

## Microfinance: From the Village to Wall Street?

It started out small and simple. In villages throughout Latin America and the Caribbean, poor people had to find ways to compensate for the lack of financial services available from commercial banks. Credit constraints in the region traditionally were tighter than elsewhere due to limited creditor protection, stringent restrictions on banking activities, and other regulatory faults. These regulatory problems had a negative impact on microcredit markets, forcing entrepreneurs with small businesses to look for alternative forms of financing. In some cases they created informal groups among friends and neighbors, taking turns as borrowers and lenders. Others relied on the flexible but exorbitant terms offered by local moneylenders. Yet others sought out a local credit union or non-profit organization providing basic financial services.

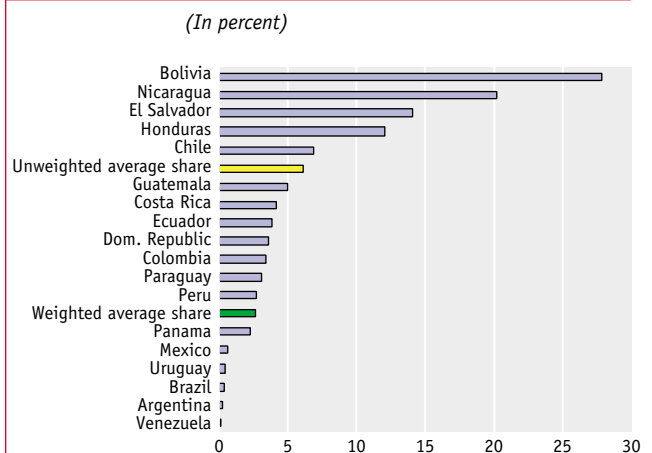
Given poor people's lack of assets, the organizations providing credit to them had to rely on measures other than collateral to assess creditworthiness and encourage repayment. As a result, loans were typically extended only for entrepreneurial activities, and the lending decision was based on a careful analysis of the person's character and the cash flow of the business. As part of this process, lenders would interview the applicant's family, neighbors and business contacts, and reward good clients with larger loans at lower rates.

Over time, some non-profit institutions became increasingly proficient with this lending methodology and began to grow rapidly. Their growth continued and in many cases accelerated in the 1990s. Today, microfinance institutions providing financial services to low-income entrepreneurs constitute an established element of Latin American financial markets, serving more than 1.5 million small and mostly poor entrepreneurs throughout the region (see Figure 8.1). If credit unions are

added to that total, the number of microenterprises served by these institutions exceeds 3 million.

The success of non-profit grassroots organizations in serving this sector has led to two important developments. First, commercial banks, realizing that there might be a profit to be made in microfinance, are starting to pay serious attention to how they can serve this segment of the market. Second, between grassroots non-profit organizations and profit-driven commercial banks, there is an emerging breed of professional financial institutions that specializes in microfinance. These are former non-profit organizations that have requested and received a license to operate as regulated and supervised finance companies or banks. These "re-constituted" institutions are in the forefront of showing that doing

**Figure 8.1** Share of Microenterprise Credit from Microcredit Institutions



Notes: Data for total microenterprises are from 1998 or 1999 (except for Peru, which are for 1997); data for microenterprises with microcredit institutional credit are from 1999. The data do not include credit unions.

Source: Westley (forthcoming).

Table 8.1 Types of Microfinance Institutions

	<b>Multipurpose financial institutions</b>	<b>Specialized financial institutions</b>	<b>Specialized nongovernmental organizations</b>	<b>General nongovernmental organizations</b>
<b>Strategy/Purpose of microfinance activities</b>	New market, image, philanthropy	Social impact, growth, profitability	Social impact, sustainability, growth	Social impact, sustainability
<b>Legal form</b>	Banks, finance companies and cooperatives	Banks and finance companies	Foundations, associations	Foundations, associations
<b>Clients</b>	Various; small and microenterprises are small share of portfolio	Small business and microenterprises	Microenterprises	Microenterprises
<b>Services</b>	Various and targeted to the specific market segment; individual credit; savings	Individual credit, group loans; limited offerings of leasing, factoring, etc.; savings	Individual credit, solidarity loans, village banking	Individual credit, solidarity loans, village banking
<b>Sources of funding</b>	Savings, shares, bonds, commercial loans	Commercial loans, shares, savings	Commercial and soft loans, guarantees, donations	Donations, soft loans, guarantees
<b>Examples</b>	Banco Solidario (Ecuador); Financiera Familiar (Paraguay); Coop. Fucac (Uruguay); MultiCredit Bank (Panama)	Financiera Calpia (El Salvador); BancoSol (Bolivia); Caja los Andes (Bolivia); FinSol (Honduras); FinAmerica (Colombia); Edyficar (Peru); Banco Ademi (Dom. Republic)	WWB (Colombia); FED (Ecuador); Acodep (Nicaragua); ADRI (Costa Rica)	Fundasol (Uruguay); Fundación Carvajal (Colombia); Fundación Cesap (Venezuela)

Source: Adapted from Lucano and Taborga (1998).

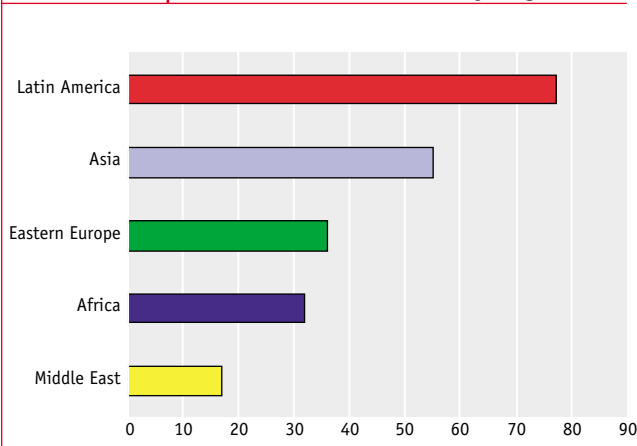
good and doing well are not necessarily mutually exclusive. There are about 35 such institutions in Latin America today.

Although many Latin American microentrepreneurs are still without access to financial services, the group as a whole is served by an increasing number of different institutions, ranging from very small non-profit organizations to very large and diversified commercial banks. The institutions differ in many ways, including their legal form, strategy, clients, services, and sources of funding, but they all contribute to serving the region's microentrepreneurs with much needed financial services (see Table 8.1).

## How Does the Microfinance Industry Measure Up?

From a regional perspective, Latin America is clearly leading the way in transforming microfinance from a subsistence activity to a profitable business. In no other region of the world are there as many financially sustainable microfinance institutions (see Figure 8.2). For a long time, the conventional wisdom held that microfinance could not possibly be a sustainable, much less profitable, business. However, microfinance institutions in Latin America are in the process of proving that notion wrong.<sup>1</sup> In Bolivia, which has the most developed microfinance market in Latin America, the most profitable financial institutions during 1999 and 2000 were not traditional commercial banks, but transformed microfinance institutions. Other countries are following suit, proving that poverty alleviation can be combined with good business practices. Peru, Colombia, El Salva-

<sup>1</sup> See Morduch (2000).

**Figure 8.2** Percentage of Financially Sustainable Microcredit Institutions by Region

Source: *The MicroBanking Bulletin*, September 2000. Data are based on a sample of 114 microfinance institutions worldwide.

dor and the Dominican Republic are all examples of countries with very strong and successful microfinance institutions. Some have become licensed and supervised, while others have remained under non-profit status (see Table 8.2).

As the microfinance industry has matured, donors and investors have become more concerned with measuring the financial performance of these institutions. Donors want to make sure their assistance is creating sustainable institutions, while investors want to see if

the institutions offer real investment opportunities. As a result of this demand for objective and reliable information, a limited number of firms have sprung up to provide specialized assessment services of microfinance institutions. The most prominent are MicroRate, which focuses on Latin America; PlaNet Finance, which focuses on Africa; and M-CRIL, which focuses on Asia.<sup>2</sup> These firms also play an important role in gathering and processing information on the industry as a whole.

A review of 22 Latin American microfinance institutions finds a number of trends.<sup>3</sup> First, in terms of return on assets, this group of microfinance institutions compares very well to commercial banks. Over the past three years, their collective return on assets was 4 to 6 percent, well above the typical return achieved by commercial banks in Latin America. Even in 1999, a year characterized by economic and financial troubles in the region, the return on assets remained above 4 percent.

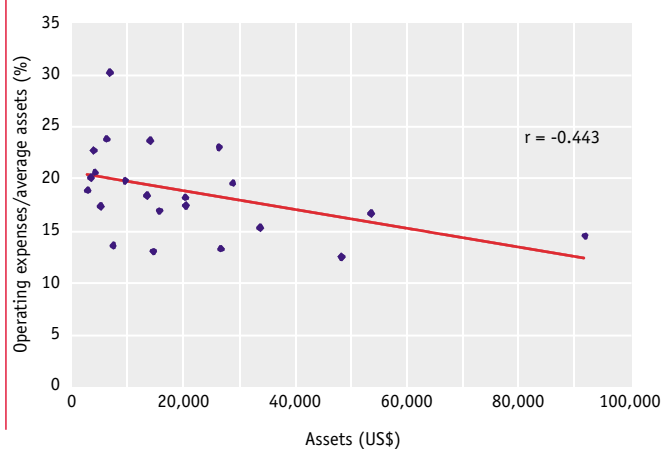
<sup>2</sup> MicroRate and M-CRIL are private for-profit concerns, while PlaNet Finance is a non-profit organization.

<sup>3</sup> The institutions are Caja los Andes, BancoSol, and Fie (Bolivia); Finamerica, WWB Bogota, WWB Bucaramanga, WWB Cali, WWC Medellin, and WWB Popayan (Colombia); Adopem (Dominican Republic); Financiera Calpia (El Salvador); Finde (Nicaragua); Financiera Vision (Paraguay); and CMAC Arequipa, CMAC Ica, CMAC Sullana, CMAC Tacna, CMAC Trujillo, Crear Arequipa, Crear Tacna, and Edyficar Proempresa (Peru). These institutions were selected not because they are considered a representative sample, but rather because information on them was available.

**Table 8.2** Financial Performance of Selected Microfinance Institutions, December 2000

	BancoSol, Bolivia	WWB Popayan, Colombia	Financiera Calpia, El Salvador	CMAC Tacna, Peru
Institutional form	Bank	Nonprofit organization	Finance company	Special financial institution owned by municipalities
Assets (millions)	\$91.8	\$7.4	\$33.6	\$15.4
Active clients	60,976	22,663	35,910	12,978 <sup>1</sup>
Average loan balance	\$1,274	\$281	\$822	\$1,187
Return on assets (%)	1	21	3	6
Return on equity (%)	4	28	13	38
Portfolio yield (%)	28	51	31	43
Debt/equity	5.3	0.36	3.53	5.6
Operating expenses/assets (%)	12.5	11.9	13.6	9.3
Loans over one day past due (%)	12	1	6	6

<sup>1</sup> Number of loans outstanding.  
Source: MicroRate.

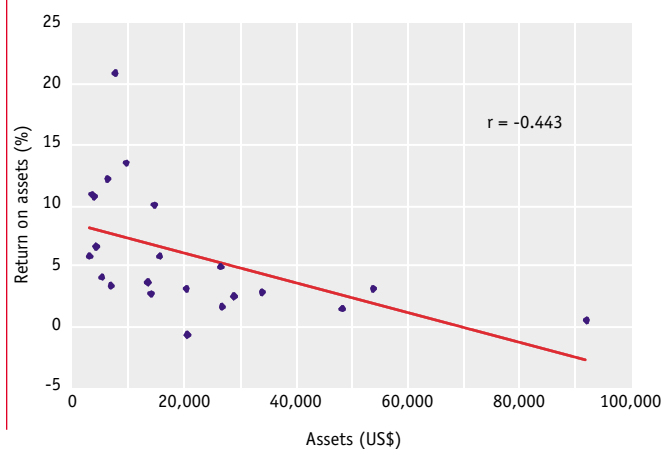
**Figure 8.3** Operating Expenses vs. Assets of Large Institutions

Source: Dataset from MicroRate.

Second, the efficiency of the 22 institutions has steadily improved over 1998-2000, continuing a longstanding trend. However, their operating costs as a percentage of assets was still about 60 percent higher than that of the region's commercial banks, which reflects the high costs of the microfinance credit methodology (small amounts, visits to clients, etc.). Therefore, the high returns on assets achieved by these institutions are primarily a result of relatively high portfolio yields (an average of 41 percent in nominal terms in 2000).

Third, the institutions are growing very rapidly, registering growth rates above 20 percent (unweighted) in all of the three most recent years. After a slowdown in 1999, the growth rate picked up again in 2000, exceeding the rate achieved in 1998. Undoubtedly, this rapid growth is another factor in explaining the high levels of profitability among microfinance institutions.

The sampling of institutions also permits a cursory analysis of some interesting correlations.<sup>4</sup> To begin with, it appears that larger microfinance institutions are more efficient than smaller ones. Given the well-established presence of economies of scale in financial services, the correlation shown in Figure 8.3 is not surprising. What may be more surprising is that, while less efficient, the smaller institutions are generally more profitable than the larger ones. Figure 8.4 shows that what small institutions lack in efficiency, they make up for in higher interest rates. Smaller institutions also seem to be marginally better at controlling loan delinquency, at

**Figure 8.4** Return on Assets vs. Size of Small Institutions

Source: Dataset from MicroRate.

least among the 22 institutions in the sample. However, when the at-risk portfolio is directly compared to efficiency, there appears to be no correlation. In other words, microfinance institutions that spend more on operating expenses relative to the size of their loan portfolio are not more successful in controlling loan delinquency.<sup>5</sup>

The rapid growth and financial success of the microfinance industry has in recent years brought another issue to the forefront for many institutions: securing additional funding sources to finance continued expansion of their lending. One major potential source of funding is the savings of their own clients and the public in general. However, as long as microfinance institutions are constituted as non-profit organizations, they are not permitted to capture savings. This has in recent years led to several large non-profit institutions requesting permission to re-constitute themselves as licensed banks or finance companies. This has prompted supervisory authorities in some countries to examine how they can accommodate microfinance within the existing regulatory and supervisory framework.

<sup>4</sup> Correlations should be interpreted with caution, as they do not demonstrate a causal relationship between variables.

<sup>5</sup> Operating expenses include personnel expenses, depreciation, board fees and other non-financial expenses.

Table 8.3 Distinctive Features of Microfinance

Category	Conventional credit	Microcredit
Ownership and governance	Profit maximizing institutional and individual shareholders	Downscaling bank or upgraded NGO; in the latter case, shareholders are mainly non-profit institutional shareholders
Client characteristics	Diverse formal businesses and salaried individuals Geographically dispersed clients	Low-income entrepreneurs with rudimentary family businesses and limited formal documentation Located in specific geographic area
Product characteristics	Larger amount Longer term Lower interest rate	Smaller amount Shorter term Higher interest rate
Lending methodology	Collateral and formal documentation Monthly repayment	Debtor and cash flow analysis through on-site inspections Weekly or bi-weekly repayment

Sources: Adapted from Jansson and Wenner (1998) and Rock and Otero (1996).

## Getting the Policy Framework Right

When Bolivian supervisory authorities granted a bank license to a small but dynamic microfinance non-profit organization in 1992, they started a process that would transform the Latin American microfinance industry. The non-profit organization was Prodem, and it reconstituted itself as a commercial bank, taking the name BancoSol. For the next five years, supervisory authorities struggled to adapt the regulatory framework and supervisory practices to effectively monitor and address the particular challenges arising from the unique activities of this new and unusual institution. In 1995, as a result of this experience with BancoSol, the Bolivian authorities took a yet another significant regulatory and supervisory step by creating a new form of financial institution: the Private Financial Fund (PFF). In several important ways, the PFF was designed to accommodate non-profit institutions prepared to offer microfinance services in a regulated and supervised setting.

Meanwhile, in Peru, a new institutional structure for microfinance was created: Entities for the Development of Small Business and Microenterprise (EDPYME).

These developments started an important trend in Latin America: the reform of financial laws, regulations and norms to accommodate microfinance. Since then, other countries have followed suit with modifications of their own, including the Dominican Republic, El Salvador, Brazil and, most recently, Mexico. The reason behind these reforms, quite simply, is the increasing

number of sufficiently large non-profit organizations that want to capture deposits from the public to further grow their lending activities.

But does microfinance require special prudential regulations to thrive? Do existing frameworks really need to be modified? If so, what changes are needed? The answers to these questions are found in the distinctive features of microfinance that make it different from conventional banking.

### *Distinctive Features of Microfinance*

As seen in Table 8.3, microfinance requires special attention because its unique characteristics give rise to a particular risk profile:

- First, the ownership structure of specialized microfinance institutions is distinct from that of conventional financial institutions (commercial banks and finance companies). The latter have individual and profit-minded institutional shareholders with deep pockets who can offer additional capital in a time of crisis, and who constantly push the institutions to perform optimally. In contrast, a specialized microfinance institution is usually majority-owned by the NGO from which it was formed. Typically, this NGO cannot easily be counted on for significant financial support at a time of crisis, and it might not prioritize efficiently or sustainably, since it is based more on a social purpose than on the profit motive.

- Second, the clients of specialized microfinance

institutions are distinct from those of conventional financial institutions. Typically, they are low-income entrepreneurs with rudimentary family businesses and limited formal documentation. As such, they are usually regarded as high-risk borrowers.

- Third, the credit products of specialized microfinance institutions are distinct from those of conventional financial institutions. Loans are typically smaller, shorter term, and carry a higher interest rate. As a result, the loan portfolio of microfinance institutions has a unique risk profile: it is more atomized, which decreases risk, but has a higher turnover, which increases risk. It also tends to be more geographically concentrated.

- Fourth, the microfinance lending methodology is distinct from that of conventional financial institutions.<sup>6</sup> Character and cash flow analysis plays a greater role, while the use of collateral and formal documentation play a lesser one. Repayments are in many cases carried out through weekly or biweekly installments rather than monthly. This methodology is appropriate for the clients of microfinance institutions, but it also results in high administrative costs. As was pointed out earlier, operating costs (relative to assets) of specialized microfinance institutions are at least 60 percent higher than for those of commercial banks.

For all the reasons mentioned, microfinance institutions have a unique risk profile, and supervisory authorities may therefore view them with considerable caution. From their point of view, microfinance institutions have high administrative costs covered by high interest rates generated from a portfolio containing a large number of short-term, uncollateralized, and geographically concentrated loans. This is not an encouraging profile from the perspective of a bank supervisor. Not only can loan delinquency rapidly get out of control if management is lax in monitoring the portfolio, but since administrative costs are so high and loans are not backed by collateral, a non-performing portfolio will have an immediate and drastic impact on the institution's bottom line. Given all these considerations, some regulatory and supervisory practices have to be adjusted to effectively control risk and protect depositors in microfinance institutions.

It is important to underscore that the purpose of modifying regulations for microfinance is not simply to exempt this activity from critical review by supervisory authorities. In some cases, standards should be made

stricter to counter the particular risk profile of microfinance. In essence, the modifications are intended to eliminate requirements that raise the cost of microfinance without offering better control of risk, and to introduce new measures and standards that will enable better control of risk without raising costs. With its already-high cost to deliver credit, the microfinance industry can ill afford regulation that unjustifiably raises even further the cost of financial services to low-income entrepreneurs.

## Establishing a Regulatory Framework

### *Step 1: Define What Is to Be Regulated*

The first step in creating an appropriate regulatory framework for microfinance is to define the objects of new or modified microfinance regulation. In other words, exactly *what* are supervisory authorities supposed to regulate? In essence, there are two possible areas of regulation: the activity and the institution. To adequately address the distinctive risk profile of microfinance, regulation has to cover both.

Regulations relating to documentation guidelines, guarantee requirements and loan loss provisions are all based on the type of activity performed by the institution (for example, consumer, commercial or mortgage lending). Unfortunately, microenterprise loans do not fit neatly into any of these categories, so before any regulations of microcredit can be proposed, the activity needs to be defined.

In many countries the task of adopting a single definition of microcredit is complicated by the fact that the government, through its various agencies and ministries, simultaneously recognizes several different definitions of microcredit and microenterprises. To the extent that supervisory authorities have approached the issue, they have typically taken one of two approaches: either defining the loan (as in Bolivia, where business loans below \$20,000 are considered microcredits for most purposes), or the client (as in Peru, where loans for productive purposes to clients with less than \$20,000 in assets are considered microcredits). The first approach

<sup>6</sup> Morduch (2000) surveys some of the types of microfinance lending contracts, especially for group lending.

has the advantage of simplicity, clarity and enforceability, but it may inadvertently include some loans that are not really for microenterprises. The second approach has the advantage of clearly defining the target group, but it may be difficult for supervisory authorities to verify that loans classified as microcredits actually went to microentrepreneurs.

But defining the activity of microcredit is not enough. Much of financial regulation is based on the *institution* as such. For example, while commercial banks are allowed to offer a virtually unlimited range of services and products to the public, finance companies are restricted in several important ways (e.g., no checking accounts, and in most Latin American countries, no savings accounts). Also, different institutional forms often have different minimum capital requirements and capital adequacy standards. A comprehensive regulatory framework for microfinance has to provide a way for microfinance services to be offered in a reasonably efficient and sustainable manner.

At present, Latin American NGOs that want to convert into regulated entities often face an unattractive choice: they can seek a license either as a commercial bank—which involves daunting entry standards such as initial capital requirements that have increased about 45 percent in the region since 1997—or as a finance company, which in many countries cannot capture savings from the public.

### **Step 2: Build Regulations Around the Key Areas**

Once a definition of microcredit is adopted, supervisory authorities can make some of the following regulatory modifications to accommodate microfinance responsibly:

- If there are interest rate restrictions in the country, microcredit can be exempted. Given the high cost of the microcredit methodology, microfinance institutions are particularly vulnerable to such restrictions. In addition, interest rate caps will cause commercial banks to restrict lending to low-income clients, since the amounts are small (which makes it costly relative to the amount lent) and the borrowers are typically considered “high risk.”

- Loan documentation requirements can be made more flexible for microenterprise loans to account for the semi-formal nature of most clients. Minimum requirements in this area should be limited to informa-

tion required to establish repayment capacity within the context of the lending methodology.

- Guarantee requirements can be made more flexible for microenterprise loans to account for clients’ lack of valuable collateral. Given the small size of the loans, the cost of recovering collateral would often exceed its value.

- Loan loss provision schedules can be simplified and tightened up. Given that microenterprise portfolios typically contain several thousand loans, the process of establishing provision must be simple. At the same time, since microenterprise loans are typically not backed by collateral, the provisioning schedules need to be relatively strict.

Some countries, including Bolivia, Peru and Costa Rica, have indeed implemented special rules for loans below a certain size. In Bolivia, there are special guidelines for evaluating loan applicants who intend to borrow \$20,000 or less. Financial institutions may use the salary of wage earners as the sole indicator to determine repayment capacity. In cases where a fixed salary is not the principal source of income, the financial institution has to consider the assets, debts, and cash flow of the applicant’s “socioeconomic unit” (i.e., business and/or household). However, when loan terms do not vary from those of previous loans and the borrower has a good repayment record, the financial institution is permitted to forego a new evaluation of the borrower’s payment capacity.

Such modifications allow both microfinance institutions and traditional commercial banks to apply the appropriate credit methodology and lower operational costs while still enabling supervisory authorities to monitor the risk of these institutions’ activities.

Moreover, supervisory authorities in Bolivia, Brazil, El Salvador and Peru have addressed the institutional side of microfinance regulation by establishing new types of institutions entirely or partly for the purpose of microfinance (see Table 8.4). This allows microfinance NGOs to re-constitute themselves as licensed financial entities with relative ease. However, such a step does not automatically entail permission to mobilize deposits. Most superintendencies prefer that new institutions take a slow approach to deposit mobilization, since this step implies a need for more sophisticated management of liquidity and other functions. In Peru, for example, it only takes \$245,000 in capital to constitute an EDPYME, but the institution needs \$1 million in capital and a

Table 8.4 Institutional Forms of Microfinance

	Bolivia	Peru	El Salvador	Brazil
Name	Private Financial Fund (PFF)	EDPYME	Savings and Credit Company	Microenterprise Credit Company
Year created	1995	1995	2000	1999
Minimum capital	\$828,000	\$245,000	\$2.86 million	\$60,000
Number of institutions	6	9	0	5 + 3 pending
Capital adequacy (%)	10	9.09	12 (same as banks)	5 x liquid assets
Checking	No	No	No	No
Savings deposits	Yes	Yes, if \$1 million in capital + rating	Yes	No
Maximum loan size (% of capital or US\$)	3% secured (\$30,000) 1% unsecured (\$10,000)	5% (\$12,225)	2.5% indiv. (\$71,500) 10% inst. (\$286,000)	\$6,000
Restricted operations	Trusts, foreign trade, equities, mutual funds underwriting	Depends on capital and maturity	Foreign investments, majority stakes in other companies	Restricted to lending to microenterprises
Supervision	Bank Superintendency	Bank Superintendency	Bank Superintendency	Central Bank
Complementary regulations	Simplified loan analysis and provision reqs.	Simplified loan analysis and provision reqs.	na	Simplified requirements and flexible collateral

Source: Interviews with officials from Central Banks and Bank Superintendencies.

favorable risk rating to qualify to receive savings. Even then, the permission to take deposits remains at the discretion of the superintendency, and no EDPYME has so far been cleared for this activity.

In the case of Bolivia, which arguably has the most advanced regulatory framework for microfinance in the region, the government created an institutional form (the PFF) that is broad enough to allow such entities to undertake microfinance as well as operations typically performed by traditional finance companies. PFFs are able to accept savings deposits (subject to a special review and clearance by supervisory authorities), offer a number of other financial services, and use chattel such as jewelry as collateral for loans. The PFF's relatively broad range of permitted operations, coupled with a reasonable minimum capital requirement of \$828,000,<sup>7</sup> eliminates the need to create a new, separate entity

specifically for microfinance. Of the seven PFFs in Bolivia, five specialize in microfinance. This arrangement prevents a proliferation of institutional forms, which has occurred in Peru, and greatly facilitates the work of supervisory authorities.

### Step 3: Establish Supervision

Finally, although the regulatory framework is important, it is only half the story. The other half is about supervision. Just because the supervisory authorities may have been able to design an appropriate regulatory framework does not necessarily mean that they have the ca-

<sup>7</sup> The minimum capital requirement is stated as SDR 630,000 (Special Drawing Rights), which currently equals US\$828,000.

capacity to effectively supervise the entities involved in microfinance. The distinctive features of microfinance call for adjustments in supervisory practices. In fact, the issue of microfinance supervision spans a range of challenges, from budgetary considerations to the organizational structure of the superintendency and special training for individual analysts and inspectors.

### *The Road Ahead*

The next challenge for microfinance is to integrate into mainstream financial markets. The Latin American microfinance industry is in the midst of a profound transition. While having started as non-profit organizations to help the poor, these institutions are increasingly incorporating other objectives, such as growth, efficiency and profit. The institutions understand that these latter objectives ultimately allow for a greater outreach to a larger number of clients. Not surprisingly, it has proven a challenge to pursue all these goals simultaneously; yet, a significant number of institutions have been remarkably successful in achieving high levels of efficiency, profit and growth without straying from their original target clientele. But success has also brought a new set of challenges.

By recent estimates, the Latin American microfinance industry has a combined portfolio of approximately \$1.4 billion. It has taken about 20 years to arrive at this stage, starting with a limited number of small and fragile non-profit organizations scattered across the region. If the industry continues its current growth of about 25 percent per year, it will need this same amount—\$1.4 billion—to finance its growth only over the *next three to four years*. While not much in relation to the enormous sums circulating in international and domestic financial markets, this amount nevertheless constitutes an unprecedented flow of funds to the sector, and especially to the microenterprises whose survival and competitiveness may hinge on it.

But who will supply these funds? Basically, microfinance institutions will have four options to attract the funds they need for future growth: donors, public savings, and local and international creditors and investors. Each faces major challenges:

- *Donors* have historically been very important suppliers of grants and loans to the industry, but their relative importance is declining. While institutions in several microfinance markets still receive considerable loan and

grant funding from donors, these resources are not keeping up with the overall growth of the market. In addition, these funds often come with strings attached that can have a significant cost of their own to a microfinance institutions.

- *Savings from the public* constitute an enormous potential source of funding for microfinance institutions. Savings are not only abundant, but also inexpensive in comparison to what it costs to borrow from local banks. However, in order to take savings, microfinance institutions need to constitute themselves as licensed and regulated banks or finance companies (or other types of institutions, if possible). As mentioned earlier, the problems and challenges associated with this process are more than trivial.

- *Local and international creditors (banks) and investors* provide most of the new financing for microfinance institutions that are not allowed to take deposits, but the relationship between microfinance institutions and creditors and investors is far from seamless. Even though local creditors and investors operate in the same market as the microfinance institutions, it is often a challenge to convince them to commit resources to the sector. Local creditors and investors do not always understand the business model and often feel there is not sufficient transparency to make informed decisions. In addition, the relatively modest sums requested by microfinance institutions give rise to relatively high transaction costs, which make the deals less attractive. Until recently, international creditors and investors were nowhere to be found as far as microfinance was concerned. During the past five years, however, the situation has changed. While purely commercial investors and creditors are still few and far between, an increasing number of international social investors are appearing on the scene. Still, these investors confront the same problems as do local actors, but even to a greater extent, since they do not have a presence in the local market.

So, while it is clear that the microfinance industry will need a significant amount of financing over the coming years, it is less clear exactly from where these funds will come. Indeed, to enable a greater flow of resources from private creditors and investors, particularly from purely commercial ones, several obstacles that stand between them and microfinance institutions—including issues of transparency, transaction costs and liquidity—must be addressed.

The gradual integration of microfinance into the formal financial sector promises to expand access to commercial sources of financing and capital. Yet, it also creates a new set of demands on the industry. In order to attract these new sources of capital and financing, microfinance institutions must impress potential creditors and investors with a high level of transparency and an attractive risk/return profile.

Lack of transparency has at least two dimensions: quality and availability. The quality of the information regarding the risk and financial performance of microfinance institutions has so far been impaired by a lack of recognized accounting standards, risk assessments, and commonly accepted minimum disclosure standards. This problem is compounded by a lack of useful, reliable and timely information about the risk and financial performance of most microfinance institutions, many of which issue financial reports only once a year, far too infrequent to allow investors to stay abreast of their investments.

Even with improved transparency, it is not a given that the microfinance industry will receive an increased flow of funds. Current creditors and investors face very significant transaction costs when they provide funds to microfinance institutions. The small amounts transacted (typically \$100,000 to \$1 million) give rise to high costs in relation to the amount provided. And the absolute costs are high as well.

It typically takes two months to a year to fund a microfinance institution, from the initial contact to the final disbursement of the loan or equity. In addition, for a \$250,000 loan, the transaction cost between a financial investor and a microfinance institution generally ranges between \$10,000 and \$20,000 (5 percent and 10 percent) with a great variance from one investor to another. Triodos Bank, a Belgian commercial bank and social investor, estimates that it pays about \$5,000 in legal expenses alone for each debt transaction. For an equity investment, the total transaction cost can easily amount to \$50,000. For both debt and equity,

the transaction costs are mainly concentrated in due diligence, legal expenses, and custodial arrangements.

These costs are very high by investment standards in conventional securities, but close to standard in the private equity and venture capital side. The high transaction costs have the effect of distorting the actual pricing of loans to microfinance institutions. If a spread of 6 percent is charged on a one-year loan, it only leaves a gross of some 3 percent over six-month Libor rates to take care of the management (usually  $\geq 1.5$  percent) and monitoring phase (0.5 percent), with little available to the investor when specific country and currency risks are combined. In short, in today's world, asset managers earn more money lending to microfinance institutions than investors themselves.

Finally, liquidity is a crucial consideration to investors in debt or equities because it allows them to instantly convert their positions into cash. Risk is therefore significantly reduced. At present, investors in microfinance debt or equities are severely limited in their ability to liquidate their positions. There is no secondary market trading of these instruments and every trade has to be individually negotiated between buyers and sellers, which is costly and time consuming.

The challenges of insufficient transparency, high transaction costs and lack of liquidity will have to be overcome before the microfinance industry can count on having access to large and steady flows of resources to finance its rapid growth. This is particularly true for purely commercial funds, where creditors and investors need to see a competitive risk/return profile before committing their money.

Admittedly, it would be an exaggeration to claim that the microfinance industry is knocking on doors on Wall Street at this point. However, the industry is definitely on a path leading in that general direction. It may still take many years before the liability/equity side of microfinance institutions is fully integrated in local and international financial markets. But there should be no doubt that it is just a question of when, not if.

## Part II References

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