The Role of Commercial Banks in Microfinance

Fiji Microfinance Week
November 4th 2009
Conceptual Evolution

• Commercial banking has been around for a while...in 1998, CGAP described com. banks as “the new actors in the microfinance world”.

• Today over 200 banks all over the world are involved in MF with a Gross loan portfolio of at least $11 Billion USD.
Competitive Advantages

• Recognizable consumer brands
• Access to Capital
• Institutional Infrastructure (In some Cases)
• Information Technology Systems
• Efficient Management Systems
• Established Internal Controls
## Ingredients for Success

### Serving the Underserved—What Makes for Success?

<table>
<thead>
<tr>
<th>Ingredient</th>
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<tbody>
<tr>
<td>Commitment from board and management, strong internal champions, and alignment with the bank’s core commercial strategy</td>
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<td>Knowledge of microfinance best practices and how to serve micro-clientele</td>
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<td>Infrastructure located conveniently for clients</td>
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<td>Products especially adapted for low-income and informal markets</td>
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<td>Systems and procedures adapted to the microfinance operations, e.g., systems that support immediate follow-up on missed payments</td>
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<tr>
<td>Appropriate staff training and incentives on new clients, products, and delivery systems</td>
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Source: CGAP
Current Approaches

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Current Approaches

1. Direct
   • Internal microfinance unit
   • Specialized financial institution
   • Microfinance service company

2. Indirect
   • Outsourcing retail operations
   • Providing commercial loans to MFIs
   • Providing infrastructure and systems
Approach 1: Internal Unit

Overview: A department or unit within the bank manages microfinance related activities.

- Is highly dependant of dedicated visionary management.
- Often new staff need to be brought on to provide retail services.
- Banks that already operate in outreach areas are at an advantage.
- This approach is the most labor intensive for bank employees.
- This is also known as downscaling.
Approach 2: Specialised financial Institution (SFI)

Overview: Bank forms a separate legal entity to undertake microfinance activities.

The SFI maintains its own corporate identity, governance, management, staff, and systems, but may use some of the parent bank’s infrastructure like office space, information technology, accounting, treasury. This is referred to as the Greenfield option.
Approach 3: Microfinance Service Company

Overview: The bank forms a non-financial legal entity.

- Provides microloan origination & portfolio management services
- Undertakes limited operations and is not regulated by banking authorities.
- Financial products are registered with the parent bank.
- Facilitates joint ventures & equity/risk sharing.
## Analysis of Direct Approaches

<table>
<thead>
<tr>
<th></th>
<th>Prerequisites</th>
<th>Relevance to Fiji</th>
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</table>
| **Internal Unit**       | • Strong Management commitment to MF.  
                          • Appropriate staff capacity  
                          • Extensive Branch Network  
                          • Detailed Market Research  
                          • Adaptable MIS  
                          • Permissive Regulatory Regime  
                          • Knowledge of Microfinance Best Practices  
                          • Capacity to process high transaction volumes |                   |
| **Specialised Financial Institution** | • Strong Management commitment to MF.  
                                      • Access to capital  
                                      • Knowledge of Microfinance Best Practices |                   |
| **Service Company**     | • Strong Management commitment to MF.  
                          • Knowledge of Microfinance Best Practices  
                          • Capacity to Process High Transaction Volumes |                   |
Approach 4: Outsourcing Retail Operations

Overview: The bank contracts a high-caliber MFI to carry-out microfinance activities.

- Loans are registered on the bank’s books.
- MFI originates loans, makes credit decisions, manages the loan portfolio.
- MFI earns a share of the interest and fees.
- MFI and bank share risk and incentives.
- The bank may ask the MFI to finance a portion of the loan, or provide a fist loss guarantee.
- The bank may restrict the MFI from servicing other banks.
Approach 5: Providing Commercial Loans to MFIs

Overview: The bank provides a term loan or line of credit to an MFI.

- This is one of the most common models as it is close to commercial bank lending.
- The bank may require regular financial reporting, and rights to inspection/audit.
- Funds can be used by the MFI for working and/or lending capital.
- The loan may be unsecured, secured by assets as collateral, a cash deposit, or by a 3rd party guarantee.
Approach 6: Provide Infrastructure and Systems

Overview: The bank provides access to its branch or ATM networks, front or back office operations.

- This includes transactions processing and IT services.
- The bank receives fees, commissions and/or rents.
- Sometimes the MFI places its own staff in the branches to serve its clients.
- Clients can have accounts with the bank or use the MFIs account at the bank.
## Analysis of Indirect Approaches

<table>
<thead>
<tr>
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<th>Prerequisites</th>
<th>Relevance to Fiji</th>
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<tbody>
<tr>
<td><strong>Outsource Retail operations</strong></td>
<td>• Strong MFI Partner with a proven model and significant outreach.</td>
<td></td>
</tr>
<tr>
<td><strong>Commercial loan to MFI</strong></td>
<td>• MFI with a profitable and stable business model.</td>
<td></td>
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</tbody>
</table>
| **Provide infrastructure & Systems** | • Extensive physical Infrastructure or Relevant Technologies.  
                                    • Ambitious MFI with a proven model and the capacity to grow it rapidly. |                   |
## Overview Comparison

<table>
<thead>
<tr>
<th>Service Type</th>
<th>Funding Source</th>
<th>Risk</th>
<th>Income</th>
<th>Staff</th>
<th>Level of Involvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Unit</td>
<td>Bank</td>
<td>Bank</td>
<td>Bank</td>
<td>Bank</td>
<td>High</td>
</tr>
<tr>
<td>Specialised Financial Institution</td>
<td>Bank</td>
<td>MFI</td>
<td>Shared</td>
<td>SFI</td>
<td>Moderate</td>
</tr>
<tr>
<td>Service Company</td>
<td>Bank/Partner</td>
<td>Shared</td>
<td>Shared</td>
<td>SC</td>
<td>Moderate</td>
</tr>
<tr>
<td>Outsource Retail operations</td>
<td>Bank/Partner</td>
<td>Shared</td>
<td>Shared</td>
<td>MFI</td>
<td>Moderate</td>
</tr>
<tr>
<td>Commercial loan to MFI</td>
<td>MFI</td>
<td>MFI</td>
<td>MFI</td>
<td>MFI</td>
<td>Low</td>
</tr>
<tr>
<td>Provide infrastructure &amp; Systems</td>
<td>MFI</td>
<td>MFI</td>
<td>MFI</td>
<td>MFI</td>
<td>Very Low</td>
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</table>
Case Study: ANZ Rural

Basic Facts:
• Began providing micro loans in Feb. 2005.
• Loans were between $200 & $2000.
• Repayment rates were extremely low.
• Were forced to write-off a very high percent of their portfolio, amounting to $264,000.
• July 2008 just short of 3.5 years after inception, the program was suspended.

Lessons Learned
• Careful research needs to be done before picking a microfinance model.
• The model needs to be piloted and rolled out slowly.
• It is hard to do microfinance without a strong connection to the borrowers.
Case Study: National Bank of Vanuatu

Basic Facts:
- NBV was established in August 1991 under the NBV Act of 1989
- The Government of Vanuatu is the sole shareholder.
- NBV provides rural banking services through its network of 21 branches.
- Micro-loans now make up more than 40% by number of NBV's total loan portfolio.
- Have been increasingly profitable for the past five years.

Lessons Learned
A positive role for government in microfinance is supportive yet “hands off”.
- Government subsidies are not the best way to support microfinance.
- High transaction costs and low population densities can still support microfinance models in the Pacific.
# Case Study: State Owned Bank

<table>
<thead>
<tr>
<th>THE BIMAS SYSTEM</th>
<th>KUPEDES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Politicized Mandates</td>
<td>Government decreases involvement</td>
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<tr>
<td>Incomplete financial records in district offices impede performance tracking</td>
<td>Districts turned into autonomous financial entities</td>
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<td>Divided approval and Collection Responsibilities</td>
<td>Collection and Approval all done by district officer</td>
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<tr>
<td>Low interest rates</td>
<td>Interest Rates above market rates</td>
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<tr>
<td>Little to no training of staff</td>
<td>Regular Training Modules for Staff</td>
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<tr>
<td>Compensation not tied to performance</td>
<td>Performance based Compensation</td>
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<td>Chronic loss maker</td>
<td>Consistent Profit maker</td>
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</table>
Financial Sustainability of Fijian MFIs

![Graph showing financial sustainability metrics for Fijian MFIs including Avg. Cost per Client, Avg. Income Per Client, Income per Loanee, and Income per Saver. The bars for West show higher values compared to FCOSS.](image-url)