



# Breaking Down the Walls between Microfinance and the Formal Financial System

**Bolivian women in line at bank teller window.**

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*Elizabeth Littlefield and Richard Rosenberg*

## **Microfinance works:**

*It enables the poor to build assets, diversify and increase incomes, and reduce their vulnerability to economic stress. Microfinance is sustainable: Dozens of institutions have proved that financial services for poor people can cover their full costs, through adequate interest spreads, relentless focus on efficiency, and aggressive enforcement of repayment. A large and growing proportion of today's microfinance services is being provided by institutions that are profitable, even after adjusting for subsidies they may have received. However, until now, microfinance has been seen as a specialized niche of development, not relevant to the larger world of financial markets and systems. Many people think of microfinance as an arena for socially-*

*oriented NGOs, not for banks and other mainstream financial players.*

*But today there is a dawning understanding that developing countries' financial systems need to be more accessible to poor people, and — more importantly — that there are practical ways to make this happen. Building financial systems that serve poor clients is beginning to engage all kinds of financial institutions providing a wide range of financial service. Financial regulators, mainstream rating agencies, commercial and state banks, insurance companies, and credit bureaus are all starting to play a part in developing sound, inclusive financial systems that serve the majority of poor countries' citizens. The boundaries between microfinance and the formal financial sector are breaking down.*

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Adapted from Elizabeth Littlefield and Richard Rosenberg, "Microfinance and the Poor: Breaking Down the Walls between Microfinance and Formal Finance," *Finance & Development* 41, no. 2 (June 2004), 38-40.

**C**ONTRARY TO a common impression, poor people need and use financial services all the time, like everyone else. They need savings, loans, and other services to take advantage of business opportunities, improve their homes, deal with other large expenses, and cope with emergencies. To meet these needs, the poor use a wide range of financial services — and have done so for centuries. Although they often lack access to formal institutions, the poor enter into a variety of financial relationships. Informal systems like moneylenders, savings and credit clubs, and mutual insurance societies are pervasive in nearly every developing country. The poor also use assets, such as animals, building materials, or cash under the mattress, as savings to be withdrawn when the need arises or opportunity knocks. For specific purposes, for instance to buy fertilizer, they may be able to obtain credit from commercial vendors. Finally, some poor people are clients of formal institutions like savings and credit cooperatives, government-owned development banks, or postal banks.

However, the financial services usually available to the poor have serious limitations in terms of cost, risk, and convenience. For example, holding cash

entails security and inflation risks. A cow is not a divisible asset that can be sold in parts to meet small cash needs at different times; it needs to be cared for, and can die or be stolen. Supplier credit and especially loans from moneylenders are very expensive. Rotating savings and credit clubs are risky, and usually do not allow much flexibility in amounts or timing of deposits and loans.

Even when the poor appear to have access to a formal financial institution, the services on offer may not match their needs. Deposit accounts may have minimum amounts and inflexible withdrawal rules. Loans from formal institutions usually have collateral requirements that exclude most of the poor.

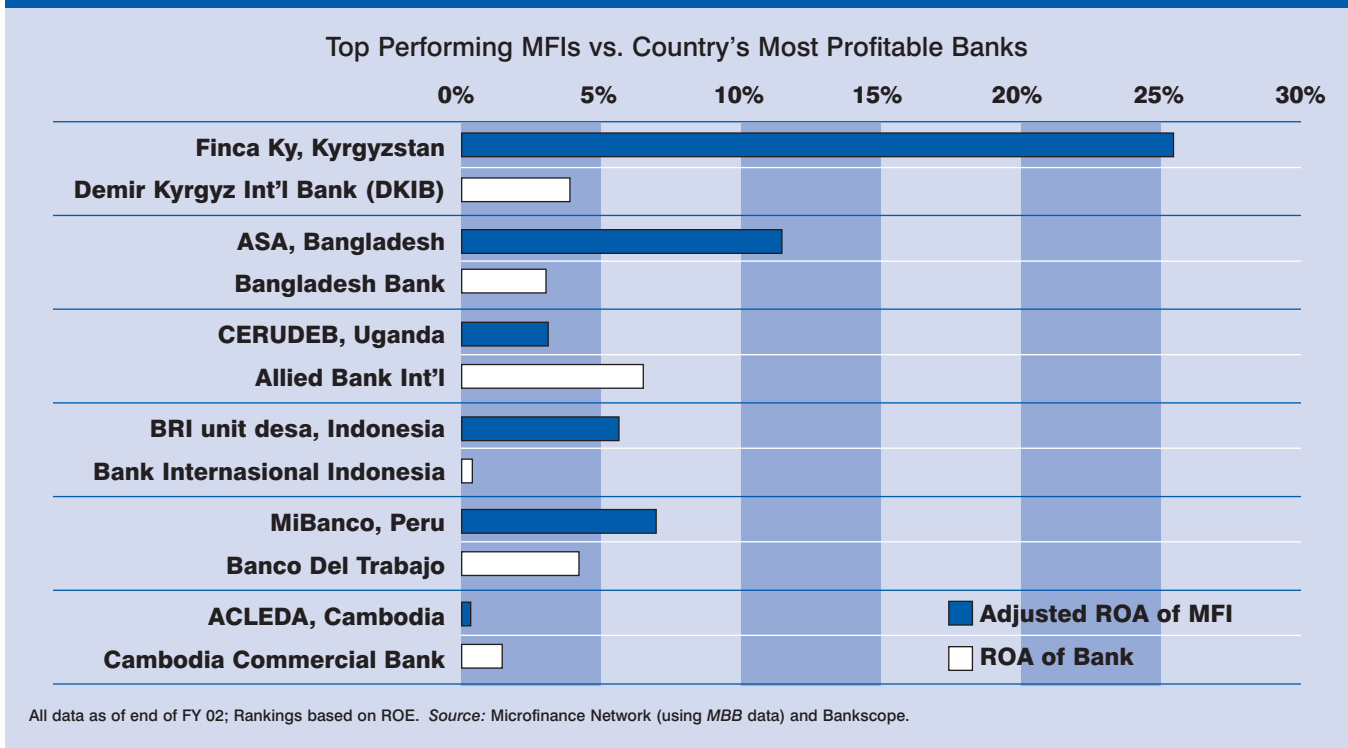
Against this backdrop, new microfinance techniques have produced some remarkable results in the past two decades, especially in debunking myths about credit for the poor. We now know that the poor will repay uncollateralized loans very reliably, that they are willing and able to pay the full cost of delivering the service, and that they require a broad range of financial services, including deposits, transfers, and insurance. Microfinance has demonstrated that the poor can be served permanently, profitably, and in some cases on a large scale.

**FIGURE 1**

MFI	Country	Year	No. of Active Borrowers	Average Loan Balance per Borrower (US \$)	Adjusted Return on Assets	Portfolio at Risk > 30 Days
ASA	Bangladesh	2002	1,976,473	71	11.5%	0.2%
BRI	Indonesia	2002	3,056,103	440	5.60%	4%
Banco Sol	Bolivia	2002	42,290	1,910	0.40%	7%
ACLEDA	Cambodia	2002	85,598	311	0.30%	2%
Mi Banco	Peru	2002	101,470	910	6.90%	3%
Finca Ky	Kyrgyzstan	2002	20,466	213	25.50%	1%
ABA	Egypt	2002	35,823	323	2.70%	2%

Source: MicroFinance Network, 2002 Financial Statistics (using MBB data)

**FIGURE 2 Profitability vs. Banks**

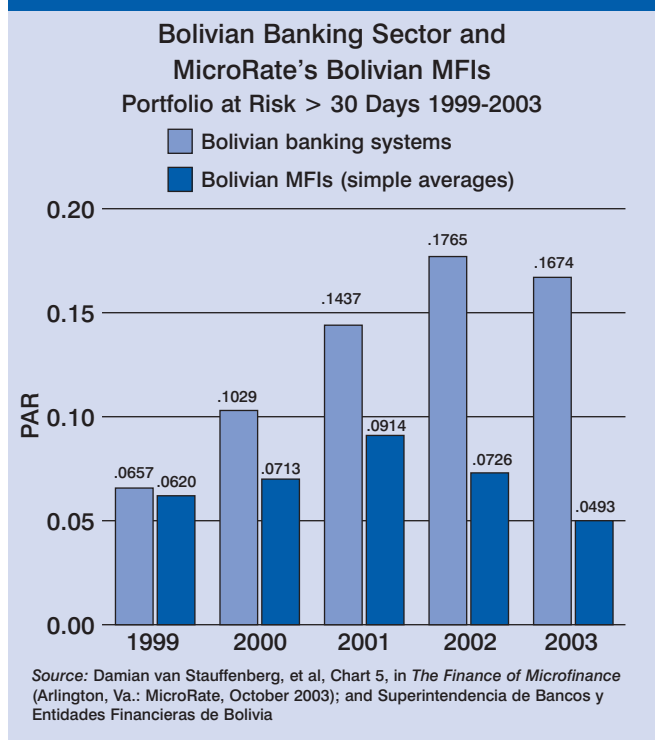


In fact, it is beginning to look like microfinance is a more stable business than commercial banking in the most turbulent times. During Indonesia's 1997 crisis, commercial bank portfolios imploded, but loan repayment among Bank Rakyat Indonesia's 26 million microclients barely declined at all. During the recent Bolivian banking crisis, MFIs' portfolios suffered, but remained substantially healthier than commercial bank portfolios.

Microfinance has generated considerable enthusiasm, not just in the development community but also at political levels. Inevitably, there has been some over-advertising. Microfinance is not a magic solution that will propel all of its clients out of poverty. But serious impact studies are demonstrating that microfinance produces real benefits for poor households.

But the microfinance model of the past two decades has its own limitations. So far, only a few MFIs have reached large scale (more than 100,000 clients). Most MFIs started as not-for-profit, non-governmental organizations delivering only loans. But NGOs often face governance problems, cannot legally offer deposit services, and have proven difficult to scale up in most markets.

**FIGURE 3**



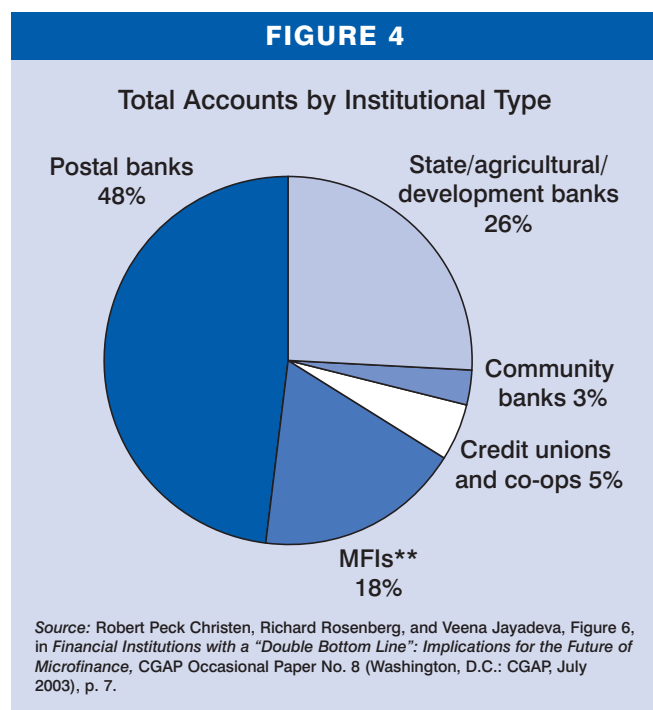
At this point it is worth noting that what we refer to as microfinance institutions are one piece of a much broader spectrum of socially oriented financial

institutions (or AFIs, alternative financial institutions), including state-owned development, postal, agriculture, and savings banks, as well as smaller entities like savings and loan cooperatives. We call these institutions “socially oriented” because for the most part they are not profit maximizers: they were created in order to reach a level of client that was not being served well enough by the commercial banking system. The AFIs represent a vast infrastructure and clientele: A recent, far-from-exhaustive survey identified well over 600 million accounts<sup>1</sup> in these institutions. There is generally no data available about what proportion of AFI clients are poor people. But the average account sizes in the AFIs suggest that this proportion is substantial. Only about 18 percent of total AFI accounts are in MFIs (that is, NGOs and other institutions using the recent microcredit models). Government-owned institutions account for the vast majority.

of the mainstream financial system. They are seldom supervised as seriously as commercial banks. If one measures the financial system by asset size, this attitude is often justified: except in a few countries, AFIs account for a small percentage of financial system assets, and may not pose systemic risk. But if one is concerned not only about systemic safety but also about access, one might count citizens instead of currency units, in which case the picture can shift dramatically. In many countries, a large proportion—often the majority—of the households using financial services get them from the AFIs. The AFI share of total financial system accounts is 53 percent in Bolivia, 65 percent in Côte d’Ivoire, and 77 percent in Burkina Faso. When large AFIs can be turned around and run on a businesslike basis, the results are dramatic. For example, in Mongolia the state agricultural bank was restructured, moved into microfinance, and is now privatized. It serves half of all the rural households in Mongolia through 375 points of sale, and is profitable. Bank Rakyat Indonesia, described earlier, is another case of a restructured state AFI that now provides high-quality services to massive numbers of poor people, and generates very healthy profits while doing it.

The general picture so far has been that financial services for the poor, despite their extensive outreach and promising new developments, suffer from being fragmented in niche institutions that are not well-integrated into the mainstream financial system. This isolation hurts the outreach and efficiency of such services. But at the beginning of the 21st century, we are seeing encouraging signs of integration. While in many countries the field is still driven by governments, donors, and NGOs, in others commercial orientation, technology, and multiplying points of sale are likely to fuel very fast growth. In some countries, competition is limited, potential synergies between public and private sectors are unexploited, and know-how is not shared, while in others we see walls coming down, partnerships being formed, and public and private sector assets being leveraged.

Integration is happening, whether the institutional form of the service provider is an NGO, a bank, or a credit union. To begin with, most of the leading



Despite their extensive outreach and infrastructure, the AFIs also have important limitations. Some of them — especially the state-owned ones — provide inferior service, are highly inefficient, and generate large continuing losses. In many countries, financial authorities do not consider the AFIs as part

<sup>1</sup> Information about numbers of clients was not available in many cases.

microfinance institutions—NGOs and banks alike—today operate on a businesslike basis using the techniques and disciplines of commercial finance. They are investing in more sophisticated management and information systems, applying International Accounting Standards, contracting annual audits from mainstream auditing firms, and seeking ratings from commercial rating agencies. Last year over 100 credit ratings of MFIs were carried out by different rating agencies, including Standard & Poor's, Moody's, and Duff and Phelps.

There is a growing recognition that building financial systems for the poor means building sound

domestic financial *intermediaries* that can mobilize and recycle domestic savings. Foreign donor and social investor capital diminishes as individual institutions and entire markets mature. For this reason, more and more MFIs are getting licensed as banks or specialized finance companies, allowing them to fund themselves from capital markets, and from deposits that are not only a source of capital but also an important service to their clients. (Most mobilize deposits from large institutional investors as well as poor clients.) Several MFIs, mainly in Latin America, have issued domestic private placements, taken up principally by domestic financial institutions.

**FIGURE 5**

**MFIs Are Beginning to Tap Domestic Debt Markets**

**Characteristics of Four Microfinance Bond Issues**

	<b>Mibanco</b>	<b>Compartamos</b>	<b>FinAmérica</b>	<b>BancoSol</b>
Year of issuance	2002	2002	2001	1997
Type of bond	Straight	Straight	Convertible bond	Straight
Amount (USD)	\$6 million (a)	\$15 million (b)	\$2 million	\$3 million (c)
Currency	Soles	Pesos	Pesos	Bolivianos
Coupon	12%	CETES + 2.5% (d)	DTF (e)	9%
Tenor	2 years	3 years	2 years	2 years
Credit Enhancement	50% USAID	None	None	50% USAID
Sale mechanism	Dutch auction (f)	Private placement	Private placement	Private placement
Main buyers	Local pension funds (82%)	70% institutional 50% individuals	Only existing shareholders	Bolivian institutions
Raters	Equilibrio, Apoyo & Asociados	Standard & Poor's	Duff & Phelps/ Fitch	n/a

Source: Interviews with executives in Mibanco, Compartamos, FinAmérica, and BancoSol.

- (a) First issuance in a planned \$30 million program over the next few years
- (b) Two separate issues, the first for \$10 million and the second for \$5 million. In the first issue 70 percent of the investors were individual and 30 percent institutional; in the second issue the ratio between institutional and individual investors were 50/50.
- (c) Three separate issues of \$1 million each
- (d) CETES are Mexican treasury bills. When adding taxes and fees the final cost to Compartamos was 13.08 percent.
- (e) DTF: Average of the 90-day certificates of deposits in the market
- (f) In a Dutch auction format, bids are accepted from lowest to highest interest rate, but the highest accepted rate is the rate paid to all investors.

Source: Tor Jansson, *Financing Microfinance*, Sustainable Development Department Technical Papers Series, MSM-118 (Washington, DC: Inter-American Development Bank, October 2002), p. 17.

Dozens of countries are considering legislation to create new types of financial licenses, usually with lower minimum capital, designed for specialized microfinance intermediaries. While generally positive, this trend does pose risks. Supervisors who are already stretched thin trying to monitor commercial banks can find it difficult to cope with responsibility for a new group of small institutions. And the move toward specialized MFIs sometimes overlooks opportunities to involve mainstream commercial banks in microfinance.

In countries as different as Haiti, Georgia, and Mexico, partnerships between commercial banks and microfinance institutions are an alternative to MFIs seeking their own financial license. They enable MFIs to cut costs and extend reach while enabling banks to tap new markets, diversify assets, and increase revenues. Partnerships vary in their degree of engagement and risk sharing, ranging from sharing or renting front offices to actual portfolio purchases and equity investments.

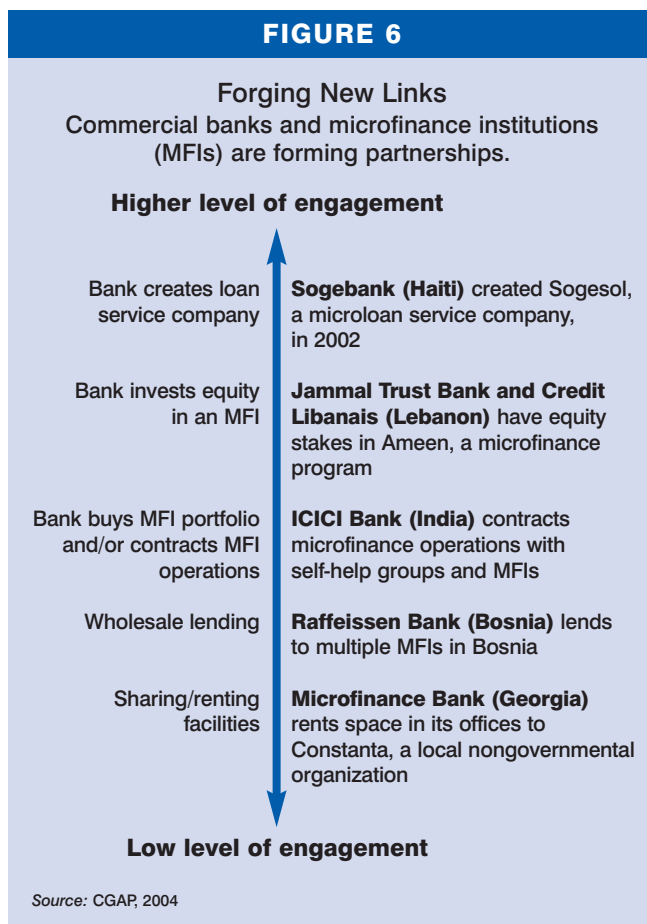
**“To achieve its full potential, microfinance must become a fully integrated part of a developing country’s mainstream financial system.”**

In Africa, Asia, and Latin America, some local financial institutions pursue lower end retail banking directly, as financial globalization brings in competition from international banks for their larger corporate customers. Banque du Caire in Egypt entered the market two years ago and now delivers microfinance alongside its traditional products in its 230 branches. It is still too early to tell whether large numbers of commercial banks will move into microfinance. Well-run microfinance has proven its profitability, but serving this market requires changes in systems, staffing, and culture that are not easy for traditional banks.

Lower-income customers have smaller account and transaction sizes, which places a premium on reducing transaction costs. Credit-scoring and computerization have underpinned many of the important new down-market opportunities, with the result that the boundary between microfinance and consumer finance is now blurring in many places. Retailers and consumer finance institutions in Chile, Zimbabwe, and South Africa are adapting microfinance methodologies so they can use their infrastructure to tap the new market of *uncollateralized*, character-based lending to the self-employed or to households in general. In Kenya a mainstream savings-based building society, the Equity Building Society (EBS), has done the same.

MFIs are beginning to tap into mainstream credit bureaus. This not only reduces risk for the MFIs, but also allows their clients to build a public credit history that makes them more attractive customers for mainstream banks and retailers.

As success in extending financial services to poorer



## FIGURE 7

**Peru:** More than 80 MFIs are registered through the network of MFIs (COPEME) to use Infocorp, a private credit bureau. Of these, 34 are unregulated MFIs (NGOs with financial operations). Twenty of these are already providing the Infocorp database with their negative information on a systematic basis.

**Rwanda:** New regulation on microfinance issued by the Banque Nationale du Rwanda (BNR) requires MFIs to communicate information on their borrowers to a credit bureau. Rwanda Microfinance Forum (RMF), a not-for-profit organization that represents and supports several MFIs, will develop and operate the credit bureau with the assistance of donors.

customers depends on cost-saving techniques, there is growing exploration of creative ways to piggyback financial service delivery onto non-financial infrastructure, such as cell phones, retailers' points of sale, internet kiosks, post offices, and even lottery outlets. Cell phone companies in several Southern African countries are developing low-cost, cell phone-based banking services to clients below the poverty line. In Brazil, Caixa Economica is the second-largest commercial bank and holds 31 percent of the country's savings accounts. It operates 8,961 federal lottery kiosks and has 1,690 branches, covering all 5,561 municipalities in the country. As of September 2003, it also had point-of-sale (POS) terminals at 2,250 retail establishments (including supermarkets and pharmacies), where clients can deposit and withdraw from checking/savings accounts, make payments, and receive social benefits. Caixa expects to add 2,000 more locations to its POS network in 2004.

New information technology holds promise to reduce risk and cut delivery costs as well. Smart cards, fingerprint readers, and personal digital assistants are being taken up by banks and microfinance institutions in Bolivia, Mexico, India, and South Africa. By reducing credit risk and operating costs, these technologies may to enable them to reach poorer clients and more rural areas than they could sustainably reach without such technology. Not surprisingly, the actual performance of new technologies in microfinance does not always match the level of initial enthusiasm they generate, but some have proven themselves already, and other advances will no doubt emerge from the ferment of experimentation now going on.

India's second largest bank, ICICI, is building a network of thousands of multi-purpose village internet kiosks that will also be equipped with low cost card readers, point-of-sale terminals, and ATMs to deliver banking and insurance services throughout rural India. Similar technologies are being experimented with in Latin America and Central Asia.

Twenty years ago, the main challenge in microfinance was methodological: finding techniques to deliver and collect uncollateralized loans to "microentrepreneurs" and poor households. After notable successes on that front, the challenge today is more a systemic one: finding ways to better integrate a full range of microfinance services into mainstream financial systems and markets. We do not yet know how far that integration will go. But the early signs are encouraging. All around the world we are seeing developments that would have been dismissed as far-fetched a decade or two ago. ■



*Building financial systems for the poor*

**The Consultative Group to Assist the Poor**

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