

The Service Company Model: A New Strategy for Commercial Banks in Microfinance¹

The Challenge: Entry and Long Term Commitment of Commercial Banks in Microfinance

Commercial banks have been increasingly important players in the development of microfinance services in Latin America during the past few years². Commercial bank “downscaling” to the microfinance market is good news for microfinance customers because banks can offer them a full range of financial services, including credit, savings and fee-based services. It is also important for microfinance as a whole, because with their extensive physical, financial and human resources, banks can launch and expand microfinance services relatively inexpensively. If commercial banks become serious players in microfinance, they can offer very strong competition to traditional microfinance institutions.

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However, there is a perception within the microfinance community that commercial bank entry into microfinance will be short-lived or shallow. For example, there is a perception that commercial banks may not move into microfinance in the first place because the time to build up a microfinance operation to a profitable level exceeds banks’ standard investment time horizon. Or, after entering microfinance, banks might move up-market by increasing loan amounts to maximize profits – or worse, exit if they are unsatisfied with the level of profitability in microfinance. These perceptions have been fueled by specific cases of commercial bank entry into microfinance and subsequent exit. At the most extreme, some practitioners have even proclaimed, “Downscaling is dead!” and abandoned the idea of working with commercial banks.

In view of the very significant advantages commercial banks can potentially bring to microfinance, ACCION International has developed relationships with several commercial banks to launch and expand microfinance operations. In most of these cases, ACCION and its partners are using an approach, known as the *service company model*, that shows early promise as a workable method to overcome very real

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² This paper focuses on the role of traditional commercial banks as opposed to the specialized banks and finance companies that have been formed specifically to reach microenterprise clients. It discusses private banks, though many of the considerations also apply to state-owned banks.

obstacles to commercial bank entry and to establish a long-lived microfinance operation through a commercial bank.

This paper describes how the service company model addresses the key issues in commercial bank entry into microfinance, identifies success factors for establishing a well-functioning microfinance service company, and presents results and lessons from the two microfinance service companies with the longest experience, SOGEBANK/ SOGESOL in Haiti and Banco del Pichincha/ CREDIFE in Ecuador. Early results suggest that the service company model represents a significant breakthrough in enabling commercial banks to enter and stay in microfinance.

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What Commercial Banks Bring to Microfinance and What Keeps Them Out

Well-established commercial banks offer the field of microfinance several advantages not generally available to NGOs or transformed microfinance institutions, and these advantages also make them potentially strong competitors:

- *Physical and Human Infrastructure.* Large commercial banks often have an extensive network of branches, frequently covering all major cities in a country. If this infrastructure proves suitable for microfinance, it can substantially cut the cost of opening a new microfinance outlet. In addition, banks may bring advanced technology infrastructure (MIS, ATMs). Finally, commercial bank staff represent human “infrastructure” – people with skills in areas such as human resources, customer service, information technology, marketing, legal and financial management who can support microfinance operations.
- *Market Presence and Brand Recognition.* Banks that have been in the market for a long time are well known to the public and have a recognized brand. In many cases the brand carries a high degree of trust. Some large banks already have connections into the middle and low-income population through other services such as savings accounts or payment services.
- *Access to Plentiful and Low-Cost Funds.* Banks can directly access local and international financial markets, and the larger established banks have a broad base of savings accounts. They can raise large amounts of loanable funds quickly and at a relatively low cost.
- *Low Cost Structure.* Banks generally have a much lower operating cost structure than traditional microfinance institutions. Moreover, their private ownership provides a strong incentive to be efficient.

Not all banks possess all these advantages to the same degree. Retail-oriented banks with large branch networks, particularly if branches are in low-income areas, are most likely to try and succeed in microfinance.

On the other side of the picture, several factors tend to keep banks from significant entry into microenterprise lending:

- *Market Knowledge.* Commercial banks lack an understanding of the microfinance market and its clientele, and often dismiss this segment as both too risky and too expensive. Even if a bank recognizes that microfinance can be profitable, the resulting portfolio size may be viewed as too small relative to the level of effort required to manage a microfinance operation.
- *Credit Methodology.* Banks often attempt to serve the market with inappropriate credit methodologies, for example by using adaptations of traditional commercial or consumer lending approaches. When these methodologies fail, they reinforce the idea that microfinance is not promising.
- *Trend toward Automation.* The banking sector has been moving quickly to adopt labor-saving technologies such as ATMs and internet-based banking that reduce the number of face-to-face transactions, which carry high personnel and infrastructure costs. Bankers may see the labor-intensive and personal nature of microenterprise credit as the antithesis of their drive toward more automation and less infrastructure. On the other hand, some banks have started to see microfinance as a product that can be introduced into branches in low- and middle-income areas to help them remain profitable and keep their doors open.
- *Conservative Corporate Culture.* The long tradition of banking is closely tied to specific ways of doing business, and it is difficult for banking professionals to change. With a conservative outlook, banks may tend to burden microfinance with policies and procedures that prevent its success, or they may be very slow to recognize and make needed changes. This is especially true for large, bureaucratic banks.
- *Human Resources.* Microenterprise credit requires staff who are comfortable working in the neighborhoods where clients live and work, and who must be highly productive in order to succeed. Monetary incentive systems are often used to spark such productivity. These requirements of microfinance are often incompatible with the human resources profile and policies of commercial banks.

The policy environment is also a key factor. For example, in countries with interest rate ceilings and heavy government intervention, banks will be prevented from even contemplating microfinance. Additionally, the competitive environment plays an important role. In countries with a highly competitive banking sector and a high level of market penetration, commercial banks may consider market niches they might otherwise overlook.

The challenge of bringing commercial banks into microfinance is to overcome the obstacles in order to incorporate the advantages. It is interesting that several of the key advantages are positional, while most of the obstacles involve the need to increase understanding and to change ways of thinking. The strategy is to provide a structure that uses the positional advantages of banks while preventing attitudes and processes of traditional banking from hobbling microfinance. We now consider several structuring possibilities.

Four Models of Commercial Bank Entry into Microfinance

Commercial banks have used four models to structure their participation in microfinance: an internal unit within the bank; a financial subsidiary; strategic alliances with specialized microfinance institutions; and most recently, the service company model. We consider each in turn, with emphasis on the service company.

Internal Unit

Banks can create microfinance units or even introduce a microcredit product within an existing unit. In the latter case, a bank might treat microcredit simply as a new product introduction, with a marketing and promotion campaign, but little other preparation. The new product introduction strategy is probably the lowest cost way to start microfinance operations, but it has rarely succeeded. Establishment of a microfinance division has succeeded in a number of cases, however, including Bank Rakyat Indonesia (BRI)³ and Banco do Nordeste in Brazil⁴, two of the largest and most successful microfinance programs in the world. Both are huge state-owned banks, suggesting that this model may be ideal for such banks.

An internal unit can be closely integrated into the bank, reducing the need for and cost of separate overhead. Instead, the microfinance unit relies on other departments of the bank for many services. The additional staff required are mainly those directly involved with operating microfinance services. For example, the head office staff of the BRI Unit Desa System, the microfinance unit within the bank, is very small relative to the size of the microfinance portfolio.

While the creation of an internal unit can be successful, two major disadvantages must be overcome. First, the bank must somehow differentiate the staff of the microfinance unit from the staff of the mainstream bank in order to build a distinct corporate culture within the microfinance unit. While BRI has found ways to accomplish this, it has been a source of tension at some other institutions. In MicroKing Finance, a division of Kingdom Bank in Zimbabwe and an ACCION partner, staff of the newly emerging microfinance program would like to split off from Kingdom Bank in order to strengthen their own corporate identity.

More difficult to overcome is the lack of independent governance for the microfinance unit. Without separate governance, the microfinance unit comes under the governance of the mother bank. Critical decisions concerning the microfinance operation are taken by groups of bankers with limited exposure to or concern for microfinance. Typically, microfinance has one or two champions within a bank's leadership, but the remaining senior decision-makers are focused elsewhere and may regard microfinance as a distraction. The result can be unworkable policy decisions, lack of sufficient internal resource allocation, and even about-faces regarding commitment to microfinance. Moreover, when microfinance is a unit within the larger structure,

³ For a detailed treatment of the structure of the Bank Rakyat Indonesia Unit Desa System, see Marguerite Robinson, *The Microfinance Revolution -- Volume II: Lessons from Indonesia* (The World Bank: 2002), Chapter 14.

⁴ Banco do Nordeste is part of ACCION's Network and began its microfinance operation, CREDIAMIGO, with support from the World Bank and with technical assistance from ACCION.

management rotation policies can result in frequent changes in management of the unit, including the placement of people with little knowledge of or interest in the sector. Among upwardly mobile managers, the microfinance unit may be viewed as a bad career move.

Financial Subsidiary

Some banks have established financial subsidiaries to serve the microfinance sector. An example is Financiera Solucion in Peru, a subsidiary of Banco de Credito. These subsidiaries can be wholly-owned joint ventures with other investors. The financial subsidiary option is attractive when banks and technical experts seek to work together in a transparent and commercial manner without disturbing the operations of the bank. A financial subsidiary is licensed and regulated by the banking authorities and must meet minimum capital and other requirements that go along with the license. Thus, the financial subsidiary requires its own substantial equity capital base. The decision to create a financial subsidiary of course depends on the local legal and regulatory framework. Issues that may influence the choice of whether to create a financial subsidiary in this area include interest rate rules, ongoing regulatory costs, and restrictions on deposit-taking, among other items.

The use of a financial subsidiary addresses the main drawbacks of the internal unit. It creates a separate staffing structure, management and governance, giving the microfinance operation the independence it needs. The formation of a subsidiary provides confirmation to the staff of a long-term commitment to microfinance. However, a subsidiary is less conducive to taking advantage of some of the benefits of the internal unit: it is more likely to involve duplication of staff functions at the headquarters level, with the subsidiary usually having parallel accounting, human resources and information technology departments.

In creating a financial subsidiary, a bank has the opportunity to limit its risk of entry into microfinance by sharing risk with other shareholders, particularly if those shareholders bring experience and know-how in microfinance. More intangible risks, such as image or reputation risk, are also limited by the separation between the bank and the microfinance subsidiary. The shareholders also gain by participating in governance, which allows them to ensure that the microfinance operation sticks to its mission and applies best practices.

Strategic Alliances

A deceptively simple and low-cost way for commercial banks to enter microfinance is to form strategic alliances with non-banking institutions already serving the microfinance market. Banks are often attracted to the concept of a strategic alliance because it allows them to claim credit for supporting microfinance without requiring much effort or exposing the bank to much reputation risk.

The simplest form of alliance is a loan, and banks around the world are already lending to microfinance institutions. Some banks have developed specializations as wholesalers to microfinance institutions, particularly to NGOs and credit unions. However, a simple lending relationship fails to take advantage of any of the special benefits commercial banks can offer, and recognition of this gap has led some banks and microfinance institutions to attempt to structure more complex strategic alliances. A next level of alliance involves NGOs as deposit-collecting

agents for banks, but this, too, draws little on the potential benefits commercial banks can bring to microfinance.

A more complex form of alliance would have a bank and its non-bank partner enter into an agreement in which the microfinance institution carries out some portion of the credit approval and/or credit administration process of the bank. Such an arrangement could take advantage of the market knowledge and credit methodology of the microfinance institution, while bringing in the funding and transaction processing abilities of the bank. Yet the bank would not have to make significant investments or operational changes.

In fact, such alliances are rare, and few if any have achieved lasting scale or sustainability. The lack of success derives from two factors: first, the strategic alliance does not leverage some of the most important of the bank's advantages (infrastructure, public image, cost structure), but rather adds a level of complexity onto the stand-alone microfinance model. Second, it is difficult to structure a successful agreement between a bank and microfinance institution. A successful agreement assigns *cost, risk, responsibility, and return* to each partner in a way that aligns their incentives and interests. Complex agreements of this type are difficult to structure, especially when the power of the two parties is unequal. Microfinance institutions often give up too much in order to convince a reluctant bank to form an alliance, and end up bearing much of the risk and cost while reaping little of the return. When mistakes occur, arguments break out over who was responsible for what.

The Service Company Model

A microfinance service company is a non-financial company that provides loan origination and credit administration services to a bank. The service company does all the work of promoting, evaluating, approving, tracking and collecting loans; however, the loans themselves are on the books of the bank. In return for providing these credit administration services to the bank, the service company is paid a fee (and vice versa, when the bank provides services to the service company). The service company employs the loan officers and other microfinance program staff, while the bank in turn furnishes services to the service company which could include teller support, human resources or information technology. The service company can be a wholly-owned subsidiary of the bank or it can involve additional investors.

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The service company model seeks to draw on the best elements of each of the three methods of bank involvement discussed above, while further addressing their drawbacks. Legally, a service company is a variant of the subsidiary model with the crucial distinction that it is not a financial institution. This distinction gives it important advantages. A non-financial company does not require a separate banking license, is not separately supervised by the banking authorities, and does not require a large equity base. It is thus much easier and less costly to launch and operate than a financial subsidiary.

The service company model addresses several of the shortcomings of the internal unit: it establishes a long-lived structure with its own governance and staffing that gives the microfinance operation space to operate. Because transactions are between legally separate entities rather than internal, a service company provides a more transparent framework for operation than an internal unit. In this way, it is an attractive structure for involving technical partners as investors and participants in governance. Yet, as an entity that exclusively serves a single bank, the service company can take full advantage of the benefits the bank has to offer in much the way that an internal unit can, and it has less need to develop parallel head office units because the parent bank can handle processes that do not require specialized microfinance knowledge.

As in the case of strategic alliances, service companies must negotiate detailed agreements with the parent bank that assign cost, risk, responsibility and return to each party in an effective way. And just as with strategic alliances, good agreements must align incentives to promote the overall interests of the institution. We will look more closely at how two service companies, SOGESOL and CREDIFE, structured their agreements, after a note on some key operational considerations.

Legal Form Versus Operational Structure

Each of the models described here are distinct legal structures. The legal structures suggest, but do not dictate, the operational structure. Yet operational structure choices are critical to the ability of the microfinance operation to build upon the advantages of the bank. Some of the central operational issues include:

- *Branch infrastructure.* Some microfinance operations in banks have taken advantage of bank branch infrastructure, greatly reducing costs and making it easy to scale up operations quickly. The extent of this cost savings depends more on the nature and location of the branches than on the legal model. One effective strategy is to locate microfinance branches in the same or adjacent physical structures to bank branches, but to provide separate front offices for receiving clients as shown in the photograph of SOGEBANK/SOGESOL.
- *Transactions processing.* Microfinance operations can use bank tellers, ATMs and systems for disbursement and deposit transactions, eliminating the need for duplicate staffing. However, the banks must be able to cope with the large transactions volume generated by microfinance which often exceed the volume coming from standard customers. Thus, it is very important to develop an effective transactions processing strategy that works for both the bank and microfinance operations.
- *Use of bank headquarters staff.* Bank know-how in the areas of information technology, human resources, marketing, legal issues, internal audit and financial management can alleviate the need for the microfinance operation to develop full-fledged departments in these areas, substantially reducing costs. Issues involved in this area include: a) need to develop some specialized microfinance knowledge by staff in these departments; b) low level of priority often given to microfinance by these departments in the main bank; and c)



Credit: Alex Morel

transparency of payment for services between these departments and the microfinance operation through clear agreements.

- *Branding*. Development of a brand that has its own clear identity but some connection to the parent bank achieves three aims: 1) the link to the bank enhances credibility; 2) the distinct identity welcomes low-income clients who may be intimidated by a bank; 3) the main branding of the traditional banks is undisturbed. Examples include the naming of SOGESOL (parent, SOGEBANK) and MicroKing (parent, Kingdom Bank).

Case Studies of the Service Company Model: Ecuador and Haiti⁵

As we examine the cases of SOGESOL and CREDIFE, many of the lessons they have learned relate to these operational issues, and thus can be applicable to other forms of bank involvement beyond the service company model itself.

Banco del Pichincha and CREDIFE, Ecuador

In 1997, ACCION International, with the financial support of USAID/Ecuador, conducted a series of meetings with managers and board members of the main commercial banks in Ecuador. The purpose of the meeting was to educate key leaders in these banks about microfinance with the understanding that the banks would develop business plans for launching microfinance operations. Seven institutions participated in this process and two developed business plans. Banco del Pichincha decided to launch operations in partnership with ACCION.

Microfinance was a good fit for Banco del Pichincha. During the first half of the 1990s Banco del Pichincha increased its number of branches to position itself as the leader in savings and consumer lending. However a deep economic crisis in Ecuador, starting in 1995, devastated the purchasing power of the Ecuadorian middle class, reducing the potential demand for consumer lending. In this environment Banco del Pichincha faced two alternatives. It could close branches, as other banks did, to reduce costs and move its clients to other delivery channels such as ATM and e-banking. Alternatively, it could add new financial services in its branches to reach profitability. In this context microcredit was an interesting prospect for branches in low-income areas where many microentrepreneurs live. The unused installed capacity implied that the introduction of microcredit would not raise costs greatly while providing a relatively high financial margin. Neither would it bring additional pressure to Banco del Pichincha's branch network and cashiers since these resources were already underused. Excess liquidity also pointed toward microcredit.

After considering the models of commercial bank entry discussed above, Banco del Pichincha and ACCION selected the service company model because it required little capital, had a lean structure and fast approval process. The original projections showed a break-even operation after

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⁵ ACCION also uses the service company model with its Brazilian partner, Real Microcredito, the microfinance service company of ABN AMRO/ Banco Real. ACCION is also in the process of launching a program using the service company model with Banco Caja Social in Colombia.

three years of project launch (two years after the start of lending) and an attractive rate of return on equity. ACCION participates in the project as technical assistance provider, minority shareholder in the service company, and member of the board of the service company. An attractive feature of the service company structure from ACCION's point of view is the small equity investment required to become a significant stakeholder. ACCION could fulfill one of its main objectives as an investor in microfinance, namely a voice in governance, at a low cost.

The agreement between Banco del Pichincha and its service company, CREDIFE, gives CREDIFE full responsibility for all credit evaluation and loan approval. Loans are disbursed by Banco del Pichincha, and are on the books of the bank, while CREDIFE, as the main interface with clients, is responsible for delinquency management and recovery of overdue loans. As compensation for its work, CREDIFE receives a commission in the form of a fixed percentage of the loan portfolio. The commission was calculated on the basis of expected interest income generated by the microfinance portfolio, less the cost of funds, expected provisions, and the cost of services provided by the bank. The commission rate can be penalized if delinquency in the microfinance portfolio increases above certain levels. An additional element in the agreement specifies how provisions will be calculated. The fee can be reviewed from time to time, but unlike the SOGESOL agreement, the fee rate was set in advance. This means that the bank absorbs any short-term fluctuations in the cost of funds, provisions, and costs of its services, while the service company only absorbs the risk of fluctuations in its own operating costs.

Great care was taken in negotiations over the allocation of credit risk and reward to align incentives, with most of that risk allocated to CREDIFE. Since CREDIFE's financial statements are ultimately consolidated into those of the parent bank, the bank is concerned about overall profitability of the operation more than the allocation of profits between companies. As an external investor, ACCION, however, has a strong focus on the risk and return formula for CREDIFE.

Clients of CREDIFE use Banco del Pichincha to make payments on their loans, as well to open saving accounts and other banking transactions. In most cases, CREDIFE branches are inside the same building or close to Banco del Pichincha branches but they do not handle cash transactions. CREDIFE has its own policies on hiring, staff salaries and incentives. It develops its own operating manuals as well as credit policies and procedures.

Key factors in the success of CREDIFE include the existence of an internal champion in the bank and the role of the technical partner. From the beginning one of directors of the bank led the project, and three key executives of the bank were on the board of CREDIFE. A general manager from the bank's brokerage subsidiary became CREDIFE's general manager and worked with the ACCION technical assistance team. The bank team brought its experience in banking operations while ACCION provided know-how in the implementation of microfinance operations.

CREDIFE was legally established in 1998 and made its first loans in July 1999. It achieved break-even on a monthly basis in 2001, after only 18 months of operation and during Ecuador's worst economic crisis in a century. This crisis resulted in the dollarization of the Ecuadorian financial sector, which dramatically reduced the financial margin available to CREDIFE. Since it began, CREDIFE's delinquency rate has never been above the level that would trigger the penalty clause. As of June 2003, CREDIFE had 18,227 active clients, with a portfolio of \$16 million. It

operates out of 17 branches, with four having microfinance as their main activity. CREDIFE remains on a rapid growth trajectory.

SOGE BANK and SOGESOL, Haiti⁶

SOGE BANK is the largest commercial bank in Haiti measured in total assets, with a 24 percent market share in the Haitian financial sector. SOGE BANK has the most extensive banking infrastructure in the country, with 30 branches, and is Haiti's only provider of ATM services.

SOGE BANK's involvement in microfinance followed a common pattern for banks in the sector. A senior manager at SOGE BANK became interested in microfinance after observing successful experiences in other countries. He believed that microfinance offered SOGE BANK an opportunity to achieve both social and business objectives, and he convinced the decision makers at the bank to explore the possibilities. SOGE BANK created a project team and launched a feasibility study, carried out by Bannock Consulting and financed by a grant from the Multilateral Investment Fund of the Inter-American Development Bank.

ACCION was then selected to work with SOGE BANK on the implementation of the project. Initial planning and design of operations involved a team of four ACCION consultants, including two residents, and three senior SOGE BANK managers who were brought in to work full time in the new institution. SOGESOL was created in August 2000, with ACCION and ProFund, an investment fund focused on Latin American microfinance, as minority investors. It disbursed its first loans in November 2000.

SOGE BANK's microfinance "champion" played a key role in shaping an agreement that reflected the context of Haiti and SOGE BANK in particular. As a result, the agreement between SOGESOL and SOGE BANK is structured somewhat differently than the CREDIFE agreement, although it addresses the same key elements. To avoid moral hazard and provide a strong performance incentive to management, SOGESOL's long-term contract with SOGE BANK includes the following provisions:

- The cost of funds SOGE BANK charges SOGESOL is based on the cost of funds in the Haitian market.
- SOGESOL pays SOGE BANK a transaction fee calculated as a pre-determined percentage of the portfolio when its clients use SOGE BANK branches, e.g., for all disbursements and repayments.
- SOGESOL pays SOGE BANK a fee for other services (marketing, accounting, legal, etc.).
- There is an agreed provisioning formula based on the higher amount between provisions calculated on the ACCION CAMEL⁷ standards and a maximum percentage of 3.5 percent of the outstanding portfolio (if it exceeds 3.5 percent, SOGESOL and SOGE BANK split the remaining provisioning expense evenly).

⁶ For more information on SOGESOL's history, structure and operations, please see *A Commercial Bank Does Microfinance: Sogesol in Haiti* by Guy Stuart, Kennedy School of Government Case Program, 2002.

⁷ The ACCION CAMEL™ is a diagnostic and management tool that measures the capital adequacy, asset quality, management, earnings and liquidity of microfinance institutions. It is designed to help managers assess an organization's financial health and overall performance.

Unlike CREDIFE, SOGESOL pays SOGEBANK for its services and keeps the difference between these costs and the interest rate charged to its clients, so that SOGESOL's income is subject to greater variation than that of CREDIFE. ACCION also has an option (a put) to exit that can require the other shareholders in SOGESOL to purchase ACCION shares at a certain multiple of book value. This option reduces the risk of a minority shareholder and reflects ACCION's temporary role until the microfinance operation can show reliable profitability to assure that the bank will have a permanent interest in the microenterprise sector. ACCION owns 19.5 percent of SOGESOL and holds a position on the five-member board of directors.

From the beginning, it was clear that starting microfinance operations with SOGESOL would have significant advantages. Banking operational costs are extremely high in Haiti due to poor infrastructure, limited power supply and security problems. To begin banking operations requires large investments in private communications, power generators and security. The relationship with SOGEBANK allows SOGESOL to put its branches near or inside SOGEBANK branches, reducing these costs.

As of August 2003, SOGESOL had six branches, including two outside Port-au-Prince, and was the largest regulated microfinance institution in Haiti in terms of total portfolio and number of clients. It reached full profitability in 2002 after just two years of operation, and first broke even on a monthly basis in its twentieth month. This growth was obtained in spite of the deep economic and social crisis in Haiti. However, actual growth has been lower than originally projected, as it has been more difficult than expected to achieve targeted levels of loan officer productivity.

Summary Results in SOGESOL and CREDIFE (June 2003; * indicates March 2003)

	SOGESOL	CREDIFE
Active clients	6,893	18,227
Portfolio (in U.S. dollars)	\$3,517,000	\$16,085,000
Average loan size (in U.S. dollars)	\$510	\$882
Portfolio at risk over 30 days	2.9 percent	1.5 percent
Number of branches	6	17*
Number of loan officers*	43	59
Clients per loan officer*	152	293
Portfolio per loan officer (in U.S. dollars)*	\$76,394	\$200,237
Length of time in operation	31 months	47 months
Number of months to break-even	24 months	18 months

Lessons from Initial Experience with the Service Company Model

So far the results of the service company model have been positive, particularly with regard to start-up and operating costs (although ACCION will continue to perform cost analyses). The support of a commercial bank has allowed CREDIFE and SOGESOL to focus on perfecting credit methodology without worrying about obtaining funds or opening full-fledged branches. However, problems with customer service, general resistance to change, and competing priorities have slowed the growth of these operations. ACCION is continuing to work to perfect the model based on experience to date and seeks to replicate it in bigger markets.

An important early result from the service company experience is that commercial banks getting into microfinance are not necessarily moving up-market. These banks have average loan sizes comparable to the specialized banks in the ACCION Network. Because the partner banks already serve clients demanding larger loans, there is relatively little pressure for the service company to begin moving up-market. Low cost structures allow these companies to operate profitably at lower average loan sizes.

Another early result with important implications is the relatively small external subsidy needed to launch these operations. Each institution received total grant funding from pre-feasibility through maturity of less than US\$500,000. Most of the grant funds supported pre-project planning and specialized technical assistance and training. The banks carried most of the project costs in the form of their own staff time, payment of a significant share of the technical assistance costs, and by providing the equity, loan capital and infrastructure. From a donor perspective, this cost is substantially lower than the total grant funds needed to launch brand new microfinance operations in either an NGO or start-up financial institution, which often run into the millions of dollars.

Among the specific lessons that have emerged from the service company experience are the following:

Choose the right bank. Not all banks are equally prepared to launch microfinance services. The right partner is a bank with a strategic vision to become a major retail – not corporate – bank. Important features include a network of branches in the relevant markets and a range of products already reaching down to the consumer level, such as savings, consumer lending and payment services. These features reduce start-up costs for microfinance operations and result in lower long-run operating costs, distributed among a portfolio of services.

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Find an internal “champion.” The chances of successfully creating and maintaining a microfinance service company are greatly increased with the personal support of an influential member of the bank’s management team. This person can serve as a liaison between the bank and the service company, and can help define the roles of each in the relationship.

Allocate tasks to the best-qualified entity. Banks should do what they do best, including treasury, accounting and legal functions. The microfinance unit should focus on its own comparative strengths, such as credit methodology and operations at the branch level. Some areas will require intensive coordination, particularly human resources and information systems. In these areas both sides can be brought together to complement one another. For example, a training program for middle management developed by the bank can be customized to microfinance by the subsidiary.

Anticipate standard problems. One of the most common difficulties involves internal competition, as service companies must compete for services with other subsidiaries or divisions of the bank. For example, congestion at branches can result in poor customer service for microfinance clients. More generally, an internal negative perception can mean that the service company does not receive priority attention when it experiences problems.

Create effective agreements. Service companies are more dependent on banks than are the other collaborative models since the portfolio stays within the commercial bank. Under this arrangement, the service company cannot easily access alternative sources of funding or services and thus cannot pressure the bank to reduce the cost of funds or increase the quality of services. Dependency creates a “moral hazard” since once the institution starts to operate, it is too costly to change strategic partners. This problem is most relevant for the external investors in a service company, who must seek protection through long-term contracts that specify all relationships and transactions transparently. Clear agreements should cover at least the following four items:

- Cost of funds, including the possibility to offset cost of funding on the basis of deposits from micro-clients.
- Fees for the clients’ use of the bank’s branch network for transaction processing.
- Fees for services provided by the bank to the service company (in areas such as human resources, information technology, legal services, etc.).
- Risk sharing, especially the method of calculating provisions and how potential losses will be distributed.

A Final Comment

We began by asking whether commercial banks will enter and stay in microfinance for the long-term. This question is actually a reflection of a broader question in microfinance: is it profitable to serve the microenterprise sector? If microcredit operations in banks become profitable with a risk adjusted return attractive to private capital, established commercial banks are very well positioned to dominate the sector due to their advantages in costs, infrastructure and market position.

If microcredit operations in banks become profitable with a risk adjusted return attractive to private capital, established commercial banks are very well positioned to dominate the sector, due to their advantages in costs, infrastructure and market position.

We are still in the early stages of bank experimentation with microfinance. It is instructive to remember that in the 1960s when a relatively small regional bank introduced credit cards, its first experience with this new technology was not very successful. During its first years, the product was not profitable. However, continuous experimentation and innovation with the cards led Bank of America to become one of the major players in the banking industry, and the credit card industry to experience explosive growth. Currently there are more than one billion credits cards in the United States alone.

From millions of microentrepreneurs around the world, the demand for financial services is there. Sooner or later the supply will be there, too, with the market setting the price and the return. When this happens, banks will be among the leading players.

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