

Commercial Banks in Microfinance:

Best Practices and Guidelines for Project Design, Monitoring, and Evaluation

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Foreword

It has been shown repeatedly in Latin America and the Caribbean that microfinance is a highly profitable market segment that is greatly underserved. Although banks are significant players in this market, supplying about one-third of the region's total microcredit, they continue to suffer from the revolving door syndrome, in which a bank enters microfinance with high expectations and sometimes leaves disappointed, perhaps after only a few years or even less. Typically, the bank has lost money or earned only meager profits for all of its efforts. There are two main causes for this syndrome, which has affected numerous banks. First, there is the technical failure that these banks often don't really understand microfinance and how to make it into a profitable business line. Second, there is the commitment failure that these banks often are not sufficiently committed to microfinance that they are willing to do the many things needed to make microfinance work and also to wait the years it can take for the microfinance portfolio to grow to where it has an appreciable impact on overall bank profits.

Banks have an enormous capacity to deliver microfinance services (that is, to downscale) given their many inherent advantages such as extensive branch networks, well-established back office systems, large capital base, access to loanable funds, system of private ownership which encourages sound governance and the efficient delivery of services, control by established regulatory authorities, and ability to offer deposits, loans, and other financial services. Hence, downscaling failures represent not only a great waste of resources but also of opportunities. It is hoped that by following the best practices discussed in these guidelines banks will realize their potential to help serve the many millions of microentrepreneurs who currently lack financial services and thus achieve the double bottom line of serving their shareholders as well as the greater social good.

This document aims to provide guidance to IDB staff on how to prepare bank downscaling projects, from the design phase through to monitoring and evaluation—using any of a number of IDB project vehicles. Given the importance of bank commitment, the document also emphasizes choosing banks that are committed to offering microfinance services and on structuring the project in ways that ensure this commitment. Staff interested in furthering the financial democracy goals of the IDB's recent Opportunities for the Majority (OM) initiative will often find that banks and bank downscaling operations offer an excellent avenue for achieving rapid results in this important area.

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PURPOSE

Banks are increasingly entering into microfinance, and donors such as the IDB are increasingly helping them to do so.¹ Despite this trend, banks continue to make a number of common mistakes in attempting to serve the microenterprise sector. A key to successfully serving this sector is to follow best practices; these are discussed in some detail in this note. This note also provides additional operational guidance to IDB staff on how to structure projects in this area, including choice of partner bank, mechanisms to help ensure bank commitment, and project monitoring and evaluation.

BACKGROUND

In the last several years, banks have been entering microfinance at an impressive rate. By the end of 2005, 30 downscaling banks in Latin America and the Caribbean were serving over one million microenterprise clients with US\$ 1.8 billion in loans (Table 1).² These banks provided

For a more detailed examination of best practices in bank downscaling see Glenn D. Westley. 2006. *Strategies and Structures for Commercial Banks in Microfinance*. Sustainable Development Department Best Practices Series, Working Paper No. MSM-132. Washington, D.C.: Inter-American Development Bank.

¹ Examples of IDB projects in this area from the past several years include (with country, year, and IDB operation number in parentheses): Banco Uno (Nicaragua and El Salvador, 2006, MIF/AT-743), Interbank (Peru, 2006, PE-M1037), Banco G&T Continental (Guatemala, 2005, GU-M1006), Bancasol (Guatemala, 2004, ATN/ME-8789-GU), El Comercio Financiera (Paraguay, 2001, MIF/AT-430), and Sogebank (Haiti, 1998, MIF-AT-222). Many banks have downscaled without IDB assistance, for example, ABN AMRO Real (Brazil), Banco de Venezuela (Venezuela), Banco del Pichincha (Ecuador), Banorte (Mexico), and Jamaica National Building Society (Jamaica).

² The terms “downscaling banks,” “downscales,” and “banks” are used interchangeably in this note to mean banks, *financieras*, and other regulated financial institutions that have traditionally served larger (often corporate) clients but now make loans to microenterprises.

loans to 21 percent of the microenterprise borrowers in the region and supplied 33 percent of total microcredit, substantial market shares. The compounded annual rates of growth of the number of microloan clients and of the microloan portfolio from mid 2001 to end 2005 were 32 and 45 percent, respectively, for banks—slightly above the 30 and 40 percent annual growth rates, respectively, for all microfinance institutions (MFIs) together. Thus, banks are very dynamic actors in a very dynamic field. The fact that the banks have an average loan size that is not too far above the overall average in both 2001 and 2005 provides some evidence that banks are reaching clients that are broadly similar to those reached by the other MFIs.

Banks are drawn to microfinance for many reasons, including:

- Increased competition in banks’ traditional markets (corporate and others).
- The lure of profits. For example, MicroRate reports that in December 2004 the average ROA and ROE values of the 30 leading MFIs they track in Latin America were a high 4.4 and 17.7 percent, respectively, while the maximum values were 17.5 and 48.7 percent, respectively.³
- A large unserved market: of the region’s 60 million microenterprises, only 10 percent have credit from a financial institution.
- Ample proof that microlending works, even in bad economic times. For example, MIX Market data for about 100 MFIs in Latin America show that loan delinquency rates and ROA were largely unaffected during the severe 1998-99 and 2001-02 recessions.⁴
- Diversification, in at least two senses. First, microlending involves thousands of tiny loans. Second, microlending often has low correlations with traditional bank business lines since it serves a very different type of

³ MicroRate is an MFI rating firm that also provides MFI performance data at its website www.MicroRate.com.

⁴ The MIX Market is the widest source of performance information on the microfinance industry, now covering over 800 MFIs worldwide. It can be accessed at www.MIXmarket.org.

Table 1
Microlending in Latin America and the Caribbean by Type of Institution

Type of MFI	Number of MFIs in Survey	Microloan Portfolio (US\$ million)	Number of Microloan Clients ('000s)	Average Microloan Size (US\$)
Data from end 2005				
Downscales	32	1821	1261	1444
Other regulated	66	2586	2553	1013
Unregulated	239	1035	2128	486
Total	337	5442	5942	916
Data from mid 2001				
Downscales	21	343	365	940
Other regulated	39	558	572	976
Unregulated	124	288	870	332
Total	184	1190	1806	659

Sources: 2001 data are from a survey carried out by Glenn Westley and Bob Christen; 2005 data are from Sergio Navajas and Luis Tejerina. 2006. Microfinance in Latin America and the Caribbean: How Large Is the Market? Sustainable Development Department Best Practices Series Working Paper MSM-135. Washington, D.C.: Inter-American Development Bank. www.iadb.org/sds/mic/index_MIC_e.htm. Both surveys are fairly comprehensive, covering perhaps 80 percent of the microloan clients in Latin America and the Caribbean at the time.

clientele and one with great resilience during bad economic times.

- Burnishes the bank's public image.
- Possibly the existence of underutilized capacity (for example, in branches and information systems).
- The availability of donor assistance.

With so many good reasons for entering microfinance, it is hardly surprising that banks are a large and growing presence.

JUSTIFICATION FOR DONOR OR GOVERNMENT INTERVENTION

While the donor or government role in fostering downscaling need not be a very costly one, it can be catalytic in getting banks to play a much larger and more effective part in bringing financial services to microenterprises. Many banks have sufficient loanable funds to mount a microlending program; however, they often lack knowledge of best practices in microlending. Therefore, the provision of technical assistance can be critical in enticing banks to enter this field and in giving banks a much better chance to succeed once they do.

Some may argue that banks have sufficient discretionary funds that they can buy their own technical assistance, and so governments and donors should save their scarce resources for needier microfinance institutions. There is some validity to this argument. However, it is also true that banks have an enormous capacity to deliver microfinance services to hundreds of thousands and even millions of microentrepreneurs in Latin America and the Caribbean if they wished to do so. This capacity reflects the banks' generally extensive branch networks, well-established back office systems, large capital base, access to loanable funds, system of private ownership which encourages sound governance and the efficient delivery of services, control by established regulatory authorities, and ability to offer deposits, loans, and other financial services. Moreover, banks looking for new business lines have many choices besides microfinance. Therefore, to accelerate the entry of banks into microfinance, it may be wise for donors and governments to spend modest sums to help banks successfully start up operations in a field most of these financial institutions know little about.

The main components of a downscaling project consist of technical assistance and possibly funding. Technical assistance helps the downscaler observe the best practices discussed below and is likely to be the core of most projects. Some projects may provide funding, for example, through credit lines, equity, or quasi-equity. Funding assistance may be of particular help in the case of smaller banks and *financieras* that do not have sufficient liquidity to start up a microlending program on their own. For example, some involved with the downscaling of the Paraguayan *financieras* in the mid 1990s believe that the availability of IDB funding helped motivate these financial institutions to enter microlending by providing needed funds at a mildly-subsidized rate of interest.

DOWNSCALING PROJECTS IN THE IDB

With banks a large and growing presence in microfinance, they are a vehicle *par excellence* to help achieve the IDB's Opportunities for the Majority (OM) goals in the area of financial democracy. The recently-approved OM initiative aims to bring the benefits of economic development to the region's Majority, that is, to the 70 percent of the population comprising 360 million people with annual earnings of approximately US\$ 3,260 or less. In the area of financial democracy, the OM initiative goals include doubling the number of Majority households with savings accounts (from 15 percent to 30 percent) and tripling the number of microenterprises with access to formal credit (from five to 15 million). Clearly, banks have an important role to play in helping to reach these goals given their important share of the microfinance market, their dynamic growth, their clear interest in the sector, and the enormous capacity they have to do more.

Downscaling programs can fit within a wide variety of IDB projects. Many downscaling operations have been carried out in last several years through the MIF Line of Activity, which provides technical assistance (TA) grants of up to US\$ 300,000 to a single financial institution and up to US\$ 500,000 for groups of two or more financial institutions. Regular MIF operations (outside of the Line of Activity) and IIC operations have been used to provide larger

amounts of TA and also to provide funds for on-lending to downscales. Still larger operations have been carried out through global loans, in which the IDB provides a large loan (US\$ 10-100 million or more) to a second-tier entity in a given country, which in turn onlends to regulated financial intermediaries in the country so that these intermediaries may, in turn, onlend either to microenterprises (in microenterprise globals) or to a much wider variety of firms (in multisector globals). In addition, these operations often provide TA to strengthen the capacity of the intermediaries to lend to such non-traditional clients as microenterprises. Since the financial intermediaries that participate in these global loan programs typically must be regulated, many downscaling banks have received assistance in how to do microlending through these operations. Technical assistance and funding support for downscales can also be granted as a component of competitiveness and other policy-based loans that have a financial sector component. Finally, support for downscaling banks may be given through the new Innovation and Opportunity Network Facility that is being set up as part of the Bank's recent OM initiative. Hence, there is a wide variety of instruments available to IDB staff for supporting downscaling operations.

PROJECT DESIGN

There are two main keys to ensuring a successful downscaling operation: a) avoiding technical failures by observing best practices and b) avoiding commitment failures through appropriate selection of banks and the application of appropriate incentives. This section is devoted to a discussion of these two points. Before we can begin discussing best practices, however, we must examine the four alternative structures that banks primarily use to downscale since some of the best practices depend on which structure the bank has chosen.

Four Ways to Downscale

In increasing order of effort for and cost to the bank to establish, the possible structures through which a bank can do microlending are the internal unit, service company, lightly regulated sub-

sidiary, and heavily regulated subsidiary. We now examine these four alternative microlending structures.

Internal unit. Using an internal unit simply means that the bank does microlending in house, for example through a unit, department, or division within the bank. This is how most banks have chosen to do microlending in the region and is often the fastest and cheapest way to launch microcredit operations since no separate organization needs to be created. However, as will be seen below, it is not necessarily the best way or the way that maximizes profits in the short or longer run.

External organizations. The remaining three microlending structures are all external organizations. External organizations are stand-alone companies, normally corporations, whose shareholders include the bank and which may or may not include outside investors such as international NGOs, donors, and local private investors. Creating one of these external organizations is in many ways like creating a specialized MFI. The external organization has its own board of directors, management, and staff that are all focused on offering microloans and perhaps other products for microenterprises.

Heavily regulated subsidiaries. These are perhaps the most familiar kind of external organization. Here, the parent bank creates another bank, *financiera*, or other type of financial institution that is directly regulated by the banking superintendency. This subsidiary does the microlending and perhaps offers other financial services as well. The name “heavily regulated subsidiary” refers to the direct regulation and supervision of this external organization by the superintendency, in contrast to the lightly regulated subsidiary and the service company, both of which receive little or no direct prudential regulation or supervision. Thus, heavily regulated subsidiaries must satisfy minimum capital, capital adequacy, provisioning, related-party lending, and all other regulations imposed on their type of financial institution; must file all applicable daily, weekly, monthly, and other reports with the superintendency; and are subjected to on-site inspections as stand-alone financial insti-

tutions. Heavily regulated subsidiaries must also pass through an elaborate approval process to be initially granted an operating license by the superintendency, a process that can often take a year or more. Despite their direct supervision, some heavily regulated subsidiaries are not permitted to mobilize deposits.

Lightly regulated subsidiaries and service companies. The banking regulations of many Latin American and Caribbean countries permit the creation of auxiliary providers of financial services, which are allowed to engage in one, or sometimes more than one, of the bank’s permitted operations. Perhaps the best known of these auxiliary providers are leasing companies and factoring companies, which have been set up as bank subsidiaries in a number of countries. Auxiliary providers of financial services have also been created in several countries in the region in order to do microlending, in some cases as a lightly regulated subsidiary and in other cases as a service company. The essential distinction between these two types of institutions is that the subsidiary owns the loan portfolio that it originates and collects, while the service company does not. Service companies originate and collect the microloans, but the parent bank actually owns the loans and thus books them on its own balance sheet and collects the interest and fees charged on these loans. As a result, service companies are paid a fee by the bank for their loan origination and collection services. In contrast, since lightly regulated subsidiaries own the microloan portfolio, they receive their income from the interest and fees they charge on this portfolio.

The banking laws of many Latin American and Caribbean countries typically allow banks to set up auxiliary providers of financial services with little or no review from the banking superintendency. Hence, the lengthy licensing procedures that must be followed when creating a heavily regulated subsidiary are often completely or almost completely eliminated when creating a lightly regulated subsidiary or service company.

Service companies and lightly regulated subsidiaries also receive little or no separate regulation

and supervision from the banking superintendency. Even the lightly regulated subsidiaries, which own their own loan portfolios, are generally not subjected to separate capital adequacy and provisioning requirements, insider lending limits, credit concentration restrictions, or other prudential controls. Rather, the practice is to consolidate lightly regulated subsidiaries and service companies with the parent and impose all of these restrictions on the consolidated entity. While service companies and lightly regulated subsidiaries are generally not permitted to mobilize their own deposits, some can and do sign up their clients for deposit accounts that are offered by the parent bank.

Parent banks typically fund much or all of the loan portfolios of their microlending service companies and lightly regulated subsidiaries, and to a lesser extent, of their heavily regulated subsidiaries. However, all types of external organizations can and sometimes do obtain funding from sources other than the parent.

Finally, it should be noted that the banking regulations in some countries do not permit the establishment of auxiliary providers of financial services (service companies and lightly regulated subsidiaries). Such a restriction limits the available choices to only an internal unit and a heavily regulated subsidiary, substantially simplifying the selection of the best structure.

Best Practices

Much has been learned from past bank downscaling experiences. Following the nine best practices discussed below should greatly enhance the probability that a bank will successfully downscale and that a donor project in support of this activity will succeed. Areas that have been especially problematic in the past include 1, 2, 8, and 9, though there have been important failures in following all nine best practices.

1. *Choosing the best microlending structure.* The selection of the best microlending structure depends on a host of bank and country characteristics. No single structure is best in all situations. In fact, as becomes clear when one examines the many important factors affecting which

structure is best, the bank can suffer serious setbacks and losses if it chooses the wrong structure for its situation. Of the 22 large commercial banks surveyed by Valenzuela (2001),⁵ 11 wanted formal technical assistance help with the choice of organizational structure, indicating that this is indeed a complex and important choice. Since this important best practice takes substantial space to explain, it is treated in Annex A.

2. *If you do microfinance, do it right!* Box 1 summarizes many of the elements of good microlending practice. Banks often have trouble with or resist using products and processes that are appropriate for microlending. For example, they may have trouble:

- offering loans with such short terms (which may seem wasteful of bank manpower)
- charging such high interest rates or engaging in forceful collection efforts (which may seem unfair to poor clients or bad for public relations)
- allowing loans to be approved in a decentralized fashion, without formalized collateral, or with what bankers may deem to be inadequate loan documentation (all of which may seem to be risky practices)
- permitting the use of loan officer incentive pay schemes (which may seem out of step with the bank's culture or contrary to the need to foster teamwork)

Yet these and many other features are essential parts of microlending best practices, even though they may often be counterintuitive or difficult for banks. Some of the consequences of not using appropriate microlending products and processes include:

⁵ Getting the Recipe Right: The Experiences and Challenges of Commercial Bank Downscalers. USAID Microenterprise Best Practices Paper. Washington, D.C.: USAID. Website: www.microlinks.org/ev_en.php?ID=2668_201_2&ID2=DO_TOPIC

Box 1
Key Elements of an Appropriate Microlending Methodology
(Appropriate Products and Processes)

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

- high loan delinquency rates
- high operating costs
- slow program growth
- poor profitability performance

These consequences can be quite severe. Failure to do microlending right is one of leading reasons that banks fail in their efforts to downscale and end up exiting microfinance. In these banks, microlending never achieves the scale or profitability that would justify continuing involvement.

There are several other aspects of doing microfinance right besides employing appropriate loan products and processes. These include freeing the bank’s microlender (that is, the internal unit or external organization doing the microlending) as much as possible to do the following at will in order to best meet the competition, successfully expand its microlending business and other product lines, and increase the profitability of the microlender and bank:

- introduce new products (e.g., equipment loans, housing loans, small and medium-size enterprise loans, credit cards, remittances,

insurance, and, for deposit mobilizing subsidiaries, deposit products)

- modify existing products to better fit microenterprise clients (e.g., savings accounts with low minimum balances)
- locate new branches and other points of service in areas best suited to offer microloans and other microenterprise products, and utilize part-time or mobile branches where demand does not warrant a full-time, fixed branch
- change prices (e.g., interest rates charged on the different loan products)

In addition, the microlender must have the financial resources to be able to effectively compete and maximize profits. These resources include:

- a sufficient operating cost budget so that the microlender can optimally expand the number of branches in which it is present, hire and train new loan officers and other personnel, avail itself of an appropriate management information system, design and pilot test new products, and meet all other operating cost needs
- sufficient portfolio funding from which to make loans

3. *Leaning on the bank.* The bank's microlender—whether it be an internal unit, service company, or some kind of subsidiary—should make the best possible use of the bank's infrastructure and all of the relevant services the bank provides, for example:

- such infrastructure as branch networks and ATMs, information systems hardware, and telecommunications systems
- services from such bank departments as accounting, auditing, finance, information technology, legal, marketing, personnel, and treasury

The microlender should do this to reduce its operating costs and avail itself of specialized personnel resident in the bank.

The extent to which an external organization can and should lean on the bank's infrastructure and services is sometimes not appreciated. Just because the external microlender is a separate corporation with its own board of directors, management, and staff does not mean that it cannot buy many or even most of the services it needs from the parent bank or rent the parent's facilities. For example, during its early operations, Bangente (a microlending subsidiary of Banco del Caribe in Venezuela) functioned as a virtual bank, relying almost entirely on the infrastructure and services of Banco del Caribe.

On the other hand, what the bank offers may not always meet the needs of the microlender, for example, branches that are not in the right location or a personnel department that has no idea of how to recruit or train microfinance loan officers. In these cases, the microlender needs to be free *not* to use the bank's installed capacities. This may be especially challenging for internal units, which may not have the budget or bureaucratic discretion to readily replace the bank's inadequate services or facilities.

4. *Branch locations.* Whether microlending is done through an internal unit or external organization, it needs to operate out of appropriately-located branch offices. When some of the bank branches are located in low-income neighborhoods, near to markets with substantial concentrations of microentrepreneurs, or in other areas suited to microlending, it may be best for microlenders to utilize these branches, provided two conditions are met: a) there is either sufficient space for their operations already or else the branch can be expanded at reasonable cost to accommodate microlending and b) the bank and microlender wish to be associated (see discussion below on image and branding, point A3/B3). This first condition should not be overlooked; microlending can potentially bring thousands of new clients into bank branches, and the bank needs a well thought out plan for how to accommodate this.

There are at least two important advantages of sharing branch space. First, costs may be reduced by sharing telecommunications and computer systems, security systems and personnel,

and other branch infrastructure and services. Second, microloan clients typically must go to a bank branch to cash their loan disbursement voucher or check, repay loans, and access deposit and other services that may be offered only at the bank. Thus, having the microlender and bank in one place reduces client transactions costs and facilitates cross-selling, which can be an important additional source of profits for the bank.

The microlender may also wish to open its own branches, either because the bank's branches are not in appropriate areas or do not have enough space, or else because of image and branding considerations. In deciding where to locate its new branches, the microlender should take account not only of where there are concentrations of potential microloan clients but also of where the existing bank branches are. Being near bank branches facilitates both the teller transactions required by the microloan clients as well as the cross-selling of deposit accounts and any other products that are offered only at the bank. Going a step further by locating microlending branches just upstairs from or adjacent to existing bank branches may also facilitate the sharing of infrastructure and services (such as security systems and personnel, telecommunications, and computer systems), which can yield the microlender significant cost savings.

5. *Special considerations for internal microlending units:*

i) *Internal units should have high bureaucratic rank*, perhaps out of line, especially at first, with microlending's importance in the bank's overall loan portfolio. The reason for this is to enable the microlending unit to: a) better develop what is, for the bank, a rather non-standard set of operating procedures and products and b) obtain the freedoms, cooperation, and resources from the bank's managers and directors that are needed to make this very different product, microloans, a success for the bank.

ii) *Internal units should not be located in the bank's corporate lending department*. If microlending is not placed in its own department, it should at least be placed in a department that has

experience making: a) large numbers of fairly small business loans, typically the small and medium enterprise loan department and/or b) large numbers of small consumer loans, typically the consumer lending department. The internal microlending unit is least likely to succeed when it is placed in the bank's corporate lending department, given the completely different cultures and procedures associated with corporate lending versus microlending.

iii) *Internal units should have specialized loan officers* because microlending has its own specialized methodology that takes substantial time to master, and so it is generally best to utilize specialized loan officers. High levels of loan officer productivity (400 borrowers per loan officer or more) are only achieved by microlenders using specialized loan officers. Moreover, when small business or consumer lending units use their loan officers to also make microloans, it is quite common to see high delinquency rates in the microloan portfolio because the demands of microlending are so different.

6. *Special consideration for external organizations: how to reduce start-up delays*. One of the attractions of doing microlending through an internal unit instead of an external organization is that it is often faster to start up operations when lending is done in house. This is because external organizations, being stand-alone corporations, require: a) a shareholders agreement, whenever the bank is not the sole owner of the external organization, b) a service agreement with the bank (which details the bank facilities and services the external organization can use and the price it must pay the bank for using them), and possibly c) regulatory approval from the bank superintendency. All of these impose possible delays on the start-up of microlending.

These start-up delays can be reduced or possibly even eliminated by using two time-saving tricks. The essence of these tricks is to carry out these three additional tasks (negotiate the shareholders and service agreements, and obtain regulatory clearance) in parallel with other tasks that must be done by any microlender, whether it be an internal unit or external organization.

The first trick for reducing the start-up delays is to negotiate the shareholders and service agreements while carrying out all the technical tasks that must be done simply to start up microlending (whether microlending is done in house or through an external organization). These technical tasks include, for example, carrying out detailed market and feasibility studies, creating operating and other manuals, hiring and training loan officers and other personnel, setting up loan tracking and accounting systems, and doing detailed product design work. Although it is difficult to generalize, these tasks often take approximately 6-9 months to accomplish, which is often (but not always) sufficient time to negotiate the shareholders and service agreements. An important limitation on the use of this trick is that the bank or some other entity must be willing to pay the costs of carrying out these technical tasks until a shareholders agreement can be reached and capital is paid in by all of the shareholders.

The second trick is to pilot test the microlending product in house or through a foundation connected with the bank while awaiting regulatory clearance for the external organization to begin operations. This is mainly useful when creating a heavily regulated microlending subsidiary since such subsidiaries normally require a significant period of time (6-12 months or more) to obtain regulatory approval. During this waiting period, much or all of the pilot testing of the microloan product may be carried out. For example, Banorte in Mexico saved more than a year in start-up time by using this trick.

7. Special consideration for service companies: setting the service company fee to maximize bank profits. The formula used to set the fee paid by the bank to the service company can be chosen in such a way that the service company, in maximizing its own profits, also maximizes the bank's profits. This is clearly a desirable result for the bank. In order to achieve this result the service company should be remunerated as though it were a subsidiary making arms-length (unsubsidized) transactions with the bank. This means that the service company fee should be set such that the bank does not subsidize the funding or any of the services it provides to the

service company. Neither should the bank withhold any part of the interest or commission income that is earned by the service company from its microlending operations. Finally, the service company should pay all of the provisioning and write-off costs associated with its loan portfolio. Thus, the ideal service company fee is simply the profits it would earn if it were a subsidiary and paid full cost for all of the services it obtains from the bank. This result is explained in the longer study on which this note is based (see the section entitled "Fees and Profits" on pp. 8-9). For example, Sogebol, the microlending service company of the Haitian bank Sogebank, is remunerated in this way.

8. Get technical assistance. It is both difficult and unnecessary to reinvent the wheel in microfinance. Much has been learned about how to do microfinance right and about the other best practices discussed here. Banks can save themselves from expensive mistakes and earn greater profits more quickly by accessing good quality technical assistance.

9. Beyond champions: institutional commitment. Early writers on bank downscaling emphasized the importance of a board champion, who inspired and protected the microlending program, and an operational champion, who knew how to run the program. These champions were committed to the vision of microfinance in the bank.

While this is a good start, things are likely to go even better for the microlending program if more of the bank's directors, managers, and staff understand microfinance and are convinced that it is truly a worthwhile *commercial* venture for the bank to engage in. This is because even if the microlending program is headed by an able manager, who has the backing of the chairman of the board and the bank's general manager, there are still many other upper- and middle-level managers and staff who can create any number of roadblocks and problems for the microlending program. Thus, a more general education and consciousness-raising campaign may yield large dividends, as it has for example for Micro Credit National (MCN), a lightly regulated microlending subsidiary of Unibank, which is a large commercial bank in Haiti. MCN has

not had the kinds of problems securing the cooperation of the bank's managers and staff that are reported by other subsidiaries, service companies, and internal units, such as opening new branches, resolving information systems issues quickly and effectively, and getting the many other bank departments to be responsive to the needs of microlending. To successfully launch microlending, it is often of particular importance to obtain the cooperation of the information technology department and of the managers of the branches where microlending will be offered. Without the cooperation of these key back-office and front-line personnel, microfinance may never develop into a significant business area.

Ensuring Commitment

As noted earlier, experience has shown that bank commitment is a key factor in creating a successful and durable microlending program. Therefore, donors should look for signs of such commitment in choosing which banks to assist. Indicators of bank commitment include:

- the presence of microfinance champions in the bank, including one or more board members who may inspire and protect the microlending program and one or more managers who know how to run it
- an appreciation in the bank that microfinance serves the institution's *commercial* interests (since banks that do microfinance mainly for public relations purposes tend to have small and/or short-lived programs)
- the bank's willingness to carry out initial tasks such as market and feasibility studies at its own expense, prior to the start-up of any donor assistance programs
- the bank's willingness to commit the resources needed to effectively develop microlending, including capital to start up an external organization if that is the best choice of microlending structure, as well as money for: training of loan officers and other key personnel, an adequate management information system, detailed design and pilot testing of the new microfinance products, and new branch offices if needed

Beyond looking for signs of commitment in the banks they choose to support, donors should seriously consider providing technical assistance grants on both a *conditional disbursement* and a *contingent repayment* basis. Again, the idea is to support only banks with a serious commitment to microfinance. By conditional disbursement we mean that disbursement of the technical assistance funds should be conditioned and/or tranching on performance indicators such as those measuring outreach to the target group and the delinquency rate of the microlending portfolio. By contingent repayment we mean, that if the bank does not maintain a certain minimum level of client outreach to the target group for at least two years after the last disbursement of the technical assistance grant, for example, it would be contractually obligated to repay part or all of the technical assistance funds it has received from the donor or government agency. Additional discussion of these points is taken up in the next section, on monitoring and evaluation.

MONITORING AND EVALUATION

A relatively small number of quantitative indicators generally suffices to monitor and evaluate the performance of downscaling projects. These quantitative indicators are of two types, those that measure the performance of the microlending program itself and those that measure the overall health of bank. Key indicators of the performance of the microlending program include:

- Number of borrowers; and perhaps Total microlending portfolio—if these measures are sufficiently large, they indicate that program outreach goals are being met
- Average loan size—if this measure is sufficiently small, it suggests that the program is reaching the target group, rather than much larger enterprises
- Delinquency rate of the microloan portfolio (measured as portfolio at risk)—measures whether the bank is successfully mastering the microlending methodology
- Client retention rate—important not only as a key measure of client satisfaction but also because microlenders generally lose money

on the first loan they make to each borrower⁶

- Microloan clients per microloan officer—measures whether the program is meeting efficiency targets

Key indicators of the overall health of the bank (all of which should be tracked by the regulatory authority) include:

- Capital/Risk-weighted assets—measures the solvency of the bank
- Delinquency rate of the overall bank loan portfolio (measured as portfolio at risk)—measures whether the bank is encountering difficulties in this key asset area
- Return on equity (ROE)—measures whether the bank is earning healthy profits

Typically, the project document would establish goals as well as minimum performance levels for each of these variables in each year of project execution. While the aim would be for the bank to achieve the goals in all areas, the project could be cancelled if the bank fell short of the minimum performance levels in one or more areas, especially in those related to client outreach and retention, microloan portfolio delinquency, and overall health of the bank—arguably the most critical to project success. Conditioning execution in this way provides incentives to the bank to approach the microlending program seriously and also provides a mechanism to stop disbursements if either the program itself or the overall health of the bank becomes seriously compromised. The reported indicators, perhaps supplemented by other data,

⁶ Client retention rates (CRR) may be calculated using the following formula:
 $CRR = C_1 / (C_0 + NC)$, where C_1 is the number of clients at the end of the year, C_0 is the number of clients at the beginning of the year, and NC is the number of new clients (that enter the program during the year). For example, if all clients present at the start of the year (C_0) and all the new clients (NC) remain in the program until the end of the year, then $C_1 = C_0 + NC$, and the client retention rate equals 1 (or 100 percent). If only half of each group remains at the end of the year, then $C_1 = .5 (C_0 + NC)$, and the client retention rate equals 0.5 (or 50 percent).

may also suggest how to reorient project resources during project execution. For example, if loan delinquency rates rise to unacceptable levels, technical assistance may be reoriented toward getting delinquency down rather than toward program expansion or new product development.

A stronger version of such conditional disbursement would *require* the project to be cancelled if key performance indicators fell short of the pre-established minimum performance levels, particularly if this were to occur for 2-3 consecutive semiannual reporting periods. This stronger conditionality has the disadvantage that some projects could be cancelled because of transitory shocks to the economy or bank that the bank might eventually overcome. On the other hand, the advantage of this approach is that it ensures that resources are not spent on underperforming projects or banks at risk, and also provides very strong incentives to the bank to meet at least the minimum performance standards.

An intermediate position (in between permitting and requiring that the project be cancelled if minimum performance levels are not met) can be achieved by tranching project disbursements. Total project assistance is divided into two or three tranches, with the second and third tranches only released once the bank has achieved at least the minimum performance levels associated with that tranche. This tranching is done in addition to permitting project cancellation if year-by-year (or semester-by-semester) minimum performance levels are not achieved.

As noted earlier, repayment by the bank of some or all of a technical assistance grant can be triggered by the bank's failure to maintain adequate outreach to microenterprise clients or to achieve other goals for a specified period of time (for example, two years) after the project is fully disbursed. In this way, project performance incentives can be created subsequent to as well as during project execution.

In addition to tracking the above quantitative indicators of project and bank *performance*, it is useful to monitor qualitative and quantitative

indicators of the project's main *activities*. This helps to ensure that important activities are not skipped during project execution. While these activity indicators can be quite numerous and can vary from one project to the next depending on the exact content of the project, these indicators might include the following: creating a business plan for microfinance that is approved by the board of directors; carrying out market and feasibility studies of three microfinance products (or some other number of products, possibly varying by year); pilot testing these products; offering these products in at least five bank offices (or some other number of offices,

possibly varying by year); creating all requisite manuals needed by the microlender; hiring personnel; training trainers, loan officers, and other personnel (including managers and directors) in microlending and other relevant areas; creating an incentive pay system for loan officers and possibly other personnel that is approved by the board of directors; setting up loan tracking and accounting systems; establishing internal controls and training an internal auditor; and in the case where an external microlending organization is used, creating shareholders and service agreements and obtaining regulatory clearance.

Annex A: Choosing the Best Microlending Structure

In discussing the pros and cons for the bank of the four ways to downscale, the exposition is greatly simplified if we break the process of choosing among the four structures into two steps. First, we examine the pros and cons of the bank structuring its microlender as an internal unit versus an external organization (service company, lightly regulated subsidiary, or heavily regulated subsidiary). Second, we discuss the pros and cons of the different external organization options.

Turning to the first of these two decisions, Table 2 summarizes the eight factors that favor an external organization (numbered A1 through A8) and the seven factors that favor an internal unit (numbered B1 through B7). Factors A3 and B3 are a special case in which a single factor (image and branding) could favor either an internal unit or external organization, depending on the circumstances. Consequently, this factor is numbered A3/B3 to indicate this special status.

Turning to the second of the two decisions, Table 3 presents the factors that favor a service company over a subsidiary and vice-versa. An asterisk appears next to the reference number of any factor that is (or may be) different depending on whether the comparison is made to a heavily or a lightly regulated subsidiary. For example, a service company may have an advantage over a heavily regulated subsidiary but not over a lightly regulated subsidiary, or the service company's advantage may simply be greater with respect to the former subsidiary than the latter. An asterisk is used to indicate either of these cases. As it turns out, all factors that appear in Table 3 have already appeared in Table 2. Hence, the same set of reference numbers are used in both tables (A1-A8 and B1-B7), though only a subset of the Table 2 factors actually appears in Table 3.

Pros and Cons of an Internal Unit vs. an External Organization (Table 2)

A1. *External organizations have greater freedom to do microfinance right.* The second best practice (above) defines and discusses the great importance of doing microfinance right. Heads of external organizations often cite their ability to do microfinance right in many or all of the ways noted earlier as a major advantage they enjoy over internal units and an important reason for going to the extra trouble and expense of setting up an external organization. The heads of internal microlending units of even those banks that have demonstrated some of the greatest flexibility in their treatment of microlending also agree that they would enjoy important additional freedoms if they did microlending through an external organization. This is true because most banks are still large bureaucracies which impose significant operating limits on their constituent units. Moreover, even if the bank understands microlending and intends to do microfinance right, it may fail to carry through on these intentions because microfinance is simply not one of the bank's highest priority areas.

A2. *External organizations often have greater incentives to be efficient and profitable.* This is because a microlending service company or subsidiary is a relatively small, stand-alone company, and as such often enjoys greater staff motivation, commercial drive, sense of purpose, and accountability than the internal microlending unit of a bank. In turn, these virtues derive from the fact that: a) stand-alone firms get to keep the profits they earn and b) stand-alone firms also exert a more direct influence over the gross revenue and cost streams that determine these profits.

Against these first two advantages of external organizations (greater freedom and incentives to be successful and profitable), consider the first two advantages of internal units.

Table 2
Internal Unit vs. External Organization: Pros and Cons

Reference Number	Advantages of an External Organization over an Internal Unit
A1	Greater freedom to do microfinance right (e.g., to use appropriate loan products and processes, open new branches and change interest rates at will, generate and apply budgetary resources with greater discretion to meet priority needs)
A2	The microlender's directors, managers, and staff may have much higher-powered incentives to be efficient and profitable
A3/B3	Image and branding (may be a disadvantage in some circumstances)
A4	If outside shareholders are incorporated, this can bring several benefits, including additional capital, improved governance, and high-quality technical assistance
A5	Can reduce the risks to the bank of the microlending operations
A6	May escape certain pay-related problems and the wage scale of the bank
A7	May escape from union wage scales and agreements
A8	Subsidiary may have more favorable treatment under a usury ceiling than an internal unit or even a service company
	Advantages of an Internal Unit over an External Organization
B1	Greater integration into the bank reduces operating costs (perhaps by 1-10 percent)
B2	By eliminating initial tasks, start-up cost and often start-up time are reduced; possibly less initial capital is needed; idle capital is easily avoided
A3/B3	Image and branding (may be a disadvantage in some circumstances)
B4	Outside shareholders in an external organization reduce bank profits and can create conflicts
B5	Funding advantages: a) unconstrained capital backing from the bank, b) greater availability and less uncertainty about the availability of loan portfolio funding, and c) lower funding cost than subsidiaries
B6	Value added tax may be levied on: a) payments made by an external organization to the bank for use of bank infrastructure and services and b) fees paid by the bank to a service company
B7	Duplicate capital problem (most likely to negatively affect heavily regulated subsidiaries)

Table 3
Service Company vs. Subsidiary: Pros and Cons

Reference Number	Advantages of a Service Company over a Subsidiary (Heavily or Lightly Regulated)
B1*	Greater integration into the bank reduces operating costs
B2*	By eliminating initial tasks, start-up cost and often start-up time are reduced; possibly less initial and initially-idle capital—all especially with respect to heavily regulated subsidiaries
B5*	Funding advantages: a) greater availability and less uncertainty about the availability of loan portfolio funding and b) lower funding costs
B7*	Duplicate capital problem (most likely to negatively affect heavily regulated subsidiaries)
A7*	May escape from union wage scales and agreements
	Advantages of a Subsidiary (Heavily or Lightly Regulated) over a Service Company
A1*	Greater autonomy in certain limited spheres including, for heavily regulated subsidiaries that can mobilize deposits, the chance to offer more appropriate savings products
A5	Can reduce the risks to the bank of the microlending operations
A8*	Subsidiary may have more favorable treatment under a usury ceiling than an internal unit or even a service company

Note: An asterisk (*) indicates those factors where the effect is (or may be) different depending on whether the comparison is made to a heavily regulated subsidiary or a lightly regulated subsidiary.

B1. *Internal units may reduce operating costs (by 1-10 percent according to the estimates we have) due to greater integration into the bank.* An external organization requires:

- a separate board of directors
- additional management and staff to act as liaisons with bank-provided services as well as to supply and oversee services it provides for itself, thus losing economies of scale
- additional personnel and systems to comply with regulatory requirements (especially for heavily regulated subsidiaries)
- additional personnel to obtain finance for the external organization
- added personnel to do asset-liability management (for the case of partly-owned subsidiaries)

This is not to say that internal units always have the lowest operating costs, just that there is a tendency for this to be true due to their greater integration with the bank. On the other hand, if the bank bureaucracy ties the internal microlending unit up in knots with costly and unhelpful procedures, forces it to accept a high wage scale, or denies it the technical assistance it might have used to cut costs, the internal unit may, in fact, have the highest overall operating costs of any of the four structures.

B2. *Internal units may be cheaper and faster to start up.* As noted in best practices 6, internal units may be faster to start up since no shareholders agreement or service agreement need be negotiated and no regulatory clearance need be obtained. For the same reasons, they may also be cheaper to start up. Again, these are only tendencies. External organizations can be cheaper and faster to start up if the bank makes it too difficult to get microlending going in house.

Sometimes this is as far as the comparison of internal units versus external organizations is taken. However, there are a number of other important effects to consider.

A3/B3. *Image and branding.* Image and branding considerations are a special case that may favor either the internal unit or external organization, depending on the circumstances. External organizations are advantageous when banks want to create a separation between their traditional operations and microlending. The bank may want to do this for the sake of:

- the traditional clients it hopes to keep (who may be bothered by so many poor people in the lobby)
- the new microenterprise clients it wants to attract (who may be intimidated by the bank—Banorte in Mexico and Sogebank in Haiti are clear cases of this)
- general reputational considerations (the bank doesn't want to be associated with charging very high interest rates or pressuring poor people to repay).

An internal unit is advantageous when the microlender and bank want to be as closely associated as possible:

- because the bank wants the favorable publicity and image associated with serving the poor
- because the microlender wants to benefit from being closely linked to the much larger bank, which may be seen as financially strong or prestigious (Bancolombia in Colombia is a clear case of this)

A4 and B4. *There are benefits and costs of outside shareholders,* as noted in Table 2. These benefits and costs of outside shareholders come into play only if the bank decides to be a partial owner of the external organization instead of a full owner, and thus makes room for outside shareholders.

A5. *External organizations can reduce the risk to the bank of microlending operations.* This can be done in two ways. First, if the bank is only a partial owner of the external organization, then both the risks and

rewards of microlending are reduced. For example, if the bank owns half of the external organization shares, then this reduces by half the impact on the bank of any external organization losses, but does the same for any external organization profits.

The second method works only for subsidiaries (either heavily or lightly regulated), but not for service companies. Provided the subsidiary meets certain conditions that are normally set out in local bankruptcy or banking laws, the bank's losses are limited to the capital it has invested in the subsidiary, which is typically far less than the bank's entire capital. These conditions generally include the requirements that the bank and subsidiary maintain arms-length transactions with each other and that the subsidiary be managed independently of the bank. These requirements aim to ensure that the subsidiary is effectively being run as a separate company and not just as another division of the bank.

A6 and A7. *External organizations can sometimes escape the wage scale of the bank and other pay-related problems.* For example, Credife, the microlending service company of Banco del Pichincha in Ecuador, is exempted from the collective bargaining agreements that cover bank employees in Ecuador, saving it 25 percent in personnel costs. Bancolombia estimates that by escaping the high wage scale of the Colombian banking system, it could save nearly 50 percent in personnel costs if it did microlending through an external organization instead of in house. Yet another type of problem stems from the incentive bonuses received by loan officers and other microlending staff. These can incite jealousies among the regular bank staff, who typically are paid just a flat salary and thus may receive less in total compensation in certain cases. These productivity-sapping jealousies may be mitigated by doing microlending through an external organization, which tends to separate the two sets of staff.

A8. *A subsidiary can have a more favorable treatment under a usury ceiling than an internal unit or even a service company.* In some instances, such as Paraguay until 2004, loan rate ceilings vary by type of lender. In Paraguay, banks had a lower loan rate ceiling than *financieras*, giving *financieras* an advantage. Hence, for a bank wanting to do microfinance, it would be advantageous to do microlending through a *financiera* (a heavily regulated subsidiary) in order to be able to charge more on its loans.

And, there are three final benefits of internal units.

B5. *Funding advantages.* Banks are not constrained by any prudential regulations in their ability to fund internal units. By contrast, in the case of subsidiaries (of either type) banks face credit concentration and related party lending limits that typically restrict banks to lending or lending and investing no more than 10-20 percent of bank capital in a bank subsidiary. This can become a real limiting factor on the growth of the subsidiary's portfolio as time passes and this portfolio grows. It also drives up the cost of funding the microloan portfolio if more expensive outside funding must be obtained.

The funding constraints on service companies are generally much less problematic: the bank is only limited in how much it can invest in the service company, not in how much portfolio funding it can provide. These investment limits are generally much less restrictive, as shown by the data given for 13 countries in the longer study on which this note is based (see Table 8 there, p. 50).

B6. *Value added tax (VAT)* is often levied on commissions and fees but not on interest in Latin America. Thus, VAT is occasionally levied on either or both of the following two financial flows: a) the payments external organizations make to banks for the use of the bank's infrastructure and services and/or b) the payments banks make to service companies for loan origination and collection services. This was a major factor in the decision of Bancolombia and Banco Caja Social (both in Colombia) to do microlending in house, and thus avoid having to pay VAT.

The Haitian service company, Sogesol, faced exactly this issue and devised a neat escape, which it continues to use to this day. First, Sogesol nets out all that it owes the bank for using the bank's services and infrastructure from the much larger amount of income Sogesol is due from the bank for originating and servicing microloans. Second, Sogesol calls this single accounting entry its "share of interest income," instead of a commission or a fee. Since interest is not subject to VAT in Haiti, Sogesol has avoided payment of this tax.

B7. *The duplicate capital problem* never arises for internal units, would rarely if ever arise for service companies and lightly regulated subsidiaries, but can and does come up in some countries for heavily regulated subsidiaries. The duplicate capital problem occurs when prudential banking regulations require that *separate* capital adequacy requirements be met both for a parent bank's loan to an external organization and for an external organization's loans to final borrowers such as microenterprises. This increases the total amount of capital that must back every peso the bank lends to a microentrepreneur (through an external organization), significantly increasing the costs of this lending.

Pros and Cons of a Service Company vs. Subsidiary (Table 3)

The brief additional observations given here, when coupled with the explanations already given above for each factor in Table 2, suffice to explain the choice among the three types of external organizations. We begin by examining the advantages of a subsidiary over a service company and end with the advantages of a service company over a subsidiary. The two kinds of subsidiaries are distinguished as needed.

A1. *Greater freedom to do microfinance right.* In the previous section (internal unit vs. external organization) this factor represents a broad range of advantages that service companies and subsidiaries generally have over internal units because of their greater autonomy. Here, the set of advantages is far more limited. The main advantage is that heavily regulated subsidiaries that mobilize deposits can offer deposit products that may be better tailored to their microenterprise clients than can the other external organizations, which must rely on the bank's deposit products.

A5. *Subsidiaries can reduce the risk to the bank of microlending operations.* This is an advantage, already discussed above, that both types of subsidiaries have over service companies: under certain fairly general conditions, the bank's losses from its subsidiary can be limited to the amount the bank has invested in the subsidiary.

A8. *Usury ceiling.* Depending on how the usury law or regulations are written, subsidiaries may have an advantage over service companies, though probably in very few cases.

The following points relate to the advantages of service companies over subsidiaries of either or both types.

B1. *Reduced operating costs.* Due to their greater integration with the bank, service companies typically have operating cost advantages over subsidiaries. This is especially true of heavily regulated subsidiaries because of the greater regulatory compliance costs of heavily regulated subsidiaries. In addition, there is less duplication of the bank's finance and treasury personnel and functions in service companies than in heavily regulated subsidiaries and probably even than in lightly regulated subsidiaries.

B2. *Cost and speed of start-up.* Service companies typically have an advantage over subsidiaries in cost and speed of start-up, especially over heavily regulated subsidiaries because of the greater regulatory compliance burden of establishing a heavily regulated subsidiary. The advantage over lightly regulated subsidiaries is much less pronounced.

B5. *Funding advantages.* As discussed earlier, service companies have a distinct advantage over subsidiaries because of the related party and credit concentration limits that are applied to bank lending to subsidiaries, but are not applicable in the case of service companies. Heavily regulated subsidiaries that can mobilize deposits may have less problems than lightly regulated subsidiaries in this area because their ability to mobilize deposits can reduce funding constraints and lower funding costs.

B7. *Duplicate capital problem.* As noted earlier, this factor is most likely to have adverse impacts on heavily regulated subsidiaries, though as discussed in the longer study, it can also negatively impact the other types of external organizations in certain cases as well.

A7. *Wage scales.* Service companies may be able to escape union wage scales and agreements that subsidiaries cannot. A good example of this is Credife, the microlending service company of Banco del Pichincha in Ecuador. Since Credife is a service company, and not a banking institution in its own right, it is exempted from the collective bargaining agreements that cover banking institution employees in Ecuador, saving it approximately 25 percent in personnel costs.