these and similar institutions

[2]Rhyne, Elisabeth and Maria Otero, "Financial Services for Microenterprises: Principles and Institutions," in *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor*, Maria Otero and Elisabeth Rhyne, eds. Kumarian Press: West Hartford, Connecticut: 1994.

dominate microfinance in their countries, both in terms of numbers of clients served and institutional capability.

These and similar institutions have laid the groundwork for the transformation that is beginning. With their operations that are "open books" for prospective competitors, their profit levels and scale of operations are attracting the attention of mainstream institutions and creating the possibility of entry by commercial actors. Initiatives such as the ACCION CAMEL, the Private Rating Service, and the *MicroBanking Bulletin* contribute to the generation of credible information on the financial results of leading microfinance institutions. These institutions have brought microfinance to the point at which integration with the financial system, long an ultimate goal, is now an immediate prospect.

The microfinance community is only beginning to face the profound changes coming in the market. Even now, microfinance remains largely the preserve of donors, NGOs, and related players. The best-known examples of commercialization, including nearly all the institutions just listed, depended on donor funding and specialized technical assistance in their early stages of development and were ultimately driven by altruistic motivations. Poverty alleviation, job creation, and empowerment continue to motivate these participants in the microfinance community, even those devoted to achieving commercial standards of operation. However, the new conditions and new entrants into microfinance are bringing different motivations, and their entry will break down the comfortable barriers behind which microfinance has operated.

For microfinance practitioners the old adage is becoming relevant: "Be careful what you wish for because you might get it."

Forces Transforming the Financial Sector

In the early 1980s, when microfinance began to emerge, the financial sector environment in most developing countries ensured that mainstream institutions would have little interest in micro-level clients. In most countries, financial systems operated under a set of policies now referred to as financial repression: interest rate controls; limited entry into the financial sector; crowding out of private investment by government (and parastatal) credit requirements; and directed credit. Given these policies, financial institutions had little incentive to mobilize deposits and less incentive to experiment with lending to unconventional clients. Clients on the margins were served, if at all, by highly subsidized, government-owned development banks or directed credit programs.

Financial sector liberalization has changed (or is changing) this situation. The following features characterize the financial sector in those countries where liberalization has proceeded farthest, such as Chile:

▲ Entry by foreign banks has increased competition throughout the financial market, particularly for high-end clients, throughout the financial market. In Latin America, Spanish banks have bought control of many local banks. In Africa, South African banks are investing throughout East and southern Africa.

▲ Interest rate deregulation has allowed banks pricing flexibility, opening a range of potentially profitable market niches. New financial products are being introduced, including a range of retail products.

▲ Open exchange rate policies, free interest rates, and other measures make the local financial sector more attractive to savers and are reducing capital flight. Total assets in the financial sector are increasing (financial deepening), and banks are experiencing excess liquidity.

▲ The development of capital markets, including stock markets and pension reform, has drawn high-end corporate clients away from commercial banks as primary sources of finance.

▲ Large, subsidized national development banks have gone bankrupt as subsidies have been withdrawn; the immediate effect is fewer services for marginal clients. Rural banking infrastructure, dependent on such institutions, may be shut down, particularly when the institutions are privatized.

Taken together, these changes mean that private banks are far more interested in finding new opportunities for profit than they were a decade earlier. Their competition has increased, while some of their prime customers have moved on, and they know that if they find a lucrative market, they will be allowed to price for profits. These conditions have unleashed major expansion and innovation in financial products throughout the financial systems of liberalized countries. Retail finance, in particular, has developed and now offers products such as home mortgages, leasing and hire purchase, insurance, credit cards, and consumer finance. Banks increasingly see smaller businesses and middle-income households as potential clients. And a few banks have noticed the much larger numbers in the low-income sector market. For those that look to this market segment, the profitable MFIs noted earlier offer concrete evidence of profit potential. The recent worldwide turmoil in financial markets may only serve to underscore the comparatively low risk of downmarket operations. Early evidence from Asia suggests that microfinance programs such as BRI have been fairly stable.[3]

Financial sector changes also pose a dilemma for governments, which have dinosaurs on their hands in the form of state-owned development banks. Governments want to protect their budgets from the costs or continuing losses that these banks accumulate, but they still want to ensure that marginal clients are served, particularly in rural areas. Many such institutions (or their governmental overseers) are seeking a revitalizing formula that will give them a more profitable mission.

The forces creating the conditions to interest mainstream financial institutions in microfinance are already having an effect. New initiatives are appearing, as the following sections demonstrate.

[3]McGuire, Paul, "The Asian Financial Crisis: Some Implications for Microfinance," *MicroBanking Bulletin*, Issue 2, The Economics Institute. Boulder, Colorado: 1998.

The Microfinance Scene Today

The changes in both the microfinance community and the financial system in several countries have brought microfinance to an unprecedented competitive level, characterized by several large, mature service providers and numerous smaller ones.

Microfinance and financial sector liberalization are converging most rapidly in Latin America, where both have progressed the farthest. In these countries, many new entrants into microfinance are purely commercial. In other regions, such as South Asia (Bangladesh) and East Africa (Uganda), competition is emerging in a smaller number of countries, largely through the increasing scale of donor-supported microfinance programs. Even in these countries, however, more commercially-oriented entrants, while still backed by donors, are challenging other institutions. The following sketches of microfinance programs in selected countries focus on quantitative descriptions, including active clientele and loan portfolio size. As discussed in subsequent sections of the paper, when microfinance attains a certain market share, qualitative changes in microfinance program services and products begin appearing.

Bolivia. Led by BancoSol, Fundacion para la Promocion y Desarrollo de la Microempresa (PRODEM), Centro de Fomento a Iniciativas Economicas (FIE), and Caja de Ahorros y Prestamos los Andes, Bolivia's microfinance sector has had a strong orientation toward commercial-level operations. Most of the momentum has come from NGOs transforming into regulated financial institutions, but recently some banks and finance companies have started to provide microfinance services. The push toward commercialization in Bolivia has been assisted by the government's creation (at the urging of MFIs) of a special category of institution, called private financial funds (FFPs). FFPs are regulated financial intermediaries with a relatively low minimum capital requirement. FFP status provides a pathway for NGOs that are transforming into commercial operations or for the entry of purely commercial companies with a focus on small loans. With so many institutions seeking to expand, competition for clients is becoming fierce. Existing programs are serving more than one-third of an estimated total of 600,000 microenterprises in Bolivia (see table 1). If the 25 percent growth rate in the number of clients, experienced in 1997, continues, the microfinance industry may already have bumped against the limits of growth.

Bolivia is also experiencing another phenomenon that impinges on the microfinance market— consumer lending. Consumer lenders, who serve mainly the salaried sector, have been growing at a faster rate than microfinance institutions. These lenders compete indirectly with microfinance programs because of their similar loan products. In some cases they compete directly, for example, when consumer lenders decide to target the microenterprise market.

Table 1: Licensed Microfinance Lenders in Bolivia (including prospective FFPs)

Institution	Active MicroLoan Clients (est.)	Loan Portfolio (US$ million)	Type of Institution
BancoSol	76,200	$63.8	Bank
Banco Económico	6,200	n/a	Bank
Other banks	30,000	n/a	Bank
Caja de Ahorro y Préstamos Los Andes	29,500	$20.4	FFP
Agrocapital	3,200	$2.0	FFP
FIE	22,500	$12.2	FFP
PRODEM	27,500	$8.3	FFP
Eco Group	25,000	n/a	NGO
Sartawi	5,000	n/a	FFP
FASSIL	8,500	$7.5	FFP
ACCESO	n/a	n/a	FFP
Cooperativa Jesus Nazareno	11,938	$21.0	Credit Union
Total	**243,600**	**over $135.2**	

Note: This table excludes NGOs such as Promujer (15,600 clients) and Crecer (9,700 clients), which are not applying to become FFPs. Commercial institutions are shown in italics. N/a indicates that data is not available.

Chile. In Chile, where financial sector liberalization is advanced, the microfinance market is highly commercialized. Despite a relatively small potential client base—an estimated 300,000 potential microenterprises—competition is very strong and is now led by commercial banks (see table 2). Although banks entered the market only in the past five years, they have outperformed the original NGOs that introduced microfinance to Chile in the late 1980s. NGOs now serve fewer than 20 percent of the total current microfinance clients and continue to lose market share. The banks have offered customers a more appealing array of services and have other natural comparative advantages. The banks entered the microfinance business expecting to gain a long-term profit, although their entry has been facilitated by a time-bound government subsidy. Among the banks are a state bank (Banco del Estado), a socially-conscious private bank (Bandesarrollo), and a large commercial bank (Banefe). As in Bolivia, consumer credit is a significant factor influencing the microfinance market in Chile, with millions of loans made to salaried people.

Table 2: Microfinance Lenders in Chile

Institution	Active Loan Clients (est.)	Loan Portfolio (US $ million)	Type of Institution
Banco del Estado	*8,290*	*$7.6*	*State Bank*
Bandesarrollo	*16,600*	*$15.0*	*Private Bank*
PROPESA	4,196	$4.0	NGO
Banefe	*22,000*	*n/a*	*Bank*
Other banks.	*est 10,000*	*n/a*	*Bank*
Cooperativa Liberación	4,860	$3.7	NGO
FINAM	1,454	$0.8	NGO
Other NGOs	2,000	n/a	
Total	**69,400**	**over $31.1**	

Note: Commercial organizations where donor involvement has been minimal are shown in italics.

Paraguay. Recently, Paraguay has seen a dramatic increase in the number of institutions offering microfinance loans. Before 1994, only one NGO, FUPACODES, offered microfinance services. In 1994, a for-profit finance company, Financiara Familiar, began operations. Since then, 10 other institutions have started lending, although most remain small (see table 3). Nevertheless, in the urban areas of Asuncion many neighborhoods are served by at least two financieras.

Table 3: Microfinance Lenders in Paraguay

Institution	Active Loan Clients	Loan Portfolio (US $ million)	Type of Institution
FUPACODES	4,580	$2.5	NGO
Financiera Familiar	8,633	$5.9	Financiera
Vision	8,541	$11.1	Financiera
Fincresa	1,857	$1.6	Financiera
Interfisa	3,158	$2.0	Financiera
Other financieras	1,927	$2.4	Financiera
Total	**28,696**	**$25.4**	

Source: McDonald, Jennifer, "Consultant's Report to IPC on the IDB Global Loan Program for Paraguay," November 1998.

Uganda. In Uganda the financial sector is less developed than in Bolivia, Chile, or Paraguay. Microfinance began in earnest after the country's return to peace and macroeconomic stability, and after the 1993 financial sector reform, which created a relatively free operating environment. The privatization of the Uganda Commercial Bank, which resulted in the closing of many rural branches, left large areas of the country without any formal financial services. As microfinance develops, it plays a significant role in building the financial sector rather than simply integrating with it.

All the microfinance programs in Uganda remain strongly backed by donors. Nevertheless, the trends evident in Latin America can be discerned in Uganda to a lesser degree. Competition in Kampala and its surrounding region is becoming strong, as an increasing number of institutions reach scale and become more sustainable. Parallels to Bolivia emerge in the effects of and response to competition. Moreover, NGOs are competing with banks: Centenary Rural Development Bank is a private, socially-conscious bank, while the Co-operative Bank of Uganda, also known as Coop Bank, is cooperative-owned and being restructured. These banks have distinct comparative advantages that make it easier for them to attract customers and expand than it is for the NGOs (see table 4). For example, both banks offer savings services and have branches throughout the country. Finally, although only a glimmer, private commercial banks in Uganda are starting to express some interest in developing microfinance services. Given this strongly competitive environment, continued donor funding of microfinance programs raises questions that are discussed in section V, below.

Table 4: Microfinance Programs in Uganda

Institution	Active Loan Clients (est.)	Loan Portfolio (US $ million)	Type of Institution
Coop Bank	6,675	$0.6	Bank
Centenary Bank	8,737	$8.1	Bank
FINCA Uganda	16,227	$1.3	NGO
PRIDE Uganda	8,808	$1.0	NGO
Total	**50,000**	**$11.0**	

Note: Not included in this table are several other NGOs, such as Faulu, Foccas, Ugafode, UWESO, UWFT, and World Vision, that serve several thousand additional clients.

Bangladesh. Even in Bangladesh, market forces are creating change. The original generation of microfinance programs—Grameen Bank, BRAC, and Proshika—remain market leaders in terms of client numbers, reaching 70 percent of the 6.5 million clients being served (see table 5, below). However, these programs have grown to such a scale that they compete head-to-head in hundreds of villages. Moreover, a new generation of NGOs is arising: only 5 of the current microfinance NGOs existed before 1980, while 320 began since 1990. While most of these are weak programs a few, such as ASA and Buro Tangail, are growing aggressively. The newer programs emphasize profitability in a way that the market leader, Grameen Bank, never has. They are also experimenting with new services, particularly on the savings side.

Until recently, nearly all microfinance programs in Bangladesh used the Grameen Bank or methodology or a variation; this included targeting loans nearly exclusively toward women (81 percent of all microfinance clients in Bangladesh are women). However, increasingly new loan, savings, and insurance services are being developed. In Bangladesh, donors remain major funders, accounting for 47 percent of all loanable funds held by NGOs, while commercial sources account for only 14 percent.[4] This also shows signs of changing. Formal banks are beginning to report microfinance loans, and government authorities are beginning to consider revising regulations to provide a more conducive environment for savings mobilization and lending innovations.

[4]Credit and Development Forum, "CDF Statistics," Dhaka, Bangladesh: December 1997.

Table 5: Microfinance Programs in Bangladesh

Institution	Active Loan Clients (est.)	Loan Portfolio (US$ million)	Type of Institution
Grameen Bank	2,273,000	$349.46	Special Bank
BRAC	1,750,000	$94.70	NGO
ASA	635,000	$41.80	NGO
Proshika	567,000	$53.62	NGO
Buro, Tangail	26,000	$1.70	NGO
Other NGOs*	1,280,000	$55.23	NGO
Total	**6,531,000**	**$596.51**	

*This includes approximately 375 NGOs.

The client numbers presented in the preceding sections do not describe total number of microenterprise clients that have participated in one program or another over the past few years. Programs usually count loans rather than clients and focus on current rather than cumulative indicators. The tables above only show clients that are currently active. In the absence of specific data, it may be instructive to consider the likely level of participation of the total market, using some hypothetical but reasonable assumptions.

Since most clients do not want to borrow all the time, many programs have significant client turnover. Over a few years, therefore, a program will have lent to far more borrowers than stated in its current client portfolio. For example, PROPESA, in Chile has lent to 21,000 microenterprises in its 10-year history, but has only 4,200 clients in its current portfolio. If this ratio were to hold true for MFIs in countries such as Bolivia, Chile, and Paraguay, virtually all creditworthy microenterprise clients in the target areas would have been served at least once by some program. For example, the Bolivian MFIs have a current portfolio of about 250,000 clients. If each has served 4 clients for each current client, then they would have served a total of 1,250,000 clients over the past 10 years, (in a place where total demand has been estimated at 600,000 microenterprises). Even accounting for substantial overlap between institutions—i.e. clients borrowing from two or more institutions—the total number served would be very large relative to potential demand. This example underscores the fact that, in a few countries, market penetration of microfinance providers may be very high.

Other Countries. While the five countries profiled above have more competitive microfinance markets than most others, they are clearly not the only ones in which microfinance is already developing into a competitive industry. Peru, Colombia, and South Africa, for example, are witnessing some of the same trends, and many others are laying the foundation that will lead to a similar market situation in a few years' time.

The rapid pace and growth of new commercial entry was reflected in the growing numbers of attendees at a recent conference series on commercial banks and microfinance that was sponsored by the United States Agency for International Development (USAID). At the first conference, held in 1996, approximately 10 private banks were identified that came from the commercial side to the active implementation of microfinance services. Together, these banks had about 70,000 microloans outstanding, with a combined portfolio of about $80 million.[5] Two years later, when follow-up conferences were held in Kenya (covering anglophone Africa) and Chile (covering Latin America), the numbers had grown significantly. At the Latin American conference,[6] 16 institutions from 10 different countries represented a total of 300,000 clients and loan portfolio of $450 million. The African conference[7], while it did not evidence the same growth in numbers, featured a surprisingly large number of banking institutions that were already implementing microfinance services and others that were actively seeking

[5]Robinson, Marguerite, "The Microfinance Revolution: Sustainable Finance for the Poor," Harvard Institute for International Development (forthcoming in 1999). The largest of these portfolios, from the National Development Bank of Egypt, resulted from a large USAID project. None of the others was primarily donor-driven.

[6]This conference was sponsored by USAID and CGAP.

[7]This conference was sponsored by USAID, the British Department for International Development (DFID), Citicorp Foundation and the World Bank.

to enter the field. In addition to Uganda, institutions came from Ghana, Kenya, South Africa, Tanzania, Zambia, and Zimbabwe.

These examples document the trends in microfinance: increased competition; new, more commercial players; and a rapid growth in outreach. These trends have touched some countries far more than others, but within a few years, we predict that they will be influencing microfinance in nearly every country. We turn now to examine in more detail how these forces will fundamentally change the way microfinance programs operate.

Part II

THE NEW ENTRANTS

The main commercial entrants into microfinance are consumer lenders, state-owned banks, and private financial institutions. In most of the cases described, the microfinance activities of these institutions are very new and have not been subject to much external analysis. Thus, it is too soon to know how successful these activities are, how committed to microfinance the new entrants will prove to be, or what problems they will encounter. Early indications are, however, that these new entrants are here to stay.

Consumer Credit

For microentrepreneurs, consumer credit is a close cousin of microcredit and is moving closer. Consumer credit represents an enormous challenge for microfinance providers. It targets clients from similar income levels, but uses lending principles that differ materially from microfinance principles. Consumer credit has grown exponentially in some countries, particularly where a significant percentage of the population is employed in the formal sector.

Consumer credit involves making very small loans to households or individuals in the salaried sector. Loans are secured by an agreement with the borrower's employer. As long as the borrower remains employed, the lender can be sure of repayment through the garnishing of wages, if the borrower fails to repay directly. Frequently, automatic payment mechanisms are set up. Both consumer lenders and microfinance programs need to achieve high volumes, feature quick loan processing, and charge the higher interest rates that very small loans require. Both target households at the low end of the socio-economic spectrum. It is no wonder that many consumer lenders have started to move into microfinance. If an institution is successful at consumer lending, it already has many of the competencies needed to succeed in microfinance.

However, consumer credit and microfinance differ fundamentally in the basis on which loans are made. Lending on the basis of salaries is much more straightforward than lending to people whose income is earned from informal enterprises. Therefore, consumer credit companies do not require loan officers who are trained at assessing client enterprises for creditworthiness and repayment capacity. Their staff are essentially loan processing clerks. Moreover, as consumer companies have a straightforward method of securing repayment, they do not offer the mix of incentives for repayment that microfinance programs must create, (e.g. group lending and prompt payment incentives).

At a minimum, consumer lenders challenge microfinance providers because some informal sector households have one or more members with salaried employment. These household members may become conduits for credit which is actually used for enterprise development. For example, a seamstress in South Africa may purchase a new sewing machine through a loan made to her sister who works for the electric company. The consumer lenders in South Africa claim that such loans comprise a large portion of their business, although no data is available. However, given the very large numbers of consumer loans being made in South Africa and the small size of microfinance programs, even a relatively small percentage of consumer loans would be larger than the entire client base of the self-identified microfinance providers.

In Brazil, conversations with potential clients in slums indicate that a large number already have access to consumer credit. This fact has altered the way these individuals view the availability of microenterprise loans. Around the world, wherever consumer lenders are aggressively expanding, they may bite into the potential market for microfinance services without even targeting the informal market. Although this may be a challenge for MFIs, it is a boon for informal borrowers.

In some countries, consumer lenders are seeking to develop microfinance services in addition to their standard consumer products, following the path taken by Financiera FUSA in Chile. In 1992, Financiera FUSA began making microenterprise loans with its consumer credit technology. Its operations were subsequently bought by Banco Santander and are now referred to as Banefe. Both FASSIL, a Bolivian FFP, and Banco Económico, a Bolivian commercial bank, have added microfinance units to existing consumer credit operations. Nubank, a subsidiary of the Amalgamated Banks of South Africa (ABSA) was created to serve both markets.

As consumer lenders enter the microfinance market, they bring formidable strengths to the table. Because of the routine nature of consumer lending, such lenders have developed streamlined ways of doing business that allow them to quickly process an astonishingly large number of loans. For example:

▲ In Bolivia, a finance company that is only 18 months old has made loans to 82,000 consumers, almost as many customers as BancoSol has served since it first began (as an NGO) in 1987.

▲ In Chile, consumer credit serves about 3 million clients out of an estimated workforce of 6 million.

▲ In three years, Peru's Banco del Trabajo has grown from 4 to 32 offices and from 317 to 2,343 staff, and made 180,000 consumer loans.

▲ In South Africa, King Finance Company, Ltd. requires one week to open a new branch office, including a day of training to prepare a loan processor to handle applications.

These figures reflect a great deal of commercial vitality and institutional capability in managing operating systems, information management, marketing, and human resource management. They also reflect significant amounts of private investment capital. From the microfinance perspective, these resources can be seen either as competitive threats or as major potential resources to be applied to microfinance clients.

One particular problem that consumer credit poses for microfinance is the clash of credit cultures. With access to salaries as a relatively easy recourse, consumer lenders are more relaxed than microenterprise lenders are about late payments. In fact, if penalties are charged, delinquency can actually increase returns for consumer lenders. Thus, consumer lenders comfortably maintain relatively high delinquency rates in their portfolios. In Bolivia and Chile, there are examples of consumer lenders that did not fully appreciate the reasons for the low tolerance of delinquency in microfinance, and that experienced repayment difficulties when they began offering microenterprise loans.

More broadly, microfinance lenders may find that consumer lenders operating in the same areas undermine the credit culture among their own clients. In Bolivia, for example, a new entrant is reported to ask microclients how much credit they have from an established microlender, offering them double the loan amount for double the loan term. This type of process will endanger microclients' credit histories and lead them to become overindebted. Once microclients appear as delinquent in the credit bureau, they cannot get a subsequent loan from established microlenders. Over time, a large number of heretofore excellent clients may find themselves excluded once again from the system—ironically, as a consequence of borrowing too much.

Consumer credit also challenges microfinance programs to be clear about their image and objectives as institutions committed to improving their clients' lives. Coming from a purely commercial background and often operating at the edges of the financial system, consumer lenders are sometimes seen as unscrupulous operators, that "gouge" the poor (a view that is accurate in some cases). Popular distrust of consumer lenders may focus on the high interest rates charged or on the means by which loans are secured. Microfinance institutions wish to distance themselves from potential criticism and may insist that they are ultimately altruistic, yet they also feature high interest rates and stringent practices for securing repayment. Popular opinion may not be persuaded by altruistic motivations if the public does not like the practices they see.

This situation has emerged as an issue in South Africa, where consumer lenders have been growing very rapidly and have come under public criticism for charging high interest rates. Often these rates are as high as microfinance rates, although the cost structure of the finance companies is much lower. Thus, finance companies may indeed be making high profits, as the rapid growth in value of some companies' shares on the stock exchange suggests. Some finance companies have also used collection practices that the public views as unscrupulous. One such practice requires clients to provide the finance company with an ATM card that is used to debit the client's account on paydays, even before the client can access the funds.

Microfinance practitioners and some of the more public-minded consumer financiers have joined to form the Alliance of Microenterprise Development Practitioners, established to develop a code of ethical conduct and become a regulatory body for the industry. The Alliance wishes to preserve a positive image for microfinance by distancing itself from business practices that the public finds distasteful. In response, consumer companies created the Micro Lenders Association, which has put forward its own code of conduct. At the government's request, both associations will nominate members for a regulatory body for the industry. In this way, the future of microfinance in South Africa has become intimately linked to the spread of consumer credit.

State-Owned Commercial and Development Banks

In a large number of developing countries, governments face a quandary over the fate of state-owned development banks, particularly those aimed at agriculture and rural development. Typically, these banks were established to provide subsidized credit to farmers, through extensive branch networks reaching deeper into rural areas than other banks. Poor performance and the subsequent withdrawal of most subsidies has left many of these banks bankrupt or moribund. Many governments are actively seeking to transform these institutions. They are motivated by the need to stem the bank's losses, which require significant government outlays, and by the recognition that rural areas remain vastly underserved by financial institutions. However, if these banks can be transformed effectively into MFIs, they have natural comparative advantages that could make them dominant among microfinance providers.

For example, BRI was nearly the only successfully transformed rural development bank that provided microfinance services. The combination of factors that resulted in the creation of BRI's Unit Banking System could not be assembled in other countries. However, in the past few years, several other banks have made successful transformations and created microfinance operations. These include BEME in Chile and Coop Bank in Uganda. Other banks are still in the planning or pilot stages of microfinance operations; these include Banco do Nordeste in Brazil, Co-operative Bank of Kenya, and the National Microfinance Bank in Tanzania. Still others are investigating the possibilities of transformation without yet becoming committed; these include the Regional Rural Banks of India and the Post Office Bank of Kenya.

When contemplating the transformation of a state-owned development bank, governments face several options for dealing with money-losing branch networks: they can close down those parts of the bank that are losing money—these are typically branches in small towns and rural centers; they can allow the bank to become largely a savings bank with rural branches serving as collection points for deposits channeled to urban areas; or they can restructure the bank using a microfinance model such as the one provided by BRI. Each option could be carried out with or without financial restructuring (i.e. new capital infusion) or privatization. Although the microfinance option is the most difficult, it potentially offers the greatest rewards—both profitability and outreach into rural areas.

In cases where microfinance has been implemented, the natural comparative advantages of the state-owned banks have already affected the rest of the local microfinance scene. Competitive advantages arise from: (1) an existing branch network that offers immediate channels for market penetration; (2) the ability to offer both savings (with implicit or explicit government guarantees) and payment services, thus attracting loyal customers; and (3) access to resources needed for transformation, possibly including loan capital, funds for capital improvements, and administrative infrastructure. For example:

▲ In Chile, BEME has $5 billion in assets and 240 branches, of which 100 are in locations without competition. It has an estimated 8 million active savings accounts in a country of 15 million inhabitants.

▲ Banco do Nordeste in Brazil has $8 billion in assets and 174 branches. It also has an agreement in place that would allow it to operate through the post office network.

▲ Workers Savings & Loan Bank in Jamaica has 250 outlets through post offices throughout the island. Jamaica's population is 2.5 million.

▲ The National Microfinance Bank of Tanzania will begin with a base of 700,000 savers, $260 million in assets, and the only means of making payments in most rural areas.

▲ The Regional Rural Banks of India have $4 billion in assets, almost 40 million savers, and 15,000 branches.

When these advantages are combined with good management and technical microfinance know-how, the results have sometimes been dramatic. BRI has been so dominant in its sphere that, although it had clearly demonstrated the profitability of microfinance, other banks stay out of the field, not wanting to compete with BRI. In Brazil, during the pilot micro-lending phase at Banco do Nordeste, 20,000 borrowers received loans in the first 12 months, possibly doubling the number of microloan clients in the country. In Chile, BEME has been able to grow faster than all other microfinance programs in its market area, solely on the strength of its lending to its client base of savers. Although it is the newest major microfinance program in Uganda, the microfinance program of Coop Bank has the potential to outdistance its competition when it rolls out beyond its 6 pilot agencies to its full 24-branch network.

In short, if they can "get it right," these banks will be formidable competitors, not only for NGOs, but also for other formal financial institutions. Their access to clients cannot be duplicated. However, "getting it right" is not easy. Transforming these banks involves overcoming an entrenched corporate culture that is usually antithetical to microfinance; the state-owned banks are known for low productivity, a lack of incentives and accountability for performance, political interference, and a lack of understanding of the basis for lending to informal sector borrowers. In most cases, thorough management change and major staff retraining is required. Such processes cost significant amounts of money and time, and success is far from assured. It is not surprising that, in many instances, the option of closing branches or focusing only on savings is pursued.

Even if these banks successfully implement microfinance operations, they remain vulnerable because of their ownership and governance structures. BRI, for example, may be forced to undergo restructuring, as a result of non-profitable, politically-based lending under the Suharto regime, despite the fact that its microfinance operations are strongly profitable. It remains to be seen whether these operations can be given a new, secure institutional home. Jamaica's Workers Savings & Loan Bank operates profitable microfinance operations through post offices, but regulatory authorities recently intervened in the main part of the bank, which is a privatized institution; this intervention leaves the future of the microfinance operation uncertain. In addition, the microfinance program of Coop Bank in Uganda will undoubtedly be affected by the bank's ownership restructuring process.

Private Commercial Banks

Many institutions whose names are often cited as examples of commercial banks in microfinance are either transformed NGOs, (e.g., Bolivia's BancoSol, the Dominican Republic's Banco ADEMI, Ecuador's Banco Solidario, and Peru's MiBanco), or specialized banks (e.g. Centenary Rural Development Bank of Uganda) that developed their services with donor support. While purely private commercial banks are not yet the main new entrants into microfinance, an increasing number of these banks are developing microfinance services, generally on a relatively modest scale.

Among private banks that have moved into microfinance largely on their own, three categories of institutions emerge:

Smaller banks. Smaller banks, such as Chile's Bandesarrollo or Panama's Multi-Credit Bank, see low-end clients (middle and working class families, small enterprises, etc.) as a natural market niche, sometimes because of the bank's social orientation. A number of banks in Russia and Eastern European countries, assisted by Interdisziplinare Projekt Consult (IPC), belong in this group of banks searching for a market niche.

Large mainstream banks. Large mainstream banks, such as Ecuador's Banco del Pacífico or Sri Lanka's Hatton Bank, where microfinance is a small activity, are motivated by a desire for a good public image.

A variety of banks. A variety of banks, such as Bolivia's Banco Económico or Chile's Banefe, operate in countries where microfinance is well-established and are taking advantage of the low costs to enter the market.

In the long run, the latter category may become the most important. In Bolivia, Chile, and Paraguay, entry barriers to microfinance have fallen quite low. A bank can secure all the know-how needed to implement microfinance by hiring one or two staff members from an experienced institution. As a result, several banks in these countries now offer microenterprise loan products. These banks may have little special commitment to microfinance, but offer microfinance products because they are moneymakers and may help round out the bank's array of product offerings. Once this stage in the industry's development is reached in an increasing number of countries, private entry may accelerate.

Private banks enjoy some of the same competitive advantages as large state-owned banks, in terms of their access to resources and ability to offer deposits and other products that are attractive to clients. Some have branch networks. Private banks excel relative to state banks in terms of strong management and ability to make business decisions quickly. They are also likely to continue bringing newer technologies to bear on microfinance. A prominent theme to emerge from the 1998 "Commercialization of Microfinance" conference held in Kenya and the "Regulated Financial Institutions in Microfinance" conference held in Chile was the banks' intent to bring the cost structure of microlending closer to the cost structure of other banking products, through the use of automation. If convinced that microfinance is in their commercial interest, private banks could become powerful actors in the field.

Part III

HOW COMPETITION IS CHANGING MICROFINANCE OPERATIONS

Nearly all the new events influencing microfinance will exert their influence through the force of competition. The ultimate beneficiaries of this competition will be microfinance clients who will receive more and better services. The institutions providing services, however, may find the competitive environment quite challenging.

Microfinance has been extraordinarily protected from competition. Many of the leading microfinance institutions long enjoyed a near-monopoly position in their marketplaces. Within microfinance, the only real competition has been for resources, not clients. Microfinance providers have competed for donor and, in a few instances, commercial funding. The abundance of potential clients and scarcity of institutional capacity have allowed microfinance institutions the freedom to relax their attention to client service, to a certain extent, once a successful service delivery formula was developed, thus buying time to develop institutional capacity. Most institutions were too overwhelmed by the basic tasks of survival and growth to recognize how sheltered they were. This protection from competition has been a luxury supported by donor capital.

The competitive environment microfinance is now entering will force institutions to turn their attention to matters that may have lain dormant until recently. It will also challenge some widely held tenets — or myths— about the microfinance business. No longer can these institutions regard the market as unlimited or take clients' preferences for granted.

Until recently, microfinance programs faced what has been called the "absurd gap"[8] between the number of micro-level clients with access to financial services and total market potential. For practical purposes, programs could treat the demand for their products as unlimited. In the countries cited above and in several others, this myth no longer applies. The figures given for Chile and Bolivia in tables 1 and 2 show that microlenders may already have served most creditworthy microclients who desire loans. No one knows exactly what the limit may be, but at the growth rates microfinance institutions are now projecting, market saturation in Chile and Bolivia may be close at hand. In fact, markets in Chile's and Bolivia's major urban centers, in Kampala, Uganda and in many parts of Bangladesh already show signs of saturation, such as slowed growth and increased delinquency rates.

In these environments, clients can and do move from one program to another whenever they perceive an advantage for themselves. When clients are no longer desperate for access, they begin to exert consumer preferences. The "yellow pajamas" myth—that clients would respond to nearly any requirement that microfinance programs imposed, even standing outside in yellow pajamas—is disappearing.

[8] Chu, Michael, President and CEO of ACCION International.

Improving Service Quality

Competition is leading to broader geographical coverage of the market, lower loan sizes and interest rates, and a more complete range of products available to microenterprises (and their families). Microfinance institutions facing direct client competition are anxiously devising strategies to attract and retain clients.

In Bolivia, institutions are reviewing their requirements to see which can be simplified or developing new products. For example:

▲ BancoSol is developing individual loans to prevent some of its better customers from moving to Caja de Ahorros y Préstamos los Andes, where they can avoid solidarity group requirements.

▲ PRODEM is finding ways to make its branch offices more convenient.

▲ Caja de Ahorros y Préstamos los Andes maintains a pawnshop loan product to attract lower-end customers.

BancoSol's movement to reduce group requirements in favor of individual lending may become a widely generalized effect of increased competition. Most surveys show that clients would rather have individual loans, and increasing evidence suggests that individual lenders can keep costs to manageable levels.

In Uganda, similar responses can be observed. The Foundation for International Community Assistance (FINCA) in Uganda is changing the rules governing the required savings in its village banking program, allowing a given amount of savings to qualify clients for larger loans. It recently added credit life and disability insurance and is attempting to secure a health insurance product. While FINCA Uganda may have made some of these changes in any case, the competitive environment is pushing the organization to do so far more urgently.

FINCA Uganda is also responding to competition by developing a culture of marketing within its staff, something largely lacking in many microfinance programs. Among its market strategies are: promoting and professionalizing its public image through higher quality passbooks and promotional materials, public events, and the like; training its staff in sales techniques and the importance of service quality; and investigating client preferences to craft appealing services and messages.

In Paraguay, over the period from 1995-98, loan sizes have decreased on average by around 30 percent. One reason for this appears to be the MFIs' move down-market in search of new clients. As the market becomes more crowded, finding new clients becomes harder. Loan officers now go door-to-door with fliers and business cards. One consultant's report estimated that loan officers in Asuncion must visit 25 prospective clients to gain one new client. In any new market in Paraguay, it is estimated that market leaders will only have one year to establish their market share before new entrants start to crowd them.

In Bangladesh, ASA has eliminated required attendance at weekly meetings, and Grameen Bank is providing clients' greater access to their forced savings.

Finally, in a competitive situation, customers can—and apparently do—become price sensitive, challenging the myth that clients care more about access and service quality than price. This fundamental insight into client preferences was an important factor in the development of microfinance services. However, in the newly-competitive situation, clients are assured of access to reasonably good services, freeing them to worry about the finer details, such as price. In Bangladesh, for example, ASA reduced its interest rates twice in the past year.

In Paraguay, interest rates have also decreased since 1994. Initially, these decreases were a result of reductions in the rediscount rate charged by the Inter-American Development Bank (IDB)/Central Bank microfinance window, which in turn were based on the deposit rate in the financial system. However, subsequent increases in the rediscount rate did not lead to higher interest rates charged to clients. Interest rates have continued to fall (see table 6, below)[9]. Clients in Paraguay are aware of the different interest rates among competing financieras, and loan officers often use price differences to promote their institution's products.

[9]McDonald, Jennifer, "Consultant's Report to IPC on the IDB Global Loan Program for Paraguay," November 1998.

Table 6: Interest Rates in Paraguayan Microfinance Programs

Year End	Average Monthly Interest Rate, IFIs in Global Loan Program (%)	Central Bank Rediscount Rate for Global Loan Program (%)
1994	7.8	26
1995	6.8	23
1996	6.5	18
1997	4.5	13
Sept. 1998	4.1	21

Protecting Against New Risks

Competition brings several additional risks. Organizations driven by competition to lower prices, relax eligibility criteria, or add new products may become overextended. At the same time, the cost of missteps will be high, as competitors are positioned to move in quickly. Thus, competition will undoubtedly spark a weeding-out process in favor of the most capable institutions. In a market economy, "survival of the fittest" is the norm and competition generally results in better quality services at lower prices. However, it will be something new for the microfinance field where, thanks largely to donor underwriting, institutions have rarely been forced to exit the market.

A more immediate risk concerns clients who attempt to take advantage of the competitive situation. Some clients seek multiple loans which exceed their repayment capacity, or move to new institutions to escape bad credit histories. In Bolivia, MFIs complain that borrowers are taking loans from three or four institutions at once without informing the lenders. When clients have loans from more than one source, analysis of repayment capacity is difficult and uncertain. Lenders may add to this problem as they seek to retain clients. Good repeat clients are a valuable commodity, and institutions rely heavily on them for portfolio growth in the more saturated markets. Part of the strategy is to offer larger loans to these best clients, which may at times result in pushing credit beyond prudent limits.

For example, in Paraguay one financiera offers its best clients a repeat loan before their current loans are paid off, allowing the old loans to be paid off early with the new loan proceeds. Credit cards, usually with a credit limit of between 40 to 60 percent of the value of a client's current loan, are also made available to clients with good repayment records. Loan officers at another institution, which saw delinquency rates climb alarmingly in 1998, report that repeat clients are sometimes offered a larger loan by the marketing division before the client's repayment capacity is analyzed. Loan officers are given responsibility for collecting on these loans, independently of whether they have recommended them. These aggressive policies can easily stretch clients' repayment capacity. Recently, many institutions have seen short-term delinquency rates rise. While some of this may be due to the fall in economic activity in Paraguay, it is clear that "easy credit" is dangerous for both customer and provider.

Only in Bangladesh have programs been somewhat insulated from this phenomenon because the prevailing Grameen methodology makes it difficult for people to move quickly between programs or participate in more than one program at a time. However, this protection for the institutions comes at a cost in convenience for customers.

In cases where borrowers move from program to program, the original lender has valuable information that is not readily available to the new institution. Progress has been slow toward development of credit information clearinghouses to identify such risks. Some microfinance programs have cooperated informally by sharing information about bad loan customers, but until recently the lack of head-to-head competition has not made this issue a priority.

Now that credit information is becoming a more vital issue, the difficulties of establishing reference services are appearing. Chile, with a relatively developed financial system, already has a functioning system, and its existence has played a major role in allowing banks to enter the microfinance market and offer favorable terms. However, in most other countries underlying legal constraints make development difficult. In Bolivia, for example, NGOs are placed at a disadvantage because confidentiality laws prohibit banks from sharing information outside the formal financial sector. In Uganda, efforts to identify bad borrowers systematically have been stymied by the lack of a national system of identification cards. Borrowers can simply change the names they use. Microfinance programs attempt to locate bad clients by circulating photographs or attending each other's client-intake meetings, but these are clearly unsatisfactory substitutes. Nevertheless, increased competition is forcing microlenders to cooperate to find a solution to this problem.

Certainly, development of a complete and trustworthy credit information system would be one of the most important investments that a country interested in encouraging commercial entry into microfinance could make. Such a system should include not only banking transactions, but also any commercial obligations entered into by individuals.

Offering New Products

Increasing competition in microfinance is beginning to trigger rethinking of products and services for the first time since the mid-1980s, when most microfinance methodologies became well-established. The new entrants into microfinance add creativity. They bring experience with other products, and they are not constrained by the traditional definitions and boundaries of microfinance.

New Loan Products and Customers. Commercial entrants may define microfinance products that differ from short-term, flat-rate microfinance loans and more nearly resemble existing banking products. For example, Financiera Estrellamar in Panama offers a line of credit accessible through a debit card, which allows clients to tailor borrowing precisely to their business cycles. In addition, some microfinance institutions are widening their spectrum of products to include housing loans, leasing, small business lending, and health insurance. The Small Enterprise Education and Promotion Network (SEEP)of U.S. NGOs in international microfinance devoted much of its 1998 annual meeting to exploring these products. Microfinance institutions are developing the capacity to provide one or more of these products, viewing them as ways to retain standard microfinance clients and to broaden their client base.

Competition also pushes programs to expand their geographic outreach beyond existing limits. Thus, in Uganda, one of the principal effects of competition in Kampala has been to drive programs toward rural areas: Centenary is piloting agricultural lending; Coop Bank is developing a village banking model; and FINCA Uganda is moving its operations to two towns in the north.

In Bangladesh, after years of focus on female rural borrowers typically targeted by Grameen Bank, organizations are beginning to develop products for the upper tier of the poor population.

Savings and Payments. The microfinance community has long noted that, in addition to credit, low-income clients also want savings services. More recently, attention has turned to payment services. However, microfinance programs operating as NGOs have been thwarted in their efforts to get beyond credit because they are not licensed to take savings (rightly so) and have lacked the technologies and institutional relationships needed to handle payments effectively. As part of the formal financial system, banks and other financial intermediaries are already licensed to take savings and can also participate in payment systems. Banks that identify the informal sector's market potential may increasingly tailor savings services and money transfers to this market.

When they combine savings services with microcredit, the new entrant institutions have a major competitive advantage over non-licensed MFIs. For example, Uganda's Coop Bank and Centenary Bank attract clients by offering savings services, and in so doing, develop customer relationships that the NGOs (such as FINCA and PRIDE) cannot. As its role model BRI has long shown, Coop Bank demonstrates that tying credit and savings together helps secure customer loyalty and provides valuable information about prospective borrowers. In fact, several prominent banks with microfinance programs in Africa are fully savings-funded. These include Centenary and Coop Banks; Standard E-Bank and ABSA-Nubank; the Commercial Bank of Zimbabwe; and the Tanzania National Microfinance Bank.

Savings services are also likely to become an active field of competition for MFIs in Bangladesh, where institutions have finally become aware that forced savings do not fulfill the savings needs of low-income communities. As a result, BRAC, ASA, BURO Tangail, Federal Savings, and SafeSave are all in various stages of offering voluntary savings services.

In countries including Bangladesh, Guatemala, Jamaica, the Philippines, and the countries of southern Africa remittance flows constitute a significant share of household income for many poor and moderate-income families. This income stream is attracting the attention of major banks. A bank in California, for example, has developed special remittance accounts to reduce the cost and hassles normally associated with sending money back to the Philippines.

For some rural residents, even the ability to make simple payments can be another crucial service that is not readily available. This is particularly true in African countries, such as Mozambique, Tanzania, and Uganda, that lack a viable rural banking network.

Payment services require a provider either to be connected to the financial system, so that it can transfer money between institutions, or to have a dense network of outlets. The necessary connections are not available to NGOs. For the banks that exploit these connections, payment services offer one more means of attracting and keeping micro-level customers.

New Technologies

Commercially-oriented institutions are bringing technological innovations from their other operations to microfinance at an increasing pace. Many of them have experience with these technologies in other lines of their businesses.

▲ In the Dominican Republic, ADEMI (now Banco ADEMI) offers a business-oriented MasterCard™ to borrowers with good credit histories.

▲ Standard Bank of South Africa is signing up thousands of low-income savings account clients every month through specially designed automated teller machines (ATMs) at its E-Bank.

▲ In certain Latin American programs, loan officers are being given hand-held computers that they can use in the field.

▲ Satellite communications may make it possible to carry out transactions in remote rural areas, either within institutions or across them. This is particularly important for payment transactions.

▲ Smart cards, in which the value of the account is recorded on the card, can increase the security of transactions in remote locations and assist in improving information management. A smart card system was implemented in Swaziland.

▲ New ways of identifying clients—such as pictures of clients that appear on screen—can be important in countries without secure ways of identifying clients. Standard Bank's E-Bank ATMs, for example, feature “biometric recognition,” which is client identification through fingerprints.

Further technological developments are bound to enhance the possibility of providing large volume, decentralized financial services to the poor. Microfinance practitioners are well aware of the existence of such technologies. What they may not fully consider is the fact that commercial institutions are experienced in using technologies and benefit from relatively easy access to the investment capital and human resources needed to implement them. Thus, as it now stands, these technologies are likely to work to the advantage of the new, well-financed entrants in microfinance.

Credit scoring. Credit scoring is one of the most important uses of technology that may affect microfinance. Credit scoring uses statistics to make predictions that overcome information asymmetries in lending. Microfinance techniques such as group, graduated, and character-based lending are largely approaches to overcome information asymmetries. Credit scoring, which has separate, purely commercial origins, is now poised to become a substitute—or a complement—to standard microfinance techniques.

Credit scoring begins with a large database of information linking default behavior of past clients to a range of objective indicators, in much the way an insurance company would use a database on life expectancies. A new applicant is given a "score," which predicts the likelihood that a person with his or her profile will default, and the score determines loan eligibility. The technique, developed in the U.S., can be used where these objective indicators are available. As originally developed, credit scoring tends to work against informal sector clients who lack credit histories and have no scores on other indicators.

However, banks in Peru (MiBanco) and Chile (Banco del Estado) are adjusting credit scoring techniques to work in less information-intensive societies, with less formal clients. The information in their database might include, for example, past performance as a saver in the lending institution. In South Africa, Standard's E-Bank has generated a great deal of infor-mation about the savings behavior of low-income clients. According to Roy Polkinghorne, Senior Manager of Standard Bank, once the bank's computer programs can put this information into a useable form, the bank will have a sound foundation for offering microlending to those savers.

In the hands of motivated institutions, credit scoring could extend the boundaries of the financial system to new clients. As banks learn to use credit scoring to serve less formal clients, they will probably draw clients away from microfinance programs. These banks may not view themselves as microlenders, although they may de facto become important players in the microfinance marketplace.

Part IV

CLIENTS AND THE CHANGING FACE OF MICROFINANCE

The changes occurring now will alter the “face” of microfinance—its identity and the image it presents to clients, staff, and supporters/investors. While all the changes are not yet obvious, the authors contend that at least two fundamental trends will have a major effect on the face of microfinance.

First, the traditional boundaries of microfinance are becoming blurred. The new entrants do not consider themselves microfinance institutions and are therefore unconstrained by the thinking of the microfinance field. They may define their market in different ways. Kenya’s Family Finance Building Society, for example, offers loans to smallholder farmers who grow tea, and secures their loans with tea revenues by arrangement with the Kenya Tea Development Company, the main tea buyer. This loan product is thus very different from a standard microloan, but its clients are well within the compass of microfinance: rural households with low or modest incomes. In response to competition, microfinance programs are also moving outside traditional boundaries. In a few years’ time, microfinance might no longer be a separate field, but could simply be blended into the general retail finance sector. Or it could develop more fully into a true “financial sector for the poor,” where low-income clients of all types could have access to a full range of competitive financial services from institutions that base their commercial strategy on this market segment.

Second, the primary motivation driving microfinance expansion will change from development to profit. As stated above, microfinance originated among donors, governments, and NGOs motivated by a desire to improve the standard of living of low-income people. This motivation was expressed variously as poverty alleviation, job creation, or microenterprise development and, at times, was accompanied by additional social motivations, such as empowerment. The new entrants, in contrast, are motivated by desire for market share and ultimately for profit. The more commercial MFIs, such as the NGOs that have transformed into financial institutions, combine both motivations, but still tend to see profit as the best means to reach their development goal, rather than as an end in itself. For purely commercial entrants, profits are the fundamental goal.

How will these basic changes in the identity and motivations of microfinance institutions affect clients? The microfinance community must examine whether and how client welfare will be served by commercially-motivated operations. Will the new microfinance be as “client-friendly” as the original? Will it serve the very poor? Will it still contribute to social goals such as participation and empowerment? Although there is little actual data to go on, certain trends are relatively easy to spot.

Client-friendly?

Microfinance programs originally succeeded by crafting their services to fit client needs and preferences in ways that formal banks had not. They emphasized simple loan appraisal, no or non-standard collateral, rapid loan approvals, convenient locations, and special features for people who were illiterate, spoke a non-dominant language, or lacked confidence to approach a bank. Loan sizes and terms were tailored to client business cycles. Taken together, these features constituted the friendly face of microfinance.

Although in the past, commercial banks presented a most unfriendly face to micro-level clients, the new commercial entrants often copy the methodologies of successful microfinance programs. They incorporate many or all of the features listed above, drawing on staff recruited from microfinance institutions. Those that do not incorporate these features are unlikely to remain in microfinance long, because they are unlikely to develop a loyal clientele. Among existing microfinance programs, competition pushes toward greater responsiveness to clients and better service quality. Competitive pressure has driven FINCA Uganda to spend more time learning about client preferences and organizing events to build client loyalty, and it has driven BancoSol to lower prices and make individual loans.

A market economy relies on competition to guarantee that consumers' interests are protected, and this force will be at work as microfinance is transformed. As competition grows, institutions with an unfriendly face may simply see their clients leave.

As noted, new commercial entrants are particularly oriented toward using technology to make faster and cheaper transactions and reduce risk. Although the technologies may translate into greater convenience and lower interest rates for borrowers, they may also result in less personalized service, when transactions require only machines. Using personal data in credit bureaus and credit scoring may also contribute to a loss of privacy among clients—the advent of a "big brother." These latter effects may be a regrettable but inevitable effect of a modernizing industry.

Clearly, the best programs will find ways to combine client-friendly services with technological advantages. For example, South Africa's E-Bank places attendants at groups of ATMs; the attendants are available to train clients and assist them in using the machines. E-Bank copes with low literacy among clients by offering ATM instructions in pictures and using a fingerprint recognition system. E-Bank also responds to client interests by offering prize drawings and free funeral insurance.

Serve the Poor?

Will commercially-driven microfinance leave the poor behind? The first and overwhelming consideration on this issue is that commercialization is making market saturation a possibility for the first time. In countries entering the commercial/competitive stage, financial services will soon be available to all suitable clients who seek them.

A more probing question is whether that growth in outreach will include the low end of the income spectrum, the very poor. Evidence on that question is mixed at best. Some new commercial entrants aim at the upper tier of microfinance clients, shading towards small business. In a sample of banks and finance companies interviewed for a paper on commercial banks in microfinance,[10] the average loan size ranged from less than $300 for 2 of 17 participating banks, to $3,000 to $4,000 for 2 other banks. The majority of the banks clustered in the range of average loans sizes from $300 to $2,000. This general size distribution fits with the methodologies the institutions were employing: most made individual loans, some used solidarity groups, while very few used village banking or self-help group methods. Average loan size among Paraguayan financieras is $1,200. These observations provide a very rough indication of trends, as they include both strictly commercial institutions and transformed NGOs. They are also heavily weighted to Latin American institutions. Since only average loan sizes are reported, there is no way to tell the distribution of loan sizes, i.e. whether the institutions have many very small loans in their portfolios. Nevertheless, this sample tends to suggest that commercial institutions mainly serve the upper and mainstream microenterprise clientele and address the lower end less frequently.

In the future, it is possible that commercial microfinance will reach the very poor. Perhaps commercial institutions will find ways to make smaller loans profitably. A trend toward smaller loans has characterized the microfinance community during the past decade, and technologies may hasten the process. On the other hand, commercial institutions may practice “skimming,” whereby they accept only the upper-level clients that they know to be profitable. By drawing away upper-end clients, this practice can make it more difficult for MFIs with a mission to serve the poor to achieve profitable operations. Ultimately, a real trade-off may appear, with certain types of clients or loan sizes clearly falling outside the commercial zone. We cannot tell yet where such a line may settle, but it is important to consider what the appropriate response may be.

[10]Baydas, Mayada M., Douglas H. Graham, and Liza Valenzuela, “Commercial Banks in Microfinance: New Actors in the Microfinance World,” Microenterprise Best Practices Project. Development Alternative, Inc. Bethesda, Maryland: August 1997.

Empowerment, Participation, and Social Goals

Among the NGOs and donors that have created the microfinance field, microfinance is valued for its contributions to economic goals—such as increased household and enterprise income, job creation, and entrepreneurial development—and social goals—such as improved family living conditions, more equitable gender relations, better nutrition, and empowerment. For many microfinance programs, client participation in governance is seen as a core value. Will the newly-commercial, competitive microfinance still serve these goals?

Of course, any goals that can be achieved purely through the provision of financial services will still be served. These include most social and economic benefits directly linked to increased or stabilized family incomes. These benefits have always formed the principal justification for donor support to microfinance.

However, in a competitive environment, few microfinance programs are likely to maintain the extra services that support other social goals. The transformed microfinance programs now operating as for-profit institutions are probably illustrative. For the most part, these programs have dispensed with any non-financial services. Training consists only of necessary client orientation; side messages (such as the Grameen Bank's 16 decisions or the Freedom from Hunger nutrition lessons) are minimized; and collective group actions consist only of maintaining group cohesion and discipline for loan transactions. Commercialized microfinance is not likely to serve as a platform for educational messages, group action, or social services. These side benefits will not be delinked.

The question still remains whether clients will be "empowered" once they are simply customers of for-profit institutions. This is a difficult question because empowerment is an open-ended concept which means different things to different people. A case can be made that it is empowering to have one's enterprise taken seriously as the basis for a loan and to be treated as a valued customer. It may also be empowering to be able to access finance in a convenient business-like way. And even for clients whose social needs are deeper, good financial services can take care of an important aspect of a person's economic life, allowing him or her more room to pursue social improvements in other spheres of life.

For some programs, empowerment is seen as a function of group action. However, experience shows that clients usually forego group participation if individual loans are offered. As markets respond to this preference, there will probably be a trend toward more individual lending and streamlining among group programs. On a personal note, the authors have always found it enriching to spend time with microfinance clients organized in groups, because of the energy such groups often possess. They consider it somewhat sad to think that as microfinance becomes more commercialized the social aspects of such activities may fade. While such loss of community is a well-documented phenomenon of the modernization of economic life, one can hope that people will find other foundations for community. After all, financial services may be best handled in a simple, business-like way, while other matters (local government, schools, etc.) may be more natural rallying points around which to build community.

Similarly, in terms of microfinance organizations that support grassroots participation in governance, prospects are that commercialization will render such organizations less competitive, unless they can combine client ownership with professional operations. Competitive conditions will put a premium on technically competent management and agile decision-making. While these conditions pose challenges to all MFIs, participatory organizations may have the greatest difficulty responding. Moreover, as noted above, large organizations with access to resources will have comparative advantages, while most participatory organizations are small and often poorly funded. Faced with competition, organizations with participatory governance as a core value will have to seek creative ways to combine participation and professionalism. Recent trends in the credit union movement suggests one possible response. The World Council of Credit Unions, for example, is focusing on creating a few professionally-run credit unions rather than many small institutions managed by their members. In essence, these changes will make credit unions more like other kinds of financial institutions. In some transforming NGOs, client ownership is being combined with standard shareholding arrangements, so that while clients may own shares, they will not participate in day-to-day decisions. However, such changes carry a cost to the original value placed on participation.

Part V

RETHINKING ROLES: NGOS, GOVERNMENTS, AND DONORS

As discussed above, the evolution of a competitive microfinance market will lead to a wide range of changes. Some changes will be welcome to those in the microfinance community, while others will not. What is clear is that practitioners and supporters of the traditional microfinance community's will have to respond vigorously.

NGOs

Commercialization and competition in microfinance pose challenges to NGOs as great as any they have faced in the past. NGOs may have to make major strategic changes. Relative to commercial entrants, NGOs' major advantages are commitment to their mission and knowledge of their client base. NGOs may wish to consider how best to use those advantages in competitive situations. Four possible responses are described below.

Compete Head-On. In highly competitive countries, many NGOs will need to prepare to meet the competition head-on as a matter of survival. They will need to make strategic moves quickly, in a setting where mistakes will be more costly than in earlier, more protected settings. Their competitors may seek to capture their best customers. Client convenience, service quality, and cost will all become points of competition. And yet, as they compete for clients, NGOs will still face the difficult task of building their institutional capacity. In this task, they may be at a disadvantage, if the new commercial entrants already have institutional structures in place and good access to financial and human resources. NGOs will also be limited by their legal structure, which constrains their sources of funding and limits the variety of services they can offer. In the long run, it may be that NGOs cannot compete head-to-head with commercial institutions for the same clients. This possibility suggests that an NGO seeking to become a long-term service provider in a competitive country should pursue a transformation path, so that it gains access to some of the advantages of formal institutions.

Move to New Frontiers. Some NGOs may respond to the commercialization of microfinance by turning their attention to those countries and clients where commercialization is still years away. While the trends discussed here are well advanced in South America, they are less prevalent in most other regions. In nearly all other regions, only a few countries are experiencing significant competition and commercial entry. Even in countries with several strong microfinance institutions, there are underserved clients in rural areas and clients who are very poor or suffer other disadvantages (e.g. gender or ethnic discrimination, or illiteracy). Just as PRODEM in Bolivia has penetrated the difficult rural areas of the Bolivian altiplano, other NGOs can use their knowledge to develop profitable services to less promising clientele. Some NGOs may find that, when pushed to poorer clients or poorer countries, they reach the limits of financial viability. If so, it will become more important than ever before for NGOs to justify continued subsidies by demonstrating social and economic impact. The microfinance community is increasingly focusing on this task.

Assist Commercialization. Another response is for NGOs to see themselves as demonstrators of the potential of microfinance, as the microfinance industry's research, innovation, and testing arm. For these NGOs, their role will be to create the conditions under which commercial institutions will enter, by developing products and delivery systems, spreading knowledge about microfinance to trained staff and clients, and sorting through practical, political, or regulatory problems posed by the local setting. The history of NGOs in microfinance is full of these demonstration effects. ACCION, for example, has long viewed itself as playing a demonstration role, even though it is also deeply committed to the long-term survival and competitive status of its affiliates.

NGOs seeking a demonstration role may support the entry of commercial institutions into microfinance, applying their knowledge of and dedication to microfinance clients. The most obvious way to do this is to provide technical assistance to financial institutions that want to develop microfinance services. The German consulting firm IPC, although it is for-profit, pursues this strategy in Uganda (with Centenary Rural Development Bank) and in Russia (with several partner banks). Another for-profit firm, Development Alternatives, Inc., is also pursuing this route with two banks in Haiti and another in Kenya; CARE is working on a microfinance project with the Commercial Bank of Zimbabwe; and ACCION is providing support to the Multi-Credit Bank of Panama and Banco do Nordeste in Brazil. Some NGOs may find it attractive to form strategic alliances with formal institutions to gain access to greater funding levels, infrastructure, and back office support. Others may ultimately be absorbed by banks. When the comparative advantages of each type of institution are combined —NGO knowledge of clients, products, and delivery systems, and bank access to resources, retail outlets, and financial management — important innovations could result.

Exit. Finally, in the most saturated markets, a few NGOs may decide that it is time to exit. Although it is rare for any organization to decide to close, PROPESA, one of the first microfinance NGOs in Chile, has decided to transfer a large portion of its microfinance clientele to one of the banks now dominating the market.