5 Implications of Microfinance Commercialization

So far, this analysis of the progress of microfinance commercialization and the challenges that remain has assumed that commercialization would have a positive impact on poverty reduction, including increased outreach, improved efficiency, and long-term viability of microfinance providers. For MFIs, commercialization is expected to pave the way for the entry of private capital. This, in turn, will provide more capabilities for expansion into untapped markets and more diverse microfinance products. However, some stakeholders are concerned that further commercialization could have negative social impact or result in mission drift, such as shifting the target market from microentrepreneurs and poor households to small enterprises and household at or above the poverty line. This chapter reviews a few of the most common likely implications of microfinance commercialization and addresses the related concerns.

INCREASED OUTREACH AND COMPETITION

As more microfinance providers demonstrate the profit potential of microfinance, more entrants will be attracted to the market. In this sense, increased commercialization is likely to have a positive impact on outreach in the future, resulting in more clients served and increased competition among MFIs. However, given the fact that only about 20% of the market is currently served, few negative repercussions of such competition are likely to result in the next 5–10 years, except in a handful of urban and highly-populated rural areas where some localized competition is beginning to increase.

Growth in the sector is not likely to come from the gradual growth of the vast majority of existing microfinance NGOs. It is likely that other types of organizations (for example, rural banks, cooperatives, microfinance-oriented banks, etc.) will increasingly enter microfinance, as it becomes clear that the poor can be bankable, and as the methods for reaching the poor become better understood. This has happened in other countries with relatively developed financial sectors as microfinance has matured (particularly in Latin America). Only a few microfinance NGOs will likely become self-sufficient and able to raise resources without resorting to donors and these will offer most of the outreach by microfinance NGOs. Most of the older microfinance NGOs that have not yet broken through the threshold of 5,000 active clients appear to be steeped in a multisectoral, social-service orientation that is fundamentally incompatible with large-scale outreach and viability and unlikely to change. Given the size of the Philippine market for microfinance, there is clearly a role for a number of MFIs, as long as these organizations can achieve genuine financial viability. As for expanding geographic coverage, it will take a mix of large nationwide or regional organizations and smaller local providers to cover the whole country.

IMPROVED EFFICIENCY

As discussed in Chapter 3, the legal and regulatory environment is becoming increasingly conducive for MFI geographic expansion and this is creating some friction. Before MFIs achieve financial self-sufficiency, the players in the field are generally allies but once they break-even and begin to strive for scale, they act more like competitors (Chu 1997). Striving for competitive edge in large part depends on an MFI increasing its level of operational (or cost) efficiency. Competition is one factor that can lead MFIs to drive down costs so that they can provide more demand-driven products and services on increasingly favorable terms to their clients. This allows MFIs to expand breadth and/or depth of outreach simultaneously while increasing profitability.

This trend has been demonstrated by a range of MFIs in the Philippines over the last few years. Cooperatives offering the SCWE loan product as part of their participation in the CUES project increased their OSS from 109% in 1996 to 126% by 1999; CUES cooperatives that did not offer the poverty product showed a smaller increase, from 111% to 119%, during the same period.[86] In addition, Freedom from Hunger, a collaborating partner on the project, reported that participating cooperatives offering the SCWE product generally earned a better return on assets than other cooperatives and lowered their operating expense ratio after introducing SCWE (Table 5.1). The World Council of Credit Unions, as the technical partner for the CUES project, reported that the operating expense ratio of all participating cooperatives decreased from 9.8% in 1996 to 8.0% at the end of 2001.[87]

Also, rural banks participating in the RBAP-MABS program are increasingly bringing down their costs through adoption of time- and money-saving technologies (Box 5.1). Use of linkages to cut costs via ATM technology is also helping to achieve greater efficiencies at TSPI (Box 5.2). Other microfinance NGOs, such as NWTF (Table 5.2), have increased their administrative and operational efficiency without sacrificing the quality of products and services.[88] Once NWTF achieves FSS, it can be expected to concentrate on providing microfinance on increasingly attractive terms to clients in order to increase its outreach.

INCREASED ACCESS TO COMMERCIAL FUNDS

Increased commercialization has already resulted in improved access to commercial sources of funds, especially in terms of savings mobilization, but also through private equity investment. As more and more rural banks and cooperative savings and credit banks enter the market, they bring with them the ability to mobilize savings deposits, including microsavings (amounts under P15,000) from low-income people, in a cost-effective way. Rural banks mobilize a significant amount of microsavings deposits: P5.3 billion ($106.0 million) in 4.3 million accounts as of March 2002. CUES-supported cooperatives have nearly tripled their

Table 5.1: Profitability and Costs of CUES Cooperatives

	1996	1997	1998	1999
Return on Assets (%)				
Cooperatives w/ SCWE (8)	2.4	3.4	3.3	4.4
Cooperatives w/o SCWE (4)	2.3	2.6	2.5	4.1
All CUES Cooperatives (12)	2.4	3.2	3.0	4.3
Operating Expenses/Average Total Assets (%)				
Cooperatives w/ SCWE (8)	10.6	10.7	9.1	9.7
Cooperatives w/o SCWE (4)	8.2	8.6	8.0	9.8
All CUES Cooperatives (12)	9.8	10.0	8.7	9.7

CUES = Credit Union Empowerment and Strengthening; SCWE = Savings and Credit with Education.

Source: Stack and Thys 2000, p.12

Box 5.1

Cutting Transaction Costs with Information and Communication Technology

Regardless of the legal structure of an MFI, achieving scale is critical to success. From an institutional perspective, the key to providing a wide variety of services for large numbers of clients is to reduce transaction costs. Average transaction costs can be reduced by increasing the number of transactions, and per-unit transaction costs can be trimmed by using new technologies and modes of delivery (for example, the use of ATMs through linkages; see Box 5.2).

New information and communication technology, such as smart cards and personal digital assistants (PDAs), can allow MFIs to drive down their costs as well as the transaction costs incurred by their clients. These cost savings can enable MFIs to offer more affordable and flexible products and services to greater numbers of clients in more diverse geographic areas.

For example, a few rural banks participating in the MABS program have been experimenting with use of PDAs. PDAs are small, portable handheld computers that can allow loan officers access to his/her institution's management information system from the field. Depending on location, information can be updated by the loan officer to the head office instantaneously or every day (which decreases the need for data entry clerks). The PDAs used in the pilot branches of the participating rural banks have greatly reduced the time needed for transactions between the loan officer and clients, leading to lower costs per transaction, improved service, and greater efficiency.

ATM = automated teller machine; MABS = Microenterprise Access to Banking Services; MFI = microfinance institution.

microsavings in just 3 years from $3.3 million at the end of 1998 to $9.3 million the end of 2001, despite a decline in the average savings balance from $92 to $86 in the same time period. In this way, commercial MFIs serve an underserved market for small savings accounts while also satisfying their own need for a source of funds for onlending.

Commercialization often paves the way for the entry of private capital, which, in turn, allows for expansion into untapped markets and more diverse microfinance product offerings. The Philippines presents some early evidence that this is indeed the case. For example, as part of its transformation, CARD Bank tapped into another private source of funds by selling shares to clients and staff alike (Box 5.3). Other cases of transformation have potential to yield similar results. In addition, at least one MFI as part of its transformation is accessing loans from a global social investment fund at what are arguably commercial interest rates (13% per annum). The formation of MEB with a mix of donor and social investor capital also portends the future increased flow of private risk capital to formal MFIs.

However, large-scale inflow of private risk capital to formal MFIs in the Philippines is likely still several years off because of at least two major factors. First, the track record of transformed MFIs is still extremely short. Second, the particulars of regulation and supervision pertaining to microfinance-oriented banks are still unclear. Until there is clearer profit potential (based on at least 2 years of performance by the newly transformed NGOs and new entrant MEB) and the regulatory and supervisory framework is clarified, the microfinance sector will likely have to wait some time for the entry of substantial private risk capital.

EXPANDED ARRAY OF MICROFINANCE PRODUCTS AND DELIVERY TECHNOLOGIES

Despite the historical emphasis on the Grameen model of microfinance delivery in the Philippines, other models are increasingly being adapted and local innovations are emerging from recent formal entrants into microfinance. As competition increases from new and expanding MFIs, microfinance providers will need to

Table 5.2: NWTF Selected Efficiency Indicators

	1997	1998	1999	2000	2001
Administrative Efficiency (Administrative Costs[a] Excluding Financial Costs as % of Average Net Loan Portfolio)	61.20	42.50	45.10	40.93	34.71
Operational Efficiency (Operational Costs[b] as % of Average Loan Portfolio)	79.00	35.66	29.59	32.63	31.87
Personnel Costs as % of Total Administrative Costs	51.00	65.00	63.01	63.70	59.72
Number of Active Loan Clients per Loan Officer (Year End)	235	206	147	263	278
Outstanding Portfolio per Loan Officer (Year End) (Pesos)	468,797	588,779	452,233	995,954	1,407,502
Number of Clients per Branch Office (Year End)	1,176	1,378	1,413	2,010	2,334

NWTF = Negros Women for Tomorrow Foundation.

Notes: [a] NWTF's administrative costs include nonfinancial expenses directly related to the provision of financial services or other services that form an integral part of their financial services relationship with their clients. Examples include personnel expense, depreciation, utilities, supplies, advertising, transportation, training, communications, and consulting fees.

[b] NWTF's operational costs include all administrative expenses, but exclude all financial expenses and loan loss provision expenses.

Source: ADB 2002c, p.15.

become more sensitive to the specific needs of their clients and develop an array of products and delivery mechanisms that keep customers satisfied.

In addition to microcredit product diversification, different types of flexible savings services are being designed specifically to attract microsavings in a cost-effective way. Microinsurance is another product attracting increasing interest. In addition, remittance services are being tested and leasing services may be on the horizon for MFIs. New technologies are helping to expand the array of microfinance products offered (see Boxes 5.1 and 5.2). All these trends should help increase access to microfinance over the next few years to an expanded set of clients in more diverse geographic locations.

Microcredit Products

Although much of the microfinance industry in the Philippines still draws from the Grameen model based on group lending, this is increasingly changing, as new methodologies (including individual lending, such as that of the ASA, are being adapted to the Philippines context. In addition, there is domestic experimentation and innovation by rural banks and cooperatives, as market research techniques are being promoted by several major donor-funded technical assistance projects. Moreover, new entrants are importing their particular brand of proven microfinance methodology, as in the case of MEB. These forces are contributing to a burgeoning in the types of microfinance products and services offered as well as achieving scale through reductions in average transaction costs.[89]

Box 5.2

Use of ATMs in Microfinance

TSPI and the Land Bank of the Philippines (LBP) signed on 4 December 2001 a Memorandum of Agreement paving the way for use of ATMs (automated teller machines) in the delivery of microfinance to poor women entrepreneurs. A first in the Philippines microfinance industry, the use of ATMs in loan disbursement is seen as an important step toward improving efficiency in microfinance operations, facilitating expansion and outreach. ATMs allow clients to withdraw loan funds without use of a check, eliminating the check cashing process and reducing time spent waiting in line at the bank.

Use of ATMs likewise improves efficiency in branch accounting by reducing the volume of paperwork related to check preparation. Cost-saving measures not only relate to reduction of workload and paper use but also release the branch accounting clerk to concentrate on other important tasks.

TSPI = *Tulay sa Pag-unlad,* Inc.

Source: TSPI 2002, p.1–2.

Box 5.3

CARD Bank's Stock Sales

Initially, CARD Bank was owned by the CARD NGO (40%) and a few members of the board of directors and management staff (60%). In 2000, it initiated the sale of stock shares to its clients. As of May 2002, CARD Rural Bank's ownership structure consisted of the following equity owners: CARD NGO (44.2%), CARD Bank and CARD NGO staff (3.9%), CARD Bank and CARD NGO board members (22.6%), and clients (29.3%). CARD plans to transfer full ownership to landless poor women in the future, consistent with its original vision.

CARD = Center for Agriculture and Rural Development; NGO = nongovernment organization.

Source: ADB 2002e, p.5.

Leasing

MFIs are uniquely positioned to play an active role in the expansion of the leasing market for second-tier equipment, particularly because microenterprises comprise the largest segment of manufacturing, commerce, and industry in the developing world. Leasing provides MFIs with new opportunities to reach borrowers and expand into existing markets. The rapid growth of leasing in a number of developing countries indicates that leasing is addressing an important unsatisfied demand for financing. Leasing has the potential to develop into an effective financing technique that MFIs can use to reach those enterprises with financial needs that cannot be satisfied by traditional microfinance approaches.[90]

Remittance Transfers

BSP reported that remittances in 2001 were $6.2 billion, of which about 60% was from the United States and Canada.[91] Formal institutions, such as rural banks, are increasingly tapping into this large market niche and, given the scale of remittances, may become an important part of the microfinance service menu for many. Some rural banks have been developing linkages with international remittance transfer companies, such as Western Union or commercial banks.[92] Rural banks are prohibited from foreign exchange transactions; thus, they enter into an arrangement with commercial banks, which are allowed to perform foreign exchange transactions, so that the Philippine peso equivalent of the foreign exchange earnings of overseas workers can be remitted to their accounts with rural banks.

The scale of remittance transfers in the Philippines suggests that the development of remittance services may have high potential to expand the customer base of MFIs and add to their profitability. Indeed, some experimentation by CARD Bank in providing remittance services in cooperation with a domestic money transfer service provider has already taken place. In addition to the fee income generated by remittance services, other benefits for MFIs also may lay in their ability to cross-sell other services. For the consumer, the advantages of MFIs as transfer agents may include lower costs compared to those of established transfer agencies, transparency about exchange rates disclosed at the point of sale, and increased reliability/security and speed.

Microinsurance

MFIs in the Philippines are increasingly experimenting with offering microinsurance products and in doing so are following both social and commercial agendas. With regard to their social missions, several microfinance NGOs are recognizing households' needs for protection against risk. Microinsurance is seen as a means for clients to reduce their vulnerability when taking advantage of economic opportunities. In addition, access to insurance from the social perspective allows clients to reduce the impact of losses that could exacerbate their poverty situation. Regarding their commercial agenda, MFIs venturing into microinsurance desire to enhance their sustainability and profitability by reducing the impact of client risk on MFI loan and savings portfolios, by generating additional revenue, and by having better services than their competitors (Box 5.4).[93]

CARD Bank has ventured into microinsurance with well-balanced commercial and social perspectives. CARD Bank learned that when members died, their family members were often unable to pay back the loan. CARD set up an insurance fund called the Members Mutual Fund to cover death, disability, and pension benefits, based on actuarial recommendations concerning pricing and benefits. The management of the Fund was turned over to the members in September 1999 and it has been registered with the SEC as a separate legal entity called the CARD Mutual Benefit Association. Now CARD Bank, through its Mutual Benefit Association, provides life insurance, loan redemption, and provident fund/retirement savings. Fully owned by the clients, the management of the Association was turned over to them in 1999. It is now governed by its own board elected from among their ranks. Total assets

Box 5.4

TSPI's Microinsurance Initiative

As a means to help clients deal with risk, TSPI invited 11 insurance companies to bid on becoming its insurance service partner. The bidders worked around a "shopping list" of client needs and fixed fees based on payment capacity of poor microentrepreneurs. Eight insurance companies provided proposals and TSPI chose three of them to present to a sample of 79 clients for feedback. Based on client response, TSPI selected Cocolife as their insurance partner for women microentrepreneurs participating in TSPI's *Kabuhayan* (Livelihood) program (which follows the Grameen model).

Effective in October 2001, TSPI extended microinsurance coverage through Cocolife to an initial 29,968 clients. As of March 2002, TSPI had enrolled 37,743 clients for coverage. The benefits include (1) life insurance of P25,000 ($500) (amount doubled in case of accidental death), (2) disability insurance up to P25,000, (3) medical expense reimbursement up to P2,500 ($50) per year, and (4) settlement of the unpaid loan balance in case of client death. As of March 2002, TSPI had received 29 insurance claims and 15 claims for medical expense reimbursement.

TSPI has noted increased client satisfaction and motivation to participate in its broadening services. In a recent TSPI impact assessment of its *Kabuhayan* program, clients ranked "other financial services," notably the microinsurance coverage, as the most-liked program feature. Thus, while TSPI's main intention in offering microinsurance was to help clients and their families cope with risk, its offering has likewise helped TSPI to retain and expand its client base. Microinsurance benefits TSPI by decreasing its average cost of servicing loans, supporting the organization's efforts to sustain services, and assisting clients to mitigate risk while taking advantage of economic opportunities.

TSPI = *Tulay sa Pag-unlad,* Inc.

Source: TSPI 2002, p.1–2.

are valued at more than P42 million ($845,000), with benefits paid amounting to P2.7 million (about $54,000) to date.

POTENTIAL FOR MISSION DRIFT

The potential for mission drift is mainly a concern of those institutions, mainly microfinance NGOs, that provide microfinance to the lowest level of entrepreneurial poor. The potential for mission drift is less of an issue for new or potential entrants.[94] Debate centers on whether transforming credit NGOs into banks and subjecting them to formal regulation and supervision will lead to a loss of focus and sense of mission to the poor.

Two issues associated with NGO transformation are at the forefront when considering the potential for mission drift. The first has to do with the legal requirement to include at least two independent members as part of the board of directors. The second concerns the requirement to dilute ownership of the NGO in the new bank to no more than 40% within 5 years of transformation (Box 5.5).

The case of CARD Bank is instructive. Although these two legal requirements were not in place at the time of CARD's transformation, its performance provides some evidence that disputes concerns for mission drift in terms of target market, loan sizes, and effective interest rate. CARD has the longest experience with NGO transformation in the Philippines and its experience gives some indication of how transformation might affect other recently-formed, regulated commercial MFIs with regard to mission drift.

As part of its transformation, CARD raised the effective rate of interest on its loans by charging a service fee of 4% from 1996 and increased the initial loan amount from P1,000 to P2,000, suggesting possible mission drift. However, from 1998 to 31 May 2002, the yield on CARD Bank's loan portfolio actually dropped from 46% to 41%. This is comparable to that of other providers in the sector, including microfinance NGOs whose nominal interest rates range between 24% and 36% (flat) plus service charges generally in the range of 2–4%. In addition, its average loan balance of P5,450 was only about P1,000 higher than it was in 1998 (which means it actually declined in real terms). This is also in line with others in the industry (Box 5.6).

How much mission drift occurs in various microfinance NGOs and the microfinance industry as a whole depends on a variety of factors. One is the extent to which microfinance NGOs seek to transform into regulated entities as a prerequisite to mobilize significant voluntary savings (to allow them to increase their outreach substantially and sustainably). Becoming a formal, regulated financial institution can result in targeting higher-income clients with larger loans, because of profit pressures from equity shareholders.

Mission drift will also depend on the "friendliness" to microfinance of the ultimate regulatory and supervisory framework. Given that the prudential standards being developed for microfinance-oriented banks are appropriate for

Box 5.5

Transformation and the Potential for Mission Drift

"As an NGO migrates into becoming a bank, a medium-term issue on ownership will have to be addressed within a five-year time frame. The case of TSPI is one where 100% of the proposed bank will be owned initially by the NGO. Philippine laws require TSPI, as a single institution, to divest its ownership down to no more than 40% in five years time. A skillful handling of this delicate issue should be pursued in a way that the future ownership structure should sustain the purity of TSPI's vision and mission for the poor."

Ruben De Lara
Executive Director
TSPI Development Corporation
Manila, 2002

NGO = nongovernment organization; TSPI= *Tulay sa Pag-unlad,* Inc.

Box 5.6

CARD Bank's Maintained Focus on its Original Target Market

"A recent evaluation of the CARD Rural Bank's modified Grameen Bank project yielded the same results (Hossain and Diaz 1997). The bank's target clients are landless women rural workers who have no regular jobs and have total marketable assets of less than P50,000 ($1,000). Access to CARD's loans, despite an effective loan interest rate of 44% per annum, has yielded some benefits to the borrowers in terms of higher income, employment, productivity, and capital accumulation."

CARD = Center for Agriculture and Rural Development.
Source: Lamberte 2000, p.12.

formal MFIs (such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions), there appear to be no regulatory or supervisory reasons for institutions to shift focus up-market to ensure compliance.

For those microfinance NGOs that are content to serve a localized market on a competitive basis, there will likely be little to no mission drift. But such institutions will likely enjoy fewer opportunities to diversify their risks and not be able to take advantage of economies of scale in their operations. Despite the advantages of being close to their target market, these institutions can be expected to remain relatively weak compared to other types of MFIs that may expand their geographic coverage or their client base. In other words, some diversification of target markets can be beneficial to MFIs to minimize risks and improve their ability to recover costs.