Microfinance Niche for Spanish Banks in Latin America, an Andean Region Approach

June 2008

By

César Pajares Paz

Masters in Finance & Banking,
Centro Internacional de Formación Financiera
Universidad de Alcalá de Henares (Madrid), Spain

Acknowledgements:
CIFF & Universidad de Alcalá
My mother – Deriabar Paz Bartolo
My Tutor Supervisor – Sr. Tanguy Jacopin
Class of 2007/2008– Master in Finance & Banking, CIFF

Index

Introduction

1.1 Microfinance Overview

1.1.3 Origins of Microfinance

The history of microfinance started after the Second World War, specifically in the 1970s, with the active participation of international NGOs that were concerned about financial mechanisms to alleviate poverty in development countries.

Microfinance started as an experimental venture in rural areas, like the Grameen Bank of Bangladesh. Another example of rural microfinance is the "village banks", incorporated for the first time by the Foundation for International Community Assistance (FINCA) in Costa Rica in 1985 (Khawari, A. 2004).

On the other hand in the mid 80s, in South America, as part of initiative entities set up by NGOs and local leaders, appeared as urban microfinance models BancoSol in Bolivia and the Cajas Municipales in Peru. Nowadays the urban microfinance model in those Andean countries stands as a success, and having achieved financial sustainability, has been successfully replicated in many other countries. In this report, the urban and individual microfinance approach will be considered.[1]

1.1.2 Definition of Microfinance

In Latin America, microfinance is traditionally understood as financial services primarily for microenterprises: their owner/operators and their workers (Berger, M. 2006). It is a narrow sense though, because, a modern definition of microfinance considers it in a general perspective, as the activity to offer financial services for unbanked poor people. In this sense financial services include loans for business and personal use, savings and other deposit products, remittances and transfers, payment services, insurance, and potentially any financial product or service a bank can offer to this market segment. The poor include microenterprises, small farmers, low-income salaried employees, day laborers, pensioners, and poor households. The products and services can be targeted to meet the financial needs of the households as well as their income generating activities (Young, R. and Deborah D., 2005).

---

[1] Traditionally, the provision of microcredit started with group lending models relying on peer pressure/support to facilitate repayment. But nowadays, most MFIs in the region have been moving away from group lending towards individual loans as the market becomes more commercialized and geared towards individual needs.

For a bank point of view, microfinance can be best described as a hybrid of small-business and consumer banking with a strong dose of understanding the client's social and cultural characteristics.

1.2 Characteristics of the Microfinance Service

In urban microfinance certain client preferences and needs repeatedly happen. For example, clients tend to value service, speed, and agility over price. In terms of loans, this means reducing and simplifying the paperwork, formal collateral, and time involved to apply for and receive a loan. For deposits, this means unconstrained access to savings and low minimum balance requirements are usually more important than returns (Rutherford, S. 1999).

While the client's primary sources of repayment are enterprises, salaries, pensions, and remittances, current cash flows are the best determinant of future repayment capacity. Further, family and business finances tend to be mixed. This requires specialized loan appraisal techniques and the opportunity to provide personal as well as business-oriented financial services.

The informal guaranties used for the MFIs accomplish not only the basic function of payment motivation, but also, they help to increase customer loyalty for the MFIs, this is because most clients does not have many possessions to guarantee its loans and they tend to work with the MFIs that have its title deeds as "collateral", but not precisely as a formal mortgage.

2. Microfinance in Latin America an Andean Region Approach

2.1 Actual Context of the Sector

In first term, it is important to notice that the emphasis in Latin America microfinance has been on providing services to enterprises with insufficient access to financial services, as a consequence, microfinance in the region is more narrowly concentrated on enterprise credit, as opposed to other parts of the world where it tends to be broader, including savings, insurance, and other financial services, along with microcredit not only for microenterprises but also for consumers, whether in the informal sector or not (Christen and Miller, 2006).

In Latin America the microfinance industry has been developed mainly trough regulated microfinance institutions and with specialized NGOs. This scenario is reflected in the coexistence of numerous, but most small institutions.

The scenario described has been changing, because in recent years some NGOs got into special regulatory laws which allowed them to launch passive products, like saving accounts. This new funding, along with the entrance in their capital structure of small local partners, investment funds and international specialized institutions have contributed to the expansion of their credit activities. Also the reduction of subsidized funds through the microfinance business has been replaced with term deposits and wholesale sources like issue debt to the capital markets.

On the other hand, since mid 90s commercial banks are also directing their attention to microfinance. In some banks, microfinance is their main line of business (MiBanco in Peru, or Banco ProCredit in Ecuador), while in others; it is a new product (Banco Pichincha in Ecuador, Banco de Crédito in Peru or Banco Santander in Chile). In a way, banks "downscale" to be able to reach the typical microfinance client.

There are three main microfinance business models in the region. The first group includes "downscalers," that is, regulated banks that added microfinance as a new line of business (through an internal unit, a subsidiary or any other mechanism). The second group is that of "upgraders" or NGOs that have transformed themselves into regulated specialized microfinance banks. The third group consists of "greenfields," which are institutions that, since their foundation, have been operating as regulated MFIs.[2]

According to Table 1, microfinance in Latin America is having an exponential growth the last years. Around 2005, the number of microfinance borrowers was about six million, with a credit portfolio up to USD 5.6 billion. According to some estimation, continuing the growth tendency, nowadays, there are more than 9 million microfinance customers in the region.

A second important fact deriving from Table 1 is that regulated MFIs continue to have the biggest market share of microfinance. Already in 2001, 52 percent of microfinance clients were served by regulated MFIs. In 2005, this percentage went up to 65 percent. Regarding portfolio, these percentages climb to 76 percent for regulated MFIs in 2001 and 81 percent in

[2] There is another model conformed by nonregulated MFIs, which are NGOs, foundations and any other type of nonregulated financial institutions.

2005. Data also reveal an average annual growth rate of 35 percent for the number of borrowers and 46 percent for portfolio. Nevertheless it is only the beginning, considering that most Latin American people still continue unbanked.

Table 1

Microfinance Institutions in Latin America, 2001 - 2005

Type of Institution	Number of Institutions			Portfolio (USD million)			Number of clients (million)		
	2001	2005	Var. %	2001	2005	Var. %	2001	2005	Var. %
Regulated MFIs	60	98	63%	901	4,407	389%	1.0	3.8	280%
Downscale	21	32	52%	343	1,821	431%	0.4	1.3	225%
Other Regulated[1]	39	66	69%	558	2,586	363%	0.6	2.5	317%
Nonregulated MFIs	124	239	93%	288	1,035	259%	0.9	2.1	133%
Total	184	337	83%	1,190	5,442	357%	1.8	5.9	228%

Source: S. Navajas and L. Tejerina. How large is the market? IADB, 2006.
[1] It includes Greenfields and Upgrades

2.2 Most and Less Advanced Countries in Microfinance Services

In the Table 2, countries are ranked according to number of customers in microfinance institutions, so that Mexico is first, followed by more traditional microfinance markets such as Peru, Colombia or Bolivia. However, if countries are ranked for number of customers over potential microfinance market, it does change the relative position of larger countries such as Mexico or Colombia, for instance, Mexico only reach 1.2% of its population and Colombia 1.3%, in the case of Brazil it is almost cero. This reveals a huge potential market for microfinance business especially in those larger markets.

It is important to mention that the four countries of the Andean Region concentrate 51% of the Latin America microfinance Portfolio. Peru with the 27.8% of the total Portfolio has the biggest credit portfolio of the region. However this trend will change with the fastest growth rate of the major microfinance markets like for example Mexico.

In terms of Average Loan there is an important difference between Peru, Bolivia and Ecuador (Andean countries) and less mature markets, like Mexico and Brazil. In the first countries the average loan is higher than in the second group. This phenomenon is basically explained for the major competence in the referred Andean countries compared with the other quite new microfinance markets[3].

[3] According to Herfindahl-Hirschman Index, see Annex 1.

As we can see in the Annex 1, according to the Herfindahl-Hirschman Index (HHI), the most competitive countries in Latin America are in the Andean Region, specifically Ecuador, Peru and Bolivia. It seems that strong competition in those mature markets including Nicaragua, and emerging competition in Colombia and the rest of Central America, not only will increase the average loan, but also will continue to encourage MFIs to diversify their product mix in search of new growth opportunities.

Also, it is important to have taken into consideration that microfinance is developing in large countries in different ways than small ones. Except for Mexico, other big countries like Brazil, Argentina and Venezuela are not following the microfinance methods of upgraded MFIs (mainly, those of the Andean region); few nonprofits there are interested in becoming regulated institutions, and even Greenfield microfinance is limited. In Brazil, for example, nonprofits are weak, but State banks are strong, and a number of recent downscaling efforts were based on consumer credit technologies rather than the proven principles of microenterprise lending (Christen and Miller, 2006).

Table 2

Microfinance in Latin America Details Per Country, 2005

	Country	Number MFIs	Portfolio (USD million)	Number of customers (thousand)	Average Loan (USD)	MFIs Customers / Population
1	Mexico	39	471	1,218	387	1.2%
2	Peru	67	1,516	1,174	1,291	4.2%
3	Colombia	22	315	608	518	1.3%
4	Bolivia	21	635	548	1,158	5.9%
5	Nicaragua	21	261	399	652	7.0%
6	Guatemala	24	273	360	757	2.8%
7	Ecuador	20	322	327	985	2.4%
8	Chile	5	663	290	2,223	1.9%
9	Brazil	16	91	176	313	0.2%
…	Other	63	516	292		
23	Total	336	5,442	5,976	911	

Source: S. Navajas and L. Tejerina. How large is the market? IADB, 2006.

According to Navajas (2006) there are discrepancies in definitions and classifications used in countries for the microfinance business. If the definition of microfinance is understood and measured as the provision of all types of financial services to low-income segments of the population, discrepancies may be affecting the data, with possible underestimations of big countries like, Brazil and Mexico.

Today, microfinance in Latin America presents specific characteristics depending on each country culture and the local regulatory basis. For instance, in some countries, such as Bolivia, Peru or Honduras, the regulatory authorities created specialized nonbank firms for MFIs. These are supervised qualified financial institutions that need to comply with the regulations set forth by the corresponding financial authority. The most significant difference with a bank is usually lower capital requirements and a limited number of services being provided.

2.3 Urban Microfinance, the Leading Model in the Region

Specifically in the Andean region the microfinance industry focuses its attention in the urban areas. This practice happens because entering rural areas is yet difficulty and costly to IMFs, due to a lack of proper physical infrastructure, and the dispersion of the rural communities.

But in the urban areas the outreach is still modest in terms of the number of people with basic access to financial service and the type of financial services offered to low-income populations, so there is still ample room for expansion in both fronts.

The expansion of services has not been equal among countries or even within a single country. For instance, the microfinance industry has, for the most part, reached an urban clientele in small countries such as Peru, Bolivia or El Salvador, but it still lags behind in reaching their poorer rural areas. Also in the case of the largest countries (Brazil, Mexico or Argentina) both urban and rural microfinance is just beginning and investors have to consider that as those countries concentrate most of the Latin America population, they also have most of the poor people in the region.[4]

According to the United Nations (UN) to 2005, approximately 22.6% of the Latin America population lives in rural areas, about 131 million people. It is certainly true that in relative

[4] According to the World Bank to 2005 poverty in Mexico and Brazil reach 40% and 38%, respectively, about 114 million.

terms most poor population of the Latin America region is concentrated in the rural areas; poor rural people are about 54% of the total rural population, compared with the 31% of poor people that live in urban areas. However, in absolute terms, of the total poor people of the region, about 66% live in urban areas. This is mainly explained for a migration phenomenon inside each country from the rural to the urban areas, which will continue, as the UN estimates that for 2010 the rural population will decrease up to 20.9%.

2.4 More Competition: the Trend Toward More Sophisticated Products

Two microfinance business models have been prevalent in the region, both with a commercial focus. Those are MFIs that become banks: "upgrading", and commercial banks doing "downscaling" [5]. It is important to mention that those banks, not only are attending micro entrepreneurs but also they are focus its attention to unbanked people like new wage-earning, with special consumer credits or passive products like account deposits, which is a market that traditional MFIs were not given special attention due to their focus in micro-business.

In this scenario, the referred banks are offering its new customers a complete range of retail products like: transfer services facilities, new loan options like mortgages, and international credit cards, and also microinsurance to cover default micro business which represent a huge new market, due to the traditional high micro entrepreneur's default rates.

Banks in downscaling process could get faster and better outcomes by using their competitive advantage and their financial innovations for the microfinance sector. Innovative products for the microfinance business, like: loans in local currency, remittances, securitization programs, microinsurance, equity stakes or special investment funds.

This can lead to a wider range of options for further extending microfinance services. For instance, international banks can achieve greater efficiency and cost reductions for their microfinance ventures, by helping MFIs to access to the financial capital markets and by offering technical assistance to build capacity.

---

[5] Examples of Banks doing downscaling by themselves: ABN AMRO Real (Brasil), Banco de Venezuela (Venezuela), Banco del Pichincha (Ecuador), Banorte (México) and Banco de Crédito (Perú). Other banks into downscaling process with the support of the Interamerican Development Bank: Banco Uno (Nicaragua y El Salvador, 2006), Interbank (Perú, 2006), Banco G&T Continental (Guatemala, 2005), Bancasol (Guatemala, 2004), El Comercio Financiera (Paraguay, 2001) y Sogebank (Haití, 1998).

On the other hand, for the current microfinance participants, the most obvious consequence of the growth in microfinance investment is a sharp rise in competition. More MFIs are being created, existing MFIs are using new capital to support their expansion plans, and commercial banks are arriving from to establish a direct presence, or creating fund vehicles to do it for them (Lascelles, 2008).

Although demand for microfinance services continues to rise strongly, expansion on this scale is hurting the less professionally managed MFIs and could relax its credit standards as lenders fiercely compete for borrowers. This is causing alarm through much of the established MFIs, which sees its markets and profitability threatened, for instance, in Peru, Caja Municipal de Piura, a leading Greenfield MFI reduced its ROA from 3.77% at December 2005 to 1.76% at April 2008, and Bancosol in Bolivia reduced it since 2.73% to 1.5% in the same period.

Nevertheless, for those well established MFIs this tendency is helping them to enter in innovative process looking for new revenue sources, like: new products or better ways of delivering them, and also trying to improve cost control. It is also stimulating capital markets operations of biggest MFIs in the region, who see the prospect of selling out to rich commercial investors, for instance Banco Compartamos in Mexico, which raised capital successfully in the Mexican stock market.[6]

To sum up, at the end, this new diversification phenomena will be good for Latin American microfinance participants in the case of MFIs: i) products tailored to better fit client's needs can reduce risk of misuse of loans, ii) cross-selling financial products to known clients will provide new opportunities for growth, and iii) product diversification may allow lenders to establish monogamous relationships with their clients to cover all of their financial service needs. And since the point of view of microfinance actual or future customers this tendency is positive because represent more diversify and cheaper access to financial services.

2.5 Actual and Potential Market in Latin America

There is increasing evidence that microfinance is a profitable activity in Latin America and it will very likely continue to expand in the coming years. Still, a huge potential market exists for microfinance in the region: according to Navajas (2006) the potential market is close to 67

[6] In April 2007, Compartamos Mexico issue shares for USD 407 millions. But, the market capitalization of Compartamos Mexico at the end of June 2008 was about USD 2,000 millions.

million households in the region, which is the number of people that their income origin is their microenterprise activities.

In table 3 are ranked Latin American countries according the level of penetration of the microfinance service, besides the mature Andean countries, Peru and Bolivia, there are other Central America countries, with high level of penetration, especially Nicaragua that cover about 58% of its potential market.

On the other hand, the biggest countries of the region (Brazil, Mexico, Colombia, Argentina and Venezuela) that concentrate most of the region's population, about 73%, have the lower market penetration, most of them below the regional average of 8.7%. It means that to 2005, about 91.3% of the microenterprises of the region, approximately 61.7 million did not have access to financial services.

Table 3

Potential Microfinance Market in Latin America, 2005

	Country	Number MFI Customers (Thousands)	Micro-enterprises (Thousands)	MFI Customers / Micro-enterprises
1	Nicaragua	399	685	58.3%
2	Bolivia	548	1,737	31.6%
3	Peru	1,174	4,993	23.5%
4	Guatemala	363	1,600	22.7%
5	Chile	298	1,497	19.9%
6	Ecuador	327	1,991	16.4%
9	Mexico	1,217	10,395	11.7%
10	Dominican Rep.	145	1,400	10.4%
14	Colombia	608	8,713	7.0%
18	Venezuela	45	3,247	1.4%
19	Brazil	290	22,408	1.3%
20	Argentina	11	3,787	0.3%
23	Total	5,952	67,579	8.7%

Source: S. Navajas and L. Tejerina. How large is the market? IADB, 2006.

3. Business Microfinance Models: Banks, MFIs and NGOs

3.1 Evaluation of the Microfinance Models

One of the critical decisions that bankers looking to serve the microfinance market niche must make is whether to do microfinance in house or through some sort of external organization such as a service company or subsidiary. But, whether the bank chooses to do microfinance in house or through one type or another of external organization will often have a substantial impact on the success of the bank in this new venture (Westley, G. 2006). In this sense the bank should understands the pros and cons of the different structures and how they depend on country and bank circumstances.

An external organization has more relevant advantages than an internal unit, as we can see in the following table that summarize the advantages of both internal and external units.

Table 4
The Choice of Structure

Advantages of an External Organization over an Internal Unit	Advantages of an Internal Unit over an External Organization
▪ The bank's losses are limited to the amount it has invested in the external organization ▪ Image and branding ▪ Greater freedom to implement microfinance products and processes ▪ Outside shareholders can contribute to governance, technical assistance, and reduce risks for the bank.	▪ Can be faster to start-up and start-up cost are reduced ▪ Can have lower operating costs ▪ Outside shareholders are avoided ▪ Funding advantages: a) few restrictions on capital backing from the bank, b) usually lower funding cost than subsidiaries.

Source: Gutin, J. Jepsen, J. Miller, M. Natilson, N. Singleton, T. and Young, R. (2005).

An important advantage of doing microfinance through an external organization instead of an internal unit is that the external organization may be able to escape the rigidities, bureaucracy, and culture of the bank to a much greater degree and thus use much more appropriate microfinance procedures and products.

From an image and branding point of view, external organizations are advantageous for banks that want to create a separation between their traditional operations and its microfinance activities. The bank may wish to create an external organization, if the bank considers that tactics in which poor people are charged high interest rates, pressured to repay loans, or have their household goods or equipment seized could damage its general reputation.

The external organization has other possible advantages, for instance, when the bank takes on outside shareholders, specialized in microfinance business like ACCION International[7] or Kreditanstalt für Wiederaufbau (KfW)[8], and is only a partial owner of the MFI, those partners typically provide high quality technical assistance to the organization in how to do microfinance properly, increasing the microfinance program's chances of success.

On the other hand, among the advantages of an internal unit over an external unit, it is important to mention that usually, greater integration into the bank reduces operating costs. Mainly, because there are economies of scale in all of the methods a financial institution uses to fund itself: borrowing from donors, banks, and other sources; mobilizing deposits; issuing bonds; and issuing stock.

Another advantage of the internal unit is the natural reduction in market risks stemming from balance sheet netting. With less risk, risk-mitigation costs are normally reduced.

To sum up, there is not a unique solution to the question of best structure. It mainly depends on the strategy of the bank to enter into microfinance business and of course on the legal requirements of each country.

3.2 Drivers to the Downscaling Approach into Microfinance

Table 5 shows the most important drivers, both internal and external that a commercial bank can have take into consideration for a process of downscaling into the microfinance industry.

[7] ACCION International is a NGO that receives funding of both public and private sources, for instance: USAID, IFC, Citigroup Foundation, JP Morgan Chase, Open Society Institute. ACCION develop its operations mainly in Latin America, where have supported the launch of some of the most successful upgrade MFIs: Bancosol in Bolivia, Mibanco in Peru, Banco Solidario in Ecuador and Banco Compartamos in Mexico.

[8] KfW is a German development bank, very active in the area of microfinance, nowadays support more than 87 microfinance projects. The bank contribution to the microfinance business is not only with financial support (credit lines, collaterals, etc), but also through technical services, like for instance the initial assistance for the creation of the Cajas Municipales de Ahorro y Crédito in Peru.

Table 5

Drivers for Bank Downscale Into Microfinance

Internal Factors	**External Factors**
• Profit • Risk diversification • Excess liquidity • Image - Social responsibility • Cross-marketing opportunities • Bank leadership • Compatibility with bank strategy or other lines of business	• Large microenterprise and low-income market • Competition • Trend • Regulations • Donor or government initiative • Market pressure on margins • Desertion of traditional clients

Source: Young, R. and Drake D. (2005) and Valenzuela, L (2001)

Experience has repeatedly shown, however, that microfinance best succeeds in institutions that possess a sound business reason for entering the market; and the most important are: a continued support of the bank's board and most senior management; and a group of midlevel managers who are persistent in establishing and advancing the microfinance concept. These internal drivers must be matched by an environment favorable for microfinance, with sufficient demand, freedom to set prices, and reasonable regulations.

The most classical reason for international banks is the good image that allocate money to microfinance means, because public usually tend to relate microfinance as a corporate social activity, considering its focus on serving the poor.

The microfinance portfolio itself achieves substantial diversification, not only because the performance of the microfinance portfolio may have low correlations with traditional bank business lines due to the very different nature of the clients and activities, but also as a bank business line that have performed well in times of recession.

MFIs display no statistically significant relationship with global market movements. But, regarding exposure to domestic Gross Domestic Product, it is demonstrated that MFIs are not detached from their respective domestic economies. In this sense, according to a recent study (Krauss, N. and Ingo, W. 2008), MFIs may have useful diversification value for international portfolio investors able to diversify away from country risk exposures

According to Westley (2006), specifically in Latin America the main reasons why banks are downscaling into the microfinance business are:

- Increased competition in the banks' traditional markets, such as serving large firms, small and medium size enterprises, and consumers.
- The attractive profits on microfinance business. For example, the Microbanking Bulletin reported that of 52 Latin American MFIs reporting for 2003, the median adjusted return on assets (ROA) was a 1.8 percent and the median adjusted return on equity (ROE) was 9.5 percent.
- A large unserved market in most Latin American countries, which holds out the prospect of rapid growth.
- Ample proof that microfinance works, and continues to work well even in bad economic times. For example, Westley (2006) presents individual data on 11 leading individual MFIs in Bolivia, Colombia, and Peru that show remarkably low delinquency rates and high ROAs during the particularly deep and difficult 1998-99 recession.
- Credit coefficients. The governments of some countries, such as Brazil, Colombia, and Venezuela, encourage or force all banks to dedicate a certain percentage of their demand deposits, loan disbursements, or loan portfolio to microloans.

4. Microfinance Niche for Commercial Banks

4.1 Double Bottom-Line Microfinance Business

Success microfinance programs indicate that low-income markets can be served on a "sustainable" basis, that is, with full cost recovery and a market return, without subsidy (Gutin, J. Jepsen, J. Miller, M. Natilson, N. Singleton, T. and Young, R. 2005). It means that the double bottom approach for microfinance is the leading model to assure, not only the sustainability of the microfinance as a new bank business line, but also as a proved approach to reduce poverty.

As a result, nowadays some major international banks are using microfinance for both; serve the unbanked people for corporate responsibility motives, and as a business case and long-term commercial activity. Also, the participation of international banks in microfinance can stimulate innovations for microfinance and contribute to efficiency gains for microfinance operations, having into consideration their scale and expertise. This could open the door to increasing the outreach of microfinance services around the world.

The difficulty, however, is in marrying these newer commercial objectives with microfinance's traditional philanthropic mission. While many of the professionally managed MFIs measure their success in terms of profitability and investor returns, these indicators are not used for most of the industry, especially non-regulated NGOs, whom sees its main purpose as relieving poverty and serving the financially excluded.

One important difference in both approaches is the charge of higher interest rates for microfinance loans in the case of the commercial approach. However, the growth of healthy microfinance portfolios in a diversity of countries, for instance in the Andean Region, show that micro entrepreneurs and other low income clients can and will pay higher prices for loans and other banking services, based on their higher cost opportunity that they pay to moneylenders and other sources of financing, as well as the fact that is higher the profit margins that microenterprises generate compared with the cost of microfinance loans.

The fact is that worldwide microfinance is under huge pressure to become more commercial, thus regulated, because without firm commercial foundations, it is questionable whether microfinance would become the sustainable business that it needs to be in order to survive and do well for the poor. Commercial pressures may be painful but they are also rigorous on governance, management, cost control, transparency, areas that showed to be actual or potential areas of weakness for most MFIs.

4.2 Replication of Best Practices in the Downscaling Process

Banks entering microfinance will need to make decisions in every area, from selecting strategic partners to designing the appropriate operating model, internal organizational structure and product offerings. At the same time, they should notice that, some aspects of retail banking, such as credit systems that separate the credit application, analysis, approval, and supervision processes, are not effective for microenterprise lending.

In addition to drawing on the resources of credit bureaus, a bank, especially one with consumer lending operations, may use technology such as credit scoring to help control repayment risk. But nowadays, credit scoring in microfinance is in its very early stages (implemented by only a few sophisticated MFIs) and its use has been hampered by a lack of consistent historical household data (Young, R. and Drake D. 2005).

Of the Latin America urban and individual lending model, there are some special characteristics or processes of microfinance that any bank should have to take into consideration in any downscaling program, like for instance: i) charge much higher interest rates to compensate for the smaller sizes, shorter terms, and more frequent repayments of these loans; ii) the microfinance procedures gives much greater reliance on character and household cash flow analyses than on collateral, acceptance of a lack of borrower financial statements and other business records; iii) loan officers who spent most of their time in the field looking for loan applicants on site and calling borrowers with overdue payments.[9]

Also, it is necessary to use available technical assistance about how to do microfinance right. As is mentioned in the Annex 2, there are some key rules, which have been probed to be successful during many years in Latin America. Following those rules banks would save expensive mistakes and earns greater profits more quickly.

4.3 Risks and Impact of Future Microfinance Ventures

Financial valid arguments for commercialization of microfinance is that the risk of financial failure tends to be low relative to the returns, and that the risk-adjusted total returns on microfinance exhibit low correlations to those of other available asset classes, thereby presenting investors with an attractive opportunity for portfolio diversification.

But to take a decision about a microfinance venture, besides the financial risks, banks should understand that the sector is undergoing great structural changes. Convergence is occurring between microfinance and mainstream banking as MFIs grow in size and sophistication, and commercial banks enter the market. These trends have boosted the size and quality of the microfinance sector, but also created new pressures of competition and sharper expectations.

There are some failure experiences in downscaling programs in Latin America. The two main causes of failure are, first, a technical failure because those banks often don’t really understand microfinance characteristics and processes and how to make it into a profitable business line. Second, a bank’s failure because a lack of commitment of those banks to

[9] For a detailed list of Elements of an Appropriate Microfinance Methodology see Annex 2.

consider microfinance as a profitable business. In such cases the microfinance program never achieves the scale or profitability that would justify continued involvement.

Another risk facing microfinance worldwide is the uneven quality of management at MFIs at a time of rapid change. Closely linked to management there are concern about the quality of corporate governance and staffing in MFIs, both of which are seen to be weak and a drag on development (Lascelles, D. 2008).

Specifically in Latin America, MFIs practitioners are focused closely on external factors bearing on their business: competition, regulatory and political pressures. Also related to the growing commercial pressures to which they feel exposed a new important concern is their major exposition to interest rate risk (Lascelles, D. 2008).

The risk of diversification can lead to increase loan balances per borrower as MFIs make multiple loans to repeat customers. Furthermore, MFIs entering the consumer market face lending without the strong guaranties that come with microenterprise loans or by group lending methodologies. The combination of the trends towards larger, often riskier individual loans, especially for consumer use, and rising loan balances may lead to higher delinquency, along with problems associated with over-indebtedness.

Finally, it is important to mention the major risk factor that microfinance deal with in Latin America is the uncertain political environment of the region. The risk is that the stability of microfinance policies will affect the activity, for instance, there are some governments that impose ceiling levels to interest rates or create bureaucracy subsided institutions which compete with the MFIs without commercial terms.

5. Strategies of Spanish Banks Related to Microfinance in Latin America

BBVA is one of the top financial groups in Latin America, providing banking, pension and insurance services to most countries in the region. The Group is the leader in Mexico, Colombia, Peru, Argentina, Chile, Venezuela, Puerto Rico, Paraguay, Uruguay and Panama. It has more than 20 million customers in the region. In 2007, the region recorded its highest ever net attributable profit, with a figure of USD 3,424 million and growth over 2006 of

12.7%[10]. In the region there is a high concentration on its operations in Mexico which represent the 75% of the total profits of the region.

On the other hand, Santander Group[11] after the acquisition of Banco Real in Brazil has become the largest banking group in Latin America. In terms of profits, the bank continue its strong growth trend in Latin America: revenues and profits generated in the region doubled between 2003 and 2006, in 2007 attributable profit increased 27.3% to USD 3,648 million. Growth was quite concentrated within the region, because the three large markets: Brazil, Mexico and Chile accounted for 79% of the total profit of the region. The bank is also present in Argentina, Venezuela, Puerto Rico, Colombia, Uruguay and Peru.

It is important to mention that both banks have similar goals to their expansion plans into the region. In the case of Santander Group, focus in Brazil, aspire to double its business and customer revenues in three years in the region, as well as reach more than 30 million individual customers in 2009 (26 million in 2007). BBVA, on the other hand, have a Banking Penetration Plan in Latin America 2008-2010, that have the goal of double its credit portfolio, with 4 million new customers in Mexico and 3 million in South America.

But, to first capture the huge potential market of unbanked people in Latin America, about 61 million microenterprises that do not have access to formal financial services; Spanish banks with considerable presence in the region have different strategies. In the case of BBVA, there is a new strategy to enter in this business with an important investment through a microfinance foundation, on the contrary, Santander, does not have a noticeable strategy to support the microfinance activities of their Latin America subsidiaries. In this scenario an analysis of both bank approaches in the region is showed to identify their drivers and characteristics.

5.1 BBVA Group

The BBVA's general plan to increase bank accessibility to the poor people is focused in both, banking and social programs (BBVA's Annual Report 2007). Into the banking programs, which the bank considers as a strong growth engine, there is a strategy to serve immigrants in Spain (Credit Express), but also to attend unbanked people in Latin America. In relation to the

[10] The total Net Attributable Profit in 2007 was about USD 8,380 million, 29.4% up on 2006.
[11] Santander is the first bank in the Euro zone and the fifth Worldwide by profits. In 2007 got Net Attributable Profit for USD 11,100 million, a year increase of 23%.

social programs, there are social plans programs in Spain as well as in Latin America, but the BBVA Microfinance Foundation is the differential factor into this general strategy.

BBVA Microfinance Foundation[12]

The large flow of money going into microfinance institutions is a potential problem, for most Latin America MFIs, because most small MFIs show weak and limited managerial capacities and few worthwhile projects to fund. An alternative option to this approach is equity financing of micro credit financial organizations, linked to technical assistance, which is exactly the one adopted by BBVA's Microfinance Foundation.

BBVA realized that entering in microfinance they require a radically different approach compared to conventional banking. With a purpose specific institution the bank expect acquire significant holdings in specialist organizations, developing a range of services and unique policies for risk approval and management. BBVA consider that as, the microfinance industry is extremely fragmented, therefore to make an effective impact in poorest areas, usually under-banked levels of society, it is necessary a specialized microfinance banking network that would provide the economies of scope and scale, needed to make it competitive.

In these sense, in 2007, BBVA set up the BBVA Microfinance Foundation, as a strategic initiative, considering that according its studies it will fulfills bank's requirements of profitability, sustainability and also good image. This non-profit institution will promote access to financial services among people with low incomes, focusing especially on those socially and economic disadvantaged areas. The Foundation is independent of the BBVA Group in terms of both governance and management, and its mid-term goal is to consolidate its position as one of the largest microfinance networks both in Latin America and worldwide.

The foundation's strategy involves driving microfinance through partnerships and holdings in microfinance institutions with a proven local track-record and solvency in the management of such resources. Also, as a complement, the foundation is to undertake programs in professional coaching, technological innovation, the provision of information and the know-how and best practices in corporate governance that will help to create an environment that is more propitious to the development of microfinance.

[12] Information was collected from BBVA's web site and BBVA's Press Releases.

The foundation currently has an allocation of €200 million, of which €20.1 million were invested in 2007. The foundation's operations are initially centered on Latin America, with priority being given to those countries in which the BBVA Group is present. Accordingly, in 2007 the foundation purchased majority holdings in two Peruvian entities (Caja Rural de Ahorro y Crédito Nor Perú and Caja Rural de Ahorro y Crédito del Sur), which are to be merged in 2008. In Colombia the foundation had created a new regulated entity, called Bancamía, in cooperation with the world women's corporations: Corporación Mundial de la Mujer-Bogotá and Corporación Mundial de la Mujer-Medellín.

The bank's aim is that the future microfinance network will to create synergies, because there will be an interchange of knowledge and experience, for instance, the BBVA Microfinance Foundation will add: risk management, growth capabilities, access to the capital markets, information technology development, technical and management abilities and be part of a big network with international credibility. MFIs partners would add: knowledge of the local markets and knowledge of their specific industry.

Table 6

BBVA Microfinance Foundation First Acquisitions

	Caja Nor Peru Peru	Caja Sur Peru	EDPYME Crear Tacna Peru	CMM Bogotá Colombia	CMM Medellin Colombia
Loans	37.3	25.9	21.3	34.9	32.4
Equity	6.6	5.3	4.4	6.7	5.8
Delinquency	4.6%	4.5%	4.33%	1.64%	1.96%
ROE	25.6%	24.0%	18.7%	18.1%	16.8%
ROA	3.4%	3.6%	3.2%	3.6%	3.5%
Employees	436	160	114	284	254
Branches	17	10	11	27	17

Source: S. Navajas and L. Tejerina. How large is the market? IADB, 2006. And SBS Peru

Table 6 shows that BBVA first country focuses are in the Andean region where the bank has presence. It seem that those five acquisitions have similar characteristics, but as it is mentioned previously, each country have its own peculiarities, for instance, Peruvian acquisition are regulated institutions and Caja Nor Perú and Cajasur finance most of their operations with savings accounts. On the other hand, the MFIs associated in Colombia are specialized non-regulated NGOs, that having successful results, have other operating differences with its Peruvian peers, for example, they do not receive savings and have ceilings for their interest rates. In this sense, the creation of a regulated MFI in Colombia, called Bancamía, tends to imitate in Colombia the Peruvian experience.

Corporate Social Responsibility Report BBVA 2007

The report highlights that with its first operations in Peru and Colombia, the BBVA Microfinance Foundation is already reaching 200,000 beneficiaries.

Another important emphasize of the report is the creation in 2007 of the Fondo Codespa BBVA microfinance fund (hedge fund). This fund makes BBVA one of the world's first banks to roll out a microfinance hedge fund in Latin America. As well as being the nexus of union between socially responsible investors and the microfinance industry. In order to support decision-making in the selection of those microfinance institutions to be backed, the bank has contracted the services of BlueOrchard, one of the world's foremost investment managers in the microfinance field.

The creation of this new fund seems not coherent with the current double-bottom line strategy of the BBVA Microfinance Foundation, considering that most hedge funds attract institutional investors that with advanced investment strategies such as leverage and derivative positions look for generating high returns, without having into consideration corporate social goals.

5.2 Santander Group

The Corporate Social Responsibility Report Santander 2007, indicate that Santander's microfinance initiatives are focus in its Latin America operations, in this sense, the Bank participates in various initiatives in order to contribute with knowledge, capital and work for the development of the countries in which they operate. According to the referred Report, Santander has the following microcredit initiatives:

Argentina

- The local microfinance program is in its first stages, this program has two objectives: provide financial assistance to microfinance institutions organized as NGOs and improve the knowledge of Santander Rio's managers handling this business.

Chile

- Through Santander Banefe, the consumer finance firm of the local Santander subsidiary, during 2007, 56,540 micro businesses received credits, 12,743 of them for small farmers and new long-term lending products were created and added to the portfolio offered. Also, in 2007, the first branch specialized in micro-businesses was opened in Santiago.

In Chile there is the biggest Santander microfinance program, it is a downscaling microfinance program with the creation of a microfinance division in house the bank. The model is urban and individual lending and the methodology is similar than in other Latin America countries.

Brazil

- Santander has a microcredit program for small companies and individual entrepreneurs. In 2007, 30,000 customers were granted these credits. The program has developed since 2003 and today forms part of the Bank's line of products.

It is important to mention that in the case of Brazil, the next integration of Banco Real to the Santander Group, the Real Microcredito, originally established for ABN Amro, will represent a new downscaling microfinance program to the group. This program was the first case of an international commercial bank involved in microfinance in Brazil. The bank partners with ACCION International to get expertise and technical assistance for its operations, but nowadays it has a quite low outreach with a currently a portfolio of 8,250 clients.

Venezuela

- The Bank is the leader in the microcredit segment with a market share of 11.75%. Santander Venezuela's micro credits account for 5.22% of the Bank's gross lending portfolio, almost double the 3% required under Venezuela's banking regulations. The Bank also sponsors training workshops for micro business people.

- At the initiative of the Banco de Venezuela – Santander Group Foundation, Bancrecer, a development bank, has been granting small personal loans and advising people without accounts for the last two years. It has established ambitious goal, like, to grant in five years, 300,000 micro credits, generating 900,000 new direct and indirect jobs, with more than three million Venezuelan beneficiaries.

The case of Bancrecer in Venezuela is another downscaling process of a Santander subsidiary. It is important to notice that this program follows the methodology prevalent in the Andean region, that is, urban and individual lending, for instance, according to information of the bank, to reach its target, the bank's credit officers goes to the street looking for its customers located in popular neighborhoods.

To sum up, Santander already has three downscaling microfinance programs in its Latin America subsidiaries. But despite that all these programs have the characteristics of the leading microfinance models in the region, which are to be urban and individual focus; they do not seem as an integral or coordinated program.

5. Conclusions

Nowadays is clear that microfinance outreach does not have to be at the expense of profitability. Alleviate poverty and profitability are not necessarily mutually exclusive; there are many large MFIs which manage to produce acceptable financial returns while also meeting their social responsibility goals.

The past years Latin American microfinance is growing increasingly diverse, not only in terms of the types of institutions but also in the different products they offer. Traditional and leader local banks as well as some international banks are gradually becoming more involved by offering more products and services. And as a response to the rise in competition, some well established MFIs are diversifying with consumer, mortgage, home improvement and other varied financial instruments. But, according recent estimations in major populated countries of the region there is a huge gap between the current supply of financial services to microenterprises or low-income population345678s and the demand for it.

And to reach this potential market there is not a unique model of Latin American microfinance; but the leading approach is the microfinance cluster in the Andean region, which is an urban, individual methodology, that after more than 25 year has stand as a sustainable commercially focus microfinance model. In this sense, when a microfinance venture is directed to other countries of the region, either through an internal or external unit, this model should be consider as a basis model to have better chances to succeed. Also in downscaling programs banks should be taken into consideration circumstances of each country, for instance: the regulatory framework, the degree of development of local financial markets and macroeconomic conditions.

Banks that are successful at microfinance, in terms of growth and profitability, have built their programs on a sound business case and operate in environments that are conducive to commercial microfinance. In this sense of the analysis of the microfinance approaches of the Spanish banks in Latin America, it seems that neither BBVA nor Santander have a conclusive strategy. In the case of BBVA, realizing just in 2007 of the potential microfinance market of the region, the bank launched a long term program as a strategic approach, due to the size of the money allocated, it appeared as an impressive attempt. But with the creation of a hedge fund for microfinance, an opposite approach, the microfinance strategy of BBVA looks incoherent. Besides the bank replication attempt of the Peruvian model, should be carefully implemented and monitored depending on each country peculiarities in order not to have failure results.

On the other hand, Santander with bigger presence in the major unbanked country of the region, Brazil, does not have an integral and coordinated strategy for the microfinance activities of their Latin America subsidiaries. However it is important to notice that Santander have inner strengths in microfinance methodologies, considering its successful downscaling programs in Chile and Venezuela, consequently, the bank could use this expertise to support new microfinance ventures in other bigger markets, where it have presence. But, first at all, the bank should consider microfinance not only as a corporate social responsibility issue, but also as a commercial value added business.

References

Berger, M. Goldmark, L. Miller-Sanabria, T. editors (2006). An Inside View of Latin American Microfinance. Inter-American Development Bank.

Christen, R., R. Rosenberg and V. Jayadeva. (2004). Financial Institutions with a Double "Bottom Line": Implications for the Future of Microfinance. Occasional Paper No. 8. Consultative Group to Assist the Poor. Washington, D.C.

Corporate Social Responsibility Report BBVA 2007. BBVA's web site, www.bbva.com.

Corporate Social Responsibility Report Santander 2007. Santander Group's web site, www.santander.com.

Economist Intelligence Unit (EIU), IDB/MIF and the CAF. Microscope on the Microfinance Business Environment in Latin America 2007 – Country Profile.

Gutin, J. Jepsen, J. Miller, M. Natilson, N. Singleton, T. and Young, R. (2005). "Banking the Underserved: New Opportunities for Commercial Banks, Exploring the Business Case". Bethesda, Maryland: Development Alternatives, Inc., commissioned by the Department for International Development (DFID).

Khawari, A. (2004). Microfinance: Does it hold its promises? A survey of recent literature. HWWA Discussion Paper.

Krauss, N. and Ingo, W. (2008). Can Microfinance Reduce Portfolio Volatility?

Lascelles, D. Microfinance Banana Skins 2008: Risk in a booming industry. Centre for the Study of Financial Innovation, New York.

Maarten Brocades Zaalberg. (2006). A Billion to Gain? A study on global financial institutions and microfinance. ING Microfinance Support.

Navajas, S. and Tejerina, L. (2006). Microfinance in Latin America and the Caribbean: How Large Is the Market? Sustainable Development Department Best Practices Papers, MSM-135. Inter-American Development Bank. Washington, D.C.

Rutherford, S. (1999). The Poor and Their Money. Institute for Development Policy and Management University of Manchester.

Valenzuela, L. (2001). Getting the Recipe Right: The Experiences and Challenges of Commercial Bank Downscalers. U.S. Agency for International Development.

Westley, G. (2006). Strategies and Structures for Commercial Banks in Microfinance. Sustainable Development Department Best Practices Papers, MSM-123. Inter-American Development Bank. Washington, D.C.

Young, R. and Drake D. (2005). Banking at the base of the pyramid: a microfinance primer for commercial banks. Development Alternatives and USAID.

Annex 1

Microfinance Business Competition in Latin America 2007 – Country Profile[13]

Country	Level of competition	Comentary
Argentina	0.0 (HHI: 4702.6)	There is very little competition among MFIs. But in specific regions, competition is beginning to arise (eg, the province of Buenos Aires, Mendoza, Salta). Many provinces are served by only one institution.
Bolivia	2.0 (HHI: 1459.6)	There is moderate competition among MFIs. But there is a well-developed microfinance market with considerable outreach of both regulated and non-regulated institutions.
Brazil	0.0 (HHI: 4541.6)	There is very little competition among MFIs. But the level of competition has grown in recent years, but is still quite low.
Chile	0.0 (HHI: 4165.8)	There is very little competition among MFIs. There is reportedly good financial access for formal microentrepreneurs, but poor access for informal microentrepeneurs.
Colombia	1.0 (HHI: 2207)	There is little competition among MFIs. But Colombia has one of the largest non-regulated MFI sectors in the region.
Ecuador	3.0 (HHI: 561.7)	There is sustantial competition among MFIs, with the lowest HHI score in the region indicating the lowest level of industry concentration. Ecuadorian microfinance has had one of the highest rates of growth in recent years (even more than Bolivia and Peru). But It still needs more specialisation in product supply and operators.
Guatemala	0.0 (HHI: 2962.9)	There is a very low level of competition among MFIs. Competition is still in a "basic stage of formation", and "lacking in market entrants".
Mexico	1.0 (HHI: 2417.4)	There is little competition among MFIs. Competition was still low, but growing. Interest rates and costs remain high.
Paraguay	2.0 (HHI: 1719.3)	There is a moderate level of competition among MFIs, with one important area for improvement being high interest rate spreads, particularly at finance companies.
Peru	3.0 (HHI: 781.1)	There is considerable competition among MFIs. Peru and Bolivia are the most competitive MFI markets in the region. There is substantial competition among and between regulated and non-regulated institutions.
Uruguay	0.0 (HHI: 5662.5)	There is very little competition among MFIs.
Venezuela	0.0 (HHI: 5587.7)	There is very little competition among MFIs. But with new market entrants it may be poised for modest growth.

*The Herfindahl-Hirschman Index (HHI) is a measure of the size of firms in relationship to the industry and an indicator of the amount of competition among them, it can range from 0 to 10,000, decreases in the HHI index generally indicate a loss of pricing power and an increase in competition, whereas increases imply the opposite.

[13] Adapted from Economist Intelligence Unit (EIU), IDB/MIF and CAF

Annex 2

Key Elements of an Appropriate Microfinance Methodology[14]

1. Small, short-term loans that may increase in size and term if successfully repaid.
1. High interest rates (much higher than banks charge for their larger loans) to compensate for the high operating cost margins associated with making small loans.
2. Greater reliance on cash flow and character analyses than on collateral, in which:
   - The unit subjected to the cash flow analysis is the entire household, not just the business.
   - The character analysis is based on visits to the client's home and work place and on talks with business associates, neighbors, friends, and relatives.
   - Collateral generally consists of unregistered household goods and business equipment and/or group guarantees.
3. Some use of non-traditional repayment frequencies to facilitate greater monitoring of borrowers (weekly or biweekly instead of monthly), or even of installment payments that vary in size and/or frequency (for clients with strong seasonal variations in their income, as often occurs in the agriculture and tourism sectors).
4. Decentralized loan approval processes, rather than several departments signing off on loan approvals.
5. Rapid loan approvals and disbursements, with little or no formal documentation required of clients (such as financial statements and collateral appraisals).
6. Loan officers who spend 80-90 percent of their time in the field (developing and screening new clients and checking on old ones, especially those who are delinquent).
7. Loan officers who see their loans through from origination to collection and have an important part of their remuneration (perhaps 30-70 percent) determined by their portfolio delinquency rate and loan volume.
8. A strong and effective loan collection program that includes immediate and repeated follow-ups on loan delinquency and a management information system that supports this with daily reports to loan officers showing which of their clients are delinquent.
9. Operating costs are often held down by having loan officers use inexpensive modes of transportation and by operating out of relatively modest branch offices.

[14] Westley, G. 2006