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Commercial banks in microfinance: entry strategies and keys of success

Abstract

Microfinance emerged in the 1990s to become a real industry around the world, composed of a wide variety of institutions that providing financial services to people who are excluded from the traditional banking system. With the spectacular success of microfinance, a growing number of commercial banks have entered this new market, motivated on the one hand by the growing competition in the banking sector and on the other hand, by the pressure of some governments. However, if some banks choose the direct way to enter in microfinance “*downscaling*”, others prefer to play the card of prudence by building partnerships with microfinance institutions (MFIs). Microfinance activities can pose different risks from those related to traditional banking activities. This paper aims to explore entry strategies by commercial banks in microfinance and take the keys of success to make microfinance a profitable part of its business.

Keywords: commercial banks, microfinance institutions, downscaling, partnerships.

JEL Classification: G21.

Introduction

In the 1980s, new funding initiatives were developed for the unbanked poor in developing countries. From isolated projects, often developed on charitable basis, these operations themselves are structured: they cover today a sectoral activity clearly identified, “microfinance”, most often exercised by institutions having legal personality, “microfinance institutions” or MFIs.

A few years ago, microfinance was the exclusive domain of non-profit organizations and cooperative societies. In 1998, commercial banks were described as “new actors in the microfinance world” (Baydas, Graham and Valenzuela, 1998). Today, commercial banks occupy a prominent place in microfinance. Non-governmental organizations (NGOs) constitute 40 percent of microfinance institutions and reach 36 percent of microfinance borrowers. Private banks constitute 9 percent of the institutions, but, because they are larger, they reach another 36 percent of the borrowers (Buera, Kaboski and Shin, 2012). Banks have a wide range ways to choose from when entering the market. The current approaches can be divided into two main ways, direct and indirect, based on how the bank makes contact with the client.

The following analysis focuses on the following questions: *why banks turned to microfinance sector? What are the strategies put in place to allow this entry? And what are the keys of success in microfinance?*

To give an answer to these questions, this paper will be organized in the following way: firstly, we present

disincentives and incentives for commercial banks entry into microfinance, secondly we will discuss the classification of the main operating strategies currently used by banks for entering the microfinance market and finally we rely on the success keys of commercial banks involvement in microfinance.

1. Commercial banks entry into microfinance: discouraged or encouraged

1.1. Overview and basic concepts. The question of commercial banks’ presence in microfinance market raises some interest in literature for some years. The thesis has often been advanced is that banks, for risk reasons and costs, are not interested in microfinance. Some banks may not be completely indifferent, have adopted a hesitant and suspicious profile. Others, however, achieve much, and sometimes all, of their activities in this sector. Before presenting disincentives and incentives for commercial banks entry into microfinance, it is necessary to describe briefly the basic concepts related to the subject.

Commercial banking can be defined very shortly, but effectively, as “deposits takings and loans making”. In other words, commercial banks simply borrow money mainly in the form of deposits and lend money to families and to firms (Iannotta, 2010, p. 1).

Microfinance is defined as “the category of financial services offered to lower-income people (micro-entrepreneurs), where unit size of the transaction is usually small (“micro”), typically lower than the average gross domestic product (GDP) per capita, although the exact definition varies by country” (Isern and Porteous, 2005, p. 1). In the literature, the terms microfinance and microcredit are often confused therefore, it is important to highlight the difference between them. Both terms refer to small transactions, but microcredit relates only to the lending side of financial operations. Microfinance, on the other hand, refers to a whole range of

financial services including microcredit (microloan), microsaving as well as money transfer and microinsurance. So, microcredit is a component of microfinance.

Microcredit and microsaving are the financial products that are mostly used in microfinance activities. A typical *microcredit* is essentially characterized by a small amount, a short-term maturity (less than one year in general) and a high interest rate. A broad vision of the structure of microcredit can be gleaned from the Microfinance Information Exchange (MIX) Micro Bank Bulletin 2006-2008 benchmark, a survey of 611 microfinance institutions, totaling US\$ 30 billion in loan portfolio and 65 million borrowers. The average microfinance loan size (based on volume of loans outstanding by number of active clients) varies geographically; it is generally larger in the latter regions, compared with South Asia and East Asia and Pacific, where microfinance has its roots (Table 1). Methods of microcredit delivery can generally be divided into the two broad categories of individual and group approaches, based on how the MFI delivers and guarantees its credits. Both of them have proven effective, these can also be combined in the same institution.

Table 1. Average microfinance loan size by region in 2011

Region	Africa	EAP	EECA	LAC	MENA	S-Asia
Average loan size (US\$)	471.3	418.6	1,896.3	1,026.3	606.3	154.0

Notes: South Asia and the East Asia and Pacific (EAP), Latin America and the Caribbean (LAC), Eastern Europe and Central Asia (EECA), and in Sub-Saharan Africa (Sub-S. Africa), Middle East and North Africa (MENA), South Asia (S-Asia).

Microsavings is central to low income people's economic management strategies: their current income is rarely sufficient to manage crises, to invest when an opportunity appears, or to pay for large lifecycle expenses. They want savings accounts to help them manage. The availability of saving services, sometimes purely stand-alone savings accounts (voluntary savings), but often linked to credit as a compulsory condition of having a loan (compulsory savings). Mobilizing savings may be important in the long run to satisfy both the client and financial needs of the MFI such as a more stable and lower-cost source of funds; Bank Rakyat Indonesia is a well-known example of commercial bank downscaler with fast-growing savings mobilization.

Bank Rakyat Indonesia (BRI) is the most dramatic example of a general commercial bank that includes microfinance as part of its core banking services generates significant profits from its micro banking

operations. BRI's microbanking system offers important lessons for funds mobilization as well as lending. Since the 1990s, it has been self-reliant and viable by mobilizing its own resources and generating profits. The total sum mobilized and transferred to the branches from 1989 to 2008 amounted to US\$24.7 billion⁴; an indicator of successful savings mobilization. As of December 2008, BRI's microbanking system has mobilized 19,6 million savings accounts with total savings of US\$ 5,9 billion, averaging US\$ 300 per account and it has reached 4,5 million borrowers with US\$ 3,9 billion in total loans approved, the average loan size in 2008 was US\$ 875. Net profit in the same year amounted to US\$564 million (Seibel and Rachmadi, 2009).

While BRI is the most successful commercial bank in the field of microfinance, there are several other examples of successful commercial banks. These include Bank Dagang Bali in Indonesia, Panabo Rural Bank in Philippines, BancoSol in Bolivia, Caja de Ahorro y Crédito Los Andes in Bolivia, Banco del Desarrollo in Chile, Banco Agrícola in El Salvador, Centenary Bank in Uganda and Standard Bank in South Africa (Nsabimana, 2004; Valenzuela, 2002).

1.2. Obstacles. The main reasons given by bankers in large commercial banks to not enter the market of microfinance are the risk of default, high costs, and socio-economic and cultural barriers. They also face some internal constraints such as (see Baydas, Graham and Valenzuela, 1998; Barlet, 2003):

- ◆ *Market knowledge:* commercial banks lack an understanding of the microfinance market and its clientele, and often dismiss this segment as both too risky and too expensive. Even if a bank recognizes that microfinance can be profitable, the resulting portfolio size may be viewed as too small relative to the level of effort required to manage a microfinance operation.
- ◆ *Organizational structure:* commercial banks find it difficult to integrate microfinance within a larger bank culture and structure that is not geared toward a high volume, small loan size business.
- ◆ *Financial methodology:* most commercial banks lack the financial methodologies to reach and retain low-income clients who require small amounts of capital.
- ◆ *Human resources:* microenterprise credit requires staff who are comfortable working in the neighbourhoods where clients live and work, and who must be highly productive in order to succeed. Monetary incentive systems are often used to spark such productivity. These requirements of microfinance are often incompatible with the human resources profile and policies of commercial banks.

- ♦ *Cost-effectiveness*: traditional bank mechanisms and overhead structures make it difficult for banks to minimize processing costs, increase staff productivity, and rapidly expand microfinance loan portfolios.
- ♦ *The policy environment*: in countries with interest rate ceilings and heavy government intervention, banks will be prevented from even contemplating microfinance (Rhyne, 2003).

1.3. Advantages. Despite these constraints, commercial banks have several organizational and structural features that can lend themselves to successful microfinance operations:

- ♦ Large commercial banks often have an extensive network of branches, frequently covering all major cities in a country.
- ♦ They have well-established internal controls and administrative and accounting systems to keep track of large numbers of transactions.
- ♦ Banks that have been in the market for a long time are well known to the public and have a recognized brand. In many cases the brand carries a high degree of trust.
- ♦ The ability to offer loans, deposits, and other financial products make them attractive to microfinance clients.

1.4. Reasons for entry. Little has been written in 1998 about the role of commercial banks in

microfinance. The reason is simple: there has been little to tell because commercial banks have been so notably absent from this field (Baydas, Graham and Valenzuela, 1998). Ten years later, the situation is any other, commercial banks in developing and developed countries have begun to see microfinance as a potentially profitable business and starting to venture into this field. Nowadays, over 200 banks all over the world are involved in microfinance with a gross loan portfolio of at least US\$ 11 billion (Fiji Microfinance Week, 2009).

There are many reasons that encourage banks to enter into microfinance which are the following:

- ♦ Growing competition in markets traditionally served by banks along with the resulting fall in banks' returns has encouraged the search for new market niches (Nsabimana, 2004).
- ♦ Entering a new sector enables banks to diversify their loan portfolio, focusing on a population segment previously unattended by them.
- ♦ Opening to the microfinance client allows banks to improve their image in society.
- ♦ Regulations imposed by the government.
- ♦ The profitability of microfinance activities. Isern and Porteous (2005, p. 2) have proved that certain microfinance-specialized banks are more profitable than the banking sector average in their country as shown in Figure 1.

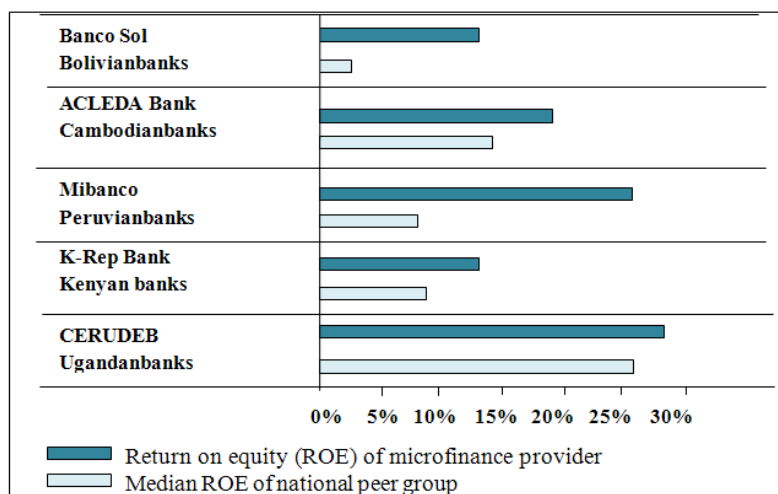


Fig. 1. Profitability of banks specialized in microfinance relative to the median profitability of the banking sector

2. Entry strategies of commercial banks into microfinance

There is not one single way in which banks become engaged in microfinance market. For one thing, different banks will have different business goals, and the competitive and regulatory environment will vary (Isern and Porteous, 2005). Some banks enter the market directly by expanding their retail operations to reach micro clients. Others take an indirect way by working with existing microfinance providers.

2.1. The direct way “downscaling”. The word *downscaling* expresses the involvement of commercial banks in microfinance, which implies reducing the volume of their affairs by opening to a new even if more risky market niche: poor people and micro entrepreneurs (Segrado, 2005). The first experiences of *downscaling* were recorded in Latin America and in Asia where the pioneer institutions as Banco do Nordeste, Bank Rakyat Indonesia and Banco de Credito penetrated successfully this market.

In the literature, there are three direct models: the internal microfinance unit, the specialized financial institution and microfinance service company.

2.1.1. Internal microfinance unit. In this model, the Bank can use two approaches: create in its existing structure an internal unit that provides microfinance services or introduce microfinance products into an existing unit (Nsabimana, 2009). In the latter case, a bank might treat microcredit simply as a new product, with a marketing and promotion campaign. The new product introduction strategy is probably the lowest cost way to start microfinance operations, but it has rarely succeeded. The ease with which the product is processed explains its lack of success; the microcredit is a specific product that does not require the same method of preparation as a classic banking product. However, the internal unit has succeeded in a number of cases including Bank Rakyat Indonesia (BRI), one of the largest and most successful microfinance programs in the world.

The advantage of this model lies in the simplicity of its implementation. The microfinance unit is neither a separate legal entity nor regulated separately from the bank. The microfinance operations leverage existing staff and systems of the bank. An internal unit requires adaptations of the bank's systems and procedures to the specialized requirements of microfinance-related operations. However, because of the specificity of microcredit, the lending decisions and their follow-up often require the use of qualified personnel in the field of microfinance.

While the creation of an internal unit can be successful, two major disadvantages must be overcome. First, the bank must somehow differentiate the staff of the microfinance unit from the staff of the mainstream bank in order to build a distinct corporate culture within the microfinance unit. While Bank Rakyat Indonesia (BRI) has found ways to accomplish this, it has been a source of tension at some other institutions such as Kingdom Bank in Zimbabwe. More difficult to overcome is the lack of independent governance for the microfinance unit. Without separate governance, the microfinance unit comes under the governance of the mother bank. Critical decisions concerning the microfinance operation are taken by groups of bankers with limited exposure to or concern for microfinance (Rhyne, 2003).

2.1.2. Specialized financial institution. Rather than set up an internal unit, the Bank can create a specialized financial institution (SFI) to support microfinance activities. The SFI is licensed and regulated by the local banking. It may be wholly-owned or a joint venture with strategic partners and investors. The SFI maintains separate corporate

identity, governance, management, staff, and systems from those of the parent bank.

The use of a financial subsidiary addresses the main drawbacks of the internal unit. This is the case of Financial Bank in Benin who decided in November 1998 to expand operations and create an internal unit to manage its microfinance operations. Building on its growing success, the bank spun off its internal microfinance unit as Finadev, a specialized financial institution. The new institution began operating in July 2001 with these shareholders: Financial Bank Benin (25%), the Financial Holding Company (15%), The SFI-Group, The World Bank (25%), Dutch FMO (25%), Fayette Participations-Horus Bank and Finance (10%) (Nsabimana, 2009). In creating a specialized financial institution, a bank has the opportunity to limit its risk of entry into microfinance by sharing risk with other shareholders, particularly if those shareholders bring experience and know-how in microfinance.

2.1.3. Microfinance service company. A microfinance service company is a non-financial company that provides microloan origination and portfolio management services to a bank (Barlet, 2003; Nsabimana, 2009). The service company does all the work of promoting, evaluating, approving, tracking and collecting loans. Loans and other financial services (savings, transfers, payment services, etc.) offered to service company clients are registered on the books of the parent bank and the company is paying for services rendered (Barlet, 2003; Isern and Porteous, 2005; Fall, 2009). This model is fairly recent and has been tested mostly in Latin America. Accion International presents the following banks and some of the lessons they have learned as service company examples: Banco del Pichincha from Ecuador and its service company CREDIFE, and Sogebank from Haiti and its service company SOGESOL (Barlet, 2004).

The service company model seeks to draw on the best elements of each of the two methods of bank involvement discussed above, while further addressing their drawbacks. Unlike the financial institution, the service company doesn't require a separate banking license, is not separately supervised by the banking authorities, and does not require a large equity base. It is thus much easier and less costly to launch and operate than a financial institution (Delfiner and Peron, 2007). The service company model addresses several of the shortcomings of the internal unit: it establishes a long-lived structure with its own governance and staffing that gives the microfinance operation space to operate (Rhyne, 2003). The service company may be wholly or partly owned by the bank. However, the service company structure offers the bank the

ability to involve technical service providers with expertise in the delivery of microfinance and other interested investors as equity partners, which it cannot do with an internal unit.

2.2. The indirect way “partnerships with microfinance institutions”. One way for a bank to get involved in microfinance without exposure directly to risk is to develop partnerships with MFIs already established. Also, one way for the MFIs to automate, develop and acquire long resources for its future development is to build partnerships with banks. This indirect way has a brand of complementarity; each institution has a comparative advantage in the production of its goods reference. So, the partnership between the two types of institutions is mutually beneficial: banks as MFIs find their account. These relations of partnership enable microfinance institutions to cut costs and extend reach while enabling banks to tap new markets, diversify assets, and increase revenues (Littlefield and Rosenberg, 2004). In the literature, partnerships between banks and microfinance institutions can take several forms which are not mutually exclusive and can be combined gradually.

2.2.1. The institutional partnership. This can take different forms depending on how developed the MFI is. The simplest form which committed the least the bank is patronage (Moulin, Hugh and Teuwa, 2011). During the project stage, the bank can play a determining role when it comes to setting up an MFI: initiator, supervisor, president or member of the steering committee. This form of partnership allows the bank to be recognized as a supporter of microfinance, without exposing its brand image. This type of partnership is more common in areas where microfinance is in the start-up phase.

Fall (2009, p. 493) cited as an example of institutional partnership the National Agricultural development Bank of Mali (BNDA) who played a significant role in the creation of Self-Managed Village Savings and Credit Banks (CVECA) networks and mutual credit institutions. It assured the role of supervisor in creating five of the six CVECAs networks that exist in Mali, as well as two mutual credit institutions. The National Agricultural Credit Intermediary of Senegal (CNCAS) played a determining role in the creation of some certain MFI in the image of Savings and Credit Cooperative of Hann (MECH) in Dakar and the Savings and Credit Cooperative of Sedhiou, became Union for Mutual Savings and credit (UMEC- Sedhiou).

In this type of partnership, the bank helps define the MFI's institutional “model”, which is chosen by the operator, as well as the contractual framework that links the institutions concerned. It can influence the strategic choices made by the MFI (zones of

intervention, target populations, proposed products, interest rates, etc.), impose rules, development standards and conditions that govern the collaboration between the MFI and its environment (Wampfler and Baron, 2002). Other forms of institutional partnerships which are more mundane consist for a bank to subsidize microfinance institutions starting or building a trophy for the players in microfinance. One of the elements of institutional partnership success is based on the promoter's positioning coherence with the strategy of the bank (desire to diversify its portfolio of credit...).

2.2.2. The technical partnership. The technical partnership is generally based on services provision of the bank for the benefit of the MFI. It can be in the form of training, transfer of funds, audit and control. It can also be closely linked to the MFI's financial service: the bank ensures that credit is granted and savings are collected at its counters, while the MFI concentrates on a mediating role (setting up groups, analysis of applications for credit, validation and monitoring of files, etc.).

The Alexandria Business Association is an MFI that operates in Alexandria, Egypt. It has successfully developed a particularly effective relationship with a partner bank: the MFI deposited available credit funds into a bank account. Once applications have been approved by the MFI, borrowers then withdraw their credit from the bank using a cheque from the MFI. The repayments are paid into the MFI's bank account, the bank informs the MFI of daily withdrawals and deposits which mean that it knows when payments are late and can act the day after one is reported. The fact that the institution's agents do not handle funds facilitates control (Wampfler and Baron, 2002). A technical partnership can be complemented with a financial partnership based on the service that the bank provides for the MFI.

2.2.3. The financial partnership. The scope of a financial partnership will depend on how much confidence there is between two institutions, the financial performances obtained and the available resources on both sides. The type of financial partnership which requires the least commitment from the two institutions constitutes the investment of the MFIs' surplus savings and treasury in the bank guaranteeing security and ultimately payment. This form of partnership is a traditional relation of a client with his banker. In the Economic and Monetary Union of West Africa (UEMOA) region, all MFIs, given PARMEC regulations, are required to place their surplus cash in bank. The Bank also is benefiting as well because, it expanded its sources of funding. In this case, it is essentially the criteria of geographic proximity and the characteristics of deposit products which are offered (remuneration,

availability) that determine which bank is chosen by the MFI. A broader financial partnership can exist. It is for the two institutions to sign a partnership of refinancing and require a higher degree of confidence between two institutions (Wampfler and Baron, 2002). In order to achieve this, conditions are agreed on (interest rate, calendar for credit repayments), which could become more flexible, to a certain point, as confidence grows. The Societe Generale financial corporation in Benin with mutuals and the BNDA in Mali with village banks are part of the most existing experiences in UEMOA region (Fall, 2009). This partnership has a disadvantage for the MFI that is found often constraint to commit to deposit its surplus cash in a single bank (Mayoukou, 1999).

2.2.4. Other forms of partnerships. Other forms of partnerships can be presented as hybrid models in the direction that they can both contain financial, technical and institutional dimensions. These partnership models are highly developed in northern countries, especially Europe and are made by large banks and financial institutions whose main investors devote sensitivity to the concept of development and socially responsible investment.

Figure 2 shows the considerations that should be carefully evaluated by commercial banks that wish to take advantage of the opportunities in microfinance. Different factors may give rise to a different choice of strategy.

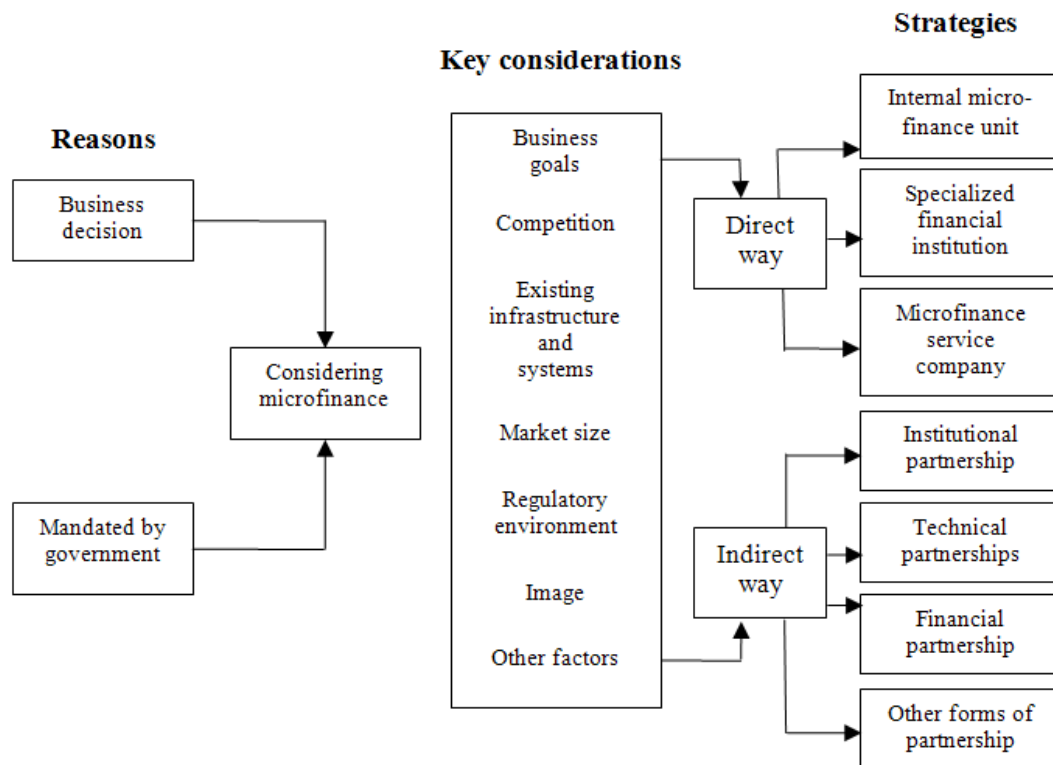
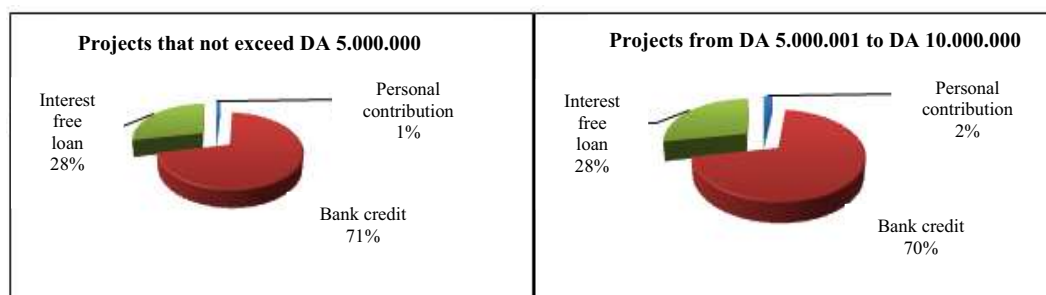


Fig. 2. Reasons and strategies of commercial banks entry into microfinance

2.2.5. The involvement of the Algerian commercial banks in microfinance. Algeria is facing major social challenges mainly in unemployment, particularly amongst young people. Therefore, support for microenterprises is one of the Algerian's priorities for economic growth, job creation and economic and social cohesion. In this regard, the Government has initiated the National Agency for the Support of Youth Employment, known by its French initials, ANSEJ (Agence Nationale de Soutien à l'emploi des jeunes).

ANSEJ is a government organization established under the Ministry of Labor, Employment and Social Security in 1996 by the Law No 296/96 of September 8, 1996 adjusted by the Executive Decree No. 231/98 of June 13, 1998 to combat youth

unemployment and promotes the creation of microenterprises by young Algerians between the ages of 19 and 35 who have graduated from universities or technical institutes. In addition to the others government measures to support new projects through ANGEM (The National Microfinance Management Agency), and CNAC (The National Unemployment Benefit Fund), the ANSEJ appears as an important tool for promoting entrepreneurship and opening the way for microfinance in Algeria. Actually, the microcredit remains mostly an institutional account managed by public bodies. As shown in Figure 3, seventy percent (70%) of it is covered by encouraging public banks in the framework of ANSEJ's triangular financing formula (the promoter-ANSEJ-the commercial bank).



Notes: The Algerian dinar is the official currency of Algeria. The symbol for the dinar is “DA” and the currency code for Algerian Dinar is DZD. 1 EUR = 103.46 DZD on October 3, 2012.

Fig. 3. The triangular financing: Algerian commercial banks with ANSEJ

ANSEJ is in charge of a first analysis of the projects and of deciding whether they can be submitted to banks still have the option of denying the youth’s financing request. The partner banks with ANSEJ are five (5) public banks: Popular Credit of Algeria (CPA), Bank of

Local Development (BDL), External Bank of Algeria (BEA), National Bank of Algeria (BNA), and Bank of Agriculture and Rural development (BADR). Ben Chenhou and Ben Allal (2011) have proved that the percentage of loans granted by those banks is varying as shown in Figure 4.

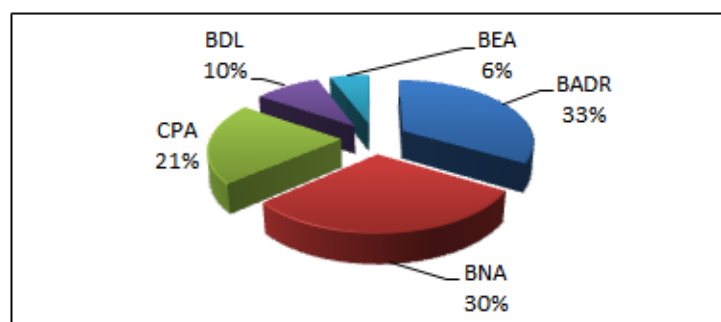


Fig. 4. Percentage of microcredits granted by the partner banks with ANSEJ in the Wilaya (province) of Tlemcen from 1999 to 2010

In the last years, international investors and private banks had also interested in supporting the microcredit in Algeria. Bank al Baraka, an Algerian Islamic bank is launching a microfinance product in 2009 with foreign partner FIDES (www.fidesgroup.org) that, created in 2008 FIDES Algeria, the first Algerian private company offering access to finance for microenterprises excluded from the banking sector in the Wilaya (province) of Ghardaia.

3. Keys of success of commercial banks in microfinance

Banks and MFIs are two categories of institutions of different essences but they often to consecrate for the same objective, namely: collect the savings of surplus agents for the purposes of financing projects that are judged profitable (Fall, 2009). Generally, these two types of institutions have not fully the same target of customer and are not always submit to same bank regulations. Compared with banking activity, microfinance particularized by the reduced scale of its operations (micro-credits, micro-savings, micro-insurance), the temporary aspect of its contracts, the innovative mechanisms used in the selection and monitoring of projects. Also, banks

are invested with money creation authority, they are monetary financial institutions, while microfinance institutions have not this license, and they are non-monetary financial institutions (Fall, 2011). In addition, if the banks work with a financial logic of profitability, the MFIs originated, in most cases, with a dual mission that combines social and financial.

Given the differences between classic banking and microfinance, commercial banks need to view microfinance as a new business line and conduct the same kind of research that any company would entering a new market. For one thing, the clients and products may pose different risks from the risks of traditional banking.

3.1. Risk management. A risk is an exposure to the chance of loss. Risks are not inherently bad. Sometimes, it is necessary to take risks to accomplish worthy and meaningful goals. This is especially true in microfinance where loan officers take risks every day by lending money to people without credit histories, without business records and often without collateral. One has to take risks to operate a successful microfinance institution but it is

important to take calculated risks. Risk management, or the process of taking calculated risks, reduces the likelihood that a loss will occur and minimizes the scale of the loss should it occur. Risk management includes both the prevention of potential problems and the early detection of actual problems when they occur (Churchill and Coster, 2001).

Risk management entails four key processes (National Bank of Ethiopia, 2010):

1. *Risk identification*: the first step in risk management is to identify risk. Almost every microfinance product and service has a unique risk profile composed of multiple risks. In a publication released in 2000, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) cited three major risk categories: financial, operational, and strategic. Generally, microcredit is the main product of microfinance program, therefore loan portfolio is the most valuable asset, the financial risks – credit, market and liquidity – are of greatest concern. Financial risks begin with the possibility that a borrower may not pay the loan on time with interest (credit risk). They include the possibility that the bank might lose a significant part of the value of its loan portfolio as a result of an economic downturn, hyperinflation, and other externally generated causes (market risk). Financial risks can also include changes in interest rates of government lending programs or the possible enforcement of old usury laws. Market risks include lower prices for borrowers' products and services, which could directly affect their ability or willingness to repay an outstanding loan. Given the rapid pace at which demand for funds can grow, banks should be particularly aware of liquidity risk; the lack or shortage of funds for current and future expenses or loans. Liquidity risk can result from an overly aggressive lending strategy, low levels of on-time payment, seasonal variations of demand, or unanticipated expenses (Goldberg and Palladini, 2010).
2. *Risk measurement*: risks should be measured in order to determine their impact on the bank's profitability and capital. Each risk should be viewed in terms of its three dimensions: size, duration and probability of adverse occurrences. Accurate and timely measurement of risk is essential to effective risk management systems.
3. *Risk control*: following risk identification and measurement, banks should control or minimize risks. There are basically three ways to control significant risks, or at least minimize their adverse consequences: avoiding or placing limits on certain activities (risks), mitigating

risks and/or offsetting risks. It is a primary management function to balance expected rewards against risks and the expenses associated with controlling risks.

4. *Risk monitoring*: it means developing reporting systems that identify adverse changes in the risk profiles of significant products, services and activities and monitoring changes in controls that have been put in place to minimize adverse consequences.

A relatively small number of quantitative indicators generally suffices to monitor and evaluate the performance of commercial banks downscalers. These quantitative indicators are of two types, those that measure the performance of the microcredit program itself and those that measure the overall health of the bank (Westley, 2007):

1. Key indicators of the performance of the microcredit program include:
 - ◆ Number of borrowers and perhaps total microcredit 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 microcredit portfolio (measured as portfolio at risk): measures whether the bank is successfully mastering the microcredit methodology.
 - ◆ Client retention rate (CRR): important not only as a key measure of client satisfaction but also because microcreditors generally lose money on the first credit they make to each borrower. Client retention rates may be calculated using the following formula: $CRR = C1 / (C0 + NC)$, where C1 is the number of clients at the end of the year, C0 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);
 - ◆ Microcredit clients per microloan officer: measures whether the program is meeting efficiency targets.
2. 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.

3.2. Basel Committee: shedding light on microfinance conducted by commercial banks.

The Microfinance Work stream of the Basel Committee on Banking Supervision has developed Guidance for the application of the Core Principles to microfinance activities conducted by banks and other deposit taking institutions (ODTIs). The Guidance is intended to highlight the key differences between the application of each Core Principle to conventional retail banking and microfinance in banks and nonbanks, pointing out areas that may require tailoring (Basel Committee on Banking Supervision, 2010). Most Principles require some degree of tailoring in their implementation compared to conventional retail banking. This approach would incorporate the need for specialized knowledge of supervisors to identify and measure risks that are specific to microfinance, particularly to microcredit; additional effort to allocate supervisory resources efficiently; as well as a proportional regulatory and supervisory framework that does not add significant costs to microfinance activities across different institutional types.

To implement Principle 7 (Risk management process), for instance, supervisors need to develop specialized knowledge and tailor supervisory techniques to risks in microcredit portfolios and other products such as micro-savings and micro-insurance, for banks. Given the distinctive features of microcredit products, client profile and loan underwriting methodology, managing credit risks is significantly different in the microfinance business. Implementation of Principle 8 (Credit risk) should be carefully tailored to the particular risks of micro-lending. It should also take into account the context in which micro-lending occurs, i.e. as a business line within a large diversified bank. In applying Principle 9 (Problem assets, provisions and reserves), supervisors should adjust provisioning and classification requirements to the unique risks of microcredit compared to other loan types. The regulatory framework should also compel financial institutions to recognize the risk posed by past due microfinance loans quickly and accurately, and provide the supervisor with flexibility to deal with unique situations, as necessary. Not only credit risk requires specific knowledge and supervisory tools. In applying Principle 13 (Market risks), supervisors should pay particular attention to sources, risks and concentrations in ODTI foreign currency borrowings. The application of Principle 14 (Liquidity risk) and Principle 16 (Interest rate risk in the banking book) should take into account the unique features of microfinance assets and funding liabilities, particularly in microfinance institutions compared to those of a diversified commercial bank. Implementation of Principle 15 (Operational risk) should be tailored to the differing risks, practices and trends in micro-

finance operations – including outsourcing and the typical decentralized and labor-intensive microcredit methodology, which, although important to contain credit risk, has significant implications for operational risk management in comparison with retail banking, as well as for the evaluation of internal controls put in place by the institution, as described by Principle 17 (Internal control and audit). The implementation of these Principles must take into account that micro-lending methodologies, as well as other lines of business such as micro-savings, may require different organizational arrangements and controls from those of conventional retail banking. Requirements should be strict while at the same time accommodating proven practices. In applying Principle 18 (abuse of financial services), supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

3.3. Internal and external success factors. The different models outlined offer a range of risk levels for banks, and ways of managing them. Any bank looking to get into the microfinance market will need to take into account the bank’s own interests and institutional capacity, competition, and other market factors. Despite the different strategies for entering the banks in microfinance, in 2005, the CGAP has outlined six *internal factors* that underlie the success of commercial banks in the micro-finance market:

- ◆ Commitment from board and management, strong internal champions, and alignment with the bank’s core commercial strategy.
- ◆ Knowledge of microfinance best practices and how to serve micro-clients.
- ◆ Infrastructure located conveniently for clients.
- ◆ Products especially adapted for low-income and informal markets.
- ◆ Systems and procedures adapted to the microfinance operations, e.g., systems that support immediate follow-up on missed payments.
- ◆ Appropriate staff training and incentives on new clients, products, and delivery systems.

These internal factors must be matched by an environment favorable for microfinance, with sufficient demand, freedom to set prices, and reasonable regulations. In other words, the success of commercial banks’ microfinance program depends on an interaction between the internal and the *external factors* (the context in which the program is implemented). The elements of an optimal policy context identified by literature are (Goodwin-Groen, 1998; and Berger, Goldmark and Miller-Sanabria, 2006):

- ◆ Sound macroeconomic policies, especially stable prices or predictable inflation levels, which enable microfinance institutions and their customers to withstand economic cycles more easily.
- ◆ Minimal restrictions to profitable lending, particularly no interest rate caps.
- ◆ Enhanced ability to establish a small commercial bank which can focus on this sector such as a low minimum capital requirement.
- ◆ Appropriate prudential regulations for this market including capital adequacy ratios, asset quality indicators and unsecured loan limits.
- ◆ Political connections that can be helpful, but not required.
- ◆ In addition, reasonable levels of competition which provide incentives for better service and lower cost, but are not predatory.

Anyway, entering this market is a long-term business proposition. No bank should expect to make a “*quick buck*” from microfinance. But the evolving models and profit records of successful players are encouraging more banks to see the long-term business rationale. There is a massive potential market for banks that approach these clients successfully.

Conclusion

This paper shows how a “*win-win*” situation between microfinance and commercial banks can be achieved. The entrance of banks into microfinance market is significant for banks to diversify their activity portfolios, increase their revenues and improve their image in society as for microfinance as a whole, because given their physical, financial and human resources, banks are able to develop microfinance services relatively, at little cost.

In countries where there is a minimum of confidence between the population and commercial banks, it may be considered the direct entry of banks into microfinance by developing their retail operations to achieve a “micro-level”. To do this, they create an internal microfinance unit, a specialized financial institution or a microfinance service company. None of these strategies are inherently better than another, and there is no universal recipe for penetrate the market of poor or vulnerable people. The choice of an operative mode depends on internal and external factors. Otherwise, the banks may enter in microfinance indirectly by doing partnership relations with the MFIs. The best

form of partnership between the Bank and MFI depends largely on the development degree of the MFI. Thus the first form of partnership which is the institutional partnership will be more indicate for an MFI “start-up” because it has the advantage of giving the MFI from the know-how of banks that may intervene as an initiator, member of the steering committee of the project or even supervisor. The second form of partnership which is the technical partnership seems more appropriate in the next phase of the MFI development. To continue growing in a balanced and sustainable manner, the MFI can indeed make the economy of a capacity building and of a requirement of professionalization of its activities. It is in this framework that the technical partnership can be beneficial to the MFI. This one might strengthen its human resources through training including banking techniques provided by the partner bank. The IMF will also benefit from the know-how of the bank’s implementation of control procedures and internal and external audits. The third form of partnership which is financial partnership will help the MFI to get its autonomy. Indeed, services such as securing surplus liquidity or refinancing possibilities of the MFI that can offer the partner bank in this partnership seem to be essential to the functioning of the MFI towards the road to maturity. In this partnership the bank appears to be indispensable to the proper functioning of the IMF to the road to maturity.

Finally, this analysis reveals that the different strategies of commercial banks entry in microfinance are certainly evolving. Choosing the strategy that fits both the bank and the circumstances at the outset is an important factor in future success. Each approach has its particular rationale, risk profile, success factors, and costs. Once microfinance operations are under way, banks must constantly balance three pillars to achieve the expected success:

- ◆ High volume of operations, which is achieved by reaching thousands of clients, each with numerous, small and short-term transactions.
- ◆ High quality client service, which is delivered to meet the socio-economic needs of clients often living in the informal economy and traditionally marginalized from formal financial institutions.
- ◆ Risk management systems managed by trained people and customized to the high volume of operations and informal nature of the clients.

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