Focus

No. 6
March 1997

The Challenge of Growth for Microfinance Institutions: The BancoSol Experience

CGAP

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The rapid growth of BancoSol in Bolivia and its transformation from an NGO (PRODEM) to a licensed commercial bank illustrates important lessons for other microfinance institutions (MFIs). This note focuses on the financial and management challenges MFIs face as they grow and formalize. It is based on a 1996 Ohio State University paper, *BancoSol: The Challenge of Growth for Microfinance Organizations.*

BancoSol is a for-profit commercial bank established in 1992 to work exclusively in the microfinance sector. As of November 1996, it had a loan portfolio of US$43.1 million, with more than 69,900 loans outstanding and about 50,000 savings deposit accounts. BancoSol is now financially sustainable: interest income pays its full operating and financial expenses. Under the prudential supervision of the Bolivian authorities, it has funded the expansion of its operations by capturing commercial loans and deposits from the public. As long as its current policies continue, BancoSol can look forward to increasing the outreach of its financial services for the foreseeable future without relying on scarce and undependable donor funds.

BancoSol's clients typically work in the informal urban economy and cannot otherwise gain access to formal financial services. Customers come from poor, economically active households and must be operating a pre-existing microenterprise to qualify for a loan. As of November 1996, the average outstanding loan balance was US$617, less than the per capita gross domestic product for Bolivia, and 78 percent of the clients were women.

What contribution did PRODEM make as the NGO predecessor to BancoSol?

BancoSol was chartered in 1992, but its roots can be traced back five years earlier to the establishment of its predecessor, PRODEM, a grant-funded non-profit organization. PRODEM developed an effective lending technology that generated a well-performing loan portfolio over time. In 1992, PRODEM transferred a base of 14,300 clients and a loan portfolio of US$4.0 million to BancoSol. This portfolio gave BancoSol an immediate source of revenue and a base from which to expand future operations.

The authors contend that, in addition to the loan portfolio, other assets were transferred that have also been important for BancoSol's long-term success. PRODEM's cost-effective lending methods, which worked well in the urban Bolivian context, are still the backbone of BancoSol's lending. BancoSol also inherited experienced, highly motivated staff from PRODEM. Moreover, BancoSol began operations with a reputation of being a sustainable and serious lender, with a commitment to its mission, and with an important network affiliation with ACCION International. Each of these contributions from PRODEM's activities prior to 1992 played a major role in BancoSol's successful expansion.

The Challenges of Growth

Endowed with assets from PRODEM, in 1992 BancoSol embarked on an ambitious growth path. Expansion of its office network and loan portfolio has allowed BancoSol to extend services to many more poor clients, but growth has been neither easy nor risk-free. The balance of this note will discuss how BancoSol dealt with two primary challenges that MFIs face as they grow: (1) increasing financial pressures, and (2) changing demands on management.

1. Increasing Financial Pressures

In 1992 BancoSol placed itself on a steep growth trajectory. Formalization into a bank made this possible. As a regulated bank it has gained access to commercial funds from private sources, which are more plentiful and flexible than donor funds. Further, legal authorization to mobilize deposits has allowed BancoSol to offer savings facilities to its clientele, thereby improving the quality of its services.

Despite these advantages, BancoSol's experience with rapid growth was accompanied by severe financial pressures.

The Financial Pressures of Transformation and Rapid Growth

Upon transforming to a licensed bank, BancoSol switched from donor funding to more expensive commercial loans and deposits. As a result, the average cost of funds rose from 4 percent per year at the time of transformation to 12 percent by mid-1995. At the same time, transformation inhibited BancoSol's revenue generating capacity because legal reserve requirements reduced the proportion of assets placed in the high-return loan portfolio.

In addition there was a growing share in the portfolio of larger loans. These loans earn lower effective interest rates. These factors reduced BancoSol's return on performing assets and cut its operating margin by 13 percentage points.*

Rapid growth brought on a number of other challenges. Prior to 1992 PRODEM had experienced mostly "intensive" growth, which resulted from gains in productivity due to innovation and better capacity utilization. This had allowed PRODEM to expand its portfolio more rapidly than its costs. In contrast, BancoSol's growth has been mostly "extensive," resulting from rapid expansion of the branch network. While PRODEM had grown into 4 branch offices by the end of 1991, over the next four years BancoSol expanded to 32. The accelerated creation of new branches and hiring of new loan officers inevitably lowered "productivity" (portfolio outstanding per unit of inputs, such as branches or loan officers). The expansion entailed costs from new banking infrastructure, staff, monitoring systems, and communications that were not compensated by similarly rapid growth in the number of clients and in the total portfolio.

The crux of the challenge for BancoSol was that while total costs were accumulating rapidly, the expanded capacity was not immediately generating sufficient loans. It takes time for new staff and new branches to realize their full potential, and this potential may be more limited at marginal locations. As a result, the cost of keeping one loan on the street - i.e. the ratio of *total costs* to *average number of loans outstanding* - increased from US$149 in 1992 to US$242 in 1994. Most of this increase came from the higher cost of funds, but the ratio of *operational costs* to the *average number of loans outstanding* also increased, from US$103 to US$135. That is, it cost more to disburse one loan.

How did BancoSol meet the financial challenges of rapid growth?

BancoSol compensated for these rising costs by increasing the revenue-generating capacity of each loan. This was accomplished not by raising interest rates, but by increasing loan sizes and terms to maturity. Larger and longer-term loans produce more interest income, with little increase in operational cost per loan. This adjustment was reflected in the *portfolio efficiency*, i.e. ratio of the *average portfolio outstanding* to *total costs*, which rose from 1.67 in 1992 to 2.24 in 1995. The increase in loan size fully compensated for the rise in costs per loan and allowed BancoSol to remain financially viable.

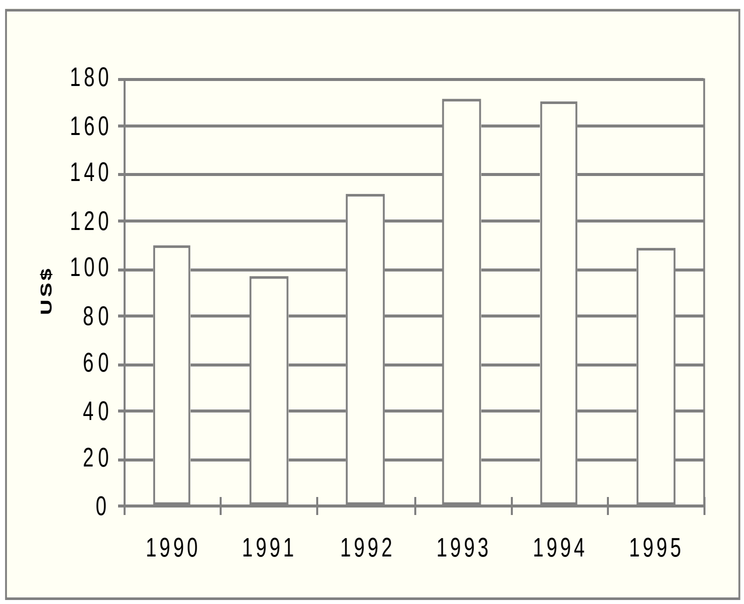
Did the financial pressures cause BancoSol to drift from its mission?

The increase in portfolio efficiency due to larger loans meant that BancoSol was able to weather the pressures of rapid growth, but did the rise in loan sizes imply a drift away from BancoSol's original clientele? To answer this question, the authors distinguish three sources of loan size growth in MFIs:

- **policy**-induced increases: due to changes in an MFI's lending criteria which may reflect a search for wealthier clients, which *could be* a form of mission drift,
- **information**-induced increases: as a result of accumulating knowledge about the clients' capacity to repay, which *does not* constitute mission drift, and
- **client**-induced increases: as a result of a demand for larger loans among repeat clients, which also *does not* constitute mission drift.

The authors report that in the earlier years of BancoSol there was a brief period of policy-induced increases of loan sizes among old and new customers. The larger loans caused some repayment problems, potentially due to overextending borrowers' debt capacity, and the policy was revised. Subsequently, the *information*- and *client*-induced loan size increases have been the primary source of portfolio expansion as clients have gained access to larger loans over time. Both of these forms of loan size growth represent a maturing relationship with repeat customers, rather than a search for wealthier ones. Evidence that substantial "mission drift" has not occurred can be found in data on initial loans sizes (Graph 1). First-time loans for new clients rose in real terms in 1992 and 1993, but declined to their original level by 1995. This conclusion is also supported by evidence from loan repetitions after the first loan. For example, the average size of the third loan given to repeat customers rose from 1992 to 1994 and then fell in 1995.

Graph 1: Average Initial Loan Size



There is another dynamic that contributes to increased average loan size, which the authors analyzed by looking at the evolution of individual loan sizes. When the growth of the number of new clients of a maturing microfinance institution slows down, the percentage of its portfolio in newer (i.e. smaller) loans decreases, and thus average loan size automatically increases, even if there has been no change in the loan size trajectory of its individual customers.

2. Changing Demands on Management

Rapid growth and transformation into a bank also forced BancoSol to adapt its organizational structure and culture. During the PRODEM stage, the institution had promoted an informal office culture which encouraged innovation, commitment to the organization's mission, and recognition of individual contributions to a team effort. The management hierarchy was simple and flat, relying heavily on interpersonal relations. This internal culture fit well with a lending methodology based on trust between the organization and its clients.

The informal culture that had served PRODEM so well became less suited to the demands of a larger institution. It proved difficult to integrate new staff and branches within the existing culture. Management needed improved information systems to cope with an expanding portfolio. BancoSol was simply becoming a larger organization that required more standard lines of authority and communication and a more businesslike approach to decision-making.

BancoSol adapted by designing a stricter management structure, improved systems, and new chains of command. Experienced bankers, human resource managers, experts in asset and liability management, and management information systems specialists were incorporated.

In contrast to the necessary formalization of the institution's structures, BancoSol has retained the technology of personalized contact with the clientele that explains low cost and risks of lending. This includes simple procedures and instruments tailored to the clients' demands.

This balanced approach to restructuring management has been influenced by BancoSol's Board of Directors. The Board represents shareholders who include NGOs, donors, and individual investors. Collectively they are concerned with the safety of their investments, their reputation, and also with preserving the integrity of BancoSol's original mission. The Board of Directors recognized the changing demands on management and demonstrated the political will necessary to make difficult decisions to improve BancoSol's organizational structure.

* Return on Performing Assets = $\dfrac{\text{Financial Income}}{\text{Average Performing Assets}}$

Operating Margin = $\dfrac{[\text{Financial Income}] - [\text{Financing Cost}] - [\text{Loan Loss Provision}] - [\text{Operating Costs}]}{\text{Average Performing Assets}}$

This synopsis was prepared by Greg Chen of the CGAP Secretariat. It draws a few key points from the paper "BancoSol: The Challenge of Growth for Microfinance Organizations" by Claudio Gonzalez-Vega, Mark Schreiner, Richard L. Meyer, Jorge Rodriguez, and Sergio Navajas; in Hartmut Schneider (ed.), Microfinance for the Poor?(Paris: OECD, 1997). Available from: OECD Publications in Paris, Bonn, Tokyo, Mexico, and Washington DC. Gabriela Santa Cruz of USAID in Bolivia provided additional data.

Focus Note Series Editor: Mohini Malhotra;Copy Editor: Mimi Mogues
Production: Valerie Chisholm; EarthWise Printing, Gaithersburg, MD (301) 977-3765.

Printed on recycled paper