# Microfinance: An Emerging Market within the Emerging Markets

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**ABSTRACT**

The microenterprise sector represents a huge untapped market for the financial service industry in Latin America and other developing countries. Microcredit - one of a number of microscale financial services -- is a lending technology that allows lenders to manage the risk and costs of lending to very small borrowers who are dependent on income from self-employment or business ownership. The data presented in this paper show that micro finance can be profitable, although the size of the loan portfolios and total assets remain small by the standards of commercial banks. Microcredit tends to have lower rates of arrears, but higher administrative costs than conventional loan products. Its higher operating costs are compensated for by higher interest yields.

The variety of micro finance institutions operating in Latin America ranges from commercial banks and finance companies with some microenterprise clients, to NGO's that give credit, but are also involved in many different non-financial activities. Over the past ten years, dramatic changes in the financial sector of most Latin American countries has increased competition and created new opportunities for expansion of microfinance. Commercial private sector participation in microfinance is on the rise, both through the creation of formal lending institutions from the portfolios of nonprofits (often called "upgrading") or by, the entrance of commercial banks and finance companies into the microfinance market (called "downsca1ing"). The paper reviews these experiences.

Microfinance appears to constitute an interesting niche for a small group of emerging market investors, but the commercial development of microfinance is still in its infancy. The locus of micro finance is just beginning to shift from the nonprofit world to private investors, and the industry does appear to have growth potential. However, while microfinance is allowing investors to tap a new emerging market within the emerging markets, its growth will ultimately depend on continued policy reform, standardization and transparency of information on lending institutions, and the industry's capacity to innovate and increase efficiency in order to serve the lowest end of the market.

## AN EMERGING MARKET?

In the early 1970s, before the term "emerging markets" became current, international development agencies and a few academics were already beginning to look with interest at the myriad of hawkers, peasant farmers, home-based workshops, and service providers that make up a large part of economic activity in Latin America, Asia and Africa.[1] Today, even as capital markets in these regions hang in the balance, a few forward-looking investors have joined the development bureaucrats and not-yet-defunct scribblers, in identifying opportunities for investment in what we now call "microfinance", the provision of financial services to the owners of these tiny businesses.

Microfinance qualifies for the label "emerging market " because it represents a developing market for private investment. Microfinance institutions (MFIs) are enterprises just beginning to access capital on customary terms in countries with underdeveloped financial markets. The MFIs' clients – microenterprises – are businesses just beginning to access capital from institutional sources in these markets.

What has happened to produce this transformation in the way we look at microenterprise and the financial services directed to it? And what is the future of the fledgling microfinance industry? The past thirty years have seen a shift in the way we think about microfinance, in the economic and regulatory policy framework within which it operates, and in the development of products and institutions capable of offering microfinance services on a sustainable basis. This paper explores these developments, focusing on the case of Latin America.

## WHAT IS MICROFINANCE?

Only recently coined, the term microfinance is already being used in many different ways. For our purposes it shall be defined as financial services – credit, deposits, insurance and others – for microenterprises. Microfinance and microcredit are often treated as synonyms, although microfinance refers to an array of financial services on a micro scale, including, but not limited to credit. This paper focuses on the credit side of microfinance, which is its most developed side, especially in Latin America.

As shown in Table 1 below, microcredit differs significantly from traditional commercial lending in that loans have smaller size and shorter-term maturities, and rely on character rather than collateral as a guarantee.

[1] The International Labor Office, which conducted a study of employment in Kenya in 1972, was one of the first development institutions to look to microenterprise as a source of employment generation in developing countries, using the term "informal sector" to describe what we now call microenterprise.

**Table 1**
**Distinctive Features of Microfinance**

| AREA | Traditional Finance | Microfinance |
|---|---|---|
| Lending Methodology | (1) based on collateral<br>(2) more documentation<br>(3) less labor intensive<br>(4) Loans are usually serviced monthly, quarterly, or yearly | (1) based on character<br>(2) less documentation<br>(3) more labor intensive<br>(4) Loans are usually serviced/repaid in weekly or bi-monthly installments |
| Loan Portfolio | (1) fewer loans<br>(2) loans larger in size<br>(3) collateralized<br>(4) longer maturity<br>(5) more stable delinquency | (1) more loans<br>(2) loans smaller in size<br>(3) uncollateralized<br>(4) shorter maturity<br>(5) more volatile delinquency |
| Institutional Structure and Governance (of regulated financial institutions) | (1) Profit maximizing institutional and individual shareholders<br>(2) Creation by spin-off from existing regulated institution<br>(3) Centralized organization with branch offices located in cities | (1) Mainly non-profit institutional shareholders<br>(2) Creation by conversion from NGO or formation of new entity<br>(3) Decentralized set of small units in areas with weak infrastructure |

**Sources:** Adapted from Rock & Otero, 1996; and Behrenbach & Churchill, 1997.

Two caveats must be borne in mind with regard to the definition of microfinance. Although the central feature of microfinance is its clientele – microenterprises – this does not mean that these clients borrow only for business purposes. Given the informal nature of most microenterprises, where household and business activities often overlap, it is common for such borrowers to seek loans for consumption as well as production. The secret to microcredit is finding ways to make credit decisions and to manage the risk of lending to customers who have neither a verifiable salary nor assets that can be easily valued or seized.

The second caveat concerns the nature of microenteprise. The lower bound of this concept is here defined as any economic activity where the owner risks his or her own resources to produce a product or generate an income; this defines as enterprises many activities that some would not consider worthy of the term. The upper bound of the definition is usually arbitrarily set by the number of employees the enterprise supports or its total assets. Employment is somewhat easier to measure, and five and ten are the most commonly used employment cutoffs. But microfinance clients at any one point in time may include businesses larger than this, since at least some longstanding customers tend to develop and grow beyond this size.

## THE ECONOMIC POTENTIAL AND LIMITATIONS OF THE MICROENTERPRISE SECTOR AS A MARKET FOR FINANCIAL SERVICES

The microenterprise sector represents a huge untapped market for the financial service industry in developing countries. There are more than fifty million microenterprises in Latin America and the Caribbean. Over 80 percent of the region´s businesses have less than ten employees (one of the most commonly used definitions of microenterprise), and they employ more than 120 million people. Though little reliable data exist, and conditions vary widely across countries, studies show that microenterprises employ a significant share of the labor force—ranging from one-third in Panama to almost 60 percent in Bolivia. Their share of national output ranges from less than 10 percent to nearly 50 percent, depending on the country[2].

According to the International Labor Office, by the mid 1990s, microenterprise accounted for roughly half of the region's employment (see Table 2 below), while the public sector and enterprises with over ten employees accounted for only 44 percent (the remaining 6 percent is in domestic service). Moreover, the share of employment in microenterprise has been steadily growing since the 1970s.

**Table 2**
**Microenterprise Employment in Latin America, Mid-1990s**

| Country | Economically Active Population (EAP) | Self-employed Microentrepreneurs (% of EAP) | Microenterprise Workers (% of EAP) | Total Microenterprise Work Force (% of EAP) | Number Employed in the Microenterprise Sector |
|---|---|---|---|---|---|
| **Argentina** | 14,345,171 | 27.0 | 18.1 | 45.1 | 6,469,672 |
| **Bolivia** | 2,530,409 | 37.1 | 19.0 | 56.1 | 1,419,559 |
| **Brazil** | 59,420,165 | 23.4 | 24.5 | 47.9 | 28,462,259 |
| **Chile** | 5,219,300 | 23.7 | 20.6 | 44.3 | 2,312,150 |
| **Colombia** | 11,669,274 | 26.4 | 30.9 | 57.3 | 6,686,494 |
| **Costa Rica** | 1,187,005 | 17.8 | 23.1 | 40.9 | 485,485 |
| **Ecuador** | 3,359,767 | 31.5 | 15.0 | 46.5 | 1,562,292 |
| **Honduras** | 1,728,599 | 31.5 | 15.1 | 46.6 | 805,527 |
| **Mexico** | 33,651,812 | 30.7 | 20.9 | 51.6 | 17,364,335 |
| **Panama** | 940,301 | 19.5 | 12.9 | 32.4 | 304,658 |
| **Paraguay** | 1,097,724 | 22.3 | 34.9 | 57.2 | 627,898 |
| **Peru** | 2,945,101 | 35.2 | 16.2 | 51.4 | 1,513,782 |
| **Venezuela** | 7,537,817 | 27.3 | 14.5 | 41.8 | 3,150,808 |

**Source:** ILO Latin American and Caribbean Office, Panorama Laboral 95.

[2] Marguerite Berger and Bernardo Guillamón, "Microenterprise Development in Latin America –A View from the Inter-American Development Bank," Small Enterprise Development, Vol. 7, No. 3 (September, 1996).

Despite the important contribution of microenterprises to output and employment in developing countries, and their sheer numbers, few of them are able to obtain loans or other services from banks, credit unions or finance companies. It is estimated that fewer than 5 percent of microenterprises in Latin America have access to institutional sources of credit.[3] A new sense of the possibilities of the microenterprise market niche has coincided with an evolution toward a more businesslike approach to the structure, management, and objectives of successful microfinance institutions, a group still largely dominated by nonprofit foundations.

Microenterprises are found in all fields of economic activity – commerce, agriculture, manufacturing, and services – but they are most prominent in the retail trade and service sectors. As noted above, microenterprises are usually defined in terms of number of employees, with either five or ten serving as the cutoff point. Others utilize a combination of assets, sales and other indicators. But no matter what the numerical definition, it cannot be more than a rule of thumb. More important are the qualitative aspects of the sector—informality in organizational structure and compliance with regulations, use of family labor, rudimentary technologies, discontinuities in production, the combination of different industrial and occupational categories in one unit, and the overlapping of household and business activities.

Although size parameters are the main element used to define the microenterprise sector, strict adherence would quickly illustrate their arbitrariness. This sector is extremely heterogeneous and varies dramatically in relative size and composition in different countries throughout the region. At the lower end of the spectrum are subsistence level household/firms that depend exclusively upon family labor, with no distinct separation between household and firm finances. At the upper end of the scale are firms that have more in common with their counterparts in the small enterprise category; they utilize relatively sophisticated production technologies and are directly linked to larger firms in the modern sector of the economy through diverse supplier-client relationships.

Few microenterprises will grow beyond two to three employees, but they are nevertheless part of the continuous process of creation and destruction of businesses that lead to improve productivity and growth. Microenterprises at the bottom of the size scale, often labeled as "survival" or subsistence businesses, may remain at the bottom because of low levels of capitalization, or because they are new start-ups, or because they have suffered a crisis from which they may or may not recover. These businesses may have a similar size, and they may be equally precarious, but the solutions to their problems are different, and are not solely related to their size.

Many microbusinesses experiencing modest growth are actually in a process of consolidation at a low level not a transformation into small or medium size businesses. [4] A third type of microenteprise already shares some characteristics with the small and medium business

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[3] Nancy Barry, The Missing Links: Financial Systems That Work for the Majority. New York: Women's World Banking, 1995.

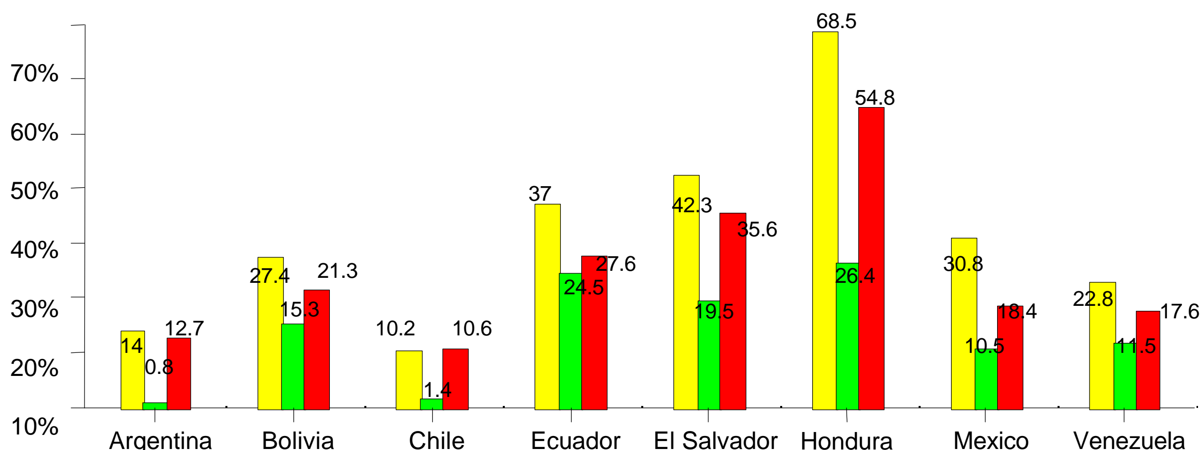
[4] This pattern of growth within the small business sector is found within the industrialized countries as well. In the US, where both birth and death rates are very high in the small business sector, the term "gazelles" is used to refer to those few small businesses that account for the bulk of growth of jobs and output in the sector as a whole.

sectors; these are the businesses that are dynamic and set to grow at a rapid pace, and consolidate themselves at a larger size. However, just because they are in a dynamic phase does not mean that they cannot be reduced to the survival state by external or internal (management) crises.

## ARE MICROENTREPRENEURS POOR?

Studies show that microenterprise owners and workers are a very diverse group, and that the relationship between microfinance and poverty is a complicated one.[5] As shown in Table 3 below, most microenterprise owner/operators do not live below the poverty line. The workers of microenterprises are poorer than workers in other businesses or the public sector, but in some countries the incidence of poverty of microenterprise workers is lower than that of self-employed owners (those with no employees).

**Table 3**
**Poverty Incidence in the Microenteprise Sector**
**(% poor in each category)**




**Source**: Orlando and Pollack, forthcoming.

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[5] Hege Gulli, Microfinance and Poverty: Questioning the Conventional Wisdom. Washington, Washington, D.C.: Inter-American Development Bank, 1998

For the private sector investor, looking for emerging market opportunities, the question remains about whether the microenterprise sector is a profitable niche or untapped customers for financial services. For the Inter-American Development Bank, the World Bank and other development agencies, the question is whether microfinance can reach the poor on a significant scale and still make a profit, and whether increasing the availability of credit to the poor and/or those microenteprises that employ them can have a significant impact on poverty.[6]

## BETWEEN POVERTY AND PROFITS: COMPETING PARADIGMS OF MICROFINANCE

The 1970s saw the emergence of a new way of looking at microenterprise, a shift from the earlier negative paradigm of "the informal sector" – an underground economy of illegal activities, tax evaders and disguised unemployment – to the informal sector as a source of livelihood for much of the developing countries' poor.[7]

While the informal sector had been seen as a transitional segment of the economy, divorced from the "mainstream," and a problem for development policy and programs to overcome, the new paradigm focused on this sector as a potential source of employment, which required and deserved public sector support to become sustainable and even expand. In this context, microcredit became an important tool to help microenterprises create jobs. It was also seen by many nongovernmental organizations as a tool for bettering the lives of the poor, and sometimes as a "hook" to draw poor people into in other activities.

A third paradigm, which emerged in the late 1980s and early 90s, is a move from microenterprise as livelihood of the poor, often accompanied by charity, to microenterprise as business. From this perspective, size, not poverty, constitutes the defining characteristic of the microenterprise sector, although advocates of microenterprise development still argue that the sector is key to reducing poverty in developing countries. Microentrepreneurs are manufacturers, retailers and service providers that are an integral part of the economy as suppliers and purchasers. They are not only creating jobs, but also contributing to economic growth. In this view, microenterprise is related to small enterprise and it is at the center of the economy in most developing countries. Along with this perspective comes a view of microenterprises as clients, as customers, of institutions providing services.[8]

In the 1990s, governments and development donors have increased their support for microenterprise development and especially microfinance, but the priorities and means of support have changed in line with the new paradigm. Microfinance institutions are no longer funded through donations alone; they are receiving loans and "equity investments" from their traditional donors and tapping commercial financial markets, especially in their home countries.

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6 Hege Gulli, 1998.

7 International Labor Office (ILO), Employment, Income and Equality: A Strategy for Increasing Productive Employment in Kenya, Geneva: ILO, 1972; Dipak Mazumdar, "The Urban Informal Sector," World Development, 1976 (no. 4, August).

8 Maria Otero and Elisabeth Rhyne, The New World of Microenteprise Finance: Building Healthy Financial Institutions for the Poor, Kumarian Press, 1994.

We are today in a world of competing paradigms: none of the three views of microenterprise described here has disappeared. Each one colors the public policy debate about microenterprise development in a different way. However, the only one that envisions microenterprises, and consequently microfinance, as "emerging markets" is the paradigm that casts microenterprises as businesses and customers. Whether this view is accurate or not, and to what extent it is compatible with either of the other two is subject to empirical confirmation. The test is now underway in Latin America, where the involvement of the commercial private sector has been the greatest.

## THE CHANGING ENVIRONMENT: FINANCIAL SECTOR REFORM IN LATIN AMERICA

Over the past ten years, the Latin American economies have experienced profound structural changes, especially in the financial sector. Changes in financial regulation in most countries in Latin America have redefined the parameters of microfinance. In some countries, such as Bolivia and Peru, changes in banking regulations have made it possible for lenders previously operating as nonprofit foundations to convert to formal financial intermediaries, thereby greatly enhancing these lenders' access to financial markets and their prospects for long-term sustainability.

Most countries of the region were characterized by financial repression during the 1980s. In the late 1980s and early 1990s sweeping reforms were carried out throughout the region, removing interest rate ceilings, reducing or eliminating directed credit, reducing barriers to entry in the financial sector (including eliminating the preferred status of government owned banks, or even eliminating such banks), and improving banking regulation and supervision. These reforms substantially changed the structure and opportunities in the financial sector, paving the way for increased competition in the sector, and increased interest in new market niches, including small and microenterprise.[9]

There is growing recognition that in order for microfinance institutions to function profitably and soundly, specific regulations will be required in such areas as capital adequacy, risk weighting of assets, provisions for bad debt and reporting requirements.[10] One example of the constraints placed on institutions that target microenterprise clients is the required minimum capitalization of formal financial institutions, whether they are full scale commercial banks, or regulated finance companies that may or may not be permitted to accept term or demand deposits. Table 4 below shows, institutions that want to specialize in microfinance would find it difficult to

[9] Carlos Cuevas, "Enabling Environment and Microfinance Institutions: Lessons from Latin America," Journal of International Development, May, 1996; and Glenn Westley, "Financial Reforms in Latin America: Where Have We Been, Where Are We Going?" Office of the Chief Economist, IDB, 1995; Paul Holden, "The Enabling Environment for Latin American Business," Small Enterprise Development, September, 1996; Expanding Access to Financial Services in Latin America, Miguel Basch and Camilo Morales, eds. Washington, DC: IDB/Johns Hopkins University Press, 1995.

[10] Tor Jansson with Mark Wenner, "Financial Regulation and its Significance for Microfinance in Latin America and the Caribbean". Occasional paper. Washington, D.C.: Inter-American Development Bank, 1997.

comply with the minimum capital standards and leverage their capital sufficiently to stay profitable. In Colombia for example, a specialized microfinance institution would need over 200,000 customers in order to satisfy both of these conditions, and this with an average loan size of $1000, considerably higher than that of the typical specialized microlender. The most successful microfinance bank in the region, Banco Sol, has fewer than 100,000 microenterprise borrowers; the region's other success story institutions have between 20,000 and 50,000 active microenterprise clients. The prospects are better for finance companies in the region, however, but these companies offer only a limited range of services.

Improving regulation and supervision for microfinance will be a challenge in Latin America, where prudential safeguards for banks and capital markets in general have lagged behind other types of financial reform. The Banking Superintendencies of the region are undergoing a process of modernization and most countries' attention is devoted to implementation of the Basle Committee's recommendations.[11] Many superintendencies are overwhelmed by the responsibility for supervising their traditional charges in a more competitive and perhaps more volatile financial sector, and have very limited desire or ability to attend to the nonbank financial institutions.

[11] The Basle Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank governors of the Group of Ten Countries in 1975. It usually meets at the Bank for International Settlement in Basle, where its permanent Secretariat is located. For further information see, "Core Principles for Effective Banking Supervision," Basle Committee on Banking Supervision, Basle, Switzerland, 1997. A short article by Andrew Crokett, General Manager of the Bank for International Settlements, also highlights these issues in the Latin American context: Andrew D. Crockett, "Separate but Converging: International Financial Standards and National Financial Systems," in Liliana Rojas-Suárez, ed. Safe and Sound Financial Systems: who works for Latin America. Washington, DC: Inter-American Development Bank, 1997.

**Table 4**
**Minimum Capital Requirements and their Impact on Micro-Loan Portfolios**

| Country | Institution | Minimum Capital (US$ Million) | Capital Adequacy Ratio | Minimum No. of Clients with Average Loan of US$1000 |
|---|---|---|---|---|
| ARGENTINA | Bank | 15 | 11.5% | 91,305 |
| | Finance Company | 15 | | 91,305 |
| BOLIVIA | Bank | 2.76 | 8% | 24,150 |
| | Finance Company | 1 | | 8,750 |
| BRAZIL | Bank | 8.5 | 10% | 59,500 |
| | Finance Company | 3.6 | | 50,400 |
| CHILE | Bank | 13.3 | 11.3% | 82,390 |
| | Finance Company | 6.8 | | 42,124 |
| COLOMBIA | Bank | 27 | 9% | 210,000 |
| | Finance Company | 5 | | 38,889 |
| ECUADOR | Bank | 7 | 9% | 54,445 |
| | Finance Company | 3.75 | | 29,167 |
| EL SALVADOR | Bank | 5.7 | 8.6% | 46,396 |
| SALVADOR | Finance Company | 1.5 | | 12,210 |
| GUYANA | Bank | 7 | 8% | 61,250 |
| | Finance Company | 2 | | 17,500 |
| MEXICO | Bank | 15.5 | 8% | 135,625 |
| NICARAGUA | Bank | 2 | 8% | 17,500 |
| | Finance Company | 2 | | 17,500 |
| PARAGUAY | Bank | 4.6 | 10% | 32,200 |
| | Finance Company | 2.3 | | 16,100 |
| PERU | Bank | 5.6 | 9.1% | 43,077 |
| | Finance Company | 2.8 | | 21,539 |
| URUGUAY | Bank | 6.3 | 8% | 55,125 |
| | Finance Company | 3.8 | | 33,250 |

**Source:** Jansson with Wenner, 1997. **Notes:** It is assumed that 70% of the institution's assets are in its loan portfolio. Shading shows countries where microlenders are unlikely to be able to comply with minimum capitalization requirements.

Two examples of the way a favorable regulatory environment can create opportunities for private sector involvement in microfinance are the cases of Peru and Bolivia: in 1995 both countries modified the laws governing their financial sectors to recognize and facilitate the creation of specialized non-bank financial intermediaries designed to provide services to micro and small businesses. Private Financial Funds (FFPs) in Bolivia and Small and Microenterprise Development Entities (EDPYMEs) in Peru are regulated financial institutions that offer limited banking services and have capital and reserve requirements tailored to microfinance rather than commercial banking.

**Table 5**
**New Financial Intermediaries:**
**Comparison of FFP and EDPYME**

| Areas Of Regulation | FFP (Bolivia) | EDPYME (Peru) |
|---|---|---|
| Minimum Capital: | US$ 1 million | US$ 265,000 |
| Capital Adequacy Ratio: | 10% (10:1) | 10% (10:1) |
| Deposits: | Savings, but not demand deposits | Savings deposits, but only after special permission from the superintendency |
| Security: | Recognizes solidarity groups, movables, and jewelry | Not defined |
| Maximum Loan Size: | 3% of net capital (US$30,000) | 5% of net capital (US$12,500) |
| Unsecured Credits: | 1% of net capital (US$10,000) | Not defined |
| Foreign Exchange: | Yes | Yes |
| Other Operating Restrictions: | No trust and foreign trade operations, equities, underwriting, or mutual fund management | Not defined |

**Source:** Adapted from Rock and Otero 1996; Resolución SBS No. 259-95 (Peru); Decreto Supremo 24,000 (Bolivia). Cited in Jansson and Wenner, 1997.

In Bolivia the first FFPs to commence operations were the Caja de Los Andes in La Paz and FASSIL in Santa Cruz. Both capture deposits and make small loans to microentreprenurs, and were capitalized by private shareholders, although Caja de Los Andes also relies primarily on nonprofit investors and international development agencies. FASSIL (a name which is similar to the Spanish word for “easy” and spells its name with two dollar signs) offers consumer credit as its primary loan product, but also lends to microenterprises for business purposes. Today there are four FFPs in Bolivia and seven EDPYMEs in Peru, and several others currently in the process of formalization in both countries. In Peru there has been considerable interest in EDPYMEs because they are easily capitalized, have access to commercial and rediscounted sources of funds, can capture deposits (at higher levels of capitalization), offer shares to private investors and provide a variety of credit instruments. CREDINPET in Lima, the first EDPYME, was founded by a non-governmental organization and a group of private sector shareholders. The possibility of using EDPYMEs and FFPs to provide consumer credit as well has sparked considerable interest on the part of private firms in Peru that are looking to finance the purchase of their products. This reelects the similarities between microfinance and consumer credit (although microfinance borrowers do not have verifiable salaries that can be used for the credit decision).

**COMMERCIALIZATION OF MICROFINANCE: FACT OR FANTASY?**

As noted above, fewer than 5 percent of Latin American and Caribbean microentrepreneurs have access to formal financial services. Suppliers credits and informal money lending are important sources of microfinance and will continue to play a key role in the future, given their advantages for overcoming the information constraints to microlending. Formal financial institutions, using their traditional credit technologies, do not serve microenterprises well because of the relatively high cost of making small loans and the lack of required forms of collateral. Microenterprises face constraints on the deposit side as well. Most microenterprises are financed through the owners' and family members' savings, but minimum deposit requirements, limited liquidity and high transaction costs limit their access and use of formal savings mechanisms.

Given the magnitude of the microenterprise sector in Latin America, the penetration of this market, even by the most successful institutions – those reaching over 50,000 microenterprise clients each – is still limited to a small percentage of the sector. In the past, significant subsidies for microenterpise support organizations providing loans to low income business owners have been justified by the high costs of such specialized financial activity. The optimistic vision of the future is that increasing competition will force microlenders to be more efficient. As a result, the need for subsidies will decrease and the microentrepreneurs who are customers of these financial services will enjoy the benefits of lower interest rates, increased access, and better services such as bill payment and credit cards. [12]

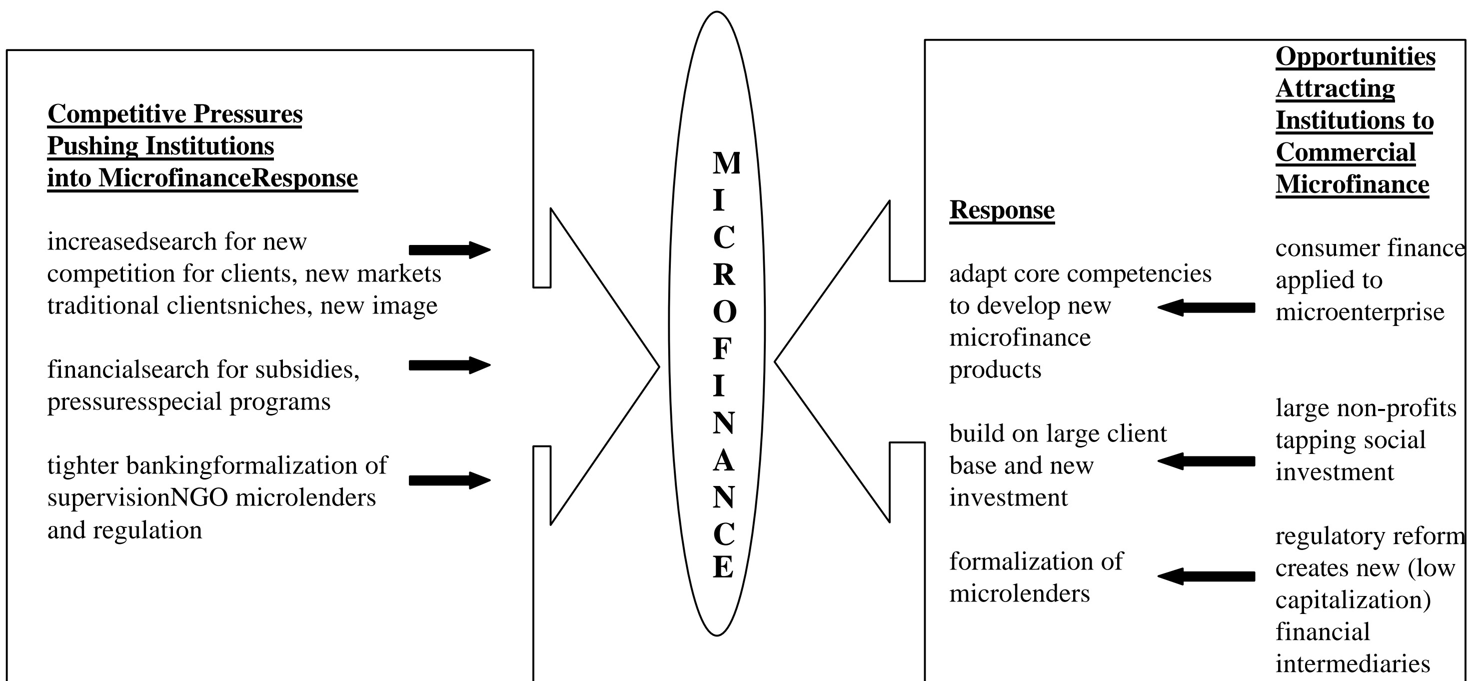
The resources available in multilateral and donor agencies are not sufficient to satisfy the demand for microfinance and other services. Financial resources for microenterprise development must come from the private sector. But investment in microenterprise development from financial markets will only be possible if those resources can be made available on commercial terms. Private investment in the sector's development is also deterred by unstable macroeconomic and financial sector conditions in emerging markets, the legal and regulatory framework and barriers to entry for new sources of capital (including lack of knowledge of the sector, especially of successful program experiences, and lack of appropriate credit and other technologies to serve the sector).

In Latin America, unlike Asia, microfinance has generally remained in the private sector, although in the hands of nonprofits. The state-run directed loan programs for agriculture and small business, prevalent in the 1960s, '70s and early '80s, did not reach the microenterprise level and tended to be captured by the better-off businesses within their target groups. The Latin American market has distinct characteristics (especially when contrasted with the better known Asian experience): higher average per capita incomes, with very high inequality, historically high inflation rates, very high real interest rates (both deposit and lending rates), high spreads, and very limited financial deepening. [13] This gives a distinct cast to microfinance in the region.

[12] Claudio Gonzalez Vega, "Microfinance: Broader Achievements and New Challenges," Economics and Sociology Occasional Paper no. 2518, Ohio State University. Columbus, OH: Rural Finance Program, Ohio State University, 1998.
[13] Sebastián Edwards, Crisis and Reform in Latin America: From Despair to Hope. New York: Oxford University Press, 1995.

Different factors are prompting the interest of private investors in microfinance in Latin America. On the one side, competitive forces and regulatory reform are pushing some institutions toward the microfinance business; on the other hand, microfinance is an opportunity pulling in institutions that can take advantage of existing core competencies or new regulations in the financial sector to develop new products for this market. Pushed by the growing competitive pressures in the financial sector, some local financial institutions are looking for untapped markets for their services—or potential subsidies (see Table 6 below). Other institutions are discovering that their experience in consumer finance or as nonprofits gives them core competencies on which to build a new business of micro-scale commercial lending. In the absence of fully functioning credit bureau, these lenders find that a large client base can yield sufficient information to screen credit applications based on risk factors.

**Table 6**
**Competitive Forces. Expanding Commercial Microfinance**



At present, the bulk of private sector interest in microfinance is not solely profit driven. The most common reasons offered by those formal financial institutions active in microfinance are somewhat complex, ranging from public relations, to a long-term view of market development and the perceived need to contribute to improving economic and social conditions in their countries.[14] Social and philanthropic motives can also come into play, frequently mixed with public image considerations.

Some institutions are willing to invest in learning how to manage small loans and deposits using new microfinance methodologies in order to cultivate future clients closer to their mainstream profile, or to increase their interest revenues. Microentrepreneurs are willing to pay higher rates of interest because they can obtain high productivity gains from relatively small infusions of capital and they have limited access to other sources of finance. However, for mainstream financial institutions, the potential for profits is often offset by the relatively high transaction costs involved in microcredit.[15]

**Table 7**
**Financial Performance**
**Selected Microfinance Institutions in Latin America**

| | Bolivia Banco Sol (Bank) | Paraguay Vision (Finance Co.) | Uruguay Fucac (Credit Union) | Peru Caja Areq. (Savings Bank) | Bolivia Los Andes (Finance Co.) | Colombia WWB-Cali (NGO) |
|---|---|---|---|---|---|---|
| **Loan portfolio (US$ millions)** | $64 | $19 | $19 | $22 | $20 | $6 |
| **Past due > 30 days** | 1.11% | 8.20% | 7.10% | 2.10% | 0.65% | 1.62% |
| **Number of clients (thousands)** | 76.2 | 12.1 | 10.4 | 36.6 | 29.5 | 10.9 |
| **Average loan size (US$)** | $828 | 1,563 | 1,868 | $593 | $693 | $539 |
| **No. of branches** | 34 | 14 | 2 | 9 | 11 | 5 |
| **Return on Assets (ROA)** | 3% | 3% | 6% | 4% | 5% | 6% |
| **Return on Equity (ROE)** | 23% | 19% | 52% | 36% | 36% | 14% |
| **Portfolio yield** | 33% | 43% | 49% | 47% | 29% | 46% |
| **Operating expenses / average portfolio** | 18% | 18% | 10% | 19% | 16% | 15% |
| **No. of clients per officer** | 416 | 205 | 2,072 | 401 | 518 | 407 |
| **Portfolio per officer (US$ thousands)** | $349 | $320 | $3,871 | $356 | $358 | $219 |

**Source**: "Standards of performance": a joint project of the Inter-American Development Bank and Private Sector Initiatives Corp. Results as of December 31, 1997.

[14] Microenterprise Development Review, (published by Inter-American Development Bank) 1998, No. 1. See also: Mayada M. Baydas, Doughlas Graham and Liza Valenzuela, "Commercial Banks in Microfinance: New Actors in the Microfinance World." Bethesda, MD: Microenterprise Best Practices. Development Alternatives, Inc. 1997.

[15] Mark Wenner and Sergio Campos, "Lessons in Microfinance Downscaling: The Case of Banco de la Empresa, S.A.," occasional paper No. MIC-105. Washington, D.C.: Inter-American Development Bank, 1998.

Can microfinance make money? Based on current experience in Latin America, it appears that microfinance can be profitable, with or without support from international donors. Table 7 illustrates the types of returns obtained by some of the best performing microfinance institutions in the region.

The data presented in Table 7 show that microfinance can be profitable, although the size of the loan portfolios and total assets remain small by the standards of commercial banks, due to the small average loan size. The return on assets in some of the top performing institutions cited in the table ranges from 3 percent to 6 percent, and return on equity ranges from 14 percent in the case of Women's World Banking-Cali to 52 percent in the case of FUCAC Credit Union in Uruguay. The tendency is for return on equity to outperform industry standards, while return on assets is lower, reflecting the lower leverage of microfinance institutions. Microcredit also tends to have lower rates of arrears, but higher administrative costs than conventional loan products. Its higher operating costs are compensated for by higher interest yields.

It appears that at its best, microcredit is a "lending technology" that allows lenders to manage the risk and costs of lending to very small borrowers who are dependent on income from self-employment or business ownership. What is less clear is whether there exists a tradeoff between the ability to reach very small borrowers (including those who live below the poverty line) and profitability. It is also not clear how high up the scale of small enterprise customers these techniques will work. They appear to have built-in drawbacks when applied to larger scale clients since they are based on the experience of lending to large numbers of very small clients, creating their credit history by gradually increasing loan size, and covering relatively high operating costs with high interest rates. From the investor's point of view, both the upper and lower boundaries of this market are a concern; from the development agency's point of view, the lower bound is the main issue. As shown in Table 8 below, there does seem to be some tradeoff between customer size (as measured by average loan size in the microloan portfolio) and profitability.[16]

**Table 8**
**Performance and Outreach of Microfinance Institutions in Latin America**

| | | | **Average** | **ADJ** | **Financial** | **Profit** | **Real Int.** | **Admin Expense/** | **Clients per Loan** |
|---|---|---|---|---|---|---|---|---|---|
| **Location** | **Peer Group** | **N** | **Loan Size** | **ROA** | **Self Suff.** | **Margin** | **Yield** | **Loan Portfolio** | **Officer** |
| | | | | | | | | | |
| World | Fully Sustainable | 26 | $428 | 4% | 113% | 10% | 34% | 27% | 108 |
| Lat. Am. | Large Broad Based | 6 | $636 | 4% | 116% | 12% | 26% | 26% | 130 |
| Lat. Am. | Med. Broad Based | 7 | $414 | 6% | 115% | 15% | 45% | 32% | 96 |
| Lat. Am. | Med./Low Broad Based | 8 | $340 | -8% | 83% | -23% | 31% | 42% | 160 |
| Lat. Am. | Small/Low Broad Based | 5 | $120 | -17% | 73% | -42% | 49% | 69% | 96 |

**Source:** The Microbanking Bulletin, Issue No. 2 (Boulder, CO: The Economics Institute, July 1998)

[16] Elizabeth Rhyne, "The Yin and Yang of Microfinance", The Microbanking Bulletin, Boulder, Colorado: The Economics Institute, issue No. 2 (July 1998).

However, it is not clear whether this is due to the newness of some of the institutions in the lower-end peer groups, poor credit decisions, or inherently higher costs of doing business at the low end.

## NEW MICROFINANCE MODELS IN LATIN AMERICA

Even *The Wall Street Journal* readers have heard of Banco Sol, the microfinance bank in Bolivia with over 70,000 clients and enviable financial performance, but there are many other microfinance institutions in Latin America worthy of notice. Table 9 presents a typology of the variety of microfinance institutions that operate in Latin America today. They range from commercial banks and finance companies with some microenterprise clients, to NGOs that give credit, but are also involved in many different non-financial activities.

Not all of the MFIs in Table 9 involve commercial interests. Commercial private sector participation in microfinance comes about through the creation of formal lending institutions from the portfolios of nonprofits (often called "upgrading") or by the entrance of commercial banks and finance companies into the microfinance market (called "downscaling"). We will review some of these experiences in greater detail below.

**Table 9**
**Typology of Microfinance Institutions**

| | COMMERCIAL FFIs | SPECIALIZED FFIs | SPECIALIZED NGOs | MULTIPURPOSE NGOs |
|---|---|---|---|---|
| **Strategy and goals** | • Expansion into new markets<br>• Institutional Image | • Profitability<br>• Social Impact | • Social Impact<br>• Cost coverage<br>• Graduation | • Social Impact<br>• Initial cost coverage |
| **Clients** | Microenterprises in minority | Micro and Small Enterprises | Microenterprises | Microenterprises |
| **Legal form** | • Banks<br>• Finance Companies<br>• Credit Unions | • Banks<br>• Finance Comp.<br>• Credit Unions | NGOs | NGOs |
| **Methodology** | • Individual lending<br>• Instruments vary according to segment | • Individual and/or solidarity group lending<br>• Leasing | Individual and/or solidarity group lending | Individual and/or solidarity group lending |
| **Sustainability** | The FFI as a whole is sustainable. | Striving towards profitability and efficiency | Striving towards operational efficiency | Difficult to isolate microenterprise activities |
| **Capital sources** | • Capital<br>• Certificates<br>• Inter-bank loans<br>• Clients' savings<br>• Donor Funds | • Capital<br>• Certificates<br>• Inter-bank loans<br>• Clients' savings<br>• Donor Funds | • Bank loans<br>• Subsidized<br>• Social Funds<br>• Donor Funds | • Few bank loans<br>• Subsidized<br>• Social Funds<br>• Donor Funds |
| **Examples** | Bco del Comercio (C.R.)<br>Bco Empresarial (Guat.)<br>FASSIL (Bolivia)<br>Bco del Pacifico (Ecua.)<br>Financ. Familiar (Par.) | FIE (Bolivia)<br>Mibanco (Peru)<br>Los Andes (Bolivia)<br>BancoSol (Bolivia)<br>Fin. Calpia (El Salv)<br>Multicredit (Panama) | Propesa (Chile)<br>Emprender (Arg.)<br>Fundasol (Urug)<br>Prodem (Bolivia)<br>Funadeh (Honduras) | CARE<br>FINCA<br>Catholic Relief Serv.<br>Various NGOs, Village Banks and grassroots org. |

**Source**: Fernando Lucano and Miguel Taborga, "Tipologia de instituciones financieras para la microempresa en America y el Caribe," occasional paper. Washington, DC: Inter-American Development Bank, 1998.
Note: "FFI" refers to (regulated) formal financial institutions. "NGO" refers to non-governmental (non-profit) institutions.

***Up-grading.*** Non-profit organizations have been lending to microenterprises in most countries in Latin America since the 1970s. Although they have operated for a long time in a gray area at the edge of legal regulations, some of these institutions have grown and transformed themselves into regulated financial institutions, providing a vehicle for private capital investment. Others have become majority shareholders in new banks or finance companies that specialize in microfinance. Banco Sol in Bolivia led this process, followed by Caja de Ahorro y Credito Los Andes, also in Bolivia, Financiera Calpia in El Salvador, Finansol in Colombia (now Finamerica), and others in Peru, Venezuela, Dominican Republic and Haiti.

Not all NGO transformations have been successful, however. The region's successful microfinance institutions are only now being tested by a major economic slump. In the case Finansol, a finance company formed by an NGO engaged in microfinance in Colombia, rapid portfolio growth masked serious problems. Corposol, the non-profit parent of Finansol, retained the credit extension staff while Finansol, the commercial financial institution, served only as a booking and financing agent. Since most of Corposol's operating revenues were generated by training fees charged concurrently with loan disbursements, this created an incentive to disburse loans quickly and disregard loan collection. The institution launched an overly ambitious variety of new products using unproven methodologies, in some cases allowing two or three different types of loans per client. In addition, Finansol appears to have misrepresented its rate of asset growth to the Superintendency of Banks by using questionable accounting practices.[17]

***Downscaling*** is the name being given to commercial bank operations that reach the microfinance market. Some commercial banks, such as Banco del Pacifico in Ecuador, Caja Social in Colombia and Banco del Desarrollo in Chile entered this market out of a sense of social responsibility. Others, such as Banco Weise in Peru, offered loans to NGOs that on-lend to individual microenterprises in the past and are now experimenting with their own microfinance products and subsidiaries. Some banks and finance companies, such as Banco del Desarrollo in Chile and Financiera Vision in Paraguay, have built on existing competencies and financial products to expand their activities into microfinance. Commercial bank cost structures and corporate culture present significant challenges, however, and specialized products, credit technology, information systems and properly trained credit officers are key to overcoming these barriers.[18]

***Intermediate models.*** In order to overcome the management problems inherent in entering the microfinance market, some banks have teamed up with nonprofits or absorbed their microfinance portfolios to jump-start their entry into this market. This is the case of Bangente in Venezuela (Banco de la Gente Empresarial – Bank for Entrepreneurial People, or People's Bank for short), that grew out of a partnership between a large existing commercial bank, Banco del Caribe, and three nonprofit foundations involved in microfinance – Fundacion Mendoza, Grupo Social CESAP, and Fundacion para la Vivienda Popular. Bangente is a subsidiary of Banco del Caribe that will accept deposits and make loans to microenterprises. It will conduct these operations in association with its NGO partners who have considerable experience in

[17] Jean, Steege. The Rise and Fall of Corposol: Lessons Learned from the Challenges of Managing Growth. Bethesda, MD: Microenterprise Best Practices, Development Alternatives, Inc. 1998.

[18] See Wenner and Campos, 1998, for example, and Baydas, Graham and Valenzuela, 1997.

microenterprise development. Customers will move from the NGO portfolio to the new bank, and the NGOs will then specialize in nonfinancial services for these and other customers. In its pilot project phase, loan disbursement and collection will be through a single agency of the Banco del Caribe in Caracas, while loan preparation and follow-up services will be out-sourced to the non-governmental organizations.

Other examples along these lines are found in the case of Banco Solidario in Ecuador, a bank subsidiary that used technical assistance from microfinance NGOs to get its start, and now offers advisory services to microfinance NGOs seeking to upgrade their banking technology and skills, as well as microfinance services to its own clients. The case of Banco del Comercio in Costa Rica presents yet another model: it is a commercial bank that purchased outright an NGO portfolio of microloans and built on this to create a new area of operations that has proved more profitable than its traditional corporate finance activities.

Private foundations, some of which combine a mix of social and religious motivations with a philosophy of generating sufficient revenues for full cost coverage with growth, have invested as shareholders in microfinance institutions. Fundación Social is a private foundation based in Bogota, Colombia and controlled by the Jesuits. It has built consolidated assets of over US$1.3 billion since it began in 1911. Fundación Social entered the field of microfinance in 1991 by opening branches of its bank, Caja Social de Ahorros, in extremely poor neighborhoods. It has close to a million deposit accounts averaging $200, three quarters of its loans in amounts less than $3000, and is ranked among Latin America's most profitable banks.

***State-owned banks***. So far the state-owned banks that still exist in Latin America have been slow to become involved in microfinance. One notable exception is the Banco del Estado in Chile, which after watching the experience of a private Chilean bank, Banco del Desarrollo, is creating its own microfinance products and growing rapidly. Banco del Estado has a solid base of small savers drawn from the same low and middle income segments that include most microentrepreneurs. It may be able to build on this base, as Caja Social in Colombia is doing, to create a profitable microcredit portfolio. The municipal savings banks in Peru (Cajas Municipales), owned by the local municipal governments, are another interesting type of microfinance institution. They tend to target better-off clients and the local government as depositors, while targeting lower income microentrepreneurs for short term loans at relatively high rates. Many of them have excellent financial performance, as illustrated by the Caja Municipal de Arequipa in Table 7.

***Finance Companies***. Nonbank financial intermediaries, such as finance companies and other lenders with varying degrees of regulation and supervision, may ultimately become the most important actors in commercial microfinance. Finance companies offer products similar to microcredits in terms and payment, but they generally depend on a consumer durable purchase as collateral that can be repossessed. They also use the salary of the borrower to calculate his or her ability to repay. In Bolivia, Chile, Paraguay and Peru, however, there are examples of consumer finance companies that are developing new techniques to assess and manage the risks of lending to borrowers who do not have a regular salary, and it is likely that many more will emerge in the future.

Private non-bank financial intermediaries, such as consumer finance companies, small savings banks, credit unions or specialized entities like Peru´s EDPYMEs or Bolivia´s FFPs can offer advantages not available to a commercial bank in terms of capital, reserve and provision requirements, leaner cost structures, and greater flexibility and responsiveness. Some can mobilize savings. Existing finance companies that have provided consumer credit have the advantage of experience in managing numerous small transactions. Many also have extensive payment history records for their clients that can be adapted to assess the risk of lending to microenterprises using credit scoring techniques developed for other markets.

***Credit Unions***. Credit unions are very numerous in Latin America, despite the problems they have endured over the past two decades. Their recent history is one of struggle to recover from hyperinflation and the distorting effects of past donor funding, which undermined their deposit base and eroded the repayment culture of their members. However, their focus has traditionally been on lending to salaried workers (often credit union membership is organized around employment in a particular firm or the public sector) or land-owning agricultural producers. Despite targeting the popular market of middle and lower-middle class workers, they have been slow to expand services to the self-employed and microenterprise owners. Recent experiences in Guatemala and Uruguay, however, show that credit unions may become important actors in the microfinance industry in the future.[19]

## INNOVATIVE MODELS FOR LINKING MICROFINANCE TO FINANCIAL MARKETS

***New Products***. Credit cards and smart cards are poised to become a new wave in microfinance. Credit cards offer lenders the advantages of lower transaction costs, ease of information management, and increased customer access. MasterCard and other credit card finance companies have their eye on the potential of the microcredit market. They have seen their traditional upper and upper middle class market become saturated in recent years, and are looking at lower income segments as potential clients.[20] In the Dominican Republic, ADEMI, Banco Popular and MasterCard have teamed up to offer a MasterCard ADEMI Popular for members of ADEMI. Cardholders may receive cash advances, check balances, and make payments through the sixty ATMs and forty-five offices of Banco Popular. The card also offers travel and theft insurance, bill payment services, and up to twelve-month terms for consumer credit. Smart cards also offer the potential to facilitate transactions on both the deposit and borrowing side, but as yet their use has been limited in this industry.

***Deposits.*** So far, microfinance institutions have lagged behind in developing products that meet microenterprise demand for instruments to facilitate payments, safeguard money and

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[19] Glenn D. Westley and Sherrill Shaffer, "Credit Union Policies and Performance in Latin America," Office of the Chief Economist, Working Paper No. 355. Washington, DC: Inter-American Development Bank, 1997. Gloria Almeyda, Money Matters: Reaching Women Microentrepreneurs with Financial Services. Washington, DC: Inter-American Development Bank, 1996. Bradford L. Barham, Stephen Boucher and Michael R. Carter, "Credit Constraints, Credit Unions, and Small-Scale Producers in Guatemala," World Development, Vol. 24, No. 5 (1996), p. 793-806.

[20] Laura M. Ruis-Velasco, "La Revolución Consumista," América Economía, No. 103 (Jan. 1996), p. 30.

accumulate savings.[21] Commercial banks, savings banks and credit unions are far better placed than NGOs to develop these services, since NGOs are not regulated and in most countries are even prohibited from accepting deposits from the public. The same obstacles that plagued microcredit in its infancy are facing microdeposit products today – their small size implies very high administrative costs. The development of new microdeposit products will be important, however, as a vehicle for keeping good customers by offering services they want, enhancing information on borrowers to assess lending risk, creating sizeable assets to mitigate lending risk, and funding lending operations. Unfortunately, many inexperienced MFIs, unfamiliar with managing the liabilities side of a financial institution, see the last reason as the most important. Formal institutions familiar with deposit services are likely to be more cautious, even though they are in a better position to develop microdeposit products.

## DEVELOPING SOURCES OF FUNDING FOR MFIS

Until recently MFIs, which were mainly non-profit NGOs, have been almost entirely dependent on donor funding for their expansion. This has led them to concentrate their effort on improving the asset side of their business – developing their lending products and credit technology, controlling arrears, and reducing administrative costs associated with lending to mircoenteprise. Now, these institutions, some of them newly transformed into for-profit financial institutions, are looking for ways to capitalize themselves and improve their leverage by borrowing from formal financial institutions, among other means. This is part of a new phase of development of the microfinance industry – a phase where development of the liabilities side of the balance sheet is as important as the asset side. In this new phase, for-profit institutions will come to dominate the market because they already understand the liabilities side of the business and are in a better position to raise capital. New investment facilities and instruments will be developed, and in this context, the need for better information on the performance of MFIs will be accentuated.

***Investment funds***: The Calvert Fund, a U.S.-based socially responsible investment fund, recently began to make loans to microfinance institutions in the U.S. and Latin America. Institutional investors can also pool their assets and share the risks of investing in emerging market microfinance institutions through two specialized funds –Profund and a new fund created by the Banque International de Luxembourg.

? ***Profund***: Profund – a specialized financial institution based in Panama with shareholders of several nationalities – makes investments throughout Latin America in micro and small enterprise financial institutions. Its shareholders are mainly development institutions, such as the Multilateral Investment Fund (MIF) of the Inter-American Development Bank, but the Calvert Fund and private individuals are also among the shareholders. With US$15 million initial paid-in capital from ten shareholding institutions, Profund is now capitalized with over

[21] Alfred Haning, Laura Elserand and Sylvia Wysniwski, Comparative Analysis of Savings Mobilization Strategies (Overview of Four Case Studies). Eschborn, Germany: Deutsche Gesellschaft fur Technische Zusammanarbeit (GTZ), 1997.

US$23 million in preferred and common shares. Profund supports the growth of regulated, efficient financial intermediaries by investing in or lending to new financial institutions developed by experienced non-profit small and microenterprise lenders; new financial institutions created by existing commercial banks, finance companies similar institutions proposing to serve small and microenterprise clients; and existing financial institutions that already serve small and microenterprise clients and are seeking to expand their operations with equity or debt financing.

? ***The Banque International de Luxembourg*** (BIL) recently announced the creation of a fund for microfinance investments – both long term loans and equity investment. The fund, which targets only institutional investors, will be managed by a large European financial company, AXA.

***Intermediary guarantees***: Intermediary guarantee funds, or guarantee mechanisms that are structured to include a third party institution, as intermediary between the financial institution providing the capital and the micro-borrower, have been used for microfinance since the mid-1980s[22]. Some networks, such as Accion International and Women's World Banking, provide guarantees to their affiliate programs. Other networks, such as FINCA and Opportunity International, are in the process of developing this type of microfinance guarantee fund as well. National programs also issue this type of institutional guarantee to non-formal microlenders in Colombia and Ecuador.

So far, no fund of this type has been undertaken on a for-profit basis, although some appear to be able to cover their costs. The Latin America Challenge Investment Fund (LA CIF), a new second story guarantee company and investment fund for microfinance that is being financed by the Inter-American Development Bank through its Multilateral Investment Fund, will develop a guarantee mechanism that assumes 100 percent of the risk of lending to MFIs by providing guarantees in favor of local banks to permit them to lend to MFIs at lower rates of interest. LA CIF may then be able to charge a premium sufficient to cover its costs and give returns to its investors.[23]

***Securitization:*** Private investment in securities issued by microfinance institutions is hindered by shallow, incipient markets and the small size of potential offerings. Buying and selling of securitized microfinance loan portfolios in the capital markets has yet to happen. The main impediment has not been credit risk, but rather currency and transfer risk. Recently, 24 percent of the shares of BancoSol, a microfinance bank in Bolivia, were sold by the Inter-American Investment Corporation (IIC), the finance corporation of the IDB group, to a consortium of non-governmental organizations that had been involved in the bank's creation. Although a private bank bid for the shares, the consortium took the opportunity to retain control of what continues to be a unique and profitable institution.

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[22] Robin Young, Lara Goldmark and Rosario Londoño, Microfinance Guarantees: A Basic Primer and Review of Experiences in Latin America and the Caribbean. Washington, D.C.: Inter-American Development Bank, 1998.
[23] Microenterprise Development Review, Vol. 1, No. 2 (December, 1998).

***Increasing Transparency*:** Private investors need to be able to assess the strength of microfinance institutions easily. Uniform auditing standards, such as those being developed by Deloitte and Touche under contract to CGAP, are one piece of the puzzle.[24] Ratings could be another important tool. Diagnostic instruments developed by commercial banks and adapted for application to microfinance institutions have been in use in Latin America since 1993[25]. Although their continued application and refinement are creating a tool for diagnosing financial performance in terms of capital adequacy, asset quality, management, liquidity and efficiency, significant work remains to be done in making comparisons across institutions, across countries and over time. PSI, a U.S.-based organization, plans to establish an agency that will rate microfinance institutions based on a comparatively simple diagnostic technique, making this information available to investors.

[24] The Consultative Group for Assistance to the Poorest (CGAP). External Audits of Microfinance Institutions: A Handbook. Washington, D.C.: The World Bank, 1998.
[25] Sonia Saltzman, Rachel Rock and Darcy Salinger, Performance Standards in Microfinance: Accion's Experience with the CAMEL Investment. Cambridge, MA: Accion International, 1998.

**MICROFINANCE FROM THE MARKET PERSPECTIVE: IS THERE A MICROFINANCE INDUSTRY IN THE FUTURE?**

There is no doubt that microfinance constitutes an interesting niche for a small group of emerging market investors. The commercial development of microfinance is still in its infancy. How far this market will grow remains an open question. Although the locus of microfinance is just beginning to shift from the nonprofit world to private investors, what is now being called an industry does appear to have growth potential.

An enabling macroeconomic and regulatory environment has drawn lenders' interest to new financial market niches, including micro and small enterprise. Additional improvements in government policy, including controls on interest rates and use of directed credit by government lenders are needed to develop the microfinance industry further in Latin America. Reduction of barriers to entry in the financial sector, and improvements in prudential regulation and supervision of financial institutions will also help create conditions for commercial microfinance to grow.

At the institutional level, a series of innovations and changes in management practices will be required for profitable expansion of the industry. First and foremost, especially for banks and finance companies entering this market, appropriate microcredit products and technology are needed to attract customers and keep transaction costs down. Second, a significant scale of operation and growth are required to allow cost coverage, meet excess demand, and obtain profits. As is the case with consumer finance products such credit cards, specialized management expertise and institutional structures may be required for microfinance. Banking institutions typically set up subsidiaries to handle their credit card operations because the products, cost structures, risk, liquidity management and even organizational culture are different from their other business lines. Although the basic principles of due diligence, management and control are the same as in any other economic activity, provisioning, liquidity management, and advanced information systems are areas of special concern for management of microfinance. Detailed, reliable information on the client pool is a very important part of microcredit technology.

NGOs seeking to expand and formalize their microfinance operations face another set of challenges. They will need to make progress in setting interest rates with respect to real costs, in maintaining operating costs within acceptable parameters and in achieving a good currency match between assets and liabilities in order to hedge foreign exchange exposure. They need to create management and governance structures that take into account the interests of all stakeholders, and develop adequate controls using sophisticated management information systems, in order to be successful microfinance institutions in the long run. Some will successfully make this transition, and others will contract as they face a shrinking availability of the external donations on which they depend. However, the current popularity of microfinance may forestall this process for several years.

A significant expansion of private investment will require widely-accepted standards of financial performance and risk for the microfinance industry as a whole. In addition to satisfying their macro level concerns such as sufficient liquidity in the financial system and a favorable regulatory environment for micro-finance, potential private sector investors need to be able to asses the viability of specific microfinance institutions or microfinance departments within their

own institutions. Transparency of information and proper regulation and supervision are needed to support this process.

## MICROFINANCE FROM THE DEVELOPMENT PERSPECTIVE: HOW LOW CAN THE MARKET GO?

The expansion and diversification of financial services for microenterprises -- whereby institutions reach out and down to smaller clients -- is still a key task for the future of microfinance from the development perspective. On the one hand, technological and organizational improvements should continue, enabling microfinance institutions to lower transactions costs. Improved information systems and supervision can also reduce their riskiness and improve their access to the capital needed to expand their operations. On the other hand, certain characteristics of microfinance could limit its reach and profitability. High levels of risk are associated with the high interest rates charged for microloans, a particularly severe problem now, given the economic uncertainty in emerging markets. In addition, the greater severity of information and administrative cost bottlenecks at progressively lower loan sizes, the costs of regulatory compliance, and the likelihood that poor microentrepreneurs are riskier clients would limit commercial penetration of the lowest segments of the market for some time to come. Thus, while microfinance is allowing investors to tap a new emerging market within the emerging markets, its growth will ultimately depend on the industry's capacity to innovate and increase efficiency, in order to serve the lowest end of the market.