MICROFINANCE *for* BANKERS *and* INVESTORS

UNDERSTANDING THE OPPORTUNITIES AND CHALLENGES OF THE MARKET AT THE BOTTOM OF THE PYRAMID

ELISABETH RHYNE

Managing Director, Center for Financial Inclusion, ACCION International

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PREFACE

On my office wall I keep a photograph of Xavier, who sells frozen fish and a few groceries at a dusty intersection on the outskirts of Maputo, Mozambique. Wearing a crisp white shirt and tie, he poses before an electric typewriter in his kiosk. Everything about the picture, including the pride in his face as he looks at the camera, reflects his striving to become a successful businessman. On the afternoon when Xavier told me his story, I learned that the big institutions of society had either failed or ignored him, except for the Coca-Cola distributor that brought him cases of soft drinks to sell. Xavier was putting the pieces of prosperity together for his family on his own by building his business. He had a loan from a microfinance cooperative, but it was small, suitable only for financing a little extra stock.

Xavier could be a loyal customer for many other financial services—savings accounts to help him build for the future, a home-improvement or fixed asset loan, health insurance, and remittance services to send money to his relatives in South Africa. A suite of financial services designed with an eye for his needs could help him create the better life he craves for himself and his family—if only there were institutions prepared to provide them.

The success of microfinance institutions in making small loans to people like Xavier has begun a revolution in financial sectors around the world. The consequent media attention to microfinance is leading the business community to consider what their roles might be in bringing financial services to population groups that have long been marginalized. The gaps we see in Xavier's financial needs point toward many opportunities that await entrepreneurial companies prepared to engage the low-income market.

ACCION and the Private Sector

ACCION International, a nonprofit organization dedicated to fighting global poverty through microfinance, has advocated private-sector engagement for almost two decades. We are finally in sight of a tipping point.

But in the 1970s when ACCION first started working in what has become microfinance, only nonprofits were willing to serve the people ACCION wanted to support. These were the millions of people streaming into Latin America's burgeoning cities looking for a better life. No one was likely to offer them a job, so they created tiny enterprises to survive. ACCION's partners learned how to offer credit to support their corner groceries and seamstress shops. By the early 1990s, models of microfinance reached significant scale and were financially viable. This opened the way for the transformation of nonprofits into financial institutions, starting with BancoSol in Bolivia, ACCION's original flagship institution and the first private commercial bank devoted to microfinance.

At that point, María Otero, at ACCION, and I, then at the United States Agency for International Development (USAID), began to envision how microfinance could evolve to change the whole financial system. María was seeking to expand ACCION's reach, and, as part of a donor agency, I was seeking to catalyze the microfinance community at large. We developed what we called the "financial systems approach," which has guided ACCION's thinking and influenced the microfinance community ever since.[1] We saw that moving from the prevailing elite-oriented financial systems to financial systems that serve the majority of the population could only occur with private-sector buy-in. In fact, the private sector would need to become the leading actors.

ACCION first demonstrated the potential for scale and profitability of microfinance through BancoSol and its sister organizations, such as Mibanco in Peru and Banco Solidario in Ecuador. Once these institutions became commercial banks, they started to outperform many of the mainstream banks in their countries. BancoSol was repeatedly named Bolivian bank of the year, based on return on assets and equity, portfolio quality, and other top line financial indicators. This kind of success captured the attention of the private sector, but did not yet provide a way for the private sector to enter into microfinance.

ACCION then created vehicles for the private sector to invest in microfinance, such as the Bridge Fund (a guarantee fund) and ACCION Investments (an equity fund), making connections possible between Wall Street investors and the poor on the back streets.

The next step involved the private sector more actively—as direct service providers. ACCION worked with pioneering commercial banks like Sogebank in Haiti and Banco Pichincha in Ecuador, which decided to serve the low-income market directly. These prominent local banks led the way in their countries at a time when other banks remained hesitant. Both institutions now have thousands of loyal clients in this market segment.

As the financial systems approach moved to each new stage, we often felt like we were pushing against a reluctant private sector. Most business leaders just did not believe low-income people could be profitable customers. It was, in fact, discouraging! But there were always a few committed champions in our partner institutions to keep us going.

Awakening Interest in Microfinance

Today ACCION and the whole microfinance community are finally feeling a strong pull coming from the private sector, though the 2008-2009 financial crisis is putting some of that pull on hold as this book goes to press. In the years until the crisis, private business interest in financial inclusion soared, a result of many factors. The growth and increasing purchasing power of the vast global market of low-income people attracted private-sector attention across sectors. In finance, the success of the microfinance movement demonstrated the business viability of financial services for the poor. The microfinance "industry" now serves between 60 and 130 million borrowers, depending on who is counting,[2] many of them reached by profit-making institutions. And new technologies promised to bring down costs, making smaller transactions and accounts profitable. When the world economy pulls out of its slowdown, we look for this momentum to rebound. We have confidence that our vision of universal financial inclusion can be realized.

The Project: From Microfinance to Inclusive Finance

"Inclusive finance" heralds a new stage in the effort to bring financial services to the poor, building upon and going beyond microfinance. The United Nations defines an inclusive financial sector as "a continuum of financial institutions that together offer appropriate financial products and services to all segments of the population."[3] No longer is it enough to offer a single product, such as a microloan for a small enterprise. Poor people need an array of financial services. Inclusive finance emphasizes contributions by a variety of players. While microfinance is a tight community of like-minded institutions, inclusive finance challenges all financial-sector participants to play a role.

This book is about how private businesses can engage in financial inclusion. It grew out of a project conceived by the private-sector members of the UN Advisors Group on Inclusive Financial Sectors, a high-level body formed to spur governments, the private sector, and others to more vigorous action to broaden the reach of financial services. Visa Inc. and ACCION, each represented on the UN Advisors panel, took up the challenge of communicating to the private sector—bankers, investors, and supporting companies—about the opportunities. Visa and ACCION provided financial support, and the Center for Financial Inclusion, ACCION's industry-building arm, carried out the work.

We knew that the best way to convince businesses about opportunities in inclusive finance was to draw on the stories of companies already leading the way. We begin by surveying the landscape of opportunities in financial inclusion, explaining who is serving whom. We then delve into specific areas where the private sector can powerfully alter the landscape. Private players have the potential to meet needs with new products, develop creative delivery channels to complete the last mile, and apply technologies to bring down the cost of reaching the poor. Investors can provide finance to microfinance institutions. We illustrate all these possibilities in the second half of the book through 16 case studies featuring both global brands and lesser known companies that are already making strides in inclusive finance.

Inclusive Finance and the Global Financial Crisis

As this book neared completion, the world witnessed a dramatic financial-sector contraction leading into a recession. Many of the rapid growth trends we cite, which continued through the first half of 2008, have slowed dramatically and will recover only gradually. Yet even in this context, inclusive finance remains relevant, perhaps even more relevant than before. The financial sector is waking up to the idea that a resilient financial system may need to place greater reliance on smaller players distributed throughout the sector rather than on a few players concentrated at the center. Inclusive finance could become one important element of a stronger and more just financial system.

Though inclusive finance aims to serve low-income people, as did the subprime mortgage market that provoked the financial crisis, many of the practices of the best inclusive-finance providers, like leading microfinance institutions, differ in fundamental and refreshing ways from subprime lending.

First, most lending to low-income customers in developing countries—especially microenterprise lending—is based on an assessment of current ability to pay, not speculation about the future value of assets. What stands out as a lesson in this regard is the risk associated with a failure to follow sound consumer protection practices. The microfinance industry is increasingly aware of the value of client protection for long-run business success.

Second, few of the financial institutions involved in inclusive finance are involved in the chains of selling and reselling assets that—in the financial collapse—separated those responsible for managing risks from the consequences of poor judgment. Moreover, the informal sector, where many of the clients of inclusive finance operate, is somewhat countercyclical. When formal economies shrink, many individuals are driven into this sector, which plays a cushioning role. In past recessions in countries like Indonesia and Bolivia, microfinance institutions proved more resilient than mainstream banks. Investor analysts argue that the countercyclical nature of microfinance makes it a good part of a risk diversification strategy. These claims will be tested during the global recession.

We are confident that the provision of financial services to the world's poor is a sound business proposition, and that when financial sectors are once again looking for new lines of business, inclusive finance will be among them. We hope that this book opens the eyes of private-sector leaders to the enormous opportunity represented by a billion Xaviers and that it leads them to decide how their companies can seize that opportunity.

Elisabeth Rhyne and the Center for
Financial Inclusion Team

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INTRODUCTION

Imagine a world in which a farm couple in the highlands of Nicaragua saves enough money to provide for their old age, a slum dweller in Mumbai who falls ill gets medical treatment without sacrificing her life savings, and a snack vendor in Uganda borrows money and builds a small restaurant.

Imagine that these examples are not special cases, but are multiplied hundreds of millions of times across the world.

Now imagine that these fortunate events are made possible by financial services provided by private companies. These companies are touted in the highest business circles as savvy and successful—*and* valued and trusted by their low-income customers. Finally, imagine that for these companies, reducing global poverty goes hand in hand with profitable business operations and strong market valuation.

This book argues that through inclusive finance, companies can make money and help solve the global problem of poverty. By inclusive finance we mean opening access to high-quality financial services to everyone who needs them, especially low-income and previously excluded people. We also discuss how microfinance—until recently a small, close-knit community of institutions offering microloans—is evolving into an essential part of global financial systems and engaging with new private-sector players.

My colleagues and I at ACCION's Center for Financial Inclusion believe that this vision is not a distant dream. We trust that it is surprisingly close at hand. Today, perhaps only a fraction of low-income people around the world have such life-supporting financial services. But many of the building blocks for universal access to financial services are now in place. Profitable models of financial service delivery exist, and private companies can emulate them and bring them to scale.

Ten years ago, when we first started to talk with major corporations about their role in inclusive finance, the only people who would listen were from corporate philanthropy departments. The Citibank Foundation, one of the most prescient, began working with microfinance organizations, including ACCION, in the 1980s. As valuable as this support was to the growth of microfinance, it did not come close to tapping the real potential of Citibank to contribute to financial inclusion. And, while the foundation work contributed to Citi's reputation for corporate citizenship, it made no direct contribution to Citi's bottom line. Citibank knew this and did something about it. But that's a story for later.

What Has Changed?

Until fairly recently, barriers to entry kept most private actors out of inclusive finance. These barriers were both real—like the high cost of processing small transactions—and imagined—like the idea that low-income people would be unreliable customers. What has changed? Several factors are now converging to create a more compelling business case for serving the low-income market. An increasing number of countries have an environment favorable for inclusive finance: political and economic stability, an improved regulatory framework, and a growing domestic market with increasing spending power. New technologies and delivery channels improve the cost equation for handling the small transactions of the poor. And leading microfinance institutions not only prove that low-income people can be loyal customers, they also show how to serve these customers profitably.

University of Michigan Business professor C. K. Prahalad and Stuart L. Hart summarize the benefits to business and society when businesses operate at what they call the "bottom of the pyramid."[1]

> This is a time for multinational corporations (MNCs) to look at globalization strategies through a new lens of inclusive capitalism. For companies with the resources and persistence to compete at the bottom of the world economic pyramid, the prospective rewards include growth, profits, and incalculable contributions to humankind. . . . MNC investment at "the bottom of the pyramid" [BOP] means lifting billions of people out of poverty and desperation, averting the social decay, political chaos, terrorism, and environmental meltdown that is certain to continue if the gap between rich and poor countries continues to widen.[2]

The acronym BOP has become a popular way to refer to this market of 4 billion people who live on less than $3,000 per year and the economic opportunities they represent. We use the term here as a convenient shorthand for the people inclusive finance targets. In fact, we are indebted to Prahalad for alerting business leaders to the BOP market opportunity. Prahalad focuses on multinationals. We note that this increasingly includes businesses from developing countries, like CEMEX of Mexico and ICICI Bank of India, which are becoming regional or global players. And we highlight the importance of smaller, local companies serving their own markets.

The Benefits of Private-Sector Engagement in Inclusive Finance

Benefits *to* the Private Sector

Today, when I sit down with business executives, I hear what they're hoping to achieve through inclusive finance:

- **Short-term profits.** Low-income people are good clients. They will pay for quality financial services. The success of Mexican retailer Grupo Elektra in launching Banco Azteca demonstrates that companies can tap existing know-how to create profitable business lines for this sector.
- **Long-term growth and market share.** Phone maker Nokia assumes that the majority of the world's next billion mobile subscribers will come from emerging markets.[3] This may also hold for the next billion banking customers. Companies that connect with the broad base of the world's population will have a much stronger foundation for the future.
- **Learning for innovation.** Creative solutions to reach low-income clients may be relevant for other lines of business. For example, some companies are learning from the dynamics of group lending and peer pressure in microfinance to resolve payment issues in other areas.[4]

These points suggest the untapped market opportunity that inclusive finance presents, a "blue ocean" opportunity. Kim and Mauborgne, in their influential *Harvard Business Review* article, "Blue Ocean Strategy," write, "Blue oceans denote all the industries not in existence today—the unknown market space, untainted by competition."[5] They argue that when new demand is created, with few contestants for market share, profitable and rapid growth becomes possible. Blue ocean opportunities arise most often when the boundaries of an existing industry change, and inclusive finance involves just this kind of radical shift in the boundaries of the financial system, to include the previously excluded.

Additional benefits can accrue to companies from the social value associated with inclusive finance.

- **Goodwill.** Creating social value enhances a company's brand and reputation. It builds goodwill with increasingly socially minded stakeholders—shareholders, governments, and community leaders.
- **Employee loyalty and satisfaction.** Employees take pride in being part of a business that is making a difference.

Of course, companies may also find other benefits specific to their own situations. For example, Banco Pichincha of Ecuador initiated microlending in part to leverage its underused bank branches and earn more revenue from its excess liquidity.

Building a business case for inclusive finance requires delving into the challenges each company will encounter on the road. The challenges are at least as important to consider as the benefits, and we will explore them thoroughly throughout the book. Serving low-income markets with financial services requires good solutions—and often new solutions—to familiar business elements, like marketing, product design, technology, finance, and alliances. We do not claim that inclusive finance is easy; but then, few successful new business efforts are.

Benefits *from* the Private Sector

Private involvement in inclusive finance brings a number of benefits to society, starting with the direct and obvious benefits of making a difference to customers' lives. When people become valued financial-services customers, they come one step closer to social and economic enfranchisement. Many of them use financial services to move their families out of poverty or to build their businesses.

The human impact of financial services can be an enormous source of motivation for businesspeople to get involved, as long as it is coupled with business success.

But can't the nonprofit or government sectors do this just as well? In fact, many nonprofits and governments do an excellent job of providing financial services, especially (as we will see) in reaching out to ever more difficult market segments. Yet there are tremendous economic benefits when the private sector gets involved, starting with the greater potential of private markets to reach all those who need services. Moreover, as commercial scale becomes the driver of inclusive finance, it frees philanthropic and public resources to tackle still unsolved problems in other sectors.

Equally important, the dynamics of competitive markets stimulate innovation and reward efficiency. The result is better service quality and lower costs, as has already become evident in some highly competitive microlending markets like Bolivia and Peru, where interest rates have fallen and product range has grown. The close interaction that is emerging between business and nonprofits in microfinance may also have the indirect effect of introducing proven business methods and models to help nonprofits become more effective, accountable, and sustainable.

The Road to Inclusive Finance

This book provides a road map for business executives and investors thinking about greater involvement in inclusive finance. The map looks something like this. We start, in Part 1, with the market, beginning up close with portraits of three clients from different continents and then stepping back to the scale and purchasing power of the global market. We describe who is serving the market today—and who is not. This sketch sets up the next topic: how to take advantage of the opportunities. Chapters 3, 4, and 5 examine the unique challenges of providing financial services for low-income people and how companies can solve these challenges in designing products like housing finance, microinsurance, and remittances.

Part 2 asks about strategic entry points. We highlight three main business models that companies are using to get involved: banks launching their own microfinance operations ("downscaling"), partnerships between banks and retail networks to get services closer to customers, and investors putting debt and equity into microfinance institutions.

Part 3 discusses the building blocks of an inclusive financial system, where some of the most exciting new developments are taking place, like the penetration of card-based payments, mobile phone banking, and credit scoring.

This section also looks at the supporting role played by capital markets and governments.

In Part 4 we turn to social responsibility. We argue that inclusive finance gives companies a great opportunity to align social value with long-run business success if they incorporate social issues creatively into strategy. The explicit incorporation of social aims into business strategy has been one of the distinguishing features of microfinance and can become a hallmark of successful inclusive finance as well. In this part we also discuss the downside risk—for customers, providers, and the industry—of failing to protect customers from harm. The section ends with the challenge of measuring the social bottom line.

The Evidence: Real Companies, Real Cases

At the heart of the project are case studies researched and written by members of the inclusive finance team from the Center for Financial Inclusion at ACCION, a group dedicated to industry development. Our team identified 16 examples from across the globe in which private companies are contributing to financial inclusion in significant or innovative ways. The companies in the cases range from well-known multinationals (Citibank) to important local companies (Equity Bank of Kenya). Many are not financial institutions, but rather, market-making companies (Visa Inc.), investors (Sequoia Capital), and even surprising new entrants from other sectors (Grupo Elektra of Mexico and its Banco Azteca).

The company cases bring the opportunities and challenges of inclusive finance to life. They recount the motivations that led companies into inclusive finance, the opportunities and obstacles they saw, and the results they have experienced so far. We could have written many more cases (we do mention many more throughout the chapters), but limited ourselves to examples that have been tested long enough to show results. We sought out cases demonstrating scale, profitability, replication, and impact on clients. Not every company scores well on all of these dimensions, but all cases have at least some important elements of success.

Several cases presented in this project have been written about before, usually to describe or highlight specific innovations. In this book we seek rather to understand why and how major corporations approached the opportunity.

A few of the cases stand out for me with compelling messages. Banco Azteca built a financial-services empire serving 8 million borrowers in five years. This case highlights the potential of retailers to alter the shape of the financial industry. It is a wake-up call to everyone who thinks of scale in terms of thousands rather than millions of clients.

The case of Sequoia Capital India and SKS Microfinance helps us understand how hard-nosed investors evaluate the growth prospects of a leading microfinance institution. Sequoia bet on Google before it showed profits; time will tell whether it showed similar market acumen to bet on SKS when it had only just crossed the profitability line.

A favorite case of mine is that of Equity Bank in Kenya, which created a set of education-linked products that support low-income students, their families, teachers, and schools. Equity found a way to help Kenyans meet a deeply meaningful social need through profit-earning services, a wonderful example of proactive social responsibility.

The time is ripe for a massive move by the private sector to tackle inclusive finance. Technology holds out the promise of cutting through cost and infrastructure barriers that until recently appeared insurmountable. Economic growth is putting more money in the hands of low-income people, making it obvious that this market constitutes a substantial opportunity. If the private sector responds, the next decade may well see the contest for the inclusive finance market largely fought and won.

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Part 1

UNDERSTANDING CLIENTS, THE MARKET, AND THE OPPORTUNITIES

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1

THE BOP MARKET UP CLOSE (AND PERSONAL)

The $5 Trillion Invisible Market

The World Resources Institute's project, "The Next 4 Billion," has taken on the challenge of quantifying the opportunities at the base of the pyramid.[1] Its target, the estimated 4 billion people in the world who get by on incomes of less than $3,000 per person per year, are, in fact, a majority of the world's population. The project declared that this population segment constitutes a global consumer market worth an estimated $5 trillion, broken down as follows:

- The Asian BOP market contains 70 percent of the total spending power ($3.5 trillion). Latin America, Africa, and Eastern Europe each account for roughly 10 percent of the total.
- In Africa, despite recent growth in the middle class, the BOP market is still *the* market. It involves 95 percent of the population and 71 percent of purchasing power.
- Even in Latin America, the BOP market constitutes 70 percent of the population and 28 percent of total spending power.
- The Eastern Europe/Central Asia BOP market is worth close to $500 billion annually.

While the overall market includes many people living somewhat above their national poverty lines, an important subset is the 1 billion people who live on less than a dollar a day, the poorest segment of humanity. This group requires special attention if it is not to remain excluded while the high end of the BOP market receives more services. Much of the BOP market is rural, especially the lower-income portions, and this too poses special challenges.

Profiles of the Working Poor

Global facts and figures show the market potential in the broadest terms. We now shift to a human scale to gain an understanding of the people involved. The three portraits that follow give us insights about real people from the BOP. Knowing the people is essential for learning to serve this market effectively. Before you turn to the rest of this book, please make sure to read these profiles.

Delia

A pueblo joven *(new town) in Lima, Peru*

At the start of the day, Delia unlocks a padlock and swings back the metal gates that protect her shop at night. The shop carries groceries and a little bit of just about everything else. Delia's business sits in the middle of a dense market, an environment of concrete and metal. The pace is as fast as the beat of the Latin music coming from radios and boom boxes on all sides. Delia greets the friends who arrive to open their neighboring market stalls and the tenants who rent rooms in the three-story house she has built on top of the shop. She spends her day purchasing inventory, chatting with special customers, and looking over the shoulders of her employees.

Delia is one of millions of urbanites swelling the populations of the Andean capitals: Lima, La Paz, Quito, Bogotá, and Caracas. Though only a generation away from the *campo*, she has never known any other life than that of Peru's urban "informal sector," estimated to include more than half of the total urban Peruvian labor force.[2] The informal sector includes all those people who survive by operating micro- or small enterprises. Most informal-sector enterprises involve a single microentrepreneur working alone, with his or her family or with a couple of employees. The mom and pop shop and the small farmer are both part of the informal sector. Their enterprises are generally not registered formally with the government. They exist to satisfy immediate economic needs.

Some economists regard informality as a choice. They assume that people can choose to be formal, keep proper books, register their businesses, and pay taxes. If they "decide" to be informal, their motivation is presumed to be avoidance of the costs of formality. In this view, informals are seen as shirkers who do not pull their weight in society and compete unfairly with upstanding formal businesses. Delia would be angry and bewildered to hear talk like that. For her, informality is simply the life she knows.

Today Delia thinks of herself as a successful businesswoman. But years ago, she found herself with three young children, no livelihood, no way to earn a living, and no one to help her. Her husband had abandoned her for another woman, taking with him the proceeds from selling their market stall.

Delia and some women friends formed a group to get a loan from what is now Mibanco, Peru's leading microfinance bank. They borrowed as much as they dared, having nothing more to offer as security than each other's group solidarity. Delia's first and probably biggest hurdle was to save enough for a new stall. She invested and improved her business and her family life, upgrading the stall several times, increasing her inventory, building rooms in her house to rent out, and educating her three daughters. Over many years, she has worked her way up from a \$100 or \$200 group loan to an individual loan of \$3,000.

Delia's first steps in launching her microenterprise were small and may have appeared unpromising. When she started, the shelves had only a few items. Many retail businesses like hers crowd the market, so she had to keep her prices very low. It was hard to obtain a large enough sum of money to make significant improvements. Today the walls are filled from floor to ceiling. Every bit of space provides an opportunity to stock something else.

Before her microloan, Delia had never been a customer of a bank. If she needed a large sum of money, she had a few choices, none of them good. She could borrow from the local moneylender. She and her friends called him *chupasangre*, the bloodsucker. She could buy on credit from the wholesalers who supplied her inventory, but they would raise their prices, squeezing her profits. She could borrow from friends, but they tended to be in the same situation as she was.

When Delia first borrowed, several important things happened. First, and possibly the most significant, she turned something she was rich in—friends—from social capital into real money through the group guarantee. Second, she gained independence from the *chupasangre* and a stronger bargaining position with her suppliers. Third, her interest costs went down considerably from informal rates. Fourth, she gained permanent access to finance, which gave her the courage to plan and invest because she could count on accessing a loan when she needed it, as long as she paid it back faithfully. And finally, she had the experience of being trusted and valued by a formal institution. She had gone from invisible to included.

Xavier

Hulene, a caniço *(cane town) settlement on the edge of Maputo, Mozambique*

Xavier, whom we met in the preface, is one of very few Mozambicans of his generation with some secondary schooling. After some years of military service during Mozambique's long civil war, he learned elementary bookkeeping and got a job in the accounting department of a nongovernmental organization (NGO), part of the huge reconstruction effort to assist Mozambique to rebuild after the war ended. With an office job and a steady salary, Xavier had become a part of the tiny Mozambican professional class. He had made it.

Well, not quite. After a few years, the funding ran out and the NGO went away. Xavier was let go. His tiny pension from the Mozambican army was not enough to live on. So he started a business selling frozen fish and a few other items. He turned to microenterprise when he had no alternative.

Xavier sells from a two-room concrete block structure at the intersection of two of the broad, red-dirt paths that lace the settlement of Hulene, a suburb that combines the density of a city with the rural feel of a traditional African village. Each family in Hulene lives behind a low hedge or fence enclosing an open area, perhaps a tree or a few bushes, and one or two huts, though most of the mud and thatch has by now given way to concrete bricks. Chickens and children scrabble in clean-swept dirt yards. Much of the living and nearly all of the cooking is still done outdoors. The overall impression is irregular, unplanned, and unorganized.

Xavier is a small, perky man. If he were older, he might be described as spry. Painted across his shop is a slogan in Portuguese: O PEIXE DA MAMÁ (Mom's Fish). He participates in a simple franchise operation selling *carapão*, the cheap frozen fish that is a main source of protein for Maputo's poor. *Carapão* tastes so foul that it is never eaten by people who can afford better. Xavier says it is a good business.

Residents of Hulene pass Xavier's shop on their way home every evening after they alight from the *chapa*—the ragged commuter minibus—up on the main road. Xavier's path aspires to be a road but is so rutted and uneven that an ordinary sedan car struggles in dry weather, and even the lumbering Coca-Cola distributor's truck has trouble in the rainy season. Xavier's customers stand outside in the heat, waiting for the attendant in the dark interior of the shop to take the fish from the deep freeze, weigh it on an old-fashioned balance, and wrap it in a plastic bag.

Xavier has borrowed two or three times from Tchuma, a credit cooperative that began in 1998. One of his first loans was used to repair the roof of his shop after thieves broke in. His current loan is 5 million meticais, about $260. "The loan is good, but it is too small," he says. "I want to help my wife start a beauty salon so she will have a business, too, but the money is not enough."[3] He has already helped his mother-in-law, an immigrant to Mozambique from South Africa, to open a small retail store and soda shop across the street. She, too, had slipped backward from a more professional job—as an English teacher—and struggles with chronic illness, which creates financial stress for Xavier and his family.

Sonali

Kherwadi, a slum in Mumbai, India

Sonali's house sits along an alley of broken pavement with an open sewer running along the middle. Bundles of pipes have been laid helter-skelter on top of the pavement. Doorways are open to bring some relief to the dripping heat, and inside them sari-clad women sit on the floor in semidarkness, Sonali among them. A delicate young woman with two small children, Sonali's much older husband works when he can, but lately has been at home because of a heart problem.

Sonali has a skill: beadwork. She can take small metal bits and string them together to create necklaces and anklets. She sits with a tray on her lap, a pair of needle-nosed pliers in her hand, twisting wires hour after hour. Many of the women in Kherwadi do beadwork or a similar handicraft such as tailoring or embroidery. This kind of work suits their need to stay home, as cultural norms require, and allows them to look after the children. It is not a true microenterprise, however. Sonali actually works for a middleman who comes once a week to bring her the raw materials and take away the finished products. He pays her by the piece. She earns only a few rupees for hours of back-twist and eyestrain. Most of the work she does is of low quality and will be sold in small shops to people in Mumbai, but some of the residents of Kherwadi undoubtedly sew products that end up in handicraft markets around the world.

Sonali's earning power is fixed by the hours of her labor. One of her main financial needs is for what economists call "consumption smoothing": managing the ups and downs in her income. Sonali used her first microloan to help pay the unexpected expense of her husband's fees at the local health clinic. Although repaying the loan will be hard unless he returns to work, she is better off than if she'd gone to the moneylender. Many of the local moneylenders charge only interest, not amortizing the principal. This practice leads clients into permanent debt. If a borrower cannot get a large enough sum together to repay the principal, she will pay the interest forever. If she faces another emergency and has to borrow again, her debt burden grows.

What Do We Learn from Delia, Xavier, and Sonali?

Even the briefest look at life stories of the working poor provides great insight into their financial needs and the kinds of customers they can be.

Without stable employment in a formal-sector job and with little or no government-sponsored social safety net—in fact, with few connections to any large institutions—vast numbers of the working poor survive by operating microenterprises. In Egypt and Indonesia only 10 percent of the population works in the formal sector, and in Mexico only 20 percent.[4] These enterprises range from retail shops to family farms to artisanal manufacturing. Families often piece together several income-earning activities: Delia operates a shop and rents rooms in her home, Xavier's family runs two separate microenterprises and is trying to start a third, and Sonali supplements her husband's labor income with beadwork.

Many such families face great vulnerability, so much so that we can consider vulnerability an integral part of what it means to be poor. Among the three people profiled here, two had experienced war, one had multiple thefts, and two had economically debilitating health crises. Financial services could help them manage some of this vulnerability. In the absence of inclusive financial institutions, they turn to informal sources—friends and family, moneylenders and suppliers. The informal sources respond quickly when needs arise, but they have many drawbacks. These clients used moneylenders only reluctantly to solve crises because of their high costs. Other informal sources, especially family and friends, are often seen in a more favorable light, but their resources are limited.

The harsh realities of working poor lives, including poor living conditions and exposure to risk, create a daunting picture for businesses contemplating serving the low-income market. It would be easy to conclude that no prospects lie in their communities. Looking below the surface conditions, however, reveals a different picture, one that brings to mind qualities such as resilience, determination, aspiration, and self-reliance.

The working poor have many assets, but lack mechanisms to leverage those assets. This is the essential insight put forward by Peruvian economist Hernando de Soto in his book *The Mystery of Capital*, and it points to a crucial role for inclusive finance. De Soto pointed out that the poor actually control a surprising amount of real assets in the form of housing, business premises, and other physical wealth. In Peru alone, de Soto estimated that these assets totaled some $90 billion, about 11 times the value of the Lima Stock Exchange. Worldwide, de Soto estimated in 2001 that about $9.3 trillion of dead capital in poor communities was waiting to be leveraged from informal assets and enterprises.[5]

As important as the untapped physical assets may be, the human and social assets of the poor may be even more valuable, though far less recognized. Delia and Xavier are resourceful businesspeople who have found ways to earn a living despite numerous hardships. Delia has friends who help her, while Xavier supports members of his extended family. Both have become expert money managers through years of experience. Their aspirations to improve their life circumstances make them value the opportunities offered to them, such as a loan. That value translates into willingness to pay for services and repay credit on time. Xavier and Delia are ideal—and profitable—customers for inclusive financial products. Sonali faces more extreme poverty and has fewer assets to draw upon. It might be surprising to learn, however, that even Sonali is a client, having opened a savings account at ICICI Bank through its linkage with a microfinance institution (MFI), Swadhaar FinAccess.

De Soto's proposed solution to the lack of leverage that characterizes assets of the poor involved land titling and other forms of official recognition, for these solutions would legitimize the fruits of grassroots labor and investment. Another thinker, C. K. Prahalad, proposed a different solution—a business solution. Prahalad challenged the world's largest corporations to find their own ways to catalyze the BOP market, contending that the potential rewards of doing business in emerging communities are worth the required adaptations. He suggested four components necessary to build a commercial infrastructure for BOP markets:

- Improve access through distribution and communications systems.
- Create buying power with financial access and income generation.
- Devise local solutions through targeted R&D and grassroots innovation.
- Shape aspirations through consumer education and sustainable development.

Neither Prahalad nor de Soto are primarily interested in financial services, but their arguments point strongly toward inclusive finance as one of the most important keys for unlocking the potential of the BOP market. Financial services allow people to leverage their hidden assets (de Soto), and they are a central part of the commercial infrastructure needed to make business work in BOP markets (Prahalad).

Prahalad's suggestions require rethinking almost every aspect of doing business, whether it be the price/performance equation, brand management, market building, product design, packaging, or capital efficiency. Throughout this book we explore how such adaptations can work in the financial-services sector.

2

WHO SERVES THE BOP MARKET—AND WHO DOESN'T?

In this chapter we look at the supply side of the BOP market for financial services, developing a view of who serves the market and how, as well as a better understanding of the gaps. But first let's look at two very different kinds of players who are already in those markets, doing business with BOP clients.

Major Corporations: Shampoo and Cell Phones

Not many formal businesses or multinational corporations serve BOP customers; one of the market's defining characteristics is its relative isolation from major institutions. Among the first to enter this territory were consumer products companies like Lever Brothers and Procter & Gamble, who innovated in marketing and distribution to derive significant income from poor markets. In response to tiny amounts of disposable income, they developed sachet marketing—providing products in small individual packages affordable to even very low-income customers—which became a useful model for other industries, such as mobile phone service.

Mobile handset makers and wireless service providers have recognized the tremendous potential of taking entire nations directly to wireless communications at incredible speed. Nigeria reportedly connected only 450,000 landlines in three decades, but has subscribed 32 million mobile customers since 2001.[1] In fact, mobile communications provides a huge productivity boost. The London Business School recently determined that every 10 percent increase in mobile phone ownership in a developing economy is worth 0.6 percent of additional gross domestic product growth.[2] Technology companies are racing to invent products affordable to these BOP consumers, too, whether it's a $100 laptop from One Laptop per Child or a $1,500 electrocardiograph machine from GE Healthcare.[3] The success of these industries in low-income markets doesn't just point the way—in some cases they are providing the infrastructure that also paves the way.

Informal Finance Providers: Moneylenders and Merry-Go-Rounds

In the absence of formal financial institutions, low-income people turn to informal sources of finance, as they have for centuries. Not all informal lenders are menacing, criminal loan sharks. ACCION team member Steve Barth noticed that in his experience in Thailand, they were frequently aunties who owned small beauty parlors. And the most common forms of informal finance begin with friends and family, like the rotating credit and savings clubs found on every continent (known in different parts of Africa, for example, as *tontines*, *susus*, merry-go-rounds, and *stokvels*).

It is easy to simply dismiss informal finance providers as the "enemy," but in fact they have a lot to teach:

- They demonstrate market potential. Loan sharks prove that profits can be made in grassroots markets.
- They are actually the competition. BOP customers often manage loans from formal banks and moneylenders at the same time.
- They could even become distributors or agents. In Ghana, Barclays Bank works through *susu* collectors who are traditional, independent savings agents walking the street markets.
- Their practices point toward successful product design. Microfinance group loan techniques borrowed liberally from informal models.

The consumer products companies and the loan sharks show that doing business at the base of the pyramid can work.

Formal Providers: Banks, Microfinance Institutions, and Consumer Lenders

Only a fraction of people at the bottom of the pyramid enjoy access to financial services provided by formal institutions. This market segment is so neglected that there is little comprehensive data on how demand for financial services matches up with supply. A few critical pieces of evidence will help us grasp the main points. We will look at each major group of providers, starting with banks.

The Banking Sector

By and large, commercial banks in developing countries still fail the majority, although some of the banks we profile in Part 2 are working to change this picture. A simple comparison between the number of savings accounts, bank loans, and branch accounts and the population of various countries demonstrates this.

In Spain, a highly banked country, there are two deposit accounts per adult, and in Austria there are three. But in the Philippines there is only one savings account for every 3 adults, and in Kenya the ratio is one for every 14. Perhaps that explains why merry-go-rounds—informal savings clubs among small groups of women—are so popular in Kenya.

In Spain there is a bank loan outstanding for every 2 adults, while in Ecuador there is one loan for every 13 adults, and in Bangladesh one for 18.

The ratio of bank branches to adults in Spain is one to 1,000. Some European governments are actually starting to argue that *fewer* bank branches would create a more vibrant neighborhood feel in center cities. Fiji, Bangladesh, and South Africa would love to have the same problem: they have closer to one branch per 20,000 people (see Table 2.1). And even in rich countries, low-income neighborhoods are underserved.

These patterns apply to many countries. In Mexico, Colombia, and Brazil, studies show that between 65 and 85 percent of urban households lack any deposit account in a formal financial institution.[4] Comparable figures for the United States and Spain were 10 percent and 2 percent, respectively.

Country	Bank branches per 100,000 people	ATMs per 100,000 people	Loan accounts per 1,000 adults	Deposit accounts per 1,000 adults
Kenya	1.3	1.0	n/a	70
Bangladesh	4.5	0.06	55	229
Fiji	5.5	12.5	67	444
South Africa	6.0	17.5	n/a	n/a
India	6.3	n/a	n/a	n/a
Mexico	7.6	16.6	n/a	310
Philippines	7.8	5.3	n/a	302
Ecuador	9.3	6.3	77	420
Spain	96	127	556	2,076

Table 2.1 Indicators of Financial Inclusion in Selected Countries

Source: Thorsten Beck, Asli Demirguc-Kunt, and Maria Soledad Martinez Peria, "Reaching Out: Access to and Use of Banking Services Across Countries," draft, March 2006.

Alternative Financial Institutions

While mainstream commercial banks still largely bypass the bottom of the pyramid, the good news is that specialized providers, such as microfinance institutions, cooperatives, consumer finance companies, and some public sector "banks for the people" have made substantial progress.

In a study of alternative financial institutions—institutions serving clients of an economic level below those traditionally served by commercial banks—the Consultative Group to Assist the Poor (CGAP), a donor consortium, identified 3,000 institutions serving 152 million borrowers.[5] CGAP found 573 million savings accounts globally, slightly over half of which were in government-owned postal savings banks.

The leading alternative financial institutions demonstrate how to reach the BOP market profitably and at scale. The best of them have captured first-mover advantages while lowering entry barriers for any second mover that can quickly copy their innovations.

Let's look closely at two types of alternative financial institutions: MFIs and consumer lenders. This book will return repeatedly to the innovations, advantages, and disadvantages of consumer lenders and microfinance institutions. It is worth taking a few moments now to introduce them. They are in many ways the guides along the road to inclusive finance. Once operating in separate realms and with widely different motivations, increasingly these two sets of players compete head-to-head.

Microfinance Institutions

From tiny nonprofit beginnings in the 1970s and 1980s, microfinance has become a significant global force that increasingly operates as part of the financial sector. According to the Microfinance Information Exchange (MIX), the data custodian for the microfinance community, the 1,330 microfinance institutions[6] that report to it lend to 57 million people worldwide. The Microcredit Summit, an advocacy organization, casts a wider net, including quasi-formal providers like self-help group movements and some public-sector development banks. Its 2007 report records 133 million active borrowers in 3,316 microfinance institutions.[7]

ACCION International, as a promoter and developer of microfinance institutions, has come to inclusive finance through the microfinance movement. We believe there are good reasons to learn from and connect with microfinance, in addition to the fact that it already reaches tens of millions of clients.

First, leading microfinance institutions show how inclusive finance can be profitable. Consider Mibanco in Peru. Most of its 250,000 clients are women, including Delia, profiled in the previous chapter. For clients like Delia, Mibanco provides a full suite of services including Micapital (working capital for her shop), Micasa (which helped her build the rooms she rents), and Chasqui (a fast-cash loan named after the swift-running messengers of the Inca Empire). In 2007, Mibanco had a loan portfolio of $500 million, with an average loan size near $1,700. Its return on equity was 37 percent, making it one of the more profitable banks in Peru.[8]

Equity Bank is a Kenyan commercial bank focused on microfinance. It boasts over a million small savers.[9] In 2006, Equity successfully issued shares to the public, and in 2007 *Euromoney* recognized it as the best bank in Kenya.[10] Now, private equity investors are competing to buy newly issued shares.

A second reason to consider microfinance institutions is their potential for partnering with the private sector. Microfinance organizations are repositories of knowledge about the BOP market and how to serve it, and many of them offer portals to the market because of their client base and branch networks. Moreover, they are often enthusiastic experimenters ready to test new ways to benefit clients.

Consumer Lenders

Consumer lenders come to BOP finance from a very different angle than most microfinance institutions. While microfinance began with credit for the owners of tiny informal businesses, consumer lenders began by helping salaried workers buy things. Today, especially in Latin America, the two approaches are starting to meet and compete.

The clients of consumer lenders tend to come from the upper end of the BOP market, especially workers employed by large stable companies. Increasingly, purchase finance is just the starting point. In Mexico, big-box retailers Elektra and Wal-Mart began with purchase finance but are rapidly expanding into full retail-banking services. Elektra created Banco Azteca for this purpose in 2001 and has an enormous head start over Wal-Mart, which obtained a banking license for Mexico in 2007.

Consumer lenders and microfinance institutions may start with entirely different motivations and philosophies, yet they increasingly compete for the same customers. Consumer lending tends to be aggressively commercial, with a strong focus on scale and profit. Growth rates among consumer lenders are often extremely high, and markets can quickly become very competitive. Consumer lenders are not always beloved by society at large. The U.S. payday-loan industry is frequently vilified in the press for high interest rates and lack of transparency. And crises in consumer lending suggest that the industry has a dangerous tendency to overheat. A few years back, Bolivia saw a boom and bust in consumer lending from which it has not yet fully recovered, and excesses in consumer lending in South Africa sparked the creation of a regulatory agency focused on client protection.

In contrast, microfinance institutions begin with a social bottom line. They are more likely than consumer lenders to reach poorer clients, and especially the self-employed. Their intent is to better the lives of their clients. Financial return is valued primarily because it enables scale and staying power. MFIs don't treat profit as an end in itself. Some MFIs with a strong antipoverty orientation keep interest rates close to the break-even level, as advocated by Grameen Bank's Muhammad Yunus.[11]

With its nonprofit origins, microfinance has not yet had access to the sophisticated technologies that have enabled consumer lenders to reach scale. Nevertheless, MFIs have a deep understanding of BOP customers and can fit microfinance products to their needs. That know-how underpins an impressive worldwide body of institutions, including some commercial microfinance banks and finance companies that are attracting great interest among investors. Compartamos Banco in Mexico and Equity Bank in Kenya, for instance, have had successful public offerings.

Many leaders in microfinance worry about how to engage with the mainstream financial sector. They want the technology and financial backing the private sector can bring, but also want to ensure that if they turn over their know-how or clients, they won't be sacrificing the social commitment that has driven and inspired them.

This difference in perspective between consumer lenders and microfinance sets up one of the most interesting dynamics at play in inclusive finance. Particularly in Latin America, consumer lenders are specifically targeting core microfinance clients—informal microentrepreneurs—while some (though not all) microfinance institutions are developing consumer lending products. To a client, the providers may look similar. Both may offer a loan of approximately the same size, maturity, and interest rate.

Such competition has not yet developed in other regions but may be coming soon. In India, the recent growth of both microcredit for the poor and consumer finance for the middle class has been astonishing. The border between the two segments, previously far from one another, may soon blur and then disappear.

Prospective new entrants into the inclusive finance sector will need to evaluate the behavior and positioning of the microfinance and consumer lending subsegments in their countries before making their own moves. As I consider the future of inclusive finance, I wonder how the energy, resources, and mastery of technology of the consumer lenders can be married to the deep knowledge about and concern for low-income customers that microfinance brings. I would love to help match-make such a marriage.

3

FOUR CRITICAL CHALLENGES IN THE BOP MARKET

"How can poor people save money if they can barely put food on the table? How can they afford to pay high—or any—interest rates?"

"Aren't informal entrepreneurs risky customers? Won't they default and disappear into the slums?"

"Can an illiterate woman learn to use an ATM machine?"

We sometimes hear questions like these from businesspeople who have little exposure to the clients of the bottom-of-the-pyramid (BOP) market. While the questions may reveal a lack of sector knowledge, and some verge on the politically incorrect, they are not frivolous. In fact, they address real challenges inherent in making a successful business that serves low-income people. They demand answers.

To surface more potential doubts and hesitations, we can also ask:

What's different about the low-income market? Do they want the same products as the middle class?

How can we reduce the cost of making small loans and processing tiny transactions? Is technology the solution?

What is the best way to reach clients in rural areas and urban slums? How can we reduce the bricks and mortar costs?

Are low-income clients as risky as we fear? Where exactly do the risks lie? How do microfinance institutions manage risk? Can the private sector use the same techniques?

In the past most private companies had good reasons to avoid serving the BOP market, because they had no good answers to questions like these. No longer. We know from our experience that good answers exist and that they can be applied effectively if companies adapt their business models to market demands. Advances in technology, financial innovations, and greater market understanding provide potential solutions to the core challenges of the BOP market. Above all, success is found in nearly two decades of experience with commercial microfinance and in the experience of private-sector companies that entered the low-income financial market early on.

Four Critical Challenges

We can reduce all the many questions just mentioned into four challenges inherent in providing financial services to BOP customers:

1. **Understanding the clients.** Speaking broadly, the poor need the same kinds of financial services as middle-class customers. However, it is a classic mistake to treat products for the poor simply as scaled-down versions of those for higher-income customers. As with any market, a deep understanding of specific needs is required to get product design right. Local customs and economies, literacy, gender roles, religious taboos, or ethnic discrimination may need to be addressed. For example, microfinance institutions in the Middle East have learned how to approach Muslim clients who worry that it might be a sin to pay interest. Some banks, notably Barclays, have learned to relate to the informal lending circles—*tontines* and *susus*—that many West Africans join.
2. **Reducing costs.** The small size of accounts and transactions associated with the poor is the fundamental challenge to profitability. The cost barrier is highest for the poorest clients and those in rural and remote areas. Rather than just squeezing costs down, serious rethinking is needed. Radical product simplification is one key, and

technology may be another. When a Nepali woman can receive money from her husband working in Delhi without leaving her village, it will be technology and creative distribution channels that make it possible.

3. **Informality and risk management.** BOP clients appear risky because they are economically vulnerable and operate informally. Much of the risk is only a perception, however, and actual risks can be managed with the right techniques. Microfinance institutions using these best practices demonstrate consistently high repayment performance, so much so that in a 2008 survey of top risks, microfinance providers and investors ranked credit risk only tenth, well behind costs (which was fourth) and a range of institution management issues.[1]
4. **Building the industry.** Few providers possess the strength to create or enter a virgin market alone. Other providers help develop the market, attract supporting businesses (for example, information-technology providers or payments networks), and speak with a united voice before regulators. Avenues for cooperation in industry-building need to be identified.

Addressing the Challenges

Many private companies have already found ways to meet the four challenges. Our cases include international, regional, and national banks (Citibank, ANZ Bank of the South Pacific, and Equity Bank in Kenya). They include consumer lenders (Banco Azteca) and microfinance institutions (Compartamos Banco), telecoms and technology companies (Vodafone, Visa Inc., Temenos), investors (Sequoia Capital), and investment banks (Credit Suisse). In short, many different players operating in many different ways have found a profitable market niche in inclusive finance. Let's look at some of the challenges in more detail. The remainder of the book will show how businesses are solving each of them.

Challenge 1: Understanding Clients

Poor people have much to gain from good financial services, and therefore are likely to value them highly and perform well as clients. The economic gains that clients reap from better services allow them to pay for the services and create the income stream providers need. But this virtuous relationship only works if the products are designed and delivered with a deep understanding of the clients. Some of the characteristics providers need to consider include these:

- Much of the BOP market is self-employed, and clients must allocate their scarce financial resources across family and business needs. Personal and business finance products are not neatly distinct, and credit analysts must assess both a client's business and family activities.
- Low-income people may need financing for purchases that wealthier people would pay for outright, making products like consumer finance or school fee loans especially important for the poor.
- The lives of low-income people are characterized by vulnerability and the lack of economic safety nets. Natural disaster, unemployment or business downturn, theft, and health crises are all potentially devastating. Savings and, of course, insurance are especially important products.
- Customers in the BOP market often fear or mistrust banks—a fact of life that marketing strategists must confront early on. Successful approaches include hiring staff from the same communities as clients and sending staff into marketplaces rather than waiting for clients to appear at branch offices. Banco Pichincha of Ecuador uses a separate brand name for its microfinance arm, Credifé, to reach out to BOP clients.

Important product areas for inclusive finance include savings, money transfers, and insurance, but these are only the broad areas ripe for growth. Much creativity is needed to address the more detailed range of needs. Equity Bank of Kenya spotted an opportunity to build a package of profitable services for parents, teachers, and students, using schools as delivery nodes. We will see more examples of creative product design in Chapters 4 and 5.

To gain market knowledge, it is sensible to begin by listening closely to clients at their homes and workplaces, as ANZ Bank did when it decided to reach out to rural Fijians. ANZ discovered that vulnerability to natural disasters was a major concern for its potential clients, and consequently focused its product offer around this previously unacknowledged need. Businesses that already connect with BOP clients—such as retailers with large client databases—have an enormous advantage. Banco Azteca in Mexico used the client information from Grupo Elektra's retail stores to move quickly from pure consumer lending into a full range of financial services, rapidly outstripping all other providers to the BOP market. Businesses without access to such information may want to partner with organizations that possess it, such as microfinance institutions.

Challenge 2: Reducing the Cost of Small, Dispersed Transactions

The unforgiving arithmetic of small transactions hits the business case for the BOP market directly. A Bolivian shop owner may need only $300 to refurbish her market stall, but if a lender's break-even minimum loan is $1,000, she won't get it, especially if her shop is in an outlying town on the sparsely populated *altiplano*. The revenues from small transactions must be affordable to the client while covering the provider's costs. The arithmetic of small sizes becomes even more implacable when infrastructure is weak, as in poor urban neighborhoods, or when clients are dispersed, as in mountainous regions. It is only because these challenges are increasingly solvable that inclusive finance is spreading.

Simplification of products and processes is an important part of the solution, as is hiring a low-cost, high-productivity staff. Microfinance institutions and credit unions have traditionally done both, which put them into the BOP market early on.

The most promising new developments are happening at the "last mile," where providers meet clients face-to-face. At this point technology is making it possible to sidestep bricks and mortar with branchless banking. Successful providers to the BOP must get close to clients because the last mile is costly for clients as well as for providers. I once visited with coffee farmers in the highlands of Uganda who had traveled to the market town of Mbale to receive their crop payments in cash because there was no bank branch in the mountains. These farmers faced highway robbery on the narrow mountain road back home, and one or two people from their community had lost their lives during past holdups. Even making the journey safely had cost these farmers days of lost productivity. It is hard to imagine a more striking illustration of the importance of the last mile.

The last mile may be "owned" by a financial institution, a big-box retailer, an electronic payments company, or anyone with a network of outlets that reaches deep into rural or low-income urban areas. Nonfinancial retailers already have locations and client contacts to position themselves to perform payments transactions. It may be only a short step from there to banking services. Piggybacking on the existing infrastructure dramatically reduces the cost of opening new service points, as cost is shared by several service delivers. In Brazil, acquiring a new customer through a partnership (between a bank and a retailer, for instance) costs less than $20, compared with more than $100 in a full bank branch.[2]

Among all the cases presented in this project, the fastest growth, and quite likely the largest profits, belongs to models that leverage existing retail outlets. Banco Azteca of Mexico builds on the infrastructure of Grupo Elektra's nearly 800 stores, and Banco Bradesco of Brazil outsources client transactions to post offices through a partnership with Banco Postal. Microfinance institutions can also manage the last mile, as envisioned in India's banking correspondent regulations, which allow microfinance institutions to collect savings and handle payment transactions for banks.

Branchless banks are technology driven. Card products hold out enormous promise of reducing the cost of delivering financial services while at the same time dramatically increasing convenience and security for the customer. While card products have deeply penetrated developed-country markets and the middle classes of some developing markets, they have yet to fully realize their promise at the low end. With a few important exceptions, many experiments with BOP markets and card products have not achieved genuine scale and customer acceptance.

For example, the South African government issues prepaid Visa cards for its social payments, such as pensions, which cuts costs and simplifies government administration. Yet recipients typically cash out their prepaid cards, rarely using them for purchases and account management. Why? In some cases recipients do not know how they can use the card, and financial education is needed. More important, card use is stymied by the chicken and egg dilemma surrounding merchant participation in card systems. Customers in the informal sector do not use cards because the merchants they buy from do not accept them; merchants do not accept them (in part) because too few customers want to pay with cards. The greatest success with card products in the BOP market to date has come through basic credit cards for relatively well-off consumer credit customers, such as those of Banco Azteca. Expectations are high that prepaid cards (which do not require a bank account) will make major inroads in these markets.

Cell-phone banking could be another way to dramatically increase client convenience while reducing bricks-and-mortar costs. With many experiments now underway, tremendous growth is likely in the next few years. To date, all of the well-known BOP examples—G-Cash in the Philippines, Wizzit in South Africa, and M-pesa (Vodafone) in Kenya—are still young.

Challenge 3: Managing Informality Risk

Bankers have traditionally mistaken informality for risk, using it as a criterion to exclude clients. They may have assumed that people who live from hand to mouth wouldn't pay their debts, or they feared that without formal records, clients would conceal important information. An intuitive response to such concerns is to pile on documentation, fees, and collateral requirements, but this raises lender costs and excludes too many prospective clients.

Microfinance practitioners discovered early on that informal clients could be even less risky than clients who are better off. They learned that the best approach was not to force clients to formalize, but to adjust their own means of managing risk. In the early days, ACCION's staff met market vendors whose methods for separating business from personal finances were no more rigorous than putting money for family into the left pocket and money for business into the right. At first ACCION required clients to attend training in account keeping, but it turned out that training had no effect on repayment, and clients disliked attending a class they viewed as just one more hassle standing between them and a loan. ACCION staff eventually recognized that clients were already expert money managers. Today, ACCION's partners lend to millions of clients who keep few or no written accounts.

There are two key insights for understanding how to manage risk in the BOP market for financial services. The first is about clients. Because they know how vulnerable they are, clients value the lifeline that a relationship with a financial institution represents. Continued access matters to them. This means that motivating clients to repay is a central strategy for risk management. Lenders can increase that motivation by tapping social pressure, as peer group lenders do (see next chapter), or offering preferred services.

Nothing will suspend motivation faster than interrupted access. I recently learned of an African bank that began a small pilot microloan program. As loans were repaid, they were not renewed, on the grounds that the loan capital set aside for the poor should be spread to as many people as possible—a typical charity-based intuition. Clients got wind that the first loan would be the only loan. Repayments plummeted, and the bank dropped the pilot.[3]

The second insight is about cost-effective risk management. Because loans are small, one default does not matter. This concept allows loans to be made with very simple assessment and documentation procedures, reducing underwriting costs. What does matter is a pattern of default. Unlike the relaxed approach of consumer lenders to the middle class, who believe they will be paid eventually (and may profit from delinquency through late fees), microfinance lenders to the informal sector keep a tight rein on delinquency. They know that default risk can spread virally through a client population if clients believe delinquency is tolerated. Microlenders manage this risk energetically with capable information systems and immediate follow-up of every late payment.

Another troublesome aspect of informality for bankers is lack of documentation and record keeping. Bankers want clear proof that a client is who he says he is, lives in a certain place, owns a plot of land, etc. What do they do with a client who cannot even read the crumpled documents he brings to the bank?

There are many solutions to documentation gaps; they require only a little ingenuity to implement. The availability of biometric devices addresses both identification and literacy problems at once. ICICI Bank of India places point-of-sale devices with fingerprint readers at its banking correspondents, like Swadhaar, an MFI in Mumbai. The devices compensate for the lack of national identification cards in India and for the low literacy level of clients. At the same time they take ICICI's deposit-taking services wherever Swadhaar's staff goes, extending ICICI's outreach not just to the last mile, but to the last meter. In talking with clients of Swadhaar, I found that they were delighted at the simplicity of Swadhaar's procedures compared to the morass of papers and formalities they dread at Mumbai's public-sector banks.

Challenge 4: Building the Industry

A flourishing inclusive finance sector requires supporting conditions and cooperation among players. Direct providers—banks, finance companies, insurance companies—prefer to enter markets that have a certain amount of industry "infrastructure." This supportive framework includes both businesses that perform auxiliary services and the policies and regulations that govern the rules of the game. There are increasing opportunities for businesses like payments networks, credit bureaus, and information-technology providers to help create healthy markets.

IT providers make it possible for financial institutions to handle huge numbers of clients and transactions efficiently. The microfinance world has begun to attract core banking system providers—such as Temenos—as microfinance institutions mature sufficiently to need and value more complex systems. At the same time, the trend toward outsourcing of back-office functions, well-advanced in the mainstream financial sector, is only beginning to appear in inclusive finance, as companies like Tata Consulting and IBM begin to build products for BOP bankers. In the next few years, outsourcing may create substantial changes in the structure of the inclusive finance industry, freeing financial institutions from the burden of becoming state-of-the-art IT specialists.

Credit scoring linked to credit bureaus underpins the vast consumer lending business in developed countries. However, in many developing countries the pieces are still missing, particularly for the BOP market. It is difficult to capture relevant information about informal clients to use in building credit scores. It is not even clear which information might be most relevant.

Mainstream credit scoring and credit bureau companies like Licim and Experian have sought joint ventures with microfinance providers. In many countries where credit bureaus have not yet developed, financial institutions remain locked in uncooperative and self-defeating behavior, withholding customer information from one another that could make it easier and safer for everyone to extend loans. In some cases, regulatory hurdles stand in the way of information sharing. In Chapter 11, we examine the prospects for credit scoring to be applied to the BOP market, capturing the wisdom of thousands of past loans to make judging risk faster and more accurate. Successful scoring models could help solve both the cost and the informality risk challenges discussed here.

The importance of regulations for shaping the emerging industry points to the need for cooperation among financial institutions to advocate for legal and regulatory changes. In a survey of industry participants' views of risks, the "Microfinance Banana Skins" study identified inappropriate regulation and political interference among the top and fastest rising risks.[4]

Regulatory action is needed urgently to keep pace with rapidly evolving technologies and branchless banking. The Brazilian banking correspondent experiment has attracted government attention throughout Latin America, in India, and in parts of Africa, creating an opportunity for the private sector to help successful applications in many countries, if regulators revise regulations to accommodate technological possibilities. Where the private sector can speak with a clear, unified voice, governments will probably make better policy decisions.

The four challenges we have just surveyed represent barriers to entry into inclusive finance that have prevented a competitive marketplace from developing at the base of the pyramid. The barriers are no longer as high as they once were, and opportunities are open for companies willing to adapt their business models to find solutions. We will meet these four challenges throughout this book, each time looking more closely at how companies are overcoming them. The next chapter focuses on a key portion of the first challenge: how to turn an understanding of the BOP client into successful product design.

4

PRODUCTS FOR THE BOP MARKET

Low-income people need a full range of financial services—often the same services most readers of this book take for granted. What's more, these services make an important impact on the quality of their lives. It comes as some surprise that few inroads have been made to widen the range of services that reach the poor beyond a very basic loan or savings account.

Before we explore the keys to product design for bottom-of-the-pyramid (BOP) clients, we ask readers to consider how meaningful financial products can be for people's lives. These products are not luxuries. They are intimately connected with some of the deepest human needs: safety, shelter, and family. Lacking good financial services, people either find informal solutions that are often unsatisfactory, or they have no solution at all. Without health insurance, they may not get medical treatment. Without housing finance, they may wait years before they obtain decent housing. When they use informal money transfers, the money too often goes astray. Imagine the range of products that could be developed to fill unmet needs in this realm.

It is precisely because the needs these products address are universal and basic that their market potential is so great. Hundreds of millions of families around the world will value and therefore be willing to pay for these services.

Designing Effective Products

The Subprime Fallacy

The private sector brings deep expertise and often deeper pockets to the research, development, and market testing of new products. But successful product design for the BOP market also requires a new outlook. While a suite of financial products for these clients may sound like a standard banking mix—insurance, savings accounts, leasing—beneath the surface they operate very differently.

The first lesson for any financial-services designer for the BOP market is this: products for low-income people are not just scaled-down versions of products for the middle class. We call this the subprime fallacy. At ACCION we frequently encounter bankers committing the subprime fallacy, especially those who have been working in the United States. We try to convince them that the subprime lens prevents them from seeing the right solutions for the BOP market in developing countries. With deep and sympathetic understanding of the economic lives of their clients, product designers in developing countries can avoid the subprime fallacy. And after the failure of the subprime market in the United States, developed markets are also crying out for a fresh approach.

In U.S. and European markets, subprime loans look a lot like prime loans, only worse. Subprime loans are smaller versions of standard loans, but because they are small and the clients have poor credit ratings, they are riskier. To compensate, subprime loans are higher priced and often carry stiff fees, especially for late payment or prepayment. The subprime game often boils down to a risk/cost/return calculation with little product adaptation.

Group-based microcredit illustrates one answer to the subprime fallacy. The pioneers of group lending—Grameen Bank in Bangladesh and ACCION in the Dominican Republic—modeled their products on local folkways. They observed poor people, especially women, forming groups to help each other save and borrow, and even covering for a member who had a short-term problem. They saw that people preferred small, frequent payments. The group loan products used today by millions of women around the world incorporate these features. The loans that result are more expensive than standard commercial-bank loans (because they are small), but they are not riskier—often quite the opposite.

Housing Microfinance

Housing microfinance in Andean countries demonstrates another way to avoid the subprime fallacy. It meets clients where they are, rather than where the bank expects them to be.

In Bogotá, Lima, and Quito, migrants from the countryside squat on unoccupied land at the urban fringe. Over time, they upgrade from tin shacks to small brick huts and eventually to larger houses with improvements, all on the same plot of land, to which they gradually acquire the rights. They build the houses themselves or hire skilled, informal builders from their local communities. This pattern is an integral part of the culture of urban Latin America.

Traditional mortgage lenders have ignored the housing-finance needs of these migrants (who number in the millions). The lenders simply could not scale down the mortgage product to make it affordable, nor would they lend to clients with quasiformal land title and informally built structures. This is classic subprime thinking.

Mibanco, the Peruvian microfinance bank we met in the profile of Delia, has a better solution. Mibanco devised a home-improvement product—Micasa—that follows the progressive building patterns of slum residents in Lima with loans of one to three years, each financing a specific home-upgrading project. Rather than scaling down a mortgage product, Micasa is an adaptation of Mibanco's standard microenterprise loan; it is based on cash flow rather than asset value. Mibanco has seen excellent results with Micasa and keeps about 15 percent of its $320 million loan portfolio in this product.[1]

Radical Simplification

Only simple products can be delivered at affordable prices to low-income people. Simple products also fit the life circumstances of BOP clients and may even reduce psychological barriers. Some researchers point out that complex processes may heighten clients' fear of banks because they signal mistrust and reduce the transparency of the transaction.[2] At the same time, simplified products must incorporate risk reduction in creative ways.

Group microloans meet the simplicity and risk control tests: they omit elaborate business analysis and reduce risk instead through peer guarantee. Mibanco's housing microfinance is simple: it does not register formal mortgages;

instead, it ensures that borrowers have long-standing and locally accepted claims to their residences even if they lack formal titles.

The need for simplicity is very apparent in insurance, where the claims process must be stripped to its barest essentials to become affordable. For example, some health insurance programs for BOP clients skip expensive screening for preexisting medical conditions. That may mean the policies provide less complete coverage, but at the base of the pyramid the alternative to good enough coverage is usually none.

Partnering for Product Creation

Product design may require creating relationships that do not already exist, especially through partnerships that bring providers closer to customers. Many of these partnerships involve delivery channels, but some also involve specialists such as schools, hospitals, home builders, or energy companies. In this book we discuss many partnerships between companies and microfinance institutions, such as the health insurance examples cited in the next chapter. In Ghana, Barclays Bank has even created a linkage with the indigenous *susu* system. Traditional *susu* collectors act as barefoot tellers. They roam the markets collecting deposits from clients and depositing them in the bank at the end of each day. These collectors have been around for decades or even centuries without a formal link to a bank. Barclays's program improves the safety of deposits for the collector's customers even as it widens its customer base.[3]

Raising the Bar on Market Research

Of course, the starting point for solid product design is market research, the gathering and refining of knowledge about clients. Mainstream market research companies may not be adept at learning about the BOP customers, making it worthwhile to contact organizations that specialize in this market, such as MicroSave, a pioneer in financial-services market research for low-income populations in Africa and South Asia.[4]

A Warning: Disruptive Entrants

When mainstream financial-services providers ignore large markets, they provide an opening for other players. "Disruptive" entrants from the nonfinancial world may step in because they need to ensure that their customers have access to finance for their products. Consumer goods retailers are a classic example, and in the next chapter we will see a cement company (CEMEX) and a land developer (ARGOZ) involved in finance for this reason.

Nonfinancial companies may enter because they are already dealing with customers and can turn their infrastructure, customer knowledge, and brand name into a significant market advantage. Delgado Travel, a travel agency turned money-transfer organization, shows how a small, side foray into finance became a principal line of business. Financial institutions may find the market already taken if they wait too long.

The Innovation Premium

To offset the added cost of designing and delivering products and services for the grassroots, many are saying that the process stimulates out-of-the-box thinking in stagnant industries—innovation that trickles upmarket, even if the specific innovations themselves have limited applicability beyond the BOP. As Christopher Beshouri, writing in *McKinsey Quarterly*, points out, “Some of the factors that raise the cost of serving poor consumers are actually acute forms of challenges that businesses confront across all consumer segments.”[5]

Mind the Gap: Services That Are Not Being Provided

New ideas for BOP product design come from identifying the service gaps. According to statistics on access to financial services, the vast majority of people enjoy very limited choices: a rigid group loan or a single savings account. Consumer lending and microfinance have historically focused on credit. Microfinance typically measures its success by counting borrowers, and, in this respect, its 60 to 130 million worldwide borrowers represent an important achievement. But for other financial services the access gap is breathtaking.

Neither consumer lending nor microfinance is strong in savings, one reason the Gates Foundation has launched a major campaign to increase savings services for the poor. Frequently, consumer lenders and microfinance institutions work under regulatory frameworks that prohibit savings mobilization outside of commercial banks. As a result, most of the low-income savings accounts around the world are offered by public-sector institutions, especially post office savings banks. These institutions have been notorious for poor service. I have never forgotten the shock I felt when interviewing clients of Indian public-sector banks in the 1990s and hearing repeatedly about bribes they had to pay for the most basic services. For these clients, payouts to corrupt petty clerks were a fact of life. While post office savings banks usually safeguard savings, they have provided few other services. The best of such institutions have reformed and improved, but the generally poor quality of these banks offers a gaping opportunity to companies prepared to offer better service.

The remittances market—expatriate workers sending money home—is large and growing, at $300 billion or more per year.[6] The majority of these transfers take place between BOP participants. Although customers may feel comfortable with traditional informal channels, they may actually be better off switching to formal money-transfer services. They will spend less as a proportion of the amount sent, and their hard-earned money will be safer, too.

BOP customers typically use money-transfer organizations, such as Western Union and MoneyGram, as well as smaller specialized companies, rather than banks. The remittances corridors between the United States and Latin America are almost completely dominated by money-transfer companies, even though the enormous scale of remittance flows attracts the attention of major banks. Banks have potential cost advantages over money-transfer companies, but have not yet changed established customer behavior patterns on a large scale.

Insurance companies are beginning to wake up to the BOP market as well. While the numbers of insured are rising fast, at 78 million people in the microinsurance arena, only a fraction of BOP market households have meaningful insurance coverage today.[7]

Other services have hardly penetrated the BOP market at all. Their potential value to millions of families means that they represent tremendous opportunities in the hands of the right players. Consider the following financial services that could help make low-income people better off while furnishing providers with profitable lines of business.

Renewable Energy Loans. Inclusive finance can play a small but important role in combating climate change. Developing countries can move toward a low-carbon development path if they bring renewable energy to clients who have previously had no energy or used kerosene, charcoal, or other environmentally destructive sources. The up-front cost of a solar home lighting system is too high for most people to buy it all at once, making financing a necessity. Solar Electric Light Company (SELCO), a solar energy supplier in India, arranges for banks to make loans that finance its products. Most of SELCO's 100,000 or so customers financed this way gained access to electricity for the first time. Many small energy companies seek partnerships with financial institutions to help finance their clients' acquisitions, but so far SELCO is one of the few companies to have brought such arrangements to scale.

Education Loans. In poor communities children are an asset because of the future support they will provide to the family, and education improves their income-generating potential. School loans help families pay what for them are large lump sums when fees come due. In Kenya, Equity Bank's education loans allow families to keep children in school and improve their future standard of living. This product seems like such an easy win that it's surprising it has not already spread widely. Opportunity International, a microfinance organization, is taking a similar approach in Ghana.

Pensions and Mutual Funds. Low-income families need pension benefits to protect them from destitution during old age or disability, but in many countries, government provides no old-age safety net. In 2006 the Self-Employed Women's Association (SEWA) Bank, a specialized microfinance bank, launched India's first micropension scheme as a joint venture with the Unit Trust of India's (UTI) asset management company. As distributor, SEWA Bank collects regular contributions as low as 50 rupees ($1.20) and forwards them to UTI for a 3 percent commission. UTI opens individual retirement accounts, through which customers can invest in the Indian stock or bond markets.[8]

Most of these products are at an early stage of development, but the needs they address—energy, education, and old-age security—are fundamental. Products like these offer a next generation of opportunities for first movers.

5

THREE PRODUCTS: INSURANCE, HOUSING FINANCE, AND REMITTANCES

In this chapter we take a close look at three products: insurance, housing finance, and remittance transfers. We selected these products because they have strong growth potential and are well enough developed that best practices are emerging and growth is under way. Yet the field is still wide-open in each area. Vast numbers of clients would be thrilled to have these financial needs served well for the first time in their lives.

Insurance

The sale of used fleece outerwear is a thriving business for microentrepreneurs in Kenya's chilly highlands. Dozens of vendors in Karatina Market, the largest open-air market in East Africa, borrow working capital from Equity Bank and other lenders to purchase clothing bundles from wholesalers in the city. However, vendors in Karatina have no place to store their inventory overnight except in their open stalls beside the railroad tracks. If a fire rips through a section of the market, as it did a few years back in neighboring Kampala, Uganda, a vendor faces a loss that can take months or years to recover.

This is just one illustration of the vulnerability that is an ever-present threat in the lives of low-income people. Without insurance, any shock—flood, accident, death, or illness—can send a family into a downward economic spiral. Uninsured shocks can also turn a good borrower into a defaulter, so lenders have a special interest in seeing that their clients are insured.

When entering this market, private-sector insurance providers typically start with the easiest product—credit life insurance—and gradually introduce more complex products that are also more valuable to clients. Health insurance is the grand prize of microinsurance. It is by far the most important need for the greatest number of people, and it is among the most complex products to develop.

Globally, microinsurance programs have come a long way, but compared with the potential market, they are still small, and their experience still relatively new. In a 2007 review the International Labour Organization (ILO) found vast regional disparities in microinsurance among the world's poorest countries. Health microinsurance is more common in West and Central Africa, while there is still almost no microinsurance in North Africa and the Middle East. Rural coverage in India has expanded to 30 million low-income people, mainly due to quotas set by government regulation. Overall, however, the ILO found a thriving, evolving industry, with 246 microinsurers, 357 microinsurance products (separate from government social security schemes), and 78 million people with some kind of microinsurance coverage.[1]

Prior to 2002, only a small fraction of this coverage existed. While government-owned insurance companies serve much of this market, private insurers account for the fastest recent growth. With a large uninsured population worldwide, the study enthusiastically predicts the market will double within five years.

Designing Microinsurance Products and Services

Microinsurance product designers face exactly the same kinds of challenges that microcredit pioneers once faced. They must overcome the subprime fallacy by fitting their products to local customs, and at the same time lower cost by simplifying products and developing efficient delivery channels. They need to assess risk and set premiums accurately, even though the actuarial risks in bottom-of-the-pyramid populations are not yet well understood and often assumed to be excessive. The microcredit pioneers gradually overcame such challenges and misperceptions, and we are starting to see the same kind of experimentation demonstrating the viability of microinsurance. Let's look more closely at the strategies successful microinsurers use.

Fitting Products to Local Customs and Cultures. A poignant example of the need for cultural sensitivity is the preference low-income women in South Asia show for insuring their husbands' lives rather than their own. In settings where women have a lesser claim to their husbands' assets than other family members (such as the husband's brothers), an insurance policy on the husband's life protects a wife from becoming destitute after his death.

Simplifying. Insurance is notoriously complicated, even for mainstream clients, so there is much room for radical simplification. The pages of fine print in an insurance policy may be thrown out, and instead the client receives a one-page certificate in clear language. Where clients lack birth certificates, insurers can find other ways to verify their birth dates and identities. Perhaps most important, microinsurers do away with the kinds of exclusions that complicate insurance policies for the middle class. The exclusions are too difficult to explain to clients who are barely familiar with the concept of insurance in the first place, and the absence of exclusions makes claims straightforward, which increases client trust while reducing processing costs.

Building the Market. For most BOP clients, insurance is a strange new idea. They need providers to explain what insurance is and how it works. Thus, in new markets, intensive and ongoing client education is a must. For informal-sector clients, many of whom are wary of any formal institution, trust takes time to establish. Information clarity and rapid payout of claims are two essentials for creating that trust. The choice of a distribution channel that has already gained client acceptance is one way to build the market.

Covering the Last Mile. Finding the right delivery channel may be the greatest challenge of microinsurance. The channel must be inexpensive to operate so that premiums remain affordable, and at the same time it must be sensitive to the costs of travel and time borne by clients. A trip to an insurance office that costs a client bus fares and lost work time may be a trip not taken. Agents for Delta in Bangladesh and Tata-AIG in India market their products door-to-door because women there rarely leave their homes.

The search for successful channels leads insurers to partner with organizations that already have regular contact with clients, such as microfinance institutions. We will examine several such models in a moment.

Products That Matter. Credit life insurance, by far the most widespread microinsurance product today, reimburses lenders for the amount of a loan that remains outstanding upon a client's death. This product is easy to provide and beneficial for the lender, which explains why it is so common. However, credit life is only moderately helpful for the client's family. Companies that seriously pursue microinsurance move up the ladder of complexity to straight life insurance with a cash benefit, accident and disability, and finally to health insurance. Property and crop insurance are still less common, and many such experiments still require subsidy.

Health insurance has become a hot area for innovation. It addresses a fundamental social and economic problem, and client demand is great. However, because health insurance requires health-care providers as partners, and because of serious moral hazard and adverse selection challenges, it is by far the most complex product to put in place. A few successful examples are starting to emerge.

Let's examine some of these successful cases that exemplify the principles of good product design.

Health Insurance

Around the world, an estimated 1.3 billion people lack access to health care.[2] Poverty makes it difficult for millions more to afford good quality treatment. The cost of treatment, together with lost income during an illness, can send a working poor family back into severe poverty. The World Heath Organization estimates that every year another 100 million individuals are pushed into poverty by medical costs.[3] Health insurance has great potential to transform lives and economies, if it can be scaled up commercially.

Zurich FSG and BancoSol. Zurich Financial Services Group has found a way to provide health insurance to low-income Bolivians for only $4 per month.[4] The antecedents to this product lie in the relationship between Zurich and BancoSol, a commercial bank specialized in microfinance. Zurich provides BancoSol's savers with life insurance policies for less than $1 per month.[5] Once developed, Zurich began offering this life insurance product through multiple financial institutions—mutual housing finance companies, microfinance companies, and mainstream banks. By 2007, these policies reached 83,000 clients.[6] This experience provided a base of market and operational knowledge that served as starting points for creating a health insurance program with BancoSol. The program covers all doctor visits and most hospitalization costs. With 10,000 families participating, the program remains small, but plans are under way to scale it up and offer it through additional institutions.

ICICI Lombard, SKDRDP, and Grameen Koota. A real challenge in health insurance at the grassroots is to structure and maintain a good relationship with the hospitals and clinics that treat patients. To understand the magnitude of the accomplishment of ICICI Lombard's program in finding a workable formula, we'll look first at the problems encountered by a pilot attempt.

ICICI Lombard underwrote health insurance for the clients of Grameen Koota, an award-winning microfinance nongovernmental organization (NGO) in Karnataka, India. The initial pilot made everyone unhappy. The Grameen Koota staff did not know how to guide clients on the proper use of the scheme. Clients could not understand how the scheme worked and filed grievances when they were denied benefits they (erroneously) expected. Hospitals were unable to handle the flood of clients that suddenly appeared seeking treatment. And ICICI Lombard did not see any prospects for turning this scheme into a scalable and profitable operation. It was ended after a year.

An alternative solution presented itself with the help of an NGO, the Shree Kshethra Dharmasthala Rural Development Project (SKDRDP), which developed answers to the very list of problems the initial project encountered. SKDRDP carefully negotiated network relationships with a large number of hospitals, increasing convenient options for clients and making it easier to accommodate large numbers of new clients, who would overwhelm a single institution. It set up a department responsible for training all the program participants and managing the interface with clients. This project was made possible by SKDRDP's existing knowledge of and relationship to clients. Particularly in the early stages, this program was profitable for ICICI Lombard only because these training and administrative activities were carried out inexpensively (and with some start-up subsidy) by the nonprofit SKDRDP.

While this model may not sound fully commercial, given its use of a subsidy and the role of regulation in driving the insurance company to work in this market, the sponsors do expect it to be sustainable over time. More important, this partnership among insurer, NGO, microfinance institution, and health-care providers has proven its ability to achieve scale. Close to 1 million people get access to hospital care through this program, and the number is growing rapidly.[7]

Housing Finance

At the bottom of the economic pyramid, millions of families across the world live in conditions whose squalor would shame middle-class residents of rich countries. Dirt floors, leaky roofs, outdoor plumbing, and overcrowding are only a few of the facts of life for a huge proportion of the next billion people. It's no wonder that dreams of a better house hold such emotional power.

We noted how the subprime fallacy causes product designers to equate housing finance with traditional mortgages and to conclude that they cannot serve the base of the pyramid. Banks face other obstacles to providing low-end housing finance, too. Without secondary markets to purchase bundled housing loans, the loans tie up liquidity and cause a term mismatch on balance sheets. Longer loan terms would make loans more affordable and suit borrowers, but this leaves lenders vulnerable to interest-rate fluctuations. A major constraint is the cost of new home construction, which requires long amortization if purchase is to be financed affordably. Governments could also work faster to help residents turn their informal squatters' rights into legal title.

On the other hand, there are clear advantages to making low-income housing loans. Repayment rates are even higher than for microenterprise loans, because housing is a top priority for borrowers. This makes housing loan portfolios very stable and good for client loyalty. Operational costs are lower, because loans are longer term than business or personal loans. And there is little competition in most countries, with a huge market for early entrants.

Some Creative Approaches

Consider the examples of creative product design of the Micasa housing microfinance product of Mibanco and the Patrimonio Hoy program of CEMEX. They illustrate the key design principle of a good fit to local patterns. In both these programs, the choice to supply housing microfinance for home improvement rather than whole house finance works for Latin Americans in the informal sector, since they often expect to build their houses incrementally. Home-improvement loans also tap into the enormous quality gap in housing, where the number of people living in homes needing basic improvements is at least as large as the demand for new homes. At the same time it sidesteps the difficulty of making long-term mortgages in informal areas.

Mibanco Housing Finance Loans. Housing microfinance looks more like microcredit than like home mortgages: loans are small, generally ranging in term from one to three years, backed by nontraditional collateral. At Mibanco, housing microfinance loans are secured in the same way microenterprise loans are secured: with personal and business assets. Since the homes of the poor are not readily bought and sold, the housing market and asset price cannot be the foundations for loan repayment. An assessment of repayment capacity based on income and cash flow predicts loan quality more effectively than house value—a lesson U.S. subprime lenders failed to heed.

CEMEX Patrimonio Hoy (Equity Today) Program. CEMEX's housing microfinance product uses similar principles. CEMEX is one of the largest cement companies in the world but was faced with increasing competition in its home country of Mexico. The century-old, global building-materials supplier wanted to increase sales of cement to poor and lower-income Mexicans who improve their houses incrementally over years.

Admitting it knew little about the needs of this market, CEMEX researched home-building practices in local communities, especially the rotating savings and credit associations called *tandas*. It created a group methodology for selling building materials on credit that echoed the *tandas*. Members received technical assistance for their building projects from CEMEX architects, which helped them reduce waste.

The results were heartening: sales of cement increased, housing improvements increased, and brand recognition was strengthened. While initially designed as a gesture of social responsibility, CEMEX gradually realized that helping the poor could be achieved while making a profit. This realization led to a greater rollout of Patrimonio Hoy, which has now helped 185,000 Mexican families build the equivalent of 95,000 ten-square-meter rooms.[8] CEMEX received recognition for Patrimonio Hoy in the form of a 2007 Corporate Citizen of the Americas Award from the Organization of American States.

ARGOZ's Lease-Option Contracts. This example also highlights a nonbank source. In the absence of bank involvement, private land developers sometimes put their own financing packages together for low-income buyers. Developers like ARGOZ, El Salvador's largest land developer, buy the land, put in roads and utility hookups, and build the homes. When target buyers can't get loans, ARGOZ lends the money, too.

ARGOZ offers 10-year lease-options contracts for land purchases at rates similar to commercial bank rates for housing. Buyers legally own the land only after the final loan payment. ARGOZ does not require a down payment, and insurance is provided. After a family purchases a plot, the company continues to supply financing for construction or emergencies. ARGOZ is a highly profitable company, and low-end housing is one of its solidly profitable lines of business.[9]

Alternative vs. Bank Financing

Although it is somewhat ironic that CEMEX and ARGOZ stepped in to provide financing when no financial institutions would do so, we admit that banks may have good reasons for avoiding the low-income housing market.

Construction-industry players have hooks that banks lack. CEMEX and ARGOZ enjoy built-in risk control because the buyers rely on them for their access to housing, while banks need some other way to get a legal hold—such as a mortgage. Players like CEMEX and ARGOZ are now well-positioned to capture the enormous informal-sector housing finance market, an example of the kind of disruptive entry that can force all players to reset the terms of an industry. Until now, banks have conceded the low-income housing market to others, but perhaps with creativity they could make a stronger bid.

"If we changed our attitudes, unlearned our perceptions, and opened ourselves to learning how our customers lived and worked, we could build a whole new business model and carve out a market where it was thought there was no business for us," says CEMEX's Hector Ureta.[10] Despite the apparent obstacles, perhaps it is time banks took his words to heart.

We turn now to another product in which both financial and nonfinancial players compete for the low-income market. In this case, banks have recently become more energetic in their attempts to capture market share.

Remittances

Poverty and opportunity have always motivated people to migrate from place to place. And, having found better livelihoods, many send money home. In 2006, the International Fund for Agricultural Development estimated that close to $300 billion in remittances were sent to developing countries by 150 million migrants worldwide.[11] The World Bank believes that up to one-third of remittances may flow through informal channels.[12] And these numbers are growing rapidly from year to year. Needless to say, many financial-sector players seek to be the top choice of customers to facilitate these transfers.

Person-to-person remittance transfers are thought to be the second largest source of external capital to developing countries, after direct foreign investment. As flows from the North to the South, remittances exceed official development assistance. In several countries they are greater than 10 percent of gross domestic product, and in a few extreme cases, such as El Salvador and Honduras, transfers approach and surpass 20 percent of GDP.[13]

The upper tier of remittance senders often uses banks. The well-off send money from one bank account to another. As we move down the income pyramid, senders increasingly use money-transfer companies and informal mechanisms. Although people often feel comfortable with informal senders who bring them news of the family back home, they might be surprised to learn that these are the most expensive and least secure ways to send money. A very sizable portion of the value sent informally is lost to fees, frauds, and mishaps.

The market opportunity related to remittances differs from that of insurance and housing because it is already a full-blown competitive arena. For insurance and housing, there is an opportunity to provide an entirely new service that clients cannot now obtain. In contrast, the market for remittances is already hotly contested, and few transfers are prevented because senders can't find a way to move the money. The opportunity in remittances is to woo customers from one channel to another by offering cheaper, faster, and more convenient service. For banks, the opportunity includes attracting a new customer segment using remittances as an entry product.

In this contest, money-transfer organizations (MTOs) have a strongly dominant position. The clear market leader, Western Union, is in fact one of the most successful examples of private-sector engagement with inclusive finance we know. Western Union earned approximately $1 billion in profits in 2006;[14] a large part of this was due to its BOP remittance-sending customers. Other top players include Eurogiro and MoneyGram. In addition, there are numerous smaller players, often specialized in a single remittance channel.

Money-transfer companies have made it a point to get close to customers, both physically and psychologically. They have made agents out of the proprietors of every corner grocery store in every immigrant neighborhood. The shops that handle MTO transactions give immigrants a taste of home—a chance to converse with someone from the home country, to buy favorite foods, and to find out about local, immigrant community events.

Delgado Travel, a rapidly growing MTO, initially specialized in connecting people with their countries as a travel agency, and now does so also through phone cards and money transfers. Delgado Travel and others like it offer a lifeline to home. No wonder many customers prefer it to the anonymity of most bank branches. But the amounts of money involved in remittances are simply too large for Delgado Travel's managers to relax if they wish to maintain their market position. Two huge forces are now transforming the remittances industry: new entries and technology.

New Entries

Commercial banks have begun to make bids for the remittance market, and at the same time MTOs are becoming more regional. Previously sleepy remittance corridors have been invaded by competitors, causing prices to fall dramatically over the past decade.

Banks have not yet made significant inroads, but the trend is sharply upward. The Inter-American Dialogue notes that the percentage of Mexican immigrants using banks to transfer remittances from the United States rose from 2 to 6 percent between 2004 and 2006.[15] It's still a low percentage, but one that tripled in only two years.

One of the main questions concerning banks is the relationship between remittance sending and bank accounts. The MTOs work on a cash-to-cash basis, which allows people with no bank accounts to send and receive money. The banks want these clients to open bank accounts and transfer funds from account to account, keeping the funds in the financial system as long as possible. They also hope to turn remittance customers into profitable long-term banking customers through cross-selling.

But the preference for cash among those sending remittances is persistent. Between the United States and Latin America, 70 to 80 percent of cross-border remittances were sent through money transfer intermediaries on a cash-to-cash basis. Even for immigrants with bank accounts, only 5 to 19 percent use their banks for sending money.[16] Convenience factors, such as brand recognition, hours, locations, and speed of transfer, carry more weight.

Government policy makers also encourage remittances to move through banks, in the interests of "banking the unbanked," but this admirable goal is made more difficult by the simultaneous emphasis on "know your customer," fueled by fears of terrorism and illegal activity. Undocumented workers avoid banks because of strict identification requirements. The U.S. Patriot Act actually made it easier for immigrants to open bank accounts by allowing identification issued by foreign consulates, but many immigrants still feel that it's risky to give too much personal information to a bank. A similar challenge occurs at the receiving end, where relatives back home may be unfamiliar with or distrustful of banks. With long histories of poor treatment behind them, customers may see banks as institutions for the rich. In Mexico only 33 percent of remittance recipients have bank accounts; in Central America only 22 percent.[17]

Partnerships are especially critical in remittances: they link the sending and receiving institutions. Citibank has been active in establishing partnerships with recipient-side institutions, starting with Banco Solidario in Ecuador as a test case, and moving on to BRAC, in Bangladesh, among others. Both these microfinance institutions have many branch outlets throughout their countries, making them attractive distributors of remittances. In the massive corridor between the United States and Mexico, Citibank customers can easily make account-to-account transfers with Banamex, Citi's Mexican arm.

New Technology

Even a bank with a vast network cannot duplicate the reach of small retail stores—or more, of cell phones—and that's why technology is the big story in remittances today. Debit and prepaid cards, which are easy to place in retail outlets, provide an alternative to cash-to-cash transfers. It's estimated that by 2007, 30 to 50 percent of remittance recipients had debit or credit cards.[18] At the same time, only about 2 percent of the total outbound U.S. remittances use prepaid remittance cards, indicating an opportunity to increase the use of cards in remittances.[19]

Kiosks are another way to complete the last mile. With remittance inflows to India totaling $25.7 billion in 2006, ICICI Bank developed a service called "Money2India," which had over 670 agent locations.[20] To expand even further in rural areas, ICICI adopted a kiosk system with both an ATM and a human agent. The kiosks are independently owned and operated, paid for by user fees for other services.

The longest last mile occurs in rural areas with limited infrastructure, but mobile phones can reach right across this distance. G-Cash (electronic money) is a mobile money-transfer platform owned by Globe Telecommunications in the Philippines. Through a partnership with Maxis Communications Berhad, the largest mobile service operator in Malaysia, Globe developed the first international mobile-to-mobile direct remittance service. Maxis to Globe remittance transfers are sent without a bank or bank account and are enormously convenient, especially for rural populations. G-Cash received on the cell phone of the remittance recipient can be cashed out or used to pay bills, make loan payments, or purchase goods.

With as much as 10 percent of its total population working overseas, the Philippines is highly dependent on remittances.[21] Flows from Malaysia alone amount to billions of dollars, so G-Cash's profit potential is as impressive as its development impact. For customers, G-Cash is cheaper than any other method of transferring cash, averaging about 1 percent of the transferred amount—and it is faster, too. Globe is expanding this service to other countries where there are Filipino workers, such as the United Arab Emirates.

Part 2

MODELS AND CORPORATE CHOICES

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6

CORPORATE CHOICES

Before a company can enter the inclusive finance market, it must choose the right strategy. It must consider where it is best suited to get involved and how its own comparative advantages best address market needs. This chapter introduces three significant strategic choices companies may face, which we will then explore in greater depth in the chapters that follow.

But first, who is likely to make these strategic choices?

In many cases it will be a corporate champion with the vision and passion to persuade his or her company to consider the BOP market from a fresh perspective and the operational know-how to turn that perspective into action. Every business venture needs an entrepreneurial champion who builds a vision with business sense and emotional significance. This kind of vision will be critical in an inclusive finance venture, where champions may need to do more than the usual share of convincing.

Champions of Inclusive Finance

One such champion is Robert Annibale of Citibank. In 2004, Annibale was an 18-year veteran at Citi, known and respected across the bank for his work in treasury and risk management. His experiences in Africa convinced him of the potential of microfinance.

Annibale did not start from a blank slate, of course. By the time he began thinking about getting involved, Citibank had supported microfinance for years, largely through its foundation, but it had not yet made a business commitment to the sector—nor had many other major international banks.

However, after years of foundation-led support, a number of leaders throughout the bank understood and cared about microfinance. Building on that base, Annibale and a small group of colleagues convinced Citi to create a business unit dedicated to microfinance, which Annibale was appointed to head. The Citi microfinance unit has assisted MFIs from Bangladesh to Mexico to raise funds in capital markets and is conducting wide-ranging experiments in areas including remittances and electronic payments.

At about the same time, Nachiket Mor and Bindu Ananth played a similar role at ICICI Bank, and the microfinance sector in India has never been the same. A Ph.D. economist, Mor was, like Annibale, a veteran respected for his work in treasury and corporate finance when he was given the added charge of the bank's inclusive finance work: a social initiatives team headed by Ananth, a young academic idealist. The internal conditions were fertile for ICICI to support their work, because of Indian government priority sector lending targets and the bank's overall strategy to become India's leading bank in most if not all market segments.

Through pilot experiments (not all successful, but all providing valuable learning), and dialogue with microfinance industry players, Ananth and Mor created new ways of working with MFIs, which allowed ICICI to migrate its support to microfinance beyond a small CSR-type unit and put several hundred million dollars into the sector during the next few years. Innovations coming out of this effort included the ICICI partnership financing model, the Centre for Microfinance at the Institute for Financial Management Research, and FINO (a technology company serving MFIs), among other initiatives.

Annibale and Mor had earned trust and political capital in successful mainstream operations, and they knew how to work the cultural and political systems in their organizations in order to win sponsorship and resources for their projects.

Strategic Questions

Before they set out to rally internal support, would-be corporate champions need good answers to some of the many questions their colleagues are likely to raise. In addition to questions about the market opportunity, which we treated in earlier chapters, colleagues need to be convinced of the company's own relevant capabilities, and they need to see the outlines of a successful strategy. Among the questions a corporate champion may have to answer are these:

1. Do we possess unique knowledge or infrastructure in the market that will give us a competitive advantage?
2. Do we have the infrastructure and technology to reach clients directly? If not, would we build it or would we use someone else's?
3. Is reaching the BOP market compatible with our branding and image?
4. Can the BOP market become part of our long-run client base?
5. Does our internal corporate culture facilitate working with BOP clients?
6. Can our cost structure support working with BOP clients and their small transactions?
7. What will the regulatory environment allow us to do? What will it require us to do?
8. How should we position this work with respect to corporate social responsibility? Will we do this for profit or citizenship or other reasons?
9. Where will the income streams come from? Fee income? Any cross-selling opportunities or increased customer traffic?
10. Will this be profitable or financially sustainable?
11. What are the risks? What are the unknowns?

In short, what are we uniquely positioned to offer and how could we make this a business success?

Mor, Ananth, Annibale, and leaders in each of the 16 businesses profiled in the cases answered these questions and made effective choices, though not without a certain amount of trial and error.

Although there are many strategic decisions to be made, we focus the rest of this chapter on three critical choices that set the direction companies will take: whether to engage the BOP sector as a service deliverer or as a financier, whether and how to employ partnerships, and how to position financial inclusion on the corporate social responsibility spectrum.

Service Delivery vs. Financing

Not all companies are well-equipped to serve low-income clients directly. For some, it makes more sense to finance others who have direct delivery capacity, such as microfinance institutions or retailers.

Financiers

For organizations that lack any other direct contact with low-income clients, and who do not have a deep understanding of the market, becoming a financier may be the easiest—or only—choice. Financing microfinance requires little in the way of new capacities for large commercial and investment banks. They simply do what they already know how to do: finance successful businesses, in this case MFIs. Their main task will be to learn enough about MFIs to conduct due diligence with confidence.

Many large and especially international banks take this path. At ICICI, for example, Mor recognized that his bank's high-end and middle-class branch infrastructure and product suite did not equip it to serve low-income clients. Instead he got to know MFIs across India that operated at the grassroots and needed a financial backer. Mor and Ananth developed the ICICI partnership model, which tweaked the standard strategy of private banks toward microfinance—lending to leading microfinance institutions—but still kept ICICI out of direct service delivery. Under the partnership model, the official lender to the client was ICICI, and MFIs were their service agents. Through this model, ICICI profitably financed inclusion at an unprecedented scale, allowing the leading MFIs in India to grow rapidly. The partnership model had tremendous influence on inclusive finance in India. It orchestrated new terms under which banks and MFIs interacted, until ICICI suspended the model over regulatory issues.

The financing of microfinance is especially appealing for international and investment banks, because they can use their status and deal-structuring creativity to bring microfinance institutions to new kinds of investors. Standard Chartered Bank, for example, has used its presence throughout Africa and Asia to develop a portfolio of $170 million across 13 countries financing 41 MFIs.[1] In many cases Standard Chartered places funds from international investors who need its assistance to convert dollar or euro loans into local currency.

International investors have also been pouring money into microfinance; total international investment increased from $1 billion in 2004 to $5.4 billion in 2008.[2] At first, only socially responsible investors were interested in inclusive finance, and deals were far too small for institutional investors. As more mainstream investors enter, however, they rely heavily on well-known investment banks for quality assurance. This means that investment banks and venture funds have a unique market-making role to play in bridging between worlds.

The strong reputation and international connections of Credit Suisse were surely an important factor in the stunning success of the Compartamos Banco IPO in 2007. Shares of Compartamos Banco, a Mexican MFI previously little known to investors outside Latin America, was sold by Credit Suisse to American and European investors (among others) at the unprecedented share price for a microfinance institution of 13 times book value. Other high-profile deals included the Sequoia Capital India investment in SKS Microfinance and the Deutsche Bank's Microcredit Development Fund.

A decision to finance rather than deliver does not preclude later direct involvement. It may even pave the way. Annibale makes this point with respect to Citibank. His unit's early steps involved investment banking—bond issues for Compartamos Banco in Mexico and Mibanco in Peru, and securitization for BRAC in Bangladesh. After several years of participation at the investment-banking level, Citibank has begun to experiment with direct retail provision, for example, in remittances and payments.

Deliverers

If you really want to contribute to solving the problem of access to quality financial services, there is no substitute for direct engagement. At ACCION we are excited when companies choose to engage in delivery, because on-the-ground delivery capacity remains the fundamental constraint to wider financial inclusion.

Potential champions contemplating direct delivery must combine cost structure, branding, market knowledge, and corporate culture to create a business success. Organizations well-positioned to do direct delivery have access to or ways to develop:

- An extensive net of delivery outlets in low-income neighborhoods
- A popular sector orientation where they see themselves, and customers see them, as friendly to the BOP market, or at least to "adjacent" market segments like small business or middle income consumers
- Ability to process and manage millions of tiny transactions at low cost

If parts of this description sound more like a mass-market retailer than a commercial bank, it should come as no surprise that some of the most successful entrants into inclusive finance, like Banco Azteca in Mexico, come from retail sectors already known to customers.

Latin American banks and retailers are more likely than those in other regions to go into direct service provision, as in the case of Banco Azteca, Banco Bradesco in Brazil, and Banco Pichincha in Ecuador. Their motivations include stiff competition in mainstream markets (such as invasion of their markets by large international banks), demonstrated profitability of microfinance institutions, and the presence in some cases of underutilized branch infrastructure.

The outcomes of direct delivery strategies have varied widely from attempts that never reach many people and are abandoned after a short time, to major successes reaching millions of people—which points to a second set of important corporate choices.

In-House vs. Partnerships

For those bold enough to go into direct delivery, the next major choice becomes whether to go it alone or in partnership with other organizations. Few companies have all the attributes needed for successful entry, so they must decide whether to build the new competencies themselves, acquire them, or partner with others.

In-House

Some organizations decide to build their own capacity, thus capturing the whole revenue stream from the operation and avoiding the difficulties inherent in partnering arrangements. Companies that follow this route generally already have most of the key attributes we mentioned above.

Even for the best suited organizations, entry into inclusive finance cannot be treated simply as new product development. It often requires the creation of new structures. Grupo Elektra, which had an extensive retail structure, client connections, IT capability, and a history of financing consumer purchases, still needed to create Banco Azteca in order to take full advantage of the inclusive finance opportunity. It created the bank in part for regulatory reasons, but also to ensure focus in the new operation. Banco

Pichincha of Ecuador created a new brand, Credifé, to market itself directly to BOP clients without affecting its main brand. Sogebank in Haiti created distinct branch infrastructure to accommodate the flood of new clients microlending generated.

Many companies find that the greatest obstacles to increasing involvement in inclusive finance are internal. Their traditional core business units simply have not considered low-income people worthy clients. One solution to this problem is the service company model. Banco Pichincha, the largest Ecuadorian bank; Sogebank, the largest Haitian bank; and Banco Real, the Brazilian arm of an international bank, all opted to use a service company model developed together with ACCION International in which all loan sales, underwriting, and risk management are performed by a legally distinct subsidiary. The service company allows banks to create a workforce with its own corporate values and incentive systems.[3] Bank Rakyat Indonesia, one of the early giants of microfinance, also chose to work through a separate set of outlets, the unit *desas*, though it did not have to create a new legal body to do so.

In contrast to these companies, which provided space for microfinance operations to develop somewhat apart from the main lines of business, a few banks, such as Banco Caja Social of Colombia, pursue microfinance as part of the main structure of the bank. While Banco Caja Social has been successful, we are inclined to think that most institutions will find that greater separation allows for a more effective focus on the BOP clientele.

Partnerships

If an institution lacks a critical competence, a partnership may be the best solution. For example, partnerships can exploit synergies to lower costs, especially at the last mile.

All financial-services customers value convenience, but none more than BOP customers. A microentrepreneur whose banking transactions require a bus fare, a long wait, confusing procedures, and disrespectful treatment by bank staff may avoid the bank altogether. In this market segment, transaction timing and location matters—a lot. But bricks and mortar are expensive, hence the search for cost-effective delivery channels. Most of the partnerships we consider here cover the last mile by taking advantage of specialized delivery channels. There are also partnerships that involve outsourcing of functions such as IT.

Direct providers, such as Banco do Nordeste in Brazil, Bank Rakyat Indonesia, and Banco Pichincha, took advantage of physical branches constructed for other purposes—in the first two cases by government. The existence of these branches brought down fixed costs to a level that produced an attractive business model in each case, without reliance on external partners.

Where this is lacking, providers look around to identify existing networks they can ride on. In Brazil, this search led to the banking correspondent model, described in Chapter 8 and the Banco Bradesco case, which is practiced by many institutions and enshrined in Brazilian regulations. Banco Bradesco partners with Correios do Brasil, the postal system, which has outlets in every small town and village. Post office employees handle payments transactions, accepting deposits and paying withdrawals on behalf of Banco Bradesco, for a fee. The cost structure makes everyone happy, but success depends on well-structured agreements and careful training and monitoring of banking agents. The banking correspondent concept appeals to bank regulators who want to support financial inclusion. It spread rapidly across Latin America and has been adapted in India.

Corporations have found microfinance institutions to be especially important partners, because they know the clients so well and already have successful relationships with them. MFIs may also be more willing to experiment in the interests of their clients than are profit-oriented companies. For example, when Vodafone developed its first mobile phone banking pilot in Kenya, it partnered with the MFI Faulu Kenya to work with Faulu's client base. Faulu was prepared to enter into the M-Pesa pilot project even though immediate profitability was not assured.

American International Group (AIG), one of the first entrants into microinsurance, used MFIs as an entry strategy. It launched its first products through what it called the partner-agent model for life insurance in Uganda. The partner-agent model allowed AIG to reach the whole client base of an MFI at once. MFIs entered such a partnership eagerly because they saw how financially devastating death in the family could be for clients in a country reeling from the AIDS crisis. Other major insurers, such as Zurich, Swiss Re, and Munich Re, have established lines of microinsurance activities, working with a variety of partners.

Partnerships can involve an even broader range of institutions. In another example, ANZ Bank partners with the United Nations Development Program in Fiji. UNDP offers financial education programs that prepare client communities to use the banking services ANZ offers.

In structuring such partnerships, it is essential to ensure that solid business principles prevail and that no line of a company's business will depend on an ongoing subsidy for its success, though start-up subsidies often help reduce the risk of experimentation. Long-run subsidy dependence usually dooms projects to small scale—or ultimate failure. This issue is closely connected to the last element of corporate choice we consider here: social responsibility positioning.

Social Responsibility Positioning

When thinking about inclusive finance, companies are advised to be clear about where they place themselves on the spectrum of corporate social responsibility (CSR). Will they approach financial inclusion on purely commercial terms, or at the other extreme—as a philanthropic activity? Will they pursue a double bottom line, and, if so, how? Can attention to social value enhance financial value?

Some players see their involvement in inclusive finance strictly as corporate social responsibility. An international bank's head of microfinance, quoted in *Euromoney*, commented, "Anyone who tells you that they're in this for business reasons alone is lying to you … We have a trillion-dollar balance sheet. Do you think this really matters for our bottom line? You couldn't do three big deals with all the money in microfinance."[4] Zach Fuchs, the *Euromoney* reporter who interviewed this person, found him to be an outlier. He observed that the corporate leaders he spoke with were shifting their outlook from charity toward investment.

ACCION believes that for-profit businesses can and should incorporate social goals. Moreover, the transfer of social objectives from CSR to mainstream strategy is one of the harbingers of success for inclusive finance. Projects viewed through the CSR lens and handled by CSR departments tend to stay limited because they lack the full weight of the company behind them. Scale becomes possible when these projects move into the mainstream arena.

Corporate champions like Nachiket Mor and Bob Annibale may be motivated by their own desire to make a difference to the poor. They may operate from passion and conviction, concepts strongly on the social side of the spectrum. However, they have succeeded by crafting strategies that leverage the core business strengths of their institutions.

The companies cited in this book have motivations ranging from the highly commercial (Banco Azteca) to the highly social (ANZ Bank). Yet all the examples we selected approach inclusive finance in a businesslike manner, using sound business principles. All expect to earn profits.

Companies can find many opportunities to address important social and economic challenges if they seek them creatively. An excellent example comes from the education services of Equity Bank in Kenya, which contribute to the education of hundreds of thousands of students, address one of Kenya's highest social values, and earn Equity Bank both profits and enormous goodwill. Social goals must also include a strong commitment to consumer protection. When financial institutions do not protect consumers, as in the case of the subprime mortgage debacle in the United States, the damage can spread far beyond a single offending bank. It tarnishes the reputation—and the returns—of the entire sector.

Consumer protection is only a minimum standard, however. There is much to gain when companies pursue inclusive finance in a positive way, with client needs at the top of their minds. When they ask, "How can we improve lives through financial services?" this question may help them discover the answer to "How can we build a profitable line of business?"

7

COMMERCIAL BANKS AS MICROLENDERS

Banks can participate in inclusive finance in many ways. In this chapter we focus on one mode, often called bank "downscaling."[1] In downscaling, banks provide working capital credit directly to microentrepreneurs using techniques derived from microfinance institutions.

For a few brave banks that have launched their own microenterprise finance operations, downscaling has already provided rewards in the form of growth, profits, and social value added. ACCION has assisted seven banks to start microlending, first in Latin America and more recently in Africa and Asia. All of the operations more than two years old are consistently profitable, and together they reach more than 450,000 active borrowers. There are numerous other examples carried out by a variety of actors, notably several newly rising banks in Eastern Europe and Central Asia. And the original microfinance bank, Bank Rakyat Indonesia (BRI), although a public-sector bank, implemented what was in many ways the first successful downscaling effort in the mid–1980s, which is still going strong. BRI's microfinance division, with 3.5 million borrowers and 21.2 million savers,[2] has been consistently the most profitable part of BRI.[3]

External factors have often helped convince banks to downscale. Regulatory changes such as financial-sector liberalization and removal of interest-rate caps created conditions that allowed banks to operate profitably in the lower segment. They also created intense competition in the mainstream corporate sector, which pushed some banks toward underserved markets. In addition, banks seek to improve their images by providing services to the poor. Motives such as these have created interest in downscaling, but many banks needed an additional risk-reducing nudge. These banks have taken advantage of research and start-up subsidies from donors and multilateral institutions like the International Finance Corporation and United States Agency for International Development. Such up-front subsidies support initial trial-and-error experimentation and shorten the time to break even.

If commercial banks decide to operate microlending operations, they have several major competitive advantages to draw upon in comparison to specialized microfinance providers:

- **Physical and human infrastructure.** An existing network of branches and service technologies, if located near microfinance clients, can cut the cost of microfinance outlets. And commercial banks bring staff with skills in human resources, customer service, information technology, marketing, and law that can support microfinance operations.
- **Market presence and brand recognition.** Banks in the market for a long time are well-known and have a recognized brand even among lower-income people. Some large banks already have connections to the BOP population through savings accounts or payment services.
- **Access to plentiful and low-cost funds.** Banks can directly access local and international financial markets, and established banks have a broad deposit base. They can raise large amounts of funds that can be loaned quickly and at relatively low cost.
- **Low cost structure.** Banks generally have a much lower operating cost structure than specialized microfinance institutions.

Not all banks possess all these advantages to the same degree, but taken together, these make banks potentially successful competitors in the microfinance market.

Why is it, then, that banks have not moved faster into microenterprise lending?

- **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 management "bandwidth" required to manage a microfinance operation.

- **Credit methodology.** Banks often attempt to serve the market with inappropriate credit methodologies; for example, adaptations of traditional commercial or consumer lending approaches. When these methodologies fail, they reinforce the idea that microfinance is not promising.
- **Trend toward automation.** The banking sector is fast adopting technologies that reduce the number of costly face-to-face transactions. Bankers may see the labor-intensive and personal nature of microenterprise credit as the antithesis of their drive toward more automation and less infrastructure.
- **Conservative corporate culture.** The long tradition of banking is closely tied to specific ways of doing business. With a conservative outlook, banks may tend to burden microfinance with traditional policies and procedures that prevent its success.
- **Human resources.** Microenterprise credit requires a staff comfortable in the neighborhoods where clients live and work, and that must be highly productive. Monetary incentive systems are often used to spark such productivity. These requirements are often incompatible with the human resources profile and policies of commercial banks.

As can be seen, the advantages commercial banks can capitalize on arise from their market position, while most of the obstacles involve the need to change internal ways of thinking and operating. Successful strategies provide a structure that uses the positional advantages of banks while preventing the attitudes and processes of traditional banking from hobbling microfinance.

A close look at the hallmarks of success and failure in bank downscaling illustrates broad lessons for any corporation engaging with BOP markets. It should not be surprising that these lessons are mainly about challenges inside the company.

Incredulity, Ignorance, and Indifference

> I can summarize the reasons banks have not served the poor in three words: incredulity, ignorance, and indifference.
>
> —Michael Chu, Harvard Business School[4]

It is not a unique criticism to say that many people inside banks regard BOP clients with incredulity, ignorance, and indifference. Such attitudes have long been widely held and deeply entrenched, not just among banks, but in almost all formal institutions—in fact they often characterize societal attitudes at large. It is important to acknowledge these attitudes openly because they pose real obstacles that banks must overcome before they can carry off microenterprise lending successfully.

Incredulity that low-income people can be good customers can be addressed with firsthand examples, such as Mibanco in Peru, a microfinance institution that has become a commercial bank. Mibanco's strong profitability and resilience helps explain why banks have entered microlending in Latin America. Ignorance of how to serve the market requires learning from experienced practitioners, such as ACCION, or from staff hired away from competitors. Most important, overcoming indifference requires leadership and well-structured incentives. As we look now at some of the practical challenges involved in launching microfinance operations in a bank, note how the practical solutions also address these "softer" obstacles.

Microlending Needs Its Own Room

The core challenge for banks that want to downscale is that lending to microenterprise clients requires a credit evaluation process fundamentally different from standard banking procedures. The people who operate small income-earning activities lack the handles banks normally rely on—formal identification, business records, credit history, and an easy way to protect against loss. They don't have the salary pay stubs (from respectable formal employers) that underpin most consumer finance. To compensate, microfinance methodologies center on a specific relationship between the loan officer and the client. The replication of this relationship millions of times is one of the key factors making microfinance a significant global force today.

Take Jesse Cabacheco, a loan officer of Mibanco in Peru. He spends each day walking through the markets or knocking on doors to visit his existing clients and meet new ones. He can eyeball a fish seller's business and assess its inventory and turnover while carrying out a friendly conversation with the client. He probes to determine whether a customer is telling a cogent and credible story, and he has developed a sixth sense about the client's willingness to repay. He can do this in part because he grew up in a neighborhood very similar to the one he works in now.

Mibanco has trained him to turn his street-based observations into a cash flow and ratio analysis of microenterprise creditworthiness that will result in solid lending decisions. Cabacheco is responsible for all aspects of the clients in his portfolio, from first promotion through collections and renewal. Only if the client is very late in repaying will another staff member step in.

Microlending operations are structured around making this relationship work. Cabacheco's take-home pay depends on how energetically he develops new clients and retains existing clients, and on the quality of the resulting loan portfolio. He was recruited for his rapport with microentrepreneurs, willingness to spend his days outdoors, and ability to think with numbers. In most consumer finance, by contrast, the credit process follows an assembly line of discrete steps, each carried out by a different specialist—sales, applications, approvals, verification, and collections. The credit factory approach, while efficient, does not work well with microenterprise lending.

The lending methodology differences have many practical dimensions. Information-technology systems support the loan officer's daily routine and allow supervisors to track his performance. Salary scales and incentive systems may be incompatible with mainstream operations. For example, many skilled loan officers in microfinance operations make salaries equivalent to tellers in mainstream branches.

And there are cultural dimensions, too. Loan officers with Cabacheco's profile may not be respected by bank staff who come from higher social levels. Because their clients come from the lowest social stratum, microfinance operations may be treated as second-class within the bank. The result? The bank's IT people are too busy to work on getting the microloan systems right. The human resources department does not know where to recruit the right kind of staff. Senior managers do not regard supporting microlending as the route to career advancement.

It is not hard to see the solution to this challenge, and ACCION's experience has repeatedly borne this out. The solution is to create a distinct organizational space for microlending operations, a space in which it can be supported by the bigger bank, but allowed to differ in the key dimensions that make it work. Microlending needs room to be itself.

Models of Downscaling

Banks can create the space for microlending through a variety of structures, ranging from internal divisions to separate financial subsidiaries. The choice of structure depends in part on the operational and cultural considerations just described, but is often dictated by factors like regulatory environment, involvement of other investors, risk appetite, image/branding, and infrastructure.

The most frequent model of bank downscaling, although not always the most successful, is internal. In this model, a bank establishes a division of microfinance within its normal operations. Banco Wiese Sudameris (BWS) of Peru (now Scotiabank Peru) pursued several strategies to engage with the low-income market before settling on its current path. First, it began financing small microfinance nongovernmental organizations, and then it made a brief, unsuccessful foray into microenterprise and agricultural credit on its own. In 1997, BWS became a minority shareholder in the microfinance bank Mibanco, which allowed it an inside look at microfinance operations.

Next, after some piloting, the bank decided to enter the retail microfinance market permanently, establishing a microfinance window within its retail operations. Managers decided not to develop microlending using the special techniques described above and instead treated microloans as a standard part of branch operations. For one thing, the bank did not send loan officers into the field to attract borrowers. Consequently, its microlending portfolio was limited to walk-ins. Since its branches were located in higher-income neighborhoods, these clients tended to be at the surface of the BOP market. Microlending was merged into normal retail branch operations (the bank has a strong consumer line of business), which lowered cost.

BWS's microfinance lending broke even within six months,[5] and, on a moderate scale, the bank quickly developed a profitable portfolio—of $40 million in 2005—which has grown since then at a modest rate. This model has worked well for a bank that chose a no-fuss approach to microlending, but it has not allowed the bank to go significantly deeper or to capture a significant share of the BOP market.

Service Company Models

Banco Pichincha of Ecuador and Sogebank of Haiti established service companies to give microlending its own space. The service companies are, in effect, proprietary microfinance institutions with a dedicated staff of loan officers who conduct operations on behalf of their parent banks. They do not own their own portfolios and are therefore not regulated as financial institutions. Instead, they receive fee income from the parent bank for identifying clients, marketing products, appraising applications, and disbursing and recovering loans. The loans stay on the banks' books. Service companies are easy to set up, since they require little capital of their own and no financial institution license. Where the regulatory framework allows, they are a good way to go.

Banco Pichincha, Ecuador's largest bank with 1.7 million customers, leads the financial system with nearly a third of all deposits and a quarter of total credit portfolio. In the late 1990s, Banco Pichincha found itself with excess liquidity and a network of 235 branches, many of them underutilized and unprofitable, due to a deep economic crisis in Ecuador. The bank and ACCION launched Credifé in 1999 as the first microlending service company experiment. Pichincha established Credifé (which means "trust credit") with a distinct brand to approach the microentrepreneur market without diluting its mainstream brand name. The Credifé window is inside Pichincha branches, but the segmentation of the market is clear, and Credifé creates its own brand presence in ways that work for microenterprise clients.

Credifé is now a top competitor in the microfinance market in Ecuador, offering a range of products for the informal sector including working capital, fixed asset, and personal loans. In December 2007, Credifé measured its success by its $184 million portfolio, more than 80,000 active loans averaging around $2,300, and a portfolio at risk rate of 1 percent.[6] By sharing infrastructure with Banco Pichincha, Credifé lowered its start-up costs, allowing it to break even in less than two years. The service company has had very high returns on equity, and, more important, contributes a disproportionate share to Banco Pichincha's total profits. It represents a more serious attempt to penetrate the BOP market than does the BWS example. The attempt has yielded higher portfolio volume, more profits, and deeper reach, though as loan sizes suggest, Credifé serves mainly the upper and middle BOP tiers and leaves the lower tiers for others.

Sogebank in Haiti formed a similar microfinance entity in 2000—Sogesol—motivated by financial-sector liberalization and the offer of technical assistance financed by the Inter-American Development Bank. With its own board of directors and staff, the service company Sogesol shares interest-rate margins with its parent bank. As with other service company models, Sogesol benefited from Sogebank's infrastructure, expertise, and systems.

At year end of 2007, despite exposure to Haiti's continuing political, economic, and weather catastrophies, Sogesol had nearly 12,000 borrowers with loans averaging $1,000, a portfolio at risk ratio of 6.8 percent, and an ROE of 47 percent.[7]

Financial Subsidiaries

A third model is for banks to open a financial subsidiary. Ecobank, a regional banking group in West Africa, is doing just this in several countries, beginning in Ghana. Operationally, a financial subsidiary and a service company can be quite similar, so the choice between these models is dictated mainly by legal and regulatory issues. In Ghana, a savings and loan institution was a known quantity, acceptable to the central bank, while a service company was not. For this reason Ecobank Ghana decided to create a savings and loan, EB-ACCION, in which it is the controlling investor together with ACCION. The subsidiary leans heavily on Ecobank operations for support. As different from a service company, this choice required a substantial up-front application of equity to the new institution in order to meet minimum capital requirements.

Lessons from Downscaling

Enough experience exists regarding banks and microenterprise lending that no bank needs to make major mistakes in plotting its entry. The pioneering banks such as those mentioned above have shown the best paths and where the pitfalls lie. What follows are some of the lessons:

- **Choose the right bank.** Not all banks are equally prepared to launch microfinance services. The right bank will have a strategic vision to become a major retail—not corporate—bank. Important features include a network of branches in the relevant markets and a range of products already reaching down to the consumer level, such as savings, consumer lending, and payment services. These features reduce start-up costs for microfinance operations and result in lower long-run operating costs, distributed among a portfolio of services.
- **Find an internal "champion."** The chances of successfully creating and maintaining a microfinance operation are greatly increased with the personal support of an influential member of the bank's

management team. This person can serve as a liaison between the bank and the microenterprise operation, and can help define the roles of each.

- **Allocate tasks to the most qualified entity.** Banks should do what they do best, including treasury, accounting, and legal functions. The microfinance unit should focus on its own comparative strengths, such as credit methodology and branch operations. Some areas will require intensive coordination, particularly human resources and information systems.
- **Anticipate internal problems.** One of the most common difficulties involves internal competition, as service companies must compete for services with other subsidiaries or divisions of the bank. For example, congestion at branches can result in poor customer service for microfinance clients. More generally, an internal negative perception can mean that the service company does not receive priority attention when it experiences problems.
- **Create effective agreements.** In structuring a service company or subsidiary to carry out microlending, it is essential to allocate risk, return, and responsibility carefully to create incentives that work for the parent bank and give the microlending operation a good chance to succeed. Clear agreements address funding sources and costs, fees—especially for clients' use of the bank for transaction processing—and credit risk sharing, particularly the method of calculating provisions and how potential losses will be distributed.

The First Credit Cards

Bank experimentation with microfinance is still in its early days. It is instructive to remember that in the 1960s, when a relatively small regional bank introduced credit cards, its first experience with this new technology was not very successful. During its first years, the product was not profitable. However, continuous experimentation and innovation with the cards led Bank of America to become one of the major players in the banking industry, and led the credit card industry to explosive growth. This example gives me confidence that modest beginnings such as we see now with bank downscaling will eventually take off, making lending to low-income people a standard part of the banking landscape.

8

PARTNERS AT THE LAST MILE: RETAILERS, BANKING AGENTS, AND INSURANCE COMPANIES

Convenience is an important word in banking, and nowhere is convenience more important than in the BOP market. There are extreme cases, like the Ugandan coffee farmers mentioned in Chapter 3 who put their lives at risk on the long road between the bank and their village, or South Asian women whose customs discourage them from leaving their homes. But many people face more mundane problems. The cost of bus fare eats into the amount of money a shop owner wishes to deposit. A morning spent traveling to a bank and waiting in line means a morning when the shop is not operating and income is forgone. Low-income people need banking services near the places they live, work, or shop, accessible at times that fit their daily schedules.

The challenge of providing convenience is that conventional bank branches are too expensive to put in every low-income neighborhood and village. The volume of business at such branches does not justify the up-front investment or perhaps even the running costs. As a result, the cost of the last mile or meter has long been one of the great barriers to financial inclusion. In recent years, new models have begun to claim victory over these barriers. Banks develop branchless banking. Retailers and telecom companies decide to become banks themselves or carry out payment transactions.

In the search for ways to meet clients where they are and when they wish, it helps to ask a simple and perhaps obvious question. Who already owns the last mile? Among the answers are post offices, supermarkets, corner groceries, pharmacies, lottery ticket sellers, and gas stations. Such businesses either have a dense network of outlets or are places low-income people already frequent for everyday necessities.

Successful examples already exist, from the past or from other countries. For decades, post office savings banks were the only formal banking outlets in villages and hamlets across much of Africa and Asia. And in the developed world, supermarkets have long partnered with banks as ATM locations and checkout counter cash dispensers. The challenge is to adapt such models to serve BOP clients in developing countries where institutional infrastructure is still lagging. If banks piggyback on the investment in location and customer relationships these businesses have already made, they can reduce last-mile costs to a manageable level. CGAP analysts argue that branchless banking models reduce costs to serve customers by at least 50 percent.[1] If they're right, an entire market segment, previously too costly to serve, will soon become viable customers, among them millions of people in rural areas.

Banking Correspondents in Brazil

Modern bank-retail partnerships require supportive banking regulations. Regulators' intense concern with the integrity of security and payment systems makes them leery of arrangements that extend banking relationships onto what they may see as thin ice in terms of both physical infrastructure and the involvement of nonbank third parties (whom regulators do not oversee). But this is changing. In country after country, regulators are opening up to new technologies and institutional arrangements that assuage some of their concerns.

The Brazilian banking authorities were among the first to recognize the potential of moving banking transactions beyond bank branches. Their 2001 regulatory innovation—the banking correspondent model—has quickly and radically transformed access to financial services in Brazil and is being taken up across Latin America and even in India. Brazil's banking correspondent regulation allows banks to create agreements with retailers to act as their agents. Any enterprise can act as an agent to one or several banks and provide basic banking services such as opening accounts, taking deposits, making withdrawals, and paying bills.

After the banking correspondent regulations, access to basic financial services in Brazil leapt 89 percent in just six years. Ordinary Brazilians, from small jungle towns to São Paulo's crowded *favellas*, are transacting through 95,000 agents, including supermarkets, lottery kiosks, pharmacies, and post offices. The Central Bank estimates that the majority of banking transactions are now conducted through banking agents. At least 13 million new savings accounts have been opened.[2]

The new channels provide a triple win: for retailer, bank, and customer. Retailers gain not only commissions for each transaction, but also increased foot traffic and sales—30 percent more in Brazil.[3] They also benefit from the brand differentiation that partnership with a well-known bank can offer. Financial institutions gain access to a new customer base that brings additional revenue streams without enormous capital investment. According to the banking authorities of Peru, which introduced the banking correspondent model in 2005, a bank branch costs roughly $200,000 to set up, while an agent costs just $5,000. In Pakistan, the estimate is that an agent would cost $1,400 to establish, while a bank branch costs over $40,000. In Peru, the cost of a transaction at an agent ($0.32) is far below the cost of the same transaction at a branch ($0.85).[4] And clients gain the convenience they need, plus the comfort of dealing with retailers they already know and trust.

The banking correspondent regulations of Brazil are being copied throughout Latin America (including Colombia, Mexico, and Peru) and farther afield (Kenya, India, South Africa), with adaptation to local circumstances. Not all adaptations are fully successful, however. India's banking correspondent regulations allow only nonprofit MFIs and post offices to become banking agents, which closes off the possibility of alliances between banks and retailers even as it discourages nonprofit MFIs from becoming regulated institutions. The regulations require agents to locate 10 kilometers or more away from branches, which prevents the model from being used in urban areas.

Models of Bank-Retailer Relationships

All bank-retailer models take advantage of existing points of client contact. They reduce branching costs by avoiding the expense of building and operating these points of contact. Not all models look alike, however. Different structures facilitate tailoring of risk, return, and responsibility in ways that create incentives for good customer service, growth, and shared profitability. A workable model will involve sound solutions to these four key challenges:

- Information flow (among the bank, retailer, transaction point, and customer)
- Cash management and operational risk control
- Employee and agent training and incentives
- Image and branding

The complexity of partnerships grows with the array of services offered, from relatively simple payments transactions, to savings accounts, to loans and insurance. We examine three main models:

- **In-store banking.** The financial institution places its own employees on the premises of a retailer. Example: many banks rent space on the premises of large retailers and supermarkets.
- **Banking correspondents.** The financial institution offers services through a retailer; customers interact with the retailer's employee. Example: Banco Bradesco works with the Brazilian postal network.
- **Retailers become bankers.** The retailer leverages its physical space and employees to offer its own financial services. Example: Grupo Elektra of Mexico founded its own bank, Banco Azteca.

In-Store Banking

In this case, the financial institution typically occupies a small area inside the retail store, equipped with a communications device to link to the mother bank and staffed by a bank employee. There is little relationship between the bank and the retailer, as each party carries out business as usual. In Bolivia, for example, BCP, a large Peruvian bank, has set up small kiosks on the premises of various large retailers, usually supermarkets, to offer basic account services.

A financial institution may or may not pay retailers to occupy the space. In Uruguay, banks do not pay, claiming that the retailers benefit from the bank's presence in the form of greater customer traffic, but in other countries—especially countries like Bolivia, where only exclusive (one bank, one retailer) arrangements are permitted—the retailer has more negotiating power, and the bank does, in fact, pay a commission.

Such partnerships are relatively straightforward. They bring down the physical infrastructure cost of reducing "white space" on the map. However, there are no cost advantages in terms of IT or staffing, since the bank's own staff still processes transactions. The attractiveness of this model depends on the relative cost of opening traditional branches, which is partly determined by the regulatory framework.

Banking Agents

In the banking correspondents or agent model, the financial institution works through the retailer, leveraging the retailer's employees. Customers carry out banking transactions directly with the retailers' employees at the cash register, and a shared information-technology system processes the transactions. Risk to the banking system is minimized because the transactions take place on the agent's bank account until a general settlement at the end of the day. The agent becomes, in effect, a transaction aggregator for its area.[5]

This arrangement requires considerable integration between the two parties. The institutions need to share both information and funds platforms; thus, interfacing technology and data synchronization become important. Liquidity and cash management (such as the transport of cash) can become a challenge, especially if the amount of cash required for banking is much larger than the retailers' ordinary needs. A local convenience store that becomes a bank agent might need to multiply the amount of cash on hand several times. This increases the risk of fraud, robbery, disputes, and delayed or missing transactions. The need for control is one of several reasons that banks may find it best to work with major, well-established retailers that do a high-volume business and can invest in technology.

Moreover, because the financial institution is effectively "outsourcing" customer interaction to the retailer, the human resources challenges are greater. Customer service is in the hands of retail agents, who may or may not adequately represent the bank's interests. Agent employees could be rude or simply uninformed. They need training on products, processes, and customer service. There are also risks that retailers will not have the right image or will give low priority to supporting financial services as a line of business. In some countries, notably Brazil, regulation prohibits the financial institution from prominently displaying its brand when using agents, which may reduce the incentive of banks to work with agents.

One of the big questions about banking agents is whether banks will use them to reach new BOP customers or merely to cut costs for existing customers. It is of course much easier to shift the transaction location for existing customers, as has HSBC in Brazil.[6] Reaching new market segments requires marketing and product adjustments in addition to the work required to create the new channel. For BOP clients, financial education on anything from how to manage a savings account to protecting PIN numbers may need to accompany marketing and sales.

Banco Bradesco, one of Brazil's largest banks, has made important strides in reaching new markets. It won a government tender in 2002 to offer services through the Brazilian postal system. Within a few years its Banco Postal division had a presence in more than 5,900 post offices and amassed 5.5 million new clients, representing a third of Bradesco's client base.[7] Nearly 75 percent of these new customers earn less than $200 per month, putting them in the BOP category. The model has been especially important for geographic penetration. Before the regulations authorizing banking agents, 1,659 municipalities in Brazil had no banking services.[8] Today that number is zero.

A second big question is whether customers will use agents for a full range of banking services. In Brazil, the vast majority of transactions are for paying bills or receiving government benefits. For BOP customers new to banking, behavior change may be slow but steady.

Finally, the question remains whether Brazil's dramatic success with this model will spread. After Brazil's nearly 100,000 agents, South Africa, with only 5,000 agents, has the next largest banking agent network, followed by Kenya, with fewer than 3,000.[9] Rapid growth of agents in Peru, with 2,300 after less than two years, suggests that serious growth may be just around the corner.

Retailers Become Bankers

The third bank-retail model involves large chain retailers who obtain a banking license and offer financial services through their own outlets, as many major retailers have long done, from Sears to Wal-Mart to Tesco. These models may begin with the offer of store credit, often with a bank partner in the background. After all, American department stores developed the forerunners of credit cards as far back as the 1920s—stamped metal squares, known as charge plates, that bore customer identification.[10] But when retailers decide to move into products such as personal loans, microenterprise credit, bill payments, insurance, and savings, they need to launch their own financial institutions.

Mexico, in particular, has seen retailers founding banks, including Coppel, Grupo Famsa, Grupo Chedraui, and most recently Wal-Mart Mexico. This rapid entry follows the unprecedented success of Banco Azteca, created by appliance retailer Elektra in 2002. Banco Azteca offers deposits and loans through over 1,500 agents in Elektra stores. Banco Azteca boasts 8.1 million savings accounts, 8.3 million loans, and 11 million insurance policies.[11]

The beauty of the Azteca model is that it internalizes the complex relationships described above—information technology, human resources, branding, control—inside a single enterprise, which then reaps profits wherever they occur in the chain. This route is only open to major retail chains, however, and it requires the development of many new corporate capabilities in the banking arena.

Variations

Companies find many successful variations on these basic models. For example, the models can be combined in the same store. Mexico's Chedraui Group of hypermarkets services Compartamos Banco's microloan clients by accepting loan repayments in its checkout lines, right next to kiosks where Chedraui's own Banco Facil offers banking services.

In other cases the retailer in question is not in a fixed location. FinComún, a microlending company in Mexico, partnered with BIMBO, a major bread distributor, to offer financial services to some of the 450,000 small store operators who sell BIMBO products. BIMBO equipped its truck drivers with point-of-sale (POS) devices to record loan disbursement and repayment transactions on their regular bread deliveries. Because BIMBO has a stake in the success of the small grocers, it is willing to do more than just process transactions. BIMBO actively markets the loan product and preselects clients before a FinComún loan officer approves the loan.

Overcoming the Core Challenges

Given the triple win nature of the banking agent proposition, there is an enormous opportunity not only for financial institutions and retailers, but also for auxiliary businesses such as POS suppliers, technology designers, agent managers, or market research firms to assist in design, implementation, and ongoing support, provided key challenges are addressed.

Technology. Specialized technology is needed to equip banking agents: computer, printer, scanner, POS devices, and communication devices such as a fax or modem. For models in which the financial institution's and retailer's systems need to communicate, selecting the right technology interface and ensuring quality data synchronization are perhaps the trickiest issues to resolve. The latter, in particular, usually hinges on a robust core banking platform that may not always be present, particularly in smaller scale financial institutions.

Marketing. It is still unclear what type of clients will prefer using banking agents and how they feel about interacting with a retailer rather than a banker. Will they trust the retailer with their banking transactions? Financial literacy programs devoted to building trust and informing clients on safe use of credit and debit cards may help. Market research and segmentation are needed so that both the financial institution and retailers can make informed decisions about where to open banking agents (versus branches or ATMs) and what products to offer.

Branding is a concern, particularly when the financial institution leverages the retailer's employees. Lemon Bank, a completely branchless bank that offers mainly bill payments in Brazil through a network of over 6,500 locations, has low brand recognition, owing to the restrictions placed by the regulators on brand prominence when using agents. This may limit higher margin cross-sell opportunities for Lemon Bank in credit and especially savings, where brand confidence is essential.

Agent Network. Managing a network of retail agents is a significant undertaking for any financial institution, whether the agents are employees of a single chain or a series of small, independently owned stores. Agents, who may see provision of banking services as their second or even third priority, must provide adequate customer service, and problem-resolution mechanisms must provide back-up support. Training manuals and incentive programs for agents are essential, as are customer satisfaction metrics. Financial institutions also need to provide their own direct link to customers, preferably through a call center, to handle questions, disputes, or complaints.

In response to the complexity of developing and managing many agents, network agent managers have emerged. These managers simplify the task for banks, but reduce its revenue stream. Network managers identify agents, supply them with the necessary equipment and training, and "own" the relationship with them. Most of these are in Brazil, such as Netcash and Pague Facil, though they are starting to emerge in other countries, too.

Insurance Companies Face the Channels Challenge

Finding cost-effective distribution channels is also at the heart of insurance for the BOP market. Insurers look for aggregations where groups of clients can be insured at once, especially in the BOP market where premiums must be small. They turn to churches, labor unions, schools, and employers—any form of association with a stable, predictable membership. One of the most-used channels involves sales through the existing customer relationships of other businesses. The ideal distributor will handle money and process transactions. For this, the distributor must be financially sound and have strong IT systems. The distributors look to insurance to enhance customer loyalty as well as for the commissions it provides. Microfinance institutions have become a favored entry point for insurers trying to reach BOP clients who have few other contacts with large, well-organized institutions.

Direct Sales

The simplest but not necessarily best channel for insurance is direct sales through the insurer's own network. Birla Sun Life Insurance, a joint venture between Canadian insurer Sun Life and Indian insurer Aditya Birla, has been providing term life insurance in rural India since 2001, using a very simple and traditional approach based on direct sales through its branch offices. In order to cut costs so premiums are affordable, Birla stripped down documentation requirements and eliminated medical exclusions. The result is a simple policy with limited payouts; the maximum is about $130, about one-third the per capita income of rural India. It is highly doubtful whether Birla would grow this product if not for regulations requiring it to devote a small percentage of its total business to the poor and disadvantaged.

The Partner-Agent Model

A more cost effective way to bring insurance to low-income people is a piggybacking model. American International Group was among the first to develop this approach, in Uganda. With more than 20 years in Uganda, AIG dominated the mainstream insurance market in the country.

In 1996, FINCA Uganda, one of several large MFIs, asked AIG to create a partnership. Together, the partners designed group life insurance and accident policies that covered clients and their families in case of death, disability, or hospitalization. FINCA loan officers distributed insurance certificates, collected premiums (folded into loan repayments), and helped process claims in the course of their weekly rounds to borrower groups. Because coverage was mandatory for all borrowers, there were no costly individual negotiations or sales, and no problem of adverse selection (in which only the riskiest people choose to buy insurance), which is especially important in a country with a high HIV infection rate. Based on the success of the two-year pilot, AIG refined the product and expanded it to other microfinance institutions and other countries in the region, finding ways to reduce premiums over time.

AIG's ability to rely on a trusted MFI partner was critical to profitable entry into the low-income market. By 2003, microinsurance generated 17 percent of AIG Uganda's overall profits, and MFIs earned significant income by charging small fees for administration. By 2005, AIG's product covered about 1.6 million people through 26 MFIs in Tanzania, Malawi, and Uganda.[12]

AIG's work with FINCA helped create demand, in effect developing a new market. FINCA's clients, most of whom had no experience with insurance, told their friends about the coverage, and over the next several years clients of other MFIs began demanding insurance, too. Eventually, nearly all MFIs in Uganda tied up with insurance companies.

The model AIG created in Uganda is now widely applied by insurers using microfinance institutions as distribution channels. Compartamos Banco in Mexico, for example, is a conduit for Banamex Seguros insurance. In one program twist, Compartamos combines mandatory basic life insurance coverage with voluntary additional coverage available on demand.

The Microagent Model: Barefoot Agents

The next model seeks to get even closer to clients by turning selected clients into insurance agents. Due to the Indian government requirements to issue policies in the low-income market, many insurance companies work with MFIs through a partnership model like the one AIG developed in Uganda. AIG's Indian affiliate, Tata-AIG, attempted to do the same, but some members of its staff were concerned about the problem of continuity of coverage. Since most Indian MFIs offer loans but not savings accounts, the insurance policies were in effect only as long as the customer had a loan outstanding.

Customers who were "resting" from credit received no coverage. The Tata-AIG staff believed that life insurance coverage should be continuous and was not compatible with short-term loans.

Tata-AIG then began experimenting with a "barefoot agent" business model. In a move analogous to using small mom and pop shop owners as banking agents, Tata-AIG trained local women to become salaried representatives, selling and servicing policies to their village neighbors. The product designers found that the barefoot agent model worked best if the representatives grouped themselves into small brokerages they termed "community rural insurance groups." Tata-AIG works with local NGOs to help recruit representatives. This program achieved moderate scale, covering 21,000 rural, low-income, and landless people with term life and endowment insurance.[13] Costs in this model are higher than with the partner-agent model; however, the microagent model may be a good solution in areas without institutions that can become partners.

There are myriad variations of microinsurance distribution models. Seguros Mapfre, a Spanish insurance company, built upon the consumer lending operation of Colombia's electric utility and sells directly through utility bills sent in the mail. Azteca's insurance company works through all Banco Azteca outlets. New microinsurance initiatives in Venezuela (Cruz Salud) and Mexico (Paralife) have recently been created. Cruz Salud reaches some of its clients by placing prepaid cards in retail stores. Clients can buy health coverage the same way a U.S. customer might buy a Starbucks gift card. Opportunity International, a global microfinance organization, has established the Micro Insurance Agency to assist insurers to reach BOP clients. The pace of innovation during the past few years on this front has been dizzying.

9

MODELS OF FINANCING INCLUSIVE FINANCE

If you are not a bank, an insurer, or a retailer, how can you participate in inclusive finance? You can invest in microfinance institutions.

Investing in microfinance has become something of a fashion in recent years, but not long ago it was nearly impossible to interest private investors in MFIs. Until quite recently, almost all investors in microfinance were social or public-sector investors. Now Wall Street actors, both mainstream and specialized, have decided that microfinance is worth taking more seriously. J.P. Morgan, Citigroup, TIAA-CREF, and Standard & Poor's are just a few of the names that appear in the following pages. Landmark deals by mainstream investment firms continued to occur until slowed by the financial market contraction of late 2008. We chronicle many "firsts": the first international securitization of microloans, the first mainstream venture capital investment in a microfinance institution, and the first IPO.

While the financial crisis slowed investment in microfinance, there is confidence that it will pick up again as investors rebound. After comparing the performance of microfinance institutions against small developing country banks, analysts at J.P. Morgan concluded, "MFIs will certainly be affected by the financial crisis ricocheting across the globe, but we believe that the sector is fundamentally sound. . . . Valuations may change, but we believe the long-term outlook for equity investment in microfinance is positive."[1]

The evolution of private investment in microfinance institutions reminds me of the way children learn to swim. Children step into shallow water holding their mothers' hands, feet touching bottom. Then they paddle around with life jackets and practice strokes and breathing. Only after all these steps can they swim freely and unassisted in deep water.

The funny thing about this analogy is that it works both ways. It describes the gingerly advance of investors into the microfinance industry, and it also describes the gradual immersion of MFIs in the capital market. Both headed for the deep water but needed support (often from the public sector) to gain the knowledge and confidence to swim there. These advances were very slow until they accelerated in the early part of this decade. The first deals, in the late 1980s—mainly bank loans to MFIs—were rarely more than $1 or $2 million, and heavily guaranteed.

Today, the top deals are in the hundreds of millions, with far less support. Foreign capital investment in microfinance debt and equity grew rapidly in the years leading up to 2007, where it reached $5.4 billion.[2]

We will look closely at the path from shallows to depth after providing some context on the scope for investment.

Supply and Demand

The growth and commercialization of microfinance opens new opportunities for investors. According to the Microfinance Information Exchange, a microfinance industry information resource, there are over 2,207 MFIs from 100 countries, reaching over 77 million clients.[3] Among some 890 MFIs tracked in the Microfinance Information Exchange (MIX) industry benchmarks series, there are over 60 million borrowers and a combined portfolio of $36 billion.[4]

These numbers were unimaginable 10 years ago. The MIX reports a 23 percent median annual growth of borrowers through 2007. By that year there were 55 MFIs with loan portfolios of $100 million or more, and 74 institutions reaching over 100,000 clients.[5] In some cases microfinance institutions are more profitable than mainstream commercial banks in their countries, and sometimes more stable. If MFIs resume their annual growth rates at 15 to 30 percent, Morgan Stanley calculates that there will be a need for $2.5 to $5.0 billion in portfolio capital each year through the near future, and $300 to $400 million in additional equity to support such lending.[6]

International investors have grown increasingly eager to supply much of this debt and equity. As of 2004, foreign public and private investors had set aside $1 billion for microfinance and had actually committed $680 million of that to MFIs.[7] Most of this investment was quasicommercial, made by development banks (known as international finance institutions, or IFIs) and by socially motivated private investment funds financed by both public and private capital. By 2007, total international investment in microfinance topped $5.4 billion, a dramatic increase in only three years.[8] Much of the increase came from private investors, both institutional and individual. While many of these new investors were attracted by the social impact of microfinance, others sought solely commercial returns.

Among the investors in microfinance are:

- The rich. High-net-worth individuals and private banking clients, many looking to combine social and financial returns.
- Ordinary people. Retail investors accessing such vehicles as Oikocredit, a European fund, and Kiva, an Internet-based social investment vehicle. Most of these investors are strongly socially motivated, and some treat their investments as a charitable activity.
- Institutional investors. Pension funds, insurance companies, and the like, such as TIAA-CREF, are bound by prudential rules that restrict them to top-quality investments. For microfinance, attracting investors like these represents a major threshold crossed.
- Risk-taking investors like hedge funds and venture capitalists.
- Banks with liquidity to place, especially banks with developing-nation operations.
- Sovereign wealth funds, particularly from non-OECD countries, with excess liquidity.

Each of these investor types needs investment vehicles fitted to their special characteristics. At one end of the spectrum, MicroPlace leverages eBay technology to lower the cost of servicing tiny transactions, making it possible to work with $500 investments. At the other end, a venture capital firm like Sequoia has the skills and risk appetite to invest directly in MFI equity, as it did in SKS, a powerhouse MFI in India.

Many of the private investors in microfinance are based in Europe or North America. But local investors matter, too. Although capital markets in developing countries are often shallow, local investors work in the same currency as the MFIs they invest in, avoiding foreign exchange risk that hits MFIs borrowing in hard currency. They understand the market context and have firsthand exposure to the MFIs. For these reasons they are the most suitable investors in the long run, and their importance will rise as the markets in countries like India, Brazil, and Mexico deepen.

One final group of "investors" who fund MFIs is depositors. International investors should be aware of the importance of local depositors as core funders, as well as the importance for low-income people of access to savings services. Some microfinance-industry analysts worry that easy access to investor money will reduce the incentives for MFIs to offer savings services. The Gates Foundation has made savings services the cornerstone of its financial inclusion strategy. Investors have a responsibility to ensure that their funds end up as part of a diversified MFI balance sheet that includes plenty of savings, where permitted.

What Has Changed?

What has changed over the last 10 years to make microfinance "invest-able"?

Some changes have little to do with microfinance, and everything to do with favorable market conditions. Until late 2008, markets were liquid and looking for good places to invest. At the same time, emerging and even some frontier markets were gaining the depth and stability to make them attractive, while new mechanisms made it easier to invest across borders.

The microfinance sector, at least its more advanced portions, was ready to accept this increased interest. The leading MFIs grew to a size sufficient to absorb the amounts investors wanted to place, while at the same time lengthening their track records of stable profitability. More MFIs became regulated, coming under scrutiny by banking authorities that required them to meet prudential norms of capital adequacy and transparency. The quality and availability of information coming from individual MFIs improved.

Today, information on MFIs is much better than it was 10 years ago, which is to say it is more complete, more verifiable (audited or rated), and more in line with the financial indicators used by private-sector investors. The sector as a whole is developing a track record of lower risk than commonly expected, and lower correlation with other asset classes. Finally, as investors enter the market and experiment, the market itself has grown more sophisticated. Instruments are available for investors of different stripes. Exit options, once nearly nonexistent, are starting to emerge.

In the investment world, deals drive change. Each new deal takes markets one step further and enlarges the realm of possibility for other deals. In this section of the book, on models for entering inclusive finance, we organize our discussion around deals featuring different investment instruments. These instruments are for investors what the models of bank downscaling or banking correspondents are for direct lenders—the means to connect to inclusive finance.

Debt Deals

We can regard debt as the investors' entry strategy. Private investors have been far quicker to provide debt to microfinance institutions than to take on equity stakes. Nonprofit MFIs that cannot take deposits depend heavily on debt for lending capital, and deposit-taking microfinance banks need debt for growth, longer-term funding, and liability diversification. A wide range of investors provide debt to MFIs, from ordinary people who fund Kiva and MicroPlace, to high-net-worth individuals, to institutional investors who participate in structured finance. The debt instruments, too, range from the simple (bank loans) to the sophisticated (securitization).

Bank Loans

At the start of microfinance, donors and government supplied nearly all MFI loan capital. When a few MFIs in Latin America began to break even and grow faster than donors could respond, they decided to seek loans from local banks. This turned out to be harder than they expected. In 1985, ACCION International responded by creating the Latin America Bridge Fund to guarantee such loans.

The Bridge Fund is the first go-round in the story of financial deepening that recurs many times as MFIs gradually engage the capital markets. At first, banks were unwilling to bet on the creditworthiness of MFIs without guarantees. The public sector (USAID) provided initial backing for the Bridge Fund, but private socially responsible lenders soon joined. Although most of these private lenders were essentially philanthropic—including foundations making program-related investments and religious orders using their retirement savings to do good—these Bridge Fund lenders were in fact the first private investors willing to bear credit risk in microfinance. Most Bridge Fund–backed loans were in the range of $500,000 to $2 million, and early guarantees covered 90 or 100 percent of capital loaned. Over time, banks reduced the required cover, and eventually most Bridge Fund MFIs graduated from guarantees. These MFIs now access bank loans on their own or have moved to better—larger scale, longer term, and cheaper—sources of finance, such as bonds.

As a measure of how far bank lending to MFIs has come, in 2007, Mibanco, a Peruvian bank specializing in microfinance (and onetime Bridge Fund guarantee recipient), raised money through an oversubscribed syndicated loan organized by Wachovia Bank and the International Finance Corporation (IFC), in which 10 major international banks provided $40 million in medium-term funding.[9] While IFC presence helped give the syndication greater stature, there was no guarantee.

Bonds

In countries with active capital markets, the most appropriate providers of debt for microfinance are local investors. The domestic markets are ideal because they provide local currency, and the investors are familiar with local markets. In many countries, MFI bonds represent an attractive opportunity for local investors who have few options. Nevertheless, local capital markets were very wary of MFI bond issues at first, and so they required credit enhancements like guarantees or overcollateralization. Even with the enhancements, the first bond issues were small and carried a high interest rate. What may be surprising is how quickly the markets accepted the new institution after initial trials.

Prior to its international loan syndication, in 2002, Mibanco issued $5.7 million in two-year bonds backed by a 50 percent guarantee from USAID[10] and then a second bond with a similar guarantee from the Andean Development Corporation (CAF). Building on these experiences, in 2007, Mibanco offered a five-year bond for $10 million with an A rating on the Peruvian scale—and without a guarantee. Despite the lack of a guarantee, the interest rate on this issue fell from the 12 percent Mibanco paid on the first bonds to just over 6 percent.[11]

Financiera Compartamos, the precursor to Compartamos Banco, issued five bonds from 2002 to 2005, placing a total of $68 million with increasingly favorable conditions.[12] All of these bond issues were underpinned by strong ratings (MXA+) from Standard & Poor's and Fitch. In the 2004 offering, Citigroup/Banamex placed $44 million of peso-denominated five-year bonds.[13] Part of the deepening story for Compartamos was a shift in the nature of buyers of the bonds. The initial bonds had been bought by high-net-worth individuals willing to take a risk. It was only after Compartamos had a track record in the market that institutional investors began to participate. It is important to note that both the Compartamos and Mibanco bonds were bought mainly by commercial investors (socially oriented investors being relatively scarce in Latin America).

Bond issues have also taken place in Colombia, with Women's World Banking Colombia in Cali demonstrating that even a well-run NGO can, with proper support and structure, approach the markets. Outside Latin America there have been few MFI bond issues, in part because of less active local bond markets.

So what about more bonds? Local bond issues will probably become more common as mainstream ratings of MFIs bolster investor confidence and successful examples accumulate—provided, of course, that local markets have liquidity to place.

Collateralized Debt and Collateralized Loan Obligations

Collateralized debt obligations (CDOs), and a variation called collateralized loan obligations (CLOs), pool fixed-income assets and loans from a diversified portfolio of microfinance institutions and countries, and enable economies of scale and funding diversification. Dexia, a Franco-Belgian bank, and BlueOrchard, an asset management company, created the first CDO for microfinance, the Dexia Microfinance Fund, in 1998. Investors included retail and private banking clients, institutional investors, and funds of funds. The structure (which in 2007 managed $170 million) featured a commercial rate of return and redemption rights and was backed by a guarantee from the Overseas Private Investment Company. Because of its legal structure, the Dexia Fund can only offer short-term maturities, limiting its attractiveness to both MFIs and investors.[14]

BlueOrchard and Developing World Markets, an emerging markets fund management and consulting company, addressed this shortcoming when they created BlueOrchard Microfinance Securities I (BOMSI), which raised $87 million in two tranches in 2004 and 2005. This CDO financed 14 MFIs in nine emerging markets with seven-year loans at fixed rates.[15] Blue Orchard's next deal, BOLD, in 2006, was a CLO (that is, backed by loan assets as collateral rather than MFIs). It raised $99 million for 21 MFIs in 13 countries and was followed in 2007 by BOLD 2, together with Morgan Stanley, which securitized $110 million in loans with a rating by Standard & Poor's.[16] Behind each such deal is a proud arranger. Ian Callaghan, who led the deal for Morgan Stanley, attributed much of the success of BOLD 2 to the rating. He says it opened doors to a much wider audience of investors.

Asad Mahmood, managing director, Global Social Investment Funds of Deutsche Bank, was equally proud of the Global Commercial Microfinance Consortium he spearheaded in 2005. The consortium included Merrill Lynch, Munich Re, and Axa, along with the international development agencies of the United Kingdom, the United States, and France. Ten of the 14 institutional investors in the consortium had no previous involvement with microfinance. One of the features that structured finance deals such as this make possible is the precise application of credit enhancements only where they are most needed. In this case a DFID grant supported the equity and a partial USAID guarantee supported the first tranche of debt. Investors were stratified according to risk appetite. High-net-worth individuals and development agencies took the riskier equity and subordinated debt tranches. More risk-averse institutional investors held the senior debt tranche, with risk lowered not only by its senior status but also by a 40 percent U.S. government guarantee.[17] The fund raised $81 million, which was almost completely placed within the first year in 40 MFIs in 21 countries.

There are obstacles, to be sure. Investors prefer CDOs in euros or dollars, which puts foreign exchange risk on MFIs, though the Deutsche Bank Consortium was notable in that the MFIs received local currency. The lack of investor-quality data on MFIs hinders arranging CDOs. The biggest issue, however, is perhaps the limited number of large MFIs in the world, with the consequence that many investors are chasing the same ones, leading to an oversupply of financing.

It is unfortunate for microfinance that structured finance instruments like CDOs are perceived as risky in the public mind, in light of the role of mortgage-backed CDOs in the financial-sector crisis of 2008. With the onset of the crisis, the rate of new CDOs to finance microfinance fell to a standstill. CDOs are very good—maybe too good—at bringing investors into sectors that are either riskier or less familiar than blue-chip companies or conforming mortgages. But there is no reason to panic about microfinance CDOs. These obligations are backed by the creditworthiness of individual MFIs, most of which are regulated financial institutions. They lack the speculative element inherent in mortgages that rely on house prices to retain their value. Moreover, they are geographically well-diversified since they include organizations in various countries and regions. Nevertheless, the subprime mortgage experience provides a warning against overconfidence in microfinance (or any) popular investment vehicles.

Securitization of Microfinance Portfolios

Securitization of microloans has been viewed as a kind of holy grail for microfinance. A true securitization accompanied by a secondary market could, some hope, make investing in microcredit a function of end-borrower creditworthiness while at the same time allowing a wider range of investors to participate by creating liquidity for the securities. The quest remains, as quests often do, elusive. There have been a number of steps, but no full-fledged securitization involving all the requisite elements: (a) packaging of loans from multiple originators, (b) securities offered on the basis of the creditworthiness of the underlying assets alone (that is, without credit enhancement), (c) actual transfer of ownership of the original loans to buyers, and (d) resale and trading among investors.

The closest deal to a full securitization is that of BRAC in Bangladesh, the world's largest national NGO with over 6 million active borrowers and assets of $619 million as of 2007.[18] In 2006, MF Analytics, a financial boutique based in Massachusetts, and Citigroup structured a true-sale[19] securitization for BRAC. This deal, as a first of its kind, required enhancements, despite BRAC's 32-year history, strong balance sheet, and expanding market. The issue was 150 percent collateralized. As a result, the paper received a AAA rating from the Moody's affiliated Credit Rating Agency of Bangladesh. BRAC raised $180 million of inexpensive and long-term financing, made available over a term of six years.[20] Another true-sale portfolio securitization, for $60 million, was done for ProCredit Bulgaria, structured by Deutsche Bank and guaranteed by the European Investment Fund and KfW Entwicklungsbank in mid–2006.[21]

For a few years it looked like the ICICI Bank partnership model in India would be a stepping-stone toward securitization. In that model, created in 2002, ICICI directly loaned microfinance clients, using MFIs as loan originators and servicers, similar to mortgage originators in the United States. By transferring ownership of loans directly to ICICI, rather than to the MFI, this model set the stage for the sale of loan assets to other investors. Know-your-customer rules made it difficult for ICICI to continue developing this model, however, and the bank ended it in 2007.

Will securitization ever become standard in microfinance? Challenges remain to tempt financial innovators who want to experiment further using securitization to release capital constraints for MFIs, widen the investor pool, and provide liquidity to investors. The small size, short duration (3 to 36 months), and variable prepayment rates of microloans make them relatively expensive to group. Institutions need to pool thousands of microloans to create a security of minimum size. Variations in lending methodology from one MFI to another make it hard to create assets with a uniform and consistent risk profile. Legal frameworks in many countries need reform in order to perfect the status of the sale and the buyer's claim to the asset.

For all these reasons, most MFI quasi-securitizations, including the CDOs described above, involve pooled loans to MFIs rather than pooling the underlying loans to microentrepreneurs. At the risk of being proved wrong by enterprising financial engineers, we believe there is little reason to expect a major shift toward securitization in microfinance anytime soon.

Equity Investments

Equity investing in microfinance is still mainly for the intrepid investor equipped to take on greater risk and responsibility. Since most MFIs are privately held, many equity investors also take on governance duties. Until recently the potential upside of microfinance equity investment did not justify the added risk and responsibility, unless the investor was seeking social as well as financial returns. Public-sector development banks and nonprofits held most MFI equity. These were the kind of investors who created ProFund, the first equity fund for microfinance, which operated from 1995 to 2005. ProFund closed out with a 6.6 percent internal rate of return, and sponsors were pleased with the result.[22] At the start, few people believed the ProFund concept would work at all.

The IPO of Compartamos Banco in 2007 changed that picture in an instant. The social investors who scraped together $6 million to create Financiera Compartamos in 2000 (a time when private capital for microfinance was nearly nonexistent) earned a compound annual return of 100 percent in the IPO.[23] Word of these high returns attracted many private investors toward microfinance. It is unlikely, however, that the Compartamos IPO returns will be duplicated. Today's investor in microfinance equity should expect an attractive but not excessive return.

The deepening story of microfinance equity begins in the mid–1990s with the public sector and philanthropists who created the first shareholder-owned MFIs, and moves forward to today with mainstream private players including Sequoia Capital, TIAA-CREF, and Credit Suisse. This kind of progression has been made possible by market-creating steps that provide prospective investors with more of what they need—information, confidence, a track record of returns, stability, scale, and liquidity (ease of exit). The result of these advances is that microfinance institutions are now given more credit in the marketplace for their past performance and future growth prospects, causing valuations to rise.

During the decade when ProFund operated, from 1995 to 2005, most sales of microfinance equity were extremely quiet affairs priced at approximately book value. Such valuations represented a deep illiquidity discount because there were so few prospective buyers. Since 2005 there have been more buyers, and multiples increased substantially. Transactions such as the Compartamos and Equity Bank IPOs, with their multiples of several times book value, raised expectations about MFI valuations. Most past private trades of MFI equity have generally occurred between one and two times book value and feature price-earnings ratios between seven and eight. After the IPOs, more MFI valuations were trending up, until the slowdown in 2008. According to J.P. Morgan, even since 2008, valuations for MFIs are somewhat above the multiples associated with emerging market banks, in part "because of the higher resilience of their business to economic shocks."[24]

The progression that has taken place involves the creation of market infrastructure, such as the Microfinance Information Exchange, the development of funds aimed primarily at socially responsible investors, and the involvement of rating agencies.

But as everyone on Wall Street knows, the deals are what matter. We will look at several landmark deals with strong private commercial leadership, each representing a different model of investing.

Private Equity for Microfinance

Most investors new to microfinance equity will find it prudent to work through specialized equity funds set up specifically to invest in MFIs. The association of such funds, the Council of Microfinance Equity Funds, now has 25 members. The total capitalization represented by CMEF is growing fast, not only because new funds are forming, but also because the old funds are launching recapitalizations much larger than their first rounds. And this second generation of fundraising includes increasing numbers of private investors, though mostly still from the socially responsible arena. For example, it took Stefan Harpe of Calmeadow, a Canadian nonprofit, more than three hard years of knocking on doors to raise the first $15 million for Africap, a fund devoted to MFI equity in Africa, and nearly all of that came from the public sector. After making 10 good, solid investments, and one standout success (Equity Bank, Kenya), Africap quickly put together its second round, $50 million, approximately half of it from new private investors.[25]

Bob Patillo, a shopping center developer from Georgia who became interested in microfinance first through philanthropy and later as a social investor, has made it a personal challenge to draw private investors into microfinance. Patillo recognized that private investors needed quicker exit, greater diversity, and the ability to turn fund management over to a specialist. He conceived of a fund of funds that would foster trading of MFI equity. Investors in the fund of funds would be buying a mixed portfolio across the microfinance industry as a whole. Patillo also instigated the launch of the International Association for Microfinance Investors as a focal point for new investors wishing to enter the market via investments into existing funds. IAMFI's members include many familiar names in the mainstream investment world, such as Omidyar, MicroVest, J.P. Morgan, and BlueOrchard.

TIAA-CREF and ProCredit. One of the highest profile deals in microfinance was the investment of TIAA-CREF, a California-based fund manager, in ProCredit Holding, a group of microfinance banks. In 2006, TIAA-CREF ranked eightieth on the Fortune 500 list of largest corporations in America, with more than $380 billion in managed assets. In addition to its core business—managing retirement funds—TIAA-CREF offers individual retirement accounts, mutual funds, life insurance, and socially screened funds. In 2006, TIAA-CREF created the Global Microfinance Investment Program (GMIP), funded with $100 million in assets from its $160 billion fixed annuity account. This account represents some 2.3 million investors. It is significant that assets were pledged from mainstream accounts, rather than from the socially responsible investment account. GMIP is, in effect, mainstreaming social investment into the traditional portfolio.[26]

The GMIP made its first investment of $43 million in the equity of ProCredit Holding, the parent company of 19 small enterprise/microfinance banks in Eastern Europe, Latin America, and Africa. As of March 2006 the ProCredit Group had total assets of approximately $3 billion and more than 600,000 outstanding loans. ProCredit Holding has advantages as a target for mainstream investors over individual MFIs due to its size and geographic diversification. TIAA-CREF's investment in ProCredit responds to the support for social responsibility among many people within the fund manager's customer base. It's also a good investment because of microfinance's low correlation with other asset classes, according to Ed Grzybowski, TIAA-CREF's chief investment officer.[27]

This example illustrates how mainstream investment companies have handled some of the unfamiliarity of investing in microfinance. The IFC still retains a significant minority shareholding in ProCredit, and this boosts mainstream investor confidence, although TIAA-CREF's investment allowed IFC to make a partial exit. The risk to equity was lowered by the Overseas Private Investment Company's guarantee of some of ProCredit's debt, by the currencies involved in the transaction and by diversification across countries. Most important, investors trusted ProCredit's growth, profitability, and stable track record. ProCredit is part of the "cream of the cream" of microfinance; there are few other possibilities that match its scale and quality.

Sequoia and SKS. A few equity investors willing to dedicate their own staff resources have gone directly to individual MFIs without the mediation of an equity fund. In 2007, SKS, a large Indian MFI, received an equity investment by a mainstream venture capitalist, Sequoia Capital India. SKS Microfinance was a fast growing and newly profitable MFI serving nearly 600,000 women at the time of investment. SKS is tapping an immense market in providing not only microloans, but also a range of products including health insurance.

Like many MFIs in India, SKS started life with very little equity and operated with extremely high leverage in its early years. Its growth prospects depended on raising a solid new equity base. SKS's dynamic CEO, Vikram Akula, attracted the venture capitalists of Sequoia Capital to provide the majority stake of an $11.5 million equity investment. SKS's growth rate, product range, potential market, and leadership all made it attractive. Like Google and YouTube, in which Sequoia invested early on, SKS showed enormous growth potential, even though it had only earned profits for one or two years. At the time of investment those profits were quite modest. Getting in at this relatively early stage allowed Sequoia to obtain shares at a low valuation, which gives it good prospects for future returns.

The managing director of Sequoia Capital India, Sumir Chadha, emphasizes that this is a purely profit-motivated investment.[28] For SKS, the backing of a firm like Sequoia will bring expert business-building advice as long as Sequoia is part of its ownership group. Since the investment, SKS has continued to grow rapidly. As of 2008, SKS works in 18 states across India, reaching 3 million women with microcredit and related services.[29] Indian microfinance is attracting other investors, too: in 2007, Legatum Capital, a Dubai-based private equity firm, made a $25 million investment in Share Microfin Ltd., another of India's largest MFIs.[30]

Public Offerings

Equity investing in microfinance becomes much more accessible when MFIs are publicly traded. Only the largest and best-performing MFIs can carry out public offerings, and only in countries with functioning stock markets. Public listings by Equity Bank on the Nairobi Stock Exchange and Bank Rakyat Indonesia on the Jakarta Stock Exchange have enabled local investors to buy shares in these microfinance industry leaders.

The Compartamos IPO in 2007 was the first public listing to address international investors in a big way. This IPO was a watershed for all of us at ACCION, as ACCION was one of the main sellers of shares in the offering. In fact, the original motivation behind the IPO was ACCION's need to realize the gains residing in its Compartamos shareholding so that it could redeploy those funds to new microfinance efforts. The return on investment the original investors received was approximately 100 percent compounded over eight years.[31] In ACCION's case, a $1 million investment was valued at time of sale at roughly $400 million, certainly an unexpected result and one that is highly unlikely to be repeated. The proceeds of the IPO will fuel ACCION's investment for years to come in start-up and emerging MFIs in difficult locations such as parts of West Africa, China, and South Asia.

Before the IPO, Compartamos had already entered the bond markets, as noted above. After extensive preparation, Credit Suisse arranged an IPO, attracting new equity investors to replace 30 percent of the equity of Compartamos's original investors. The total proceeds from this sale were $468 million, with purchases by 5,920 institutional and retail investors from Mexico, the United States, Europe, and South America. The price-to-book-value multiple was 12.8, and the price-to-earnings ratio was 24.2.[32] Compartamos had been previously rated by Standard & Poor's and Fitch Ratings at MXA+. The excellent rating by a mainstream rater and the arranging by a mainstream asset management company contributed to the success of the IPO. Compartamos's two CEOs, Carlos Labarthe and Carlos Danel, known as the two Charlies, impressed potential buyers in scores of one-on-one road show presentations. After the IPO, Compartamos shares rose by another third, to a level that put the MFI's market capitalization at over $2 billion. Share prices have since moved up and down with the market as a whole, falling as the market fell in late 2008, despite continued strong profitability.

With the Compartamos IPO, the interest in public listings for MFIs has jumped. However, for the MFI it is costly and time-consuming. Success requires consummately transparent information, an excellent track record, a bright future, and superior management. External conditions for success include liquid and well-developed financial markets, appropriate regulatory frameworks, a stable currency, and a number of other factors. Very few environments meet all these requirements, and so the number of future MFI IPOs is likely to be low.

Microfinance as a Distinct Asset Class

With all these deals, has microfinance become a distinct asset class?

Talk among industry analysts can become surprisingly heated about this issue. Designating microfinance as a new asset class would signify that it had truly arrived in capital markets, and proponents of this idea want to attract more mainstream investors into the industry. But can microfinance really market its strengths and weaknesses as distinct from other asset classes? And is there enough homogeneity within the microfinance industry? After all, MFIs use widely varying lending methodologies, operate in diverse countries, provide different products, and take many legal and institutional forms.

One of the key issues is whether microfinance is correlated with other asset classes. Studies have shown that microfinance tends to be countercyclical, for the simple reason that the self-employed and informal sector acts as an employer of last resort. The client sector tends to become more active during downturns when the formal sector sheds jobs, or is partially disconnected from the economic cycles that affect formal businesses. As MFIs become more integrated into the mainstream financial system, and as global crises such as high food and energy prices affect people at all income levels, the countercyclical character of microfinance may fade.[33]

Given the paucity of historical and investor-quality data on microfinance, the asset class issue is still being debated. Once microfinance has gained greater liquidity and is well-understood and backed by years of data, perhaps it will make more sense to regard it as an asset class. Meanwhile, investors are cautioned to recognize that microfinance requires a more active learning and investigation process than more conventional investments.

Conclusion

Investors of many kinds have opportunities to invest in microfinance. MFIs continue to increase in size and profitability. Thanks to many of the groundbreaking transactions discussed above, MFIs increasingly understand sophisticated financial debt and equity instruments. There is room for more investment and more actors, and we encourage further partnerships and innovation, with the promise that efforts will not go unrewarded.

Part 3

THE EMERGING INDUSTRY OF INCLUSIVE FINANCE

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10

BUILDING THE INFRASTRUCTURE FOR INCLUSIVE FINANCE: THE ENABLING ENVIRONMENT

Poor financial infrastructure has historically been one of the biggest barriers to inclusive finance in less developed countries. As enabling conditions appear, however, far-reaching initiatives suddenly become feasible and financial institutions start new projects. Within six years after the introduction of regulations allowing retailers to become banking agents in Brazil, the number of Brazilians with bank accounts nearly doubled.[1]

Financial infrastructure means different things to different people. We think of it as the shared building blocks that allow institutions to deliver services. The building blocks include operating platforms such as ATM networks, smart card systems, and financial software. They also include institutional arrangements, such as credit reporting bureaus, clearing and settlement systems, rating agencies, and collateral registries. Many of the most important arrangements are devoted to getting information about clients, transactions, and institutions into the right places at the right times. Other arrangements raise confidence about agreements between people or institutions.

The public and private sectors have distinct roles in building strong financial infrastructure, and the best environments come from a well-functioning partnership between both. While the public sector determines the regulatory framework—the rules of the game—the private sector builds market mechanisms like credit information and technology. In the chapters that follow we will examine portions of this shared infrastructure that are especially important for financial inclusion: credit bureaus, payments systems, and the market infrastructure for investments. In these areas the private sector takes the lead. This chapter departs, however, from the book's otherwise exclusive focus on private opportunities for a brief digression on the role of government.

Financial Sector Liberalization

The good news is that in many countries governments have improved the enabling environment and are still making reforms. When financial sector liberalization swept across the globe during the 1980s and 1990s, the enabling environment for financial inclusion improved dramatically. With liberalization, governments got out of the business of providing services and soaking up financial-sector liquidity to fund themselves. The tenets of liberalization focused instead on creating a competitive marketplace with many different providers. In countries as different as Bolivia (starting in 1985)[2] and India (starting in the late 1990s), financial-sector liberalization triggered the take-off of the microfinance industry because it opened the way for competition. In both countries, liberalization created the incentives for new entrants to come into the financial sector, find their niches, and expand their reach.

In practice, the relationship between government and private sector is not always harmonious, and conflicts create obstacles to reaching previously unserved clients. In some countries liberalization has been politically challenged, and politicians seize on inclusive finance as a political tool. Providers of BOP finance count political interference as one of the biggest risks they face.[3]

What Makes a Good Enabling Environment?

The best environment for inclusive finance starts with the broad conditions that support financial institutions of all kinds. At the most basic level, we start with a business environment that includes investor-friendly policies, contract enforcement, low corruption, and the like. Macroeconomic and political stability are musts. To that foundation are added features especially important for inclusion. A laissez-faire approach may contain hidden barriers to BOP finance.

One macroeconomic factor particularly important for financial inclusion is low inflation. Across all of Latin America in the 1970s and 1980s, inflation was a scourge that kept financial sectors small. Millions of wealthy Latin Americans sent their money to Miami to maintain its value, while poor people stocked up on assets like animals or construction materials. The legacy of high inflation lingers in the belief among many low-income Latin Americans that it is risky to save money in banks. When inflation was finally tamed, financial institutions started reaching out, first to the wealthy, but ultimately (now and in the future) to the lower-income segments of the population.

In Africa, the financial sectors in a number of countries have been shortchanged by the lack of a good basic business foundation, with the least successful countries plagued by political instability, armed conflict, or corruption. In such countries inclusive finance remains small and fragmented, often involving only the NGO and cooperative sectors.

Fortunately, an increasing number of emerging economies, including many in Latin America and Africa, now have the basic market necessities.

The Architecture for Inclusion

Let's assume that a country has mastered the basic economic environment and wants to encourage financial inclusion. What then?

The foundation for inclusive finance rests on the same elements needed for a competitive mainstream financial sector: a competitive market with a level playing field for all qualified entrants. But in several areas of regulation special attention is needed to ensure inclusion. In countries that are getting the following elements right, like Peru, Uganda, and many others, inclusive finance is growing rapidly.

Licensing Rules. Rules to encourage inclusion should be tough enough to ensure that market entrants are qualified and have sufficient financial resources, but not so restrictive that they turn banking into a cabal. Inclusion requires countries to create effective pathways for the entry of qualified smaller institutions like credit unions and microfinance banks that specialize in serving lower-income people. On the other hand, rules should not restrict inclusive finance to the smaller entities; larger banks have a role, too.

Ownership of inclusive finance institutions often involves unusual partnerships with social investors and even NGOs. Regulators need to recognize the important role such unconventional players can provide in an ownership mix.

Market-Determined Interest Rates. Financial institutions need to set their own interest rates if they are to survive, and so the importance of market-determined interest rates can hardly be overstated. Paradoxically, the very interest-rate caps intended to protect the poor have historically confined credit to large borrowers. Under the banner of fairness to the poor, interest-rate caps prevent businesses from charging the generally higher rates needed to make small loans profitable and hence sustainable. In countries with caps, such as Ecuador and Venezuela, new investments in financial inclusion dry up fast, with predictable consequences for the poor.

Strong Regulation and Supervision. Politically independent regulators should be armed with ample supervisory capacity and prudential norms that promote safety and soundness. For financial inclusion, it is especially important that regulators understand the unique characteristics of BOP finance and work closely with its providers to accommodate those characteristics in their norms and procedures.

For example, when regulators in Bolivia first heard about the microfinance group loan guarantees used by their newest bank, BancoSol, they regarded those loans as unsecured, a designation relegating them to a small part of the bank's total portfolio. Pointing out its near-perfect repayment recorded in five years as a microfinance NGO, BancoSol argued that the group guarantee produced outstanding portfolio quality. Regulators agreed to allow BancoSol to operate provisionally with group loans. This was a daring step for regulators. It took banking authorities prepared to work with providers to allow careful experimentation. After a few years of close tracking, Bolivia's bank supervisors recognized the solidarity guarantee in new regulations as a legitimate way to secure loans.

Agreement That Government Is Not a Provider. Government's best role is to create a functioning market, not to provide financial services, particularly credit. When government-run institutions compete with private institutions, it is tempting for governments to favor their banks at the expense of private providers. In Andhra Pradesh, India, for example, state-government shutdown of microfinance institution offices in 2006 was ostensibly justified by inappropriate collections and interest-rate policies at the MFIs. Behind the scenes, however, the action was prompted in part by managers of the state government's microfinance program, who were angry over losing clients to private providers. More generally, India's regulatory environment favors public-sector banks as the preferred providers of inclusive finance, to the detriment of private actors, both mainstream banks and MFIs.

Legal Underpinnings. A legal framework that supports financial system operation will include secured transactions laws and collateral registries, land titling, ID systems, and consumer protection legislation. South Africa, for example, has a regulatory body, the National Credit Regulator, dedicated to protecting consumers from unscrupulous practices. Born in response to abuses in the consumer loan industry, the National Credit Regulator now ensures that responsible providers are supported and preserves the reputation of the sector as a whole.

Access vs. Stability

Is there a trade-off between access and stability in the financial system? Some regulators have acted as if they thought so. Traditionally, the mandate of regulatory authorities has been to preserve stability, a task that appears easier in a financial system with fewer participants.

Inclusive finance requires regulators to pay attention to institutions that serve many people even though monetary amounts may be insignificant. Regulators usually think the other way around, on the theory that the large players determine the health of the financial system as a whole, measured by volume of funds, not people served. Dedication to access with stability requires investment in supervisory capacity so smaller institutions still receive adequate scrutiny. A number of past experiments with opening too wide did not go well because they allowed unqualified players. Too many players entered for supervisors to keep up with. This was the case with rural banks in the Philippines and Ghana, community banks in Nigeria and Tanzania, and consumer finance companies in South Africa, India, and numerous other countries. In most of these cases supervisors have had to backtrack, overhaul small institutions, close weaker ones, tighten regulations, and seek new partners to shore up the survivors.

Openness to Different Means of Risk Management

The informality of BOP clients requires regulators to be flexible in their rules for risk management. Regulators do not generally feel comfortable with informality, however. For example, inclusive finance requires banks to accommodate clients lacking standard documentation, but efforts to move toward flexibility have been stopped cold by the rise of antiterrorism and related concerns.

Since the 2001 attacks on the World Trade Center, regulators have tried to shut down the access of terrorists to the financial system, with stronger Know Your Customer (KYC) and anti-money-laundering rules. These rules have especially affected efforts to facilitate remittance flows, though actual terrorists have probably found ways around them. American KYC rules, devised without reference for the poor of the developed world, nevertheless affect the local behavior of international banks in other countries. For instance, ICICI Bank of India reduced its financing of microfinance in part because those activities did not meet the KYC standards required by U.S. officials. The rules rippled beyond U.S. borders all the way to rural India.

In the United States, anti-immigration sentiments have made banks leery of opening bank accounts for immigrants. Moves to accept ID cards issued by embassies and consulates, such as the Mexican *matricula consular*, are an important step toward reversing this trend. The concern with preventing undocumented financial flows, whether against crime or terrorism, could be harmonized with greater inclusion if there were exemptions in place for small transactions and low balance accounts. That such exemptions are so long in coming says something about the lack of political power of the poor.

If the key banking institutions in a country get more involved with inclusive finance, so will regulators. Typically, the major institutions have bigger concerns and do not want to jeopardize their relationships with regulators over microfinance questions. But when banks come together to advocate change, they have a good chance of being heard.

Regulating for Inclusion: Branchless Banking

Examples from Banco Bradesco and its agents at Brazilian post offices, to the cell phone banking offered by Globe Telecoms, to Visa's card systems, show the potential of technology to make microfinance much more inclusive very quickly. Unfortunately, regulations do not move as quickly. Work is proceeding in different countries at different rates to allow these technologies to reach their full potential.

Traditionally, all banking transactions occurred at bank branches, and only during the "banker's hours" when they were open. At the state banks in India only a decade or so ago, I experienced those banker's hours. I brought a book to read and got in line by the time the bank opened at 10 A.M., knowing that if I was too far back in the queue, I might not be served by the time the bank closed its doors to customers at 1 P.M. Electronics have changed all that, even at sleepy Indian state banks. But branching regulations tend to lag behind the technology frontier. Traditional bank branching regulations required heavy investments in infrastructure to assure physical security, and an assessment of potential business volume in the area, to avoid unsustainable branches. In many countries, approval from banking authorities was required for each new branch established. There were good reasons for these regulations, even though they made opening branches expensive and slow. Ultimately, they were a major factor limiting the penetration of banks into low-income areas.

One must sympathize with the plight of regulators trying to keep up with the pace of transaction innovations. Just as they adjust to the ATM, along comes Internet and cell phone banking. Each new technology potentially poses threats to the integrity of the payments system, and regulators must be confident that they have considered all the possibilities before revising rules. Regulators are especially wary of allowing banking transactions to be handled by third parties with whom they have no relationship. They have also been reluctant to grant banking licenses to retailers wishing to add banking services. In the face of severe opposition from competing banks, U.S. regulators denied Wal-Mart a banking license; Mexican regulators said yes.

The regulators in Brazil who put forth banking agent rules were taking a risk that has turned out very well, but it was a bold step that not all regulators would be willing to take until someone else proved the concept, as Brazil did. Most regulators are genuinely striving to be responsive, and some are trying to lead the way.

Mobile phone banking is particularly challenging because it involves telecommunications and banking, two industries regulated by different organizations. Many of the initiatives by telecommunications companies have proceeded in part because bank regulators have not focused on these companies, and so quasibanking activities have developed outside the banking system. Mobile banking regulations in most countries are still either nonexistent or ambiguous. Central banks understandably have questions. Does a mobile operator need a banking license to "capture" money? Are encryption standards robust enough that transactions will not be intercepted? How will mobile operators meet anti-money-laundering requirements? What are the roles and responsibilities of the agents that provide deposit and withdrawal access points for customers? The Central Bank of the Philippines is one regulator that has answered these questions to create facilitating regulations, and the result is a flourishing mobile banking economy. In most other countries, regulators continue to tread cautiously.

Political Risks

Because it reaches so many people, inclusive finance can be a very attractive political target, and the bigger it gets, the more attractive it becomes. Attention to the political dynamics of inclusive finance is especially important for high-profile corporations getting into the sector.

High-level political support has sometimes given a major boost to inclusive finance. At various times presidents of Mexico, Colombia, and Bolivia each signaled their interest in microfinance, helping to ensure the essential policy changes that created conditions for rapid growth. The results of this kind of attention from responsible politicians can be incentives to encourage bank entry into inclusive finance. Among such efforts, the subsidy auction program in Chile stands out as particularly well-structured. Banks in Chile bid for temporary subsidies to serve low-income clients. The subsidies help the banks move up the early learning curve, and when banks no longer need them, they phase out.

But politicians who embrace inclusive finance often love it to death. Steve Barth, former advisor to the Government Savings Bank of Thailand, and a member of the team for this book, assisted leaders of the Thai government to promote microfinance as a sustainable form of development and a way to give the national economy greater resilience during global business downturns. The microfinance programs were so popular among the rural poor that opposition politicians made accusations linking rural microfinance to vote-buying. Though the intent was initially sincere, microfinance became a political bone of contention.

Some politicians want to score points with the electorate by treating popular finance as a form of largesse, as with Etandikwa, a lending program launched by the administration in Uganda and doled out by local government with little regard for repayment. Such efforts tend to be self-limiting, as they eat up too much budget. They can be harmful, however, if governments favor them to the detriment of private providers.

It is even more damaging when politicians decide to forgive debts, cap interest rates, or otherwise position themselves as champions of the people willing to take on "exploitative" providers. The tug of war between inclusive finance as either a development tool or a political tool is nowhere more apparent than in India. Technocrats in the central bank and finance ministry are stymied in their reform efforts by politicians favoring measures like interest-rate caps and debt amnesties. Techniques like these are also used by the populist leaders in Latin America, including Chavez of Venezuela, Morales of Bolivia, and Ortega of Nicaragua. In response to populist proposals for interest-rate caps, bankers and leaders of microfinance institutions in these countries have come together to talk with governments. And fortunately, although political interference in microfinance can make life harder for providers, in most cases so far reason has prevailed and workable accommodations have been reached.

11

CREDIT BUREAUS AND CREDIT SCORING

Internet surfers and late night television viewers in the United States are bombarded with offers of free credit reports and advised to know their credit scores (I confess to not knowing mine). While the advertisements may be a nuisance, consumers in developed countries understand that their credit histories, as revealed in their credit scores, determine not only whether they will qualify for loans but also how much they will pay for them. Without a credit score, or with a poor one, middle-class American lifestyles are nearly impossible.

Cut to the owner of a small but fast-growing shop on the outskirts of Dar es Salaam, Tanzania. With no recognized identification card in a country where people often bear the same names, he cannot establish his unique identity. If he has borrowed from a microfinance institution like Pride Tanzania, his good repayment record will do him no good at Standard Chartered Bank, since there is no system for sharing information between banks and MFIs. The end result? In all likelihood, Standard Chartered will turn him down, and Pride Tanzania will know that he is a captive client, which reduces its incentives to give him better service at lower cost.

Today's web of credit information in the United States originated a century ago in blacklists of bad customers compiled and shared by merchants. Formal credit bureaus grew after World War I, taking on broader geographic ranges due to the increased mobility of the population. Banks joined in to support their growing personal, small business, and mortgage lending businesses.[1] Although these systems took more than a generation to evolve, their spread to new countries is proceeding much faster.

The Value of Credit Bureaus for the BOP Market

Credit bureaus are widely recognized as contributing to credit growth in the financial system, lower costs for good borrowers, and a wider circle of borrowers reached. An International Finance Company (IFC) survey, based on 5,000 firms in 51 countries, found that in countries with credit bureaus there was a 40 percent probability of small firms obtaining a loan, versus a 28 percent probability in countries without credit bureaus. In countries with credit bureaus, 27 percent of small firms reported having credit constraints, versus 49 percent of small firms in countries without credit bureaus.[2]

Credit bureaus respond to two of the four challenges of BOP finance that we met in Chapter 3: reducing costs and managing risk. Since microfinance institutions worked in the absence of credit bureaus, they developed different ways to meet these challenges. Many of the distinguishing innovations of microfinance lending methodologies were created to assess or motivate good repayment behavior by informal-sector clients in places without credit bureaus. These features include group guarantees, stepped loans (moving from small to larger loans through good repayment performance), nontraditional collateral, and individual working capital credit assessments. Although these methods are effective, they come with hefty administrative costs that require high interest rates. In contrast, credit decisions in the developed countries can be made nearly instantaneously for a small fee through automated consultations with credit bureaus. For this reason, credit bureau development could be a potential boon for microfinance institutions and a facilitator of greater competition in the BOP market.

The problem of low credit bureau coverage is not confined to developing economies, because even in advanced economies credit bureaus do not include everyone. In the United States, many low-income people, especially youth and recent immigrants, lack credit histories and are closed out of the mainstream system. People who have suffered problem periods need to rebuild their credit scores. The most popular product of ACCION's U.S. arm is its Credit Builder loan, a small stepped loan of $500 to $750 aimed at helping clients develop a positive credit history. Another initiative, the alternative credit bureau MicroBilt, is developing credit scores weighted toward the kinds of payments low-income people do make—like rent and utilities payments—rather than on bank loan experience.

Making Credit Bureaus Viable: Challenges and Responses

Credit bureau development has progressed to different stages in different countries, and it is also changing fast. Policy makers increasingly recognize the potential benefits for inclusive finance that credit bureaus can bring. In particular, the International Finance Corporation has invested in credit bureau development around the world. Because of the close coordination needed among stakeholders, including government and banking authorities, credit bureaus can take five years or more to set up.[3] Meanwhile, credit bureaus in many emerging markets track information for mainstream banking and business clients, while leaving out the vast majority of low-income clients.

Credit bureaus are advancing fastest in Eastern Europe and Central Asia, followed closely by the Middle East and Africa.[4] Increases in retail credit and advances in information technologies have spurred credit bureau growth in these markets. According to the World Bank's report, *Doing Business in 2006*, approximately 67 countries had a private credit bureau operating at the end of 2005. Among developing countries, the Latin America and the Caribbean region is the most advanced: 16 out of 22 countries had a private credit bureau, and 31 percent of the adult population is covered, which is to say has credit history documented by the credit bureau (Table 11.1).

Many steps lie between the rudimentary information sharing that now takes place in the least developed countries and a full-blown credit bureau system that covers all relevant clients and provides credit scores. We discuss some of the most important building blocks, from the very basic issue of identity verification to the complex issue of building national credit scores.

OECD Countries	58
Latin America and the Caribbean	31
East Asia and Pacific	11
Eastern Europe and Central Asia	18
Sub-Saharan Africa	5
Middle East and North Africa	10
South Asia	3

Table 11.1 **Average Private Credit Bureau Coverage (percent of adult population)**

Source: "Doing Business in 2006," World Bank.

Identifying Clients—Uniquely

Credit reference requires unique identity verification, and if a national identification system is lacking, there are few good alternatives. Tanzania and India are only two of many countries without national ID systems. In Malaysia, on the other hand, some people had more than one identification number, since various states issued identification cards. A credit bureau in Nigeria, CreditRegistry Corporation, is bypassing this obstacle by using fingerprint biometrics to identify individuals. Until identity is sorted out, little progress is likely.

From Negative to Positive Reports

The pattern of credit bureau evolution has repeated itself in many countries. What starts out as an informal system of sharing bad client lists becomes a paid subscription service. Information on bad clients is supplemented by information on all clients. The data initially focuses on loans, but in more sophisticated systems, as in the United States and Europe, coverage may expand to include savings, credit cards, utilities payments, and home ownership information.

Negative reports on bad clients are immediately useful for exclusion (and lowering risk), but they do less for inclusion (expanding the number of clientele). Clients want to get credit, literally, for their past good performance, and lenders want to know who those good clients are. In hotly contested markets where overindebtedness is a risk, it is essential for lenders to know how much debt an applicant already has. Lack of such information was a big factor in the crisis in 2000 in Bolivian consumer and microfinance, discussed below.

It takes much more effort to create positive reports, and such reports are valuable only when users trust their completeness and accuracy. Since borrowing and lending goes on continually, credit bureaus must maintain real-time information. The sheer volume of information in a positive report system dwarfs that required for a negative system, both because of the number of clients covered and the number of data points per client. The technology requirements and costs of such a system are significant. The difference between negative and positive report information may well require the shift from a makeshift system of cooperation among financial institutions or a government-run credit bureau to a professional provider.

Constructing Credit Scores

A credit score is a mathematical calculation that predicts whether a person is likely to pay debts on time. The best known is the FICO score, developed by Fair Isaac and Company, Inc., and used prevalently in the United States for consumer credit. Fair Isaac has also developed a small business score, currently used by 22 of the top 25 small business credit grantors in the United States.[5]

Quality of data for credit scores is a vexing problem for those wanting to serve the BOP population, because much of the kind of data FICO uses is not available for many low-income people. Credit scores use formal documentation as well as past credit history, but many informals lack hard evidence concerning either. Informal lenders to poor clients—family members, moneylenders, and friends—do not report to credit bureaus. Accordingly, credit scores for low-income people may need to emphasize different variables than scores for middle-class borrowers. For example, gender, age, and number of family members may figure more prominently.

Some MFIs have created their own credit scoring models. ACCION International helped develop credit scoring models in conjunction with MFIs in Latin America. By extrapolating the behavior of existing clients to predict the repayment performance of new loans, ACCION created scorecards that effectively predict risk. At Mibanco in Peru one scorecard helped reduce loan origination costs by 10 percent through automated approvals.[6] A second scorecard for identifying preferred clients helped with portfolio growth and customer loyalty, while a third scorecard focused on collections helped cut the cost of following up delinquent loans.

These credit scores use internal data from the histories of the MFI's own clients. This information is proprietary, and MFIs are unwilling to share it with competitors. Only relatively advanced MFIs have sophisticated enough data capture systems to make proprietary scorecards possible. Shared industrywide data is needed if the microfinance sector is to develop generic or national scorecards that are widely applicable and suited for selecting new clients. Credit bureaus are better placed than individual banks or MFIs to develop such national credit scores, so it may be that scoring will only appear for low-income clients once credit bureaus are well-established.

Sorting Out the Players, Public and Private

In many countries, public credit registries are set up to assist bank supervisors, and participation by banks is mandatory. Governments in countries with public credit bureaus have often been reluctant to allow private credit bureaus to operate. Frequently, public credit bureaus are maintained in a monopoly position by public policy and banking laws. Unfortunately, lacking the competitive push, public registries tend to lag in terms of outreach to lower-income clients, coverage of all types of information, and technology. They often exclude nonbank financial providers, such as microfinance institutions. In some countries, banking laws restrict data sharing among institutions other than commercial banks.

In Bolivia prior to 2000, the public-sector credit registry was open only to banks and regulated finance companies, while NGOs and most credit unions were excluded. The NGOs banded together to create their own database, but since microfinance in Bolivia is provided by all types of institutions, neither the NGOs nor the regulated institutions had complete information. This situation was a contributing factor in a crisis of overlending that shut down consumer lending and damaged microfinance in 2000. The crisis moved Bolivian authorities to change regulations to open the public-sector credit bureau to all parties.[7] The NGO microfinance providers, stimulated by changes in the regulations, used their association, Finrural, to form their own private credit bureau. This credit bureau was later linked to the public credit bureau, making it possible for all BOP lenders, of whatever type, to receive credit reports covering borrower activities at all types of loan-making organizations.[8]

Microfinance Initiatives and Mainstream Entry

Although only 12 percent of MFIs participate in credit bureaus, many MFIs recognize the potential of credit bureaus to lower costs.[9] Bolivia is one of a number of cases where the microfinance sector banded together in the absence of a private credit bureau. Some of these efforts have developed into effective credit bureaus, while others are now being supplanted by international credit reference companies. We look briefly at some examples.

InfoRed and DICOM, El Salvador. MFIs in El Salvador came together voluntarily to create databases of clients. In the 1990s the U.S. Agency for International Development supported the establishment of a common borrower database for microfinance programs run by CRS, FINCA, and other NGOs. The database then became a credit bureau for the greater microfinance industry run by a private entity, InfoRed (*red* is Spanish for "network"). Another credit bureau, DICOM, now partly owned by Equifax, was developed for the banking industry. Over time, and with the growth of the microfinance industry, the DICOM/Equifax credit bureau developed a product specifically for the microfinance market, and lowered its price to make it more attractive to MFIs.[10] InfoRed provoked DICOM's quicker development of BOP market coverage.

CompuScan, South Africa. When the postapartheid government of South Africa took over in the mid-1990s, it wanted to see credit extended to millions of previously ignored South Africans. But the private credit bureaus in South Africa, which were quite sophisticated, showed little interest. MFIs had few ways to find out about bad-performing clients.

Microfinance providers in Cape Town began sharing information on an Excel spreadsheet. Gradually the number and geographic diversity of users expanded, and CompuScan was established as a private company. To cement its financial viability, it began offering other services as well, including training to microfinance providers through a specialized academy. Today, CompuScan serves more than 3,500 credit providers through South Africa, has operations in Namibia and Botswana, and plans to expand into Uganda and Zambia. CompuScan has an Internet-based software platform. Its combination of flexible technology, training programs, and focus on the users demonstrates the profitability of providing credit bureau services to financial-services providers to the BOP market.

TUCA, Central America. The IFC's Global Credit Bureau Program, launched in 2001, and supported by Visa, has been instrumental in attracting private-sector companies into the credit bureau market. One of the main concerns of private entrants is, of course, business viability. Credit bureaus earn their revenues by selling credit reports and other services. In most cases, the bureau charges a flat membership fee plus a charge per inquiry. In countries with limited liquidity or a small number of financial providers, a credit bureau may not be viable. Moreover, fees and the fixed costs of upgrading information systems for digital access may leave some small MFIs unable to use credit bureaus.[11]

In Central America, the IFC found that the best strategy for reaching sufficient volume was a single credit bureau covering several small countries. In 2002, it invested in the first regional consumer, small business, and microenterprise credit bureau, Trans Union Central America (TUCA), operating in Guatemala, Honduras, El Salvador, Costa Rica, and (soon) Nicaragua. Standardization of credit reports across countries is also expected to facilitate cross-border financial-services offerings in Central America.[12]

Mainstream Players Move In

Currently the three biggest consumer credit bureaus in the United States are Experian, TransUnion, and Equifax, members of the Associated Credit Bureaus, an international trade association that represents its members to the public and to governments. Each of these three maintains credit information on more than 200 million Americans and businesses. These companies are seeking to expand into new countries, but they want to be sure that the conditions will support commercial viability.

Experian is one of the leading international players, with credit bureau operations in 16 countries and clients for its decision support solutions in more than 50 countries. In 2007, Experian purchased the largest consumer and commercial credit bureau in Brazil, Serasa, whose market share was about 60 percent.[13] The Brazilian credit market has significant scope for growth—stimulated by changing regulations that will allow credit bureaus to gather positive information about borrowers. Both consumer and commercial lending are growing strongly, and the mortgage market is still in its infancy. Serasa increased sales over 20 percent per year during 2005 and 2006, and its earnings margins (before interest and taxes) were in excess of 20 percent.[14] Experian is betting that margins will improve further, underpinned by high growth in credit volumes.

The IFC is also supporting Experian in the creation of credit bureaus and the provision of services such as scoring and fraud detection in several countries in southeastern Europe and the Middle East.

Credit bureau companies from other developed countries are making inroads in emerging markets as well. CRIF, an Italian company, is moving into Eastern Europe. Iceland's Creditinfo competes with CRIF in Eastern Europe and is adding Kazakhstan and other countries in Central Asia. And Dunn and Bradstreet has expressed interest in the Middle East and Africa.[15]

As credit bureaus develop, the distinctive methodologies of microfinance may soon lose their monopolies as the only effective lending strategies for low-income clients. Scoring-based methodologies may come to replace group lending, stepped loans, and the like. The implications of this observation for industry development are far-reaching. If strong credit bureaus lower the barriers to entry into the inclusive finance sector, then mainstream lenders will enter using lending processes already familiar to them. Competition to reach more BOP clients with more services will follow quickly.

12

LAST-MILE TECHNOLOGIES

Technology is remaking banking at the last mile. In developed countries, consumers no longer need to travel to bank branches to get cash. Nor do they even need cash, since they can pay for purchases or move money with plastic cards with magnetic stripes or chips. Many consumers also use their cell phones or the Internet to pay bills, buy products, and transfer money between accounts. Bank card and cell phone users trust that their banks have the systems necessary to support these conveniences.

Today the financial sector is looking to expand these services into developing markets, including the BOP sector. Electronic banking, card payments, and cell phone banking will enable banks to overcome obstacles that have long made providing financial services to people in poor or remote regions uneconomical. The new technologies are bringing together telecommunications, financial services, and IT companies to find profits in markets where few have looked before.

The innovations described in this chapter are possibly the most far-reaching of any of the changes considered in this book. They have the power to capture vast numbers of new clients in a few dramatic leaps.

The Cost of Cash

Among subsistence farmers in rural areas of northern Mozambique, deep in the rain forest of New Guinea, and in other remote places, there are still people who barely participate in the cash economy. But for the vast majority of the world's low-income people, informal economies are cash economies, and money is synonymous with cash. This is about to change.

Cash is actually an expensive means of exchange, both for the people who use it and for financial institutions. Cash in the pocket is easily lost, stolen, or destroyed. Everyone has a story about cash burned in a fire, eaten by the dog, or (more likely) pilfered by a family member.[1] A roll of cash can even change spending patterns. It makes a man feel rich and sends him to the local bar to buy a round of drinks for his buddies—or so goes the stereotype. Shifting away from cash avoids or lessens all these problems.

Bankers bemoan the cost of handling cash, especially in countries with heavily devalued currency. In the early 1990s, I talked with Polish bankers who complained of the high cost of counting and handling worn-out and worthless communist-era bills. That was then, but even today Ecobank, ACCION's partner in Nigeria, maintains special counting booths to cope with mountains of cash. Market vendors bring in bundles of naira in the morning and come back at lunchtime to receive their deposit slips. They estimate the value of their stack of bills by thickness, because it would take too long to count each one. Even in countries with less devalued currency, the cost of teller-based transactions renders small deposits and withdrawals unprofitable.

Because they are radically cheaper, electronic payments can transform the economies of the last mile, which is why they are especially promising for reaching poorer and more remote populations. All the bank-retail partnerships described in Chapter 8 use electronic payments to create a dense net of transaction locations and to send tentacles from that net into new areas.

Bank cards are more secure and convenient than cash. When paired with automatic teller machines, they reduce travel and waiting time and allow 24/7 banking. When cards are paired with point-of-sale (POS) devices placed at shops, the number of locations multiplies. Cards also generate an electronic record of transactions, which helps users keep track of budgets and makes it easier for people to store money in savings accounts where they can earn interest.

For financial institutions, bank cards can dramatically reduce costs by shifting transactions away from expensive branch and teller installations. ATMs and POS networks allow banks to serve more customers per branch, greatly reducing the operating cost per client. Two commercial banks in Latin America provided our team with estimates that costs per transaction falls from roughly \$1.00 per transaction through a branch to \$0.25 through an ATM. These lower costs could allow banks to reach people in remote locations that would not support a full branch. Finally, electronic payments build a record that the financial institution uses to control fraud.

And these advantages may one day be taken to even greater extremes by cell phone banking, which can offer the ultimate in freeing payment transactions to happen anytime, anywhere.

Introducing Card Products

We can all agree that electronic payments have the potential to offer greater safety and reduce processing costs. But how to engineer the shift from the cold hard cash people have trusted for millennia to a form of money hidden in a card's magnetic stripe or a cell phone's SIM card? The change must occur incrementally, so that cash is not abandoned, just reduced in relative importance. Tipping points in the balance between cash and electronic payments may be close in many countries.

Card product applications for low-income populations are often different from the products aimed at higher-income market segments, and thus, in order for them to play a key role in expanding financial inclusion, specific product and system design issues must be tackled. Some types of cards are particularly suited for the BOP market.

- **Prepaid cards.** Many banks and card companies see prepaid cards as an entry product for low-income people because, unlike credit and debit cards, they engage clients who do not have—or do not want—permanent bank accounts. A prepaid card, such as a gift card, works much like a debit card, but is not linked to a bank account (though banks maintain underlying virtual accounts for tracking purposes). In many countries it is not necessary to associate a client name with a prepaid card. These features allow prepaid cards to be distributed widely and cheaply. Through Visa Electron's Absa Sekulula program in South Africa, the government transfers social benefit payments to recipients on prepaid cards.
- **Smart cards.** Smart cards containing a small microchip rather than a magnetic stripe are well-suited to areas where communications are poor. Because the cards store data, they do not need an online connection, which is especially useful in rural areas. Moreover, smart cards can store biometric data such as a fingerprint, which is especially important for customers without secure forms of identification. When a client of Opportunity International Bank

> Malawi, a microfinance institution serving women, wishes to make a withdrawal at a local shop, she swipes her card and puts her finger on the biometric sensor of the POS device. If the fingerprint matches the digital image stored on the card, the withdrawal is approved. Opportunity's managers report that this card became popular very quickly when the women learned that their husbands could not "borrow" their cards and withdraw money without them.[2]

Credit Cards Accepted Here?

Customers can only use cards to enhance convenience if there are many opportunities—ATMs and merchants that accept cards near where they live or work. This is known as the card acceptance environment.

It is difficult for a single actor to create a rich acceptance environment. Some banks, wishing to avoid the fees charged by international networks, set up their own proprietary card systems, ATMs, and points of sale. But sparse networks do not offer the full advantages possible with cards, so single-bank systems seldom achieve the critical mass needed to become profitable. It is much more effective for cards to link to shared networks so they can be used at all available points of sale and ATMs. This requires cooperation among multiple banks and card providers. While elaborate systems for cooperation exist, they often lack incentives to reach out to the BOP population.

For one thing, banks typically avoid low-income areas for placement of ATMs, preferring safe locations where they are sure of a high enough volume of transactions. An ATM needs several thousand transactions to justify its costs. The larger ATM manufacturers sell machines ranging anywhere from $8,000 for the most basic ATM (functions such as limited cash dispensing only) to $15,000 or even $25,000 for the most advanced types (cash deposits, biometric readers, multiple languages), excluding cost of installation. Variable costs include servicing the machine and secured transport of funds. If ATMs could be made smaller and cheaper while retaining essential functions, they could be more broadly deployed.

POS devices, at less than $100 each, are much more affordable than ATMs and can be placed very widely. However, banks have not made great efforts to enroll merchants in low-income areas. Merchant acquisition requires a specialized team to negotiate with and train merchants, place the POS devices, and provide service. Most bankers are glad to hand over these tasks to someone else. For international networks such as Visa and MasterCard, a separate company, often a third party owned by all the member banks, handles merchant acquisition for the whole country. For example, Visanet Guatemala was created by the local Visa member banks and is governed by the largest of those banks (those with at least 5 percent of the transaction volume).

If a small microfinance bank wished to increase merchant coverage in low-income areas, it would need to convince the merchant-acquiring group to act. But since the acquirers typically represent banks that serve higher-income people, they tend to show little interest in waging the uphill battle of recruiting merchants in low-income areas. Many such merchants would not meet standards or generate sufficient transaction volume to return profits to the acquiring group.

And it is also an uphill battle because merchants who cater to the BOP market are often, like their clients, part of the informal sector. They are unlikely to see benefits from accepting an alternative form of payment, especially when they have to pay a fee on each transaction, typically ranging from 3 to 8 percent of the sale. Informal merchants may also wish to avoid connections with the formal economy that could bring headaches like greater scrutiny from tax officials. Thus, the acceptance environment in poor and remote neighborhoods remains thin.

The most effective route to get cards into low-income areas has come with the banking agent models, discussed in Chapter 8, where banks partner with post offices, retail chains, or microfinance organizations. In India, ICICI Bank and Citibank place POS devices or ATMs at microfinance institutions like BASIX in Hyderabad and Swadhaar in Mumbai. The MFIs, which by Indian regulations are not allowed to capture savings, provide savings-based banking services on behalf of the commercial banks, making it possible for the banks to reach slums they would otherwise not serve.

Can This Plastic Card Really Be Money?

Another obstacle to bank card penetration is slow customer adoption. While lower-income consumers are comfortable with certain types of technology (witness the rise of mobile phones), when it comes to money, there is no substitute for holding and counting cash in the hand. There is a natural reluctance to think of a plastic card as money. When bank cards were introduced in the United States in the 1960s, it took many years until the majority of cardholders felt comfortable enough to use cards on a regular basis.

In many places slow uptake may be due to low trust in banks. Financial literacy programs that explain the hows and whys help accelerate customer adoption.

I witnessed the inaugural transactions of Citibank customers at Swadhaar, a microfinance institution in Mumbai, involving two very low-income women from a Muslim community. The women paid close attention as the Swadhaar official filled out the account-opening paperwork and explained the system. Then they moved to the ATM to register their fingerprints. When I saw the intricate henna designs on their hands, I worried that the biometric device would not be able to read the fingerprints. This was not the problem, however. More important was the fact that the women's fingers were worn so smooth from work that they had hardly any prints at all. The women waited stoically until the Swadhaar officials eventually made the technology perform. Clients like these needed assisted ATMs, manned by a bank or MFI staff member, to overcome their initial unfamiliarity and reluctance. The partnership between Citibank and Swadhaar allowed profit-oriented Citi to enter a market with much of the cost carried by the less profit-oriented Swadhaar. In the short term, this ATM probably lost money, but as a first step in developing a system, it was an investment in the future.

In some countries, low-income clients may not be functionally literate or may use a local language that is not the language of business. These customers need ATMs that use pictures or even voice. Some ATMs show pictures of currency to illustrate the menu of potential withdrawal amounts. The challenges in reaching low-income people with card products are great, but there are signs that opportunities are opening for companies that understand the overall market and can solve specific problems. We expect that tipping points are not far away, which will lead to rapid spread.

Mobile Phone Banking

Cell phones represent a unique opportunity to bring banking services to millions of unserved people. According to the International Telecommunication Union, mobile phone subscriptions have seen growth averaging 24 percent per year between 2000 and 2008. It estimates that the number of worldwide mobile subscribers will reach 4 billion by the end of 2008, a penetration of 61 percent. Mobile phone operators continue building cell towers daily, with the hope that practically everyone in the world will be covered soon. Nearly two-thirds of the world's cell phones are in developing countries, with China and India leading the way.[3] Many are in the hands of low-income people.

In most developed countries mobile phone banking is not especially exciting. Customers already have ATMs, the Internet, and thousands of retail outlets to choose from. Mobile banking does not change their access to financial services in any meaningful way. But in the developing world, just as they have bypassed expensive land-based telecommunications infrastructure, cell phones used as banking devices can bypass a great deal of expensive banking infrastructure, allowing services to reach previously unbanked low-income and remote customers. Some telecom customers can already use their phones to send money to another person, purchase goods at a store, pay bills, or make payments on a loan. The potential for growth is enormous, but growth will only come when telecom companies and banks get their business models right.

Models of Mobile Phone Banking

Cell phone banking combines telecommunications and banking in new ways, requiring unprecedented connections between the two industries. No blueprint exists to show the way, and innovation is taking many different roads.

The mobile banking initiatives recently launched in the United States are led by banks that own the accounts. The services are marketed through banks rather than phone companies. In developing countries, telecom companies are more often the initiators. Vodafone's M-Pesa service in Kenya and Globe Telecom's G-Cash in the Philippines were developed outside the banking industry by telecom companies. A bank holds the aggregated deposits, but the mobile operator takes responsibility for providing the service. (Customers do not have bank accounts, but, as in the case of prepaid cards, the bank maintains electronic accounts in the background for its own tracking purposes.) South Africa's two mobile banking platforms, Wizzit and MTN Banking, are led by a technology and telecom company, respectively. If mobile banking takes off in developing countries, it is not yet clear which business model or technology will dominate.

A variety of technologies are now being used for cell phone banking, from SMS text messaging to contactless SIM cards. NTT DoCoMo, the leading mobile operator in Japan, rolled out its "mobile wallet" service in 2004. It uses an embedded chip in the handset and NFC (Near-Field Communications, a short-range wireless communication technology). A Japanese shopper simply waves her cell phone across a sensing device at the checkout counter to complete her payment. There are over 24 million subscribers to the mobile wallet function as of 2007, and over 150,000 merchant acceptance points, much greater penetration than any other model to date.[4] While DoCoMo's service is aimed more at wealthy shopaholics than low-income people, it could be made relevant for BOP customers, too.

Most developing world models, such as experiments in Kenya, the Philippines, and South Africa, use text messaging as a money-transfer device. Clients withdraw and deposit cash in exchange for mobile money at the same retail outlets where they buy air time for their phones. They can send this mobile money to family and friends—or even a company—through text messages, provided they know the phone and account numbers of the recipients. In a few places, customers spontaneously started using air time as a kind of mobile currency even before the advent of mobile banking pilot projects. For example, a rider might pay a taxi driver in air time rather than in cash in the same way one would use a credit card. Telecom companies, observing this phenomenon, are determined to build on it.

There are still questions on the customer side. While many potential customers know and love their mobile phones, many older and less educated people demonstrate the same reluctance to use cell phones for banking as they do to use bank cards. Market research done in late 2005 for South African mobile banking player Wizzit showed that its users are more likely than nonclients to be male, high-school educated, and under 40 years old.[5] It remains to be seen whether the majority of low-income mobile phone users will decide that mobile banking meets their needs.

Benefits from Mobile Banking

Thus far, banks appear to view mobile phone banking mainly as an additional channel for serving existing clients. This positioning—focused on convenience to the existing customer base—has been taken by many U.S. banks. It's a strategy that does not necessarily generate new revenue. Rather, it transfers revenues to new channels, cannibalizing existing channels. The approach works well if the new channel is significantly less costly than the original and if clients view it as much more convenient. If it reduces congestion in bank branches, it could greatly reduce operating costs. However, an alternative approach also offers great potential: using cell phone banking to expand the customer base.

Telecom companies have so far been more nimble in this regard, in part because their rolls already include large numbers of unbanked people and they have a network of prepaid agents in place. For mobile operators, one major benefit from cell phone banking is to increase customer loyalty by providing a new value offer. Banking services are especially appealing, since bank accounts tend to be "sticky": savings account customers rarely switch banks. These services generate fees twice, as customers are charged for sending both the message and the money (the SMS and the financial transaction). Mobile operator-led banking seems to be emerging fastest in those developing markets where there is competition in the mobile communications arena. Kenya and the Philippines, for example, each have two main mobile phone operators with roughly equal market shares. All four operators provide mobile banking services.

Like proprietary bank card networks, the value of a service developed by a single telecom company is limited by a lack of interoperability. In most programs to date, customers cannot transfer funds to the phones of other carriers. In the Philippines, which has by far the most advanced mobile banking models in an emerging market, both SMART and Globe Telecom have their own exclusive mobile banking platforms. Interoperability must emerge if cell phone banking is to take off.

Another major benefit may arise if mobile phone banking can evolve from a platform chiefly targeting money transfers to one that also includes merchant payments, as with DoCoMo's service in Japan. Mobile phone commerce requires the same kind of merchant acquisition process as bank cards, and presents the same challenges in creating incentives and dividing revenues. This channel would very likely be cheaper than a card-based payment system. In the Philippines, roughly 3,100 individual merchants accept G-Cash, the mobile money offered through Globe Telecom, as a form of payment. It remains to be seen to what extent this will become a true alternative to the established Visa and MasterCard payment networks, or whether Visa and MasterCard will extend their systems to incorporate mobile wallets.

13

THE TECHNOLOGICAL BASE: PAYMENT SYSTEMS AND BANKING SOFTWARE

Payment systems are the "roads" on which money travels around the world. They can range from paper-based, such as the traditional pay-by-mail system through the post office, to sophisticated electronic networks where payments are made instantaneously across the globe. Payment systems are backed by clearing and settlement systems that transfer information and documentation and manage the final exchange of funds between financial institutions.

Public and Private Systems

Payment, clearing, and settlement systems involve complex interactions between the public and private sectors. Public sectors traditionally manage paper-based payments. Some, including the U.S. Federal Reserve Banks, may also specialize in providing automated clearinghouse services for retail payments. In some countries, private-sector operators can provide clearing services. In Serbia, among others, there is a mixed model. Serbia's Central Securities Depository and Clearinghouse was originally owned and managed by the National Bank of Serbia. In 2001, it became a joint-stock company with 51 percent of shares owned by the government. Payment system operators may also be groups of banks or banking associations.

Clearing services for card-based transactions are provided solely by the private sector in nearly all developed economies. Normally, central banks provide settlement systems. But financial institutions acting as settlement banks sometimes provide settlement services for debit and credit cards. Indirect settlement may take place in credit card networks, which often have thousands of participating financial institutions, as well as within-group networks. In such cases, a small number of member financial institutions act as central service providers.

Retail Payment Systems

Retail systems are relevant to inclusive financial sectors because they affect the consumer. Retail payment services include noncash fund transfers (checks, credit and debit cards, electronic money) and ATM payments. Participation by the private sector in this area is crucial for the development of an inclusive financial sector. Payment systems make possible the interoperability that brings power to card payments and ATM networks, but has so far eluded mobile phone banking.[1]

Retail payment systems are increasingly automated. The evolution from cash-based to cashless economies in the developed world has been rapid, and is accelerating in the developing world. Electronic systems have increased the speed and volume of payments and lowered transaction costs for lenders and consumers. Automated payments help promote financial transparency, increase the liquidity of markets, and contribute to new and innovative financial products, like electronic money.

While illiteracy, the unreliability of electrical and telecommunications infrastructure, and distrust of cashless transactions are obvious challenges in less developed countries, cashless systems attract providers that wish to reach the most rural and remote populations. These systems address many of the difficulties that particularly plague low-income people, such as high transaction costs and vulnerability to fraud and theft.

Debbie Arnold, former vice president of Emerging Markets at Visa Inc. and now a payment consultant, emphasizes that "with the advent of new innovations in technology, such as contactless chip and mobile payments, increasingly you can expect to see even the most isolated of communities able to remotely access banking services." The growth of electronic transactions in countries with established payment systems is massive. There are nearly 3 billion Visa and MasterCard cards today—enough for almost half the world's population. The total volume for Visa Inc. consumer debit and prepaid programs, including cash transactions, grew by 17 percent in 2006, reaching $2.7 trillion.[2]

Retail electronic payment systems require payment instruments (debit, credit cards), acceptance networks (the relationship between merchant, processor, and bank), and telecommunications between the parties to the transaction. There must be enough fee revenue to compensate all parties: the card-issuing banks that provide cards to consumers and businesses, acquiring banks that manage the relationship with the merchants who accept the cards as payments for purchases, ATM networks that provide additional acceptance points, and the switching service that manages information transfer at transaction and settlement. Revenues come from interchange fees, typically paid by the merchant's bank (the acquirer), to the customer's bank (the card issuer), usually as a prenegotiated percentage of the transaction.

Several challenges arise in developing and maintaining reliable payment systems for low-income customers. Electronic payment systems require consumer acceptance and a favorable regulatory environment, by no means a given in emerging markets. Break-even points will occur only after new customers have been using services for a period of time. Unstable political environments weaken financial infrastructure. Low population density has also deterred the entry of foreign banks. Other challenges include the ability of the regulatory environment to ensure the successful development, implementation, and operation of both retail and wholesale payment systems. The International Finance Company, concerned about achieving minimum efficient scale, suggests regional cooperation, pointing to their success with creating a regional credit bureau in Central America.[3]

Some challenges may provide opportunities for partnership between microfinance institutions and banks that operate private payment systems. According to Arnold, banks have the electronic payments infrastructure but lack the appetite and ability to manage risk and train the (low-income) market. Microfinance institutions have the one-to-one consumer relationships but lack access to electronic payment infrastructure to get to scale. One strategy, therefore, is to encourage bank partnerships with MFIs, uniting the convenience and security of cards and electronic payments with the powerful grassroots outreach of MFIs.[4]

Information technology infrastructure, particularly for electronic payments, is currently a large cost for institutions, and may be out of reach for smaller microfinance institutions. Partnerships, joint ventures, and mergers may be options for smaller institutions to access this technology. On the other hand, advances in electronics and telecommunications are rapidly bringing down the unit cost of data processing and transmission. Given the rapid price decreases for IT equipment and the less important role for branches as a delivery channel, setup costs have become less of a barrier to entering the payments market. This allows service providers other than financial institutions to play a larger role. Both the technology and the ability to apply it in the financial sector have now become available to a wide range of actors.

Room may be growing for private involvement in clearing systems, which have become separable into various activities. Though some clearing activities have always been outsourced, the range has broadened markedly in recent years. Outsourced activities now range from transaction processing—including the posting of payments to client accounts—to the management and operation of entire data centers.

With the unmet demand for financial services in emerging economies, the potential market supporting electronic transactions is potentially huge and profitable. Payments will only increase as a potential revenue source for financial institutions.

Core Banking Platforms for Inclusive Finance

Large commercial banks use core banking systems to make their back- and front-office operations efficient. In addition to providing essential management information, these banking applications allow for efficient transactions processing, connection to automated payments, such as ATMs and point-of-sale networks, analysis of customer data, and streamlined regulatory reporting.

Microfinance has specialized needs for software, given the rapid turnover of savings and loan accounts and the need to align software with the unique loan underwriting methodologies of microfinance. Flexible and rapid systems are required to track small deposits and withdrawals. At the same time, regulated microfinance institutions have to produce the same regulatory reports as other finance institutions. To address these needs, software packages have been designed specifically for institutions engaged in microfinance.

Among the smaller financial institutions that serve the BOP market, the use of commercial core banking systems is still not widespread. A 2004 survey by CGAP showed that 46 percent of MFIs were using manual or Excel systems, 44 percent were using custom or in-house solutions, and only 10 percent used the kind of standard commercial systems bigger banks use.[5] Fortunately, several current initiatives are addressing these gaps and providing opportunities for interested parties looking to enter this market.

MFIs forgo core banking systems when they see the software as too complex and expensive and do not recognize how it can help them in the short and long run. Many MFIs lack internal IT departments capable of supporting such systems.

Early microfinance giants, including BRAC, Grameen Bank, and Bank Rakyat Indonesia, grew to over a million clients with manual systems—often boxes of cards, one for each client. For years, their only computers were at the regional and national offices. But that was in the 1980s and early 1990s. Today, manual systems are uncompetitive except for nonregulated MFIs with only a few thousand clients. As institutions grow, they evolve through stages: from manual loan tracking, to Excel spreadsheets, to a customized microfinance application, and finally to a core banking system.

Three paths for increasing systems efficiency for small financial institutions are becoming clear, each suited to a different level of institution. Small MFIs and credit unions can employ open-source solutions. Medium-sized institutions can collaborate to consolidate back-office operations into one format that an IT provider can work with, possibly combined with some outsourcing. And larger MFIs can outsource most of their IT functions.

All of these options present business opportunities for technology companies, as long as providers take into consideration a few characteristics that have previously fragmented the MFI software market. MFIs use different lending methodologies, not only from mainstream banking, but from each other, and can be very resistant to suggested adjustments. They operate with many different languages, regulatory requirements, and operations. MFIs also vary in institutional form, scale, and sophistication, from NGOs to credit unions to commercial banks.

Furthermore, since MFIs serve lower-income people, they tend to be cost sensitive. For instance, small- and medium-sized MFIs might not be willing to pay more than \$200,000 for a core banking system because of constraints on financial resources. Large MFIs tend also to look for solutions below the \$500,000 mark. Core banking system providers must price their products accordingly or provide a combination of software and outsourcing services that could help lower the overall banking system ownership costs for MFIs.

The Grameen Foundation, with support from the Omidyar Network, led the creation of an open-source core banking system called Mifos, which aims to increase the use of core banking systems by unregulated and small MFIs. This solution is being used at Grameen Koota, an Indian MFI, as well as MFIs in Kenya, Tunisia, the Philippines, and other countries. SunGard and IBM have contributed to system development and implementation. At first, system development and technical support was done on a pro bono basis, but as more MFIs use Mifos, for-profit opportunities for providers and consultants who can tailor Mifos for specific national or company use may arise. The project identifies local technical support providers who wish to learn the system as a business opportunity. Open-source software can be adapted by software developers in-country, and a Web-based community supports rapid adoption and ongoing improvements.

Some providers, such as Temenos and i-flex, provide standardized global banking applications for MFIs. Temenos was founded in 1993 as a software provider to the financial-services industry. It has sold core banking systems to nearly 600 financial institutions, from large commercial banks to small MFIs in 120 countries. It adapted its software to MFIs by offering a scaled-back, cheaper version of its mainstream product. Only a few strong vendors are needed to serve this mid-range microfinance market. With this move, Temenos assured itself a profitable niche.

Some of the world's large commercial banks have realized that they can achieve efficiencies by outsourcing their IT operations to application service providers (ASPs), prompting ASPs such as i-flex and Tata Consulting to look at the MFI market. Salesforce.com has developed an information management system for MFIs called Salesforce Microfinance Edition. This on-demand software, available over the Internet, tracks payments, manages work flow, and analyzes client data. We expect that the ASP model will become increasingly common in the next few years.

Opportunities exist for IT providers to help MFIs transition to any of these options. Many MFIs do not have the expertise necessary to undertake such upgrades. Even MFIs with reasonable systems need help expanding their operations to remote areas in a cost-effective way. Front-end solutions such as point-of-sale devices, cards, and cell phone banking must be integrated into their main core banking systems, providing opportunities for companies that can support such integration.

The need for software for MFIs has created opportunities for small software companies. Purchase of equipment, training for staff, upgrading, system maintenance, and new product development all represent opportunities for local and international IT specialists. As microfinance grows, the demand for efficient software and systems grows. And as software, IT platforms, networks, and hardware become more sophisticated, financial services improve and expand.

14

BUILDING THE MARKET FOR INVESTING IN MICROFINANCE

Many committed professionals are dedicating themselves to integrating the market for microfinance investment into international capital markets. The hallmarks of a mature microfinance investment market will include ready availability of high-quality information about MFIs, a wide range of investors, and active trading with ease of entry and exit. When this day comes, MFIs will be able to raise funds at favorable costs that accurately reflect their risk and return profiles.

Information for Investors: Advisors, Data, and Ratings

The biggest issue in market creation is getting the right information into the hands of prospective investors. Wall Street professionals are accustomed to clicking on Bloomberg.com for an instant flood of data. But there is no microfinance page on Bloomberg. When *The Economist* took its first serious look at microfinance in 2005,[1] it complained about the lack of data and the obscure metrics that meant something to microfinance mavens but nothing to standard investors. Frustration almost jumped off the page.

For their part, MFIs "grew up" responding to donors' information needs. Only recently are they learning to understand how investors use information to make decisions. At first, MFIs with nonprofit origins may even have greeted investor requests for information as "none of your business" or as signaling lack of trust.

The information infrastructure now developing to support microfinance is multifaceted, including a central data source (the Microfinance Information Exchange or MIX), mainstream and specialized investment advisors, investor associations, and rating agencies. This chapter takes us on a quick tour of the players.

Investment Banking Services

Investment bankers deepen the market not only by placing securities but also by helping investors and MFIs understand each other. If they are to reach investors, MFIs need the expertise provided by advisors, as well as the legitimacy that partnering with mainstream players provides. As for the advisors, *Investment Dealers Digest* puts it bluntly: "As history shows, any time a new asset class emerges, Wall Street stands to profit handsomely from underwriting new securities and selling them to brokerage clients."[2]

Citibank, Deutsche Bank, and J.P. Morgan are among the major investment advisors that have launched microfinance units. These, together with specialized emerging markets and microfinance advisors like BlueOrchard and Developing World Markets, were key players in each of the international microfinance deals described in this book. If not for Citibank, for example, Mexican institutional and private investors would never have been interested in the Compartamos bond issues in 2004 and 2005. And Credit Suisse was instrumental in the success of Compartamos Banco's IPO in 2007.

The motivation behind the move into microfinance by investment banks is complex, and not purely profit-driven. Asad Mahmood of Deutsche Bank, one of the bankers who has been at this longest, insists that microfinance would not receive such corporate commitment if not for the social mission. The scale of the industry is simply too small, he argues, and will remain small compared to other industries for some time. While investment banks expect to make money from the microfinance deals they design, they might make even more putting staff to work in other sectors. On the other hand, one cannot dismiss the commitments to microfinance as mere image-building or conscience-calming. Investment banks are attracted for reasons that include penetrating emerging and frontier markets, the attraction of working at a cutting edge of finance, and tapping into the growing social investment movement. Following the U.S. financial crisis, we can add making countercyclical investments to the list.

Perhaps one of the strongest motivations includes building a motivated workforce. Many of the investment banking staff working on microfinance love what they are doing. They go to interesting places, solve challenging problems, and make a difference to people in need. Individuals like Mahmood follow personal passions and act as internal entrepreneurs to build corporate commitment. Insightful top leaders respond because they understand how a microfinance practice could enhance their company's ability to attract and retain proud, motivated employees.

Microfinance Investment Vehicles

The vast majority of international investment in microfinance takes place through microfinance investment vehicles (MIVs): debt and/or equity funds that specialize in microfinance and sometimes other forms of social investing. At the end of 2007 there were 91 MIVs with $5.4 billion under management.[3] The growth of these MIVs are a significant part of the larger phenomenon of "impact investing," which encompasses renewable energy, community development, and other investible activities with social or environmental benefits. Microfinance investing has developed somewhat independently of other forms of impact investing, but linkages are increasing.[4]

The growth in the number and size of MIVs was exponential through 2007. MIV investments more than doubled from 2006 to 2007. Most (78 percent) of the investments are in debt; however, equity investments are increasing faster. At least seven new equity funds were established in 2005–2007. This growth momentum continued through mid–2008 but was curtailed with the financial sector crisis in late 2008. Eastern Europe and Latin America receive the bulk of the investments, though South Asia and Africa are beginning to attract more investors.

MIVs have been traditionally structured as debt funds in order to attract investors not prepared for emerging and frontier markets that fall below an investment-grade rating. During the heyday of collateralized debt obligations, debt products were structured in tranches to meet the different risk appetites of investors. The structured finance vehicles created by BlueOrchard (BOLD I and BOLD II) and Developing World Markets (Microfinance Securities

XXEB) raised $270 million, and are just some of the better known of the transactions carried out in the past few years.

The first MIV, the equity fund ProFund, was created in 1995 by socially responsible investors and international finance institutions (IFIs). It invested $20 million in 10 MFIs in Latin America, closing out in 2005. International financial institutions such as the Inter-American Investment Corporation and the Dutch development bank FMO, helped launch the MIV "industry" by driving several MIV start-ups. However, according to CGAP, IFIs' share of MIV funding declined to 19 percent in 2007. Retail investors were also early supporters, generally with small amounts. They have now become a mainstay of MIV funding, at 30 percent of the total. Institutional investors are recent entrants. They increased their share of MIV funding from 14 percent in 2006 to 41 percent in 2007. That their share could leap so much in a single year reflects the large scale institutional investors can bring to bear. Pension funds such as U.S. based TIAA-CREF and Dutch ABP have led the way in allocating resources to microfinance investments. The development of MIV investment has progressed faster in Europe than in the United States: the top five microfinance asset managers, accounting for over half of total assets under management, are all found in Europe.[5]

Prospective investors in microfinance seeking to invest through an MIV might begin by reviewing information on MIVs available through the MIX. They would also want to contact one of two associations: the International Association of Investors in Microfinance (IAMFI) or the Council of Microfinance Equity Funds (CMEF). IAMFI, launched in 2007, addresses institutional investors who put money into MIVs and typically act as limited partners. CMEF is composed of MIVs that make equity investments in microfinance, typically acting as general partners. Both associations are devoted to building the practice of microfinance investment. CMEF, for example, has pursued projects related to valuation, codes of ethics, compensation standards, industry risks, and MFI governance. Through projects such as these a consensus on best practices for investing in microfinance is gradually built.

Kiva and MicroPlace

It is especially challenging to connect microfinance with individual retail investors. And yet, the concept of linking a busy American soccer mom with a hardworking Ugandan woman farmer carries such great emotional appeal that a number of entrepreneurs have created bridges, among them Kiva and MicroPlace. Kiva in particular has captured the imagination of the media, as in this gushing pronouncement from *Forbes*: "Kiva mixes the entrepreneurial daring of Google with the do-gooder ethos of Bono."[6]

Kiva and MicroPlace are MIVs that use Internet technology to allow individuals to make investments online, thereby aggregating many small investors in a cost-effective manner. In a way, their task is analogous to making cost-effective microfinance loans. But the two organizations use slightly different models. MicroPlace, an initiative associated with eBay, is clearly an investment vehicle. Its lenders place loans as small as $500 through socially responsible MIVs, including Calvert Foundation and Oikocredit. The MIVs aggregate the loans and lend them to MFIs. The MicroPlace Web site gives lenders a sense of personal connection by allowing users to select which MFI to lend to based in part on photos and stories of some of their clients.

Kiva, founded in 2005, takes the personal connection one step further. With the help of donated services from PayPal, Kiva accepts "investments" as small as $25 and allows users to select individual microentrepreneurs they wish to assist. Kiva on-lends investor funds directly to MFIs, rather than going through an MIV, and therefore Kiva must carry out the due diligence and investment consolidation tasks that MicroPlace delegates to Calvert and Oikocredit.

Kiva's person-to-person model has been staggeringly successful with the public. I realized how far and fast Kiva had penetrated American consciousness when my older son and daughter suggested giving investments in Kiva instead of Christmas presents, and some fourth graders in my younger son's school reported investing in Kiva with their families. Even some ACCION employees invest in Kiva.

Despite the wonders of technology, providing the feeling of a personal connection between borrower and lender is still expensive, and that has consequences for investor return. Kiva, with no return, straddles the border between philanthropy and social investing. MicroPlace sits in the social-investing category, as it offers a return of no more than 3 percent. So although these organizations represent important breakthroughs, retail investment in microfinance is not yet fully commercial in the United States. It has progressed further in Europe, thanks to favorable legislation in countries like the Netherlands.

Ratings

Investors depend critically on raters for judgments they regard as informed and unbiased. A company's rating, which measures the likelihood of default, determines which investors can buy its paper. Many institutional investors managing huge portfolios (money market mutual funds, banks, credit unions, insurers, state pension funds, local governments) follow strict policies limiting their choices to highly rated securities. Capital markets will be wide-open for MFIs that achieve investment-grade ratings.

Damian von Stauffenberg, the founder and CEO of MicroRate, was one of the first people to grasp the importance of ratings for opening capital markets to microfinance. He created MicroRate in 1996 as a rating agency specializing in microfinance. At first, the demand for MicroRate ratings came mainly from development agencies, which at that time were still the main funding providers to MFIs. As microfinance grew and began to commercialize, the demand for ratings soared, and new specialized raters appeared: Planet Rating (Europe), Microfinanza (Italy), and M-CRIL (India). MFIs, however, often failed to understand the significance of third-party ratings and were reluctant to pay the full cost, so MicroRate and the others required subsidies to stay afloat. Today the MIX lists 14 different microfinance rating agencies, including the two mainstream raters Standard & Poor's and Fitch. As of 2006, about 900 microfinance institution ratings had taken place, the overwhelming majority by specialized microfinance raters.[7]

The specialization of these raters in microfinance has been both an advantage and a disadvantage for the industry. The agencies have developed tools and measurements specific to microfinance, which allows for comparisons among MFIs. This has helped donors and social investors and has created awareness among MFIs about the kind of financial performance, management, and information quality they need to satisfy raters. However, these rating tools are not the ones used by the mainstream capital markets, and consequently are not seen by commercial investors as either transparent or useful for comparisons. Most of the prominent deals featured in Chapter 9 required ratings from mainstream raters.

Deals like the Compartamos bond issues in 2004 and 2005 prompted Standard & Poor's to create a task force to develop its own specialized microfinance rating protocol, which I had the pleasure of joining.[8] Cynthia Stone, former managing director, Global Business Operations at Standard & Poor's, who led the effort, believed that the absence of mainstream ratings hindered investment at a time when microfinance was growing fast. I found two of the knotty issues that the Standard & Poor's task force debated to be especially significant.

The task force struggled to come to grips with the social mission of MFIs, which it saw as unique to MFIs. Should social mission be integrated into the rating, on the grounds that a strong and effectively pursued social mission makes MFIs more creditworthy (for example, because it signals a good relationship to clients)? Or is the social mission unrelated to creditworthiness, deserving of a side comment strictly for the benefit of those investors with social interests? In other words, how precisely do social mission and business objectives relate to each other? And how do you measure social mission? We will explore these questions in Part 4 of the book.

Another problem was what to do about solid MFIs in risky countries. In standard practice, companies cannot be rated higher than the sovereign securities of their governments, under the theory that a country's political risk affects all companies within its borders. The location of many MFIs in the world's least developed countries meant that huge portions of the world's microfinance industry, including many leading institutions, would receive very poor ratings. Country risk would overshadow the quality of the institutions, making international comparisons difficult. Standard & Poor's proposed to develop a global MFI scale for comparative purposes, not limited by sovereign ratings, which would not be an "official" rating.

Mainstream raters have a hard time making a corporate commitment to microfinance because MFIs are so dispersed, often in countries where they are not active, and because only a few MFIs are prepared to pay full cost. On the other hand, the specialized microfinance raters lose their top customers when leading MFIs "graduate" to mainstream raters.

The situation is evolving. Microfinance rating agencies are incorporating mainstream tools into their repertoire and are forming alliances with each other or with mainstream rating agencies. For example, von Stauffenberg of MicroRate has negotiated an alliance with Sanjay Sinha, founder of M-CRIL, India's specialized microfinance rating agency. Together, MicroRate and M-CRIL represent the largest pool of microfinance rating expertise, having conducted over 70 percent of microfinance ratings (more than 400 MFIs).[9] Despite their strong standing in the microfinance industry, von Stauffenberg and Sinha were concerned about their long-run viability as independent agencies. Their alliance, MicroRating International (MRI), is the first step toward a merger.

Other national and regional nonspecialized rating agencies are starting to consider microfinance as a potentially viable line of business. CRISIL, a mainstream Indian rating agency, launched CariCRIS, a regional credit rating agency in the Caribbean, with private- and public-sector sponsorship. Pacific Credit Rating, which covers Peru, Bolivia, and Ecuador, where commercialization of microfinance is quite advanced, expects microfinance to be an area of ongoing business.

Where's the Data? The Microfinance Information Exchange

If we turn to information providers, we find a dilemma similar to that facing the specialized raters. The Microfinance Information Exchange, or MIX, was created to provide information on MFIs to prospective investors, and vice versa. It seeks to be a Bloomberg for microfinance and is now the first place investors turn when they want microfinance industry data. Most "authoritative" data on the industry, performance benchmarks, and individual MFIs now comes from the MIX. But mainstream investors do not routinely query the MIX, and when they do, they do not find the earnings multiples and stock price histories they are used to. Without mainstream subscribers, the MIX depends on grants, which in turn limits its ability to advance its information systems to mainstream quality—a Catch–22. Nevertheless, the commitment of microfinance industry participants to the MIX is strong, and it promises to continue to be the top data resource for microfinance for some time.

Rising Returns

It is hard to tell whether equity investment in MFIs provides reliably attractive returns, given the limited exits in microfinance history. From ProFund's 6.6 percent to the highly profitable Compartamos IPO the range of returns is vast.

Leading MFIs often earn very attractive returns on equity. Compartamos has had an ROE close to 50 percent almost every year since 1999. ACCION affiliates Mibanco (Peru) and BancoSol (Bolivia) achieved returns on equity of 37 and 33 percent respectively in 2007.[10] The ROE for the bulk of profitable MFIs falls in the range of 4 to 18 percent.[11]

International investors do not receive these returns directly, however. As in the case of ProFund, investors in equity MIVs receive returns after adjustments for fund management costs (often in the range of 2 to 3 percent per year) and foreign exchange risk. Without exchange rate losses, ProFund's returns would have been much more exciting. Even so, ProFund outperformed average nonmicrofinance investments in Latin America during the same period. And returns depend critically on valuations at the time of sale, which incorporate estimates of future earnings potential. Returns on microfinance funds have trended upward. In 2007, the average gross return for equity funds was 12.5 percent.[12]

Returns for debt financing are more straightforward. "For many institutional investors, microfinance securities have proven to be a low-volatility, noncorrelated asset class with a yield pickup comparable to a Libor or money market investment. Even with the recent dip in emerging markets, returns have been robust," writes Zach Fuchs in the e-zine *Euromoney*.[13] For debt, the question mark is the frequency of default by MFIs. So far this topic has received little scrutiny, but a study under way by IAMFI, the association of investors in microfinance, will identify and investigate instances of default (which are few), giving investors a clearer picture of MFI industry risk. Average net return for fixed income funds increased in 2007 to 6.3 percent, from 5.8 percent the previous year.[14] With the credit crunch in 2009, debt suppliers to microfinance have been seeking higher returns.

Scale

What else stands between microfinance and full inclusion in the capital markets? One factor is small scale, a factor that is hard to avoid in an industry based on making tiny loans. Big banks do not want to arrange small- or medium-sized transactions. Like tiny microenterprise loans, they cost too much to arrange relative to the potential return. Small issues appeal to individual investors who do not mind smaller scale, including those in the socially responsible realm. Among the factors that keep transactions small is the scarcity of large, profitable MFIs.

A more temporary factor is the "crowding out" of private investors by the international finance institutions (IFIs). A limited number of MFIs are candidates for investment, due to their experience, legal status, profitability, and size. These so-called "Tier One" MFIs are already supplied with debt and equity, often at favorable rates, by the IFIs, leaving little room for private capital. Ideally, given their social mission, the IFIs would take on the financing of the smaller second-tier institutions with higher risk profiles, and would invest in helping those institutions become investment ready. But like any smart investor, IFIs want to be part of the big, sexy (and safe) deals. The role of the IFIs was diminishing until the market crash in 2008 dried up liquidity throughout the world, and public-sector actors, including the IFIs, were called back in to fill the gap.

Foreign Exchange

Managing foreign exchange risk is a particular issue for microfinance because so many of them operate in countries with soft currencies, including currencies that cannot easily be hedged. Many MFIs in partially dollarized economies, especially in Latin America, borrow in dollars because they are able to lend in dollars. This strategy carries its own risks, however. A safer strategy is to organize financing in local currency, through banks such as Citibank, Standard Chartered, or Deutsche Bank, which have local operations and can provide local currency loans. More sophisticated solutions are beginning to emerge, such as multiple currency transactions, found in numerous funds that group microfinance portfolios and, more recently, hedging and currency swaps.

Morgan Stanley used a currency swap to mitigate foreign exchange risk in a 2007 transaction that involved buying bonds from a group of 20 MFIs using a CLO. Loans are made in local currencies to lower the exchange risk for the MFIs, and these currencies are exchanged in the future at an agreed upon rate.

In 2007, a consortium of socially responsible investors, IFIs, and commercial bank investors joined in an initiative to manage foreign exchange risk. The Currency Exchange Fund N.V. (TCX Fund) diversifies its holdings across a number of different currencies in order to lower currency exchange risk. The fund's total committed capital equals $470 million, which provides it with a transaction capacity of from $1 to $3 billion. TCX offers long-term currency hedges to investors who provide finance to the private sector in developing countries, including housing and infrastructure, in addition to microfinance.[15] In order to facilitate access to TCX by MFIs whose transactions are relatively small, a fund known as Microfix has been established and opened for operations in early 2009.[16]

Exit

Equity investors in microfinance still face limited exit options, though the options are expanding. When ProFund wrapped up as the first microfinance equity fund, exits were very hard to find, resulting in valuations steeply discounted for illiquidity. Now that Compartamos is a listed company, the liquidity discount is gone for its shareholders. But IPOs are complicated, costly, and viable only for a handful of top MFIs. Meanwhile, other exit possibilities are emerging, including buyouts by new strategic investors, mergers, and acquisitions, as well as a widening number of equity funds.

This quick review demonstrates that challenges remain in building the market for investment. As a result, some forms of credit enhancement will continue, especially for pathbreaking deals. The need for such enhancement has been declining over time, though it has risen in response to the financial-sector crisis. Public IFIs and private social investors will continue to be at least as active as mainstream commercial investors, though again, the trend will continue advancing toward the commercial end of the spectrum. For some time to come, microfinance will occupy a privileged position, benefiting from the capital markets while still supported by socially oriented actors. And because that kind of position will nurture the expansion of the industry, it is good news for the progress of financial inclusion.

Part 4

SOCIALLY RESPONSIBLE RETURNS

15

APPROACHES TO SOCIAL RESPONSIBILITY

Responsibly delivered financial services can have a powerful effect on the lives of those who use them. They can make the difference between seizing the next opportunity or passing it by, building a better house sooner rather than later, recovering after a calamity or slipping into poverty. By its very nature, inclusive finance has a double bottom line.

Imagine the short life of an airline company that did not take passenger safety as a central concern. While customers literally put their lives in the hands of airlines, they depend on financial-services providers in critical ways, too. Financial-services providers bear some responsibility for the well-being of their customers, and they should think carefully about how their services affect the efforts of their customers to create better lives. Unfortunately, providers have not always done this well enough to earn ongoing trust.

Providers of inclusive finance that embrace the "social bottom line" as an integral element of their strategy, corporate culture, and service delivery are more likely to succeed and become leaders in their fields. Those who ignore the social bottom line not only put their own businesses at risk but can harm the reputation of financial services providers more broadly.

Changing Views of Corporate Social Responsibility

Views on corporate social responsibility (CSR) are changing fast. It is increasingly inadequate for companies to treat social responsibility as at best an obligatory cost of business and at worst a protective tactic. It may not be surprising that 89 percent of consumers in a 2007 McKinsey study believed that "corporate obligations to shareholders must be balanced by contributions to the broader public good."[1] It may be more surprising that 84 percent of business executives also agreed. Such a consensus is a great starting point for future action.

However, views diverge on how well business is actually doing. Each key stakeholder group—executives, employees, investors, customers, and society at large—has a different take. According to the survey, 68 percent of business executives in North America thought the contribution to the public good by large corporations was "generally" or "somewhat" positive. Yet only 48 percent of consumers agreed. When asked whether consumers trusted large global corporations to act in society's best interest, only 33 percent of European consumers and 40 percent of U.S. consumers agreed. The survey also found 79 percent of consumers in China refused to buy products or services from a company that they thought acted against the best interests of society, while 49 percent of consumers in the United States responded similarly.

Traditionally, CSR has been seen as a matter of maintaining a positive reputation. Reputation is not just a soft value. Brand recognition, customer loyalty, and goodwill are all bankable commodities, and a reputation as a leader in social responsibility is becoming more valuable with the emergence of more socially conscious shareholders, investors, and consumers. But although reputation is an important driver for social responsibility, it is often reactive, placing social responsibility in the realm of risk management.

Though no single new theory of corporate responsibility has gained common acceptance, a number of prominent business theorists are searching for a satisfactory theoretical foundation. The philosopher in me likes the starting point proposed by Ian Davis, former CEO of McKinsey, who posits an implicit social contract: society grants business the right to operate because it provides socially useful goods, services, and employment. Instead of the mantra of maximizing shareholder value, Davis suggests, "It may be more accurate, more motivating—and indeed more beneficial to shareholder value over the long term—to describe the ultimate purpose of business as the efficient provision of goods and services that society wants."[2] This view is not so far away from the traditional economists' notion that the greatest social impact business has lies in its basic operations. Conservative thinkers sometimes like to point out that Bill Gates has more social impact through Microsoft than through his multi-billion-dollar foundation.

The Double Bottom Line

Within inclusive finance circles, people often talk about the "double bottom line," encompassing both financial and social returns. But everyone crosses the double bottom line at a different point. When the microfinance community first considered the idea of commercial microfinance in the early 1990s, the advocates of the approach, myself included, viewed profits strictly as a means to an end. The goal was to bring microfinance to millions of people on a permanent basis, and profits were the tool to make it happen. Business executives are more likely to start with the financial bottom line, viewing social benefit as part of a successful strategy for maximizing profit. A company must benefit its customers (and its employees, for that matter) if it is to retain their loyalty. In the long run, shareholder and customer interests are strongly aligned, as shareholder value depends critically on customer value.

It is mathematically and logically impossible to maximize two objectives at the same time, so there may never be a thoroughly satisfactory theory of the double bottom line. But we live in the practical world, where most of the time we do not need to know which bottom line is more fundamental, since both are deeply intertwined.

The key insight of Michael Porter and Mark Kramer, in an influential *Harvard Business Review* article on CSR, is that the mutual dependence of business and society presents opportunities to the company astute enough to understand and act on social trends. Porter and Kramer assert that "companies can build on the interdependence between business and society, rather than being held back by the friction between them."[3] The takeaway lesson is for companies to integrate social responsibility directly into their business strategies.

Integrating Social Responsibility into Business Strategy

Successful integration requires a thorough exploration of a company's own particular social context. Social pressures may signal a business opportunity in the form of a consumer demand that is not being adequately met, according to Davis. Companies that are alert to such opportunities can leverage innovation and research to create social value and financial return, as Toyota did with its enormously successful Prius. Looking at long-run energy trends, Toyota decided to introduce a hybrid vehicle well before it was clear that the mass market was ready. It received lasting advantage and a reputation boost from acting first.

Whole Foods has staked its business strategy on the organic food movement, riding the growth of interest in organic food to become a major corporation that commands premium prices other grocery chains envy. On the other hand, witness the slow response of the fast-food industry to rising concern about obesity in America, and its loss of consumer loyalty.

Keeping in mind these familiar corporate examples of success in socially responsible strategy, we return to financial inclusion.

Social Responsibility in Financial Services

Inclusive finance represents an enormous opportunity to put social action at the heart of business strategy. Customers can improve the quality of their lives and build assets. Local economic activity is stimulated. Companies that have pursued inclusive finance, such as Citibank and Visa Inc., have built successful lines of business. Perhaps more important, they have positioned themselves for the future, like Toyota with the Prius, by being among the first to capture a rapidly expanding market.

The heroes of social responsibility in this book are represented in the cases where businesses have moved into inclusive finance in a major way. In this chapter, we look at companies that have pursued inclusive finance under the CSR banner. These examples are ordered in a general sequence from those that look like traditional CSR (the Nike example) to the more strategic. All have been praiseworthy efforts, and they illustrate important lessons about how to incorporate social concerns into the business. Among the lessons: partner with nonprofits and government; use a mix of philanthropy and straight business tools; and analyze the needs of customers, employees, and communities. The last two examples, CEMEX's Patrimonio Hoy program and ABN/AMRO's Real Microcredito, show the power of bringing efforts first designed as CSR into mainstream business strategy.

Nike Village Development Project, Thailand

In the 1990s, Nike, the world's leading maker of athletic shoes, came under severe international criticism for outsourcing its work to sweatshops with poor labor practices. To protect its reputation, Nike greatly increased its CSR activities, focusing on the well-being of its employees and their communities. At the same time, Nike was interested in moving production into low-cost locations.

One such location was rural Thailand. Nike partnered with the Population and Community Development Association (PDA), Thailand's most prominent nongovernmental organization (NGO), to bring a range of services—including a loan fund—to the employees and local residents of a new factory. From its beginning in 2001 through 2004, this loan fund assisted 700 borrowers and grew to $560,000. While this amount is modest, it should be noted that this was not primarily a financial-services project, but included financial services in a wide-ranging community development effort.[4]

Betagro Group's Employee Loans, Thailand

Betagro, a billion-dollar chicken and pork processing company in Thailand, relies on thousands of day laborers, bussed from as far as 120 miles away, to cope with seasonal demand. Because productivity varies greatly with the amount of experience a worker has, Betagro's 13 percent monthly turnover rate was very expensive. Company leaders realized that turnover might have more to do with workers' lives outside of work, and identified financial stress as a factor. Employees experienced loan shark debt and financial strain from medical crises and other emergencies.

Betagro partnered with the Government Savings Bank (GSB) and with PDA, the same NGO Nike worked with. GSB, through its People's Bank microfinance program, offered financial services onsite at plants and in worker dormitories. In early 2008, the program was still too new for Betagro to determine whether it was having a direct impact on turnover. However, there were already clear indications of changed attitudes about Betagro among employees. Betagro executives emphasize that this program is a business activity—an investment in "sustainable competitive advantage"—rather than CSR.[5]

It may be surprising that a chicken processor and a shoe manufacturer could become involved in inclusive finance, so it is worth noting why inclusive finance became part of business strategy. For Nike, it was a very traditional CSR approach, aimed to create positive community relations. For Betagro, it was more closely linked to strategy—a way to address a problem that affected productivity.

ANZ Bank, Pacific Islands

ANZ Bank, which operates in the major centers of the Pacific region, saw a market opportunity in banking the far-flung and low-income population across the Pacific islands. But first it had to learn more about this market. Bank staff fanned out across the islands and into rural communities. They asked questions and listened. One thing they discovered was that islanders were worried about their vulnerability to natural disasters. In response, ANZ built a rural product suite around savings for disaster preparation and protection. In order to make savings accounts work in locations far removed from the power grid, ANZ developed a solar-powered ATM.

ANZ went into the project with a long-term perspective. It believed it was laying the groundwork for future profits. Not all of its experiments have broken even. As in Betagro's case, the first benefits appeared quickly in the form of goodwill from community members, local political leaders, and mainstream clients who approve of ANZ's concern for their country's development. Some of these people may be the very policy makers who affect ANZ's operating environment. This may be a general lesson: the short-run benefit of social responsibility comes in the form of image, reputation, and goodwill. If reputation is the primary motivation, this may be a reason that companies are often content to stop while the efforts are small, rather than pushing them through to profitability.

The ANZ case also reinforces the lesson of partnership in program design. Partners in the public-sector or nonprofit worlds can collaborate on challenges that are not immediately amenable to a business solution or function as an incubator of new ideas that ultimately can become business opportunities. Both Betagro and Nike developed such partnerships. ANZ partnered with the United Nations Development Program (UNDP), which provided financial literacy training in areas ANZ wanted to reach. Financial literacy helps build the market for the services ANZ provides, but the client relationships ANZ builds must be profitable over time without direct UNDP support. In crafting partnerships it is important that business profitability not depend on the continued presence of a public or nonprofit subsidy.

The microfinance community provides a rich source of ideas for potential partnerships. It is deeply engaged with the low-income sector and is constantly testing ways to make a greater difference to clients. One of the best known such partnerships is Grameen Phone, owned in part by Grameen Bank and in part by Nokia, which lends to rural women for the purchase of cell phones. The women sell phone services to their neighbors, earning income, and thus a financial service is joined with a specific income-earning opportunity for the client. The phones also benefit communities through new business opportunities, better market information, and access to services. Many microfinance institutions are potential partners in similar kinds of ventures.

Equity Bank's Education Package, Kenya

The most far-seeing companies actively search out ways to make a bigger difference in the lives of their customers, even if it means looking beyond the standard package of financial services. This blue ocean strategy actually creates new markets rather than competing for saturated ones. Equity Bank in Kenya, one of Africa's most successful microfinance banks, saw an opportunity to build value around education.

Managers at Equity Bank noticed that they had made a large number of loans to educator/entrepreneurs who were launching private schools aimed at lower-income families. The bank developed a package of products and services anchored around these schools, turning a set of previously unconnected loans into a line of business with many facets. Equity's school-based financial services include youth savings accounts, savings and loan accounts for parents and teachers, and services for schools (payroll services, construction loans, and others). Equity augmented this package with a highly visible scholarship program that provides university scholarships to the top student in each district in which the bank operates. Recently, the Equity Bank Foundation has been examining ways to channel charitable resources to further strengthen the schools it already banks. In a country that fiercely prizes education, Equity's school focus combines smart positioning with a genuine commitment to tackle an important social issue. And its orientation to youth ensures a strong client base for the future.

One of the most interesting aspects of Equity Bank's education program is the way its business, promotional, and charitable arms support one another. In moving social responsibility deeper into corporate strategy, companies may fear losing their way when the line between charitable and business activities becomes murky. It is not appropriate (or legal) to use corporate charitable activities to shore up business operations. Equity Bank navigates these waters well by focusing on a common theme that has very different activities associated with its business and social sides, but it is possible to envision conflicts arising if it were to channel grants to schools that have difficulty paying an Equity Bank loan.

CEMEX's Patrimonio Hoy Program, Mexico

When activities can be designed around a profitable core, they have a much better chance of being scaled and sustained, and this means they have a much better chance of benefiting more people. Initiatives positioned from inception in the social responsibility corner are often difficult to scale up. The mind-set is charity, not business opportunity.

Mexican cement giant CEMEX originally designed its Patrimonio Hoy ("Equity Today") program within its social responsibility arm. Through Patrimonio Hoy, CEMEX assisted low-income families to finance the inputs needed to build a simple home, including cement and other CEMEX products. The program was successful in that it allowed the intended recipients to build houses. It also gained CEMEX excellent international recognition. However, in its original form, Patrimonio Hoy was not profitable for CEMEX and thus was not on track to be scaled up to the potentially hundreds of thousands of households that might become customers.

Restructuring the program to make it profitable and scalable required rethinking everything. Operations needed streamlining. The product needed adjustments to fit customers better. The legal framework required engagement with regulators (over permissible financial activities of a nonfinancial corporation). Scaling Patrimonio Hoy thus challenged CEMEX to examine whether it wanted a showcase project or a serious business strategy.

ACCION International worked with CEMEX to restructure Patrimonio Hoy for scale and profitability, but this was not immediately endorsed by all executives within the company. Most of the executives who hesitated agreed that Patrimonio Hoy had the potential to become profitable, but were concerned about external perception and reputation risk. If CEMEX made a profit from the poor, would it be criticized rather than praised? Ultimately, CEMEX decided to move forward with the redesign, and Patrimonio Hoy has reached 185,000 Mexican families. The question its executives faced, however, foreshadows the consumer protection issue we take up in the next chapter.

ABN/AMRO Bank and Real Microcredito, Brazil

ACCION had the privilege of working with another major corporation, ABN/AMRO Bank, and observing the same progression from social responsibility to profitable line of business. Indeed, fostering this kind of progression is part of ACCION's philosophy. Banco Real, ABN/AMRO's Brazilian arm, invested with ACCION in a microlending subsidiary using the "downscaling" techniques presented in Chapter 7. Real Microcredito disbursed its first loan in São Paulo in 2002.

During its first two years, the project remained small. I often heard ACCION's staff express frustration because the project was positioned at arm's length from the real business strengths Banco Real had to offer, such as its extensive branch network. It seemed as though Banco Real would be content with the short-term reputation gains and would not see the project through to genuine business success. During the project's third year, the bank shifted its view, and allowed Real Microcredit to work through its branch network. The growth curve turned decisively upward, and by 2007 a profitable Real Microcredito had 53,000 clients.

Conclusion

Equity Bank, CEMEX, and Real Microcredito show how a strategic approach to social value can yield a double bottom line. They demonstrate that pitting social and financial returns against each other is often a false dilemma. Incorporating social considerations and goals into corporate strategy makes good business sense in every way.

The story of social responsibility in inclusive finance would not be complete without considering the risks of inadequate attention to customer welfare, as we do in the next chapter. The subprime mortgage crisis in the United States is an object lesson in what happens when the drive for profits causes lenders to encourage customers to borrow more than they can manage.

And one of the basic challenges of social responsibility, which often keeps it from gaining greater attention inside companies, is the challenge of measuring it. If the social bottom line is ever to gain some of the same recognition as the financial bottom line, better measurement is necessary. We look at this issue in the last chapter of this part.

16

CLIENT PROTECTION AND PROCONSUMER INCLUSIVE FINANCE

While the concept of treating the poor as commercial customers is gaining wider acceptance, eyebrows still rise anytime the words "poor" and "profit" appear in the same sentence. They rise especially fast when the subject is financial services.

Such skepticism is entirely warranted. From their earliest beginnings, financial services—particularly credit—have had a dark side. The evil moneylender of history is recast as the payday lender of today. It is no wonder that some CEMEX executives worry about potential risks to their reputations from turning their Patrimonio Hoy program from a corporate responsibility initiative into a profitable, mass-market operation. They are not the only executives skittish about the public's response to doing business with the poor.

When inclusive finance reaches scale, it attracts public attention, opening a political opportunity to criticize it as much as to promote it. And among providers, one institution inevitably gets greedy, a debtor commits suicide, a political organizer creates a protest. The negative repercussions can undo the benefits of 10 times as many success stories in the press. Bad news really does travel faster. And the whole sector—or the very concept of inclusive finance—suffers, not just the bad apple. Many people dismiss this pattern because it is irrational and disproportionate, but it nevertheless happens so often that it is actually predictable.

The antidote to this risk is to adopt strongly proconsumer principles and practices. Because financial services for the poor are prone to misuse, client protection rises to the top of the agenda for any company pursuing inclusive finance. Both the business case and the moral imperative of consumer protection are compelling. We will argue in this chapter that responsibility for protecting consumers lies first with the providers of financial services themselves. While regulators are also essential, industrywide success depends on a committed provider community.

The Stubborn Problem of Predatory Lending

Despite centuries of experience, financial systems have not invented a system that eliminates overzealous (predatory) lending. At best, there are practices that keep it at bay.

The problem stems from the inherent natures of finance and humanity. When borrowers sign promises to repay loans, they intend to repay and believe they can. But experience shows that human beings, especially those as vulnerable as many poor people, consistently overestimate their future ability to repay. Whether from overconfidence or desperation, vulnerable customers are prone to accept terms that will be harmful to them down the line.

In the long run it's wise to treat the welfare of clients as a sacred trust. Doing so requires restraint on the part of lenders to ensure that vulnerable borrowers do not fall into debt traps. But as long as people are prepared to overborrow, there will always be some profit-seekers prepared to overlend. The problem is magnified for bottom-of-the-pyramid clients because of the great imbalance of power and information between formal businesses and poorly educated low-income people. And because bad practices like overlending can sometimes generate immediate profits and a short-term competitive advantage, they are prone to spread and infect even those players who would prefer to pursue good practices.

Bolivia's consumer lending crisis of 2000 illustrates this syndrome. When consumer lenders began drawing clients away from microfinance institutions by offering bigger loans, microfinance institutions hiked their loan limits to keep their customers from defecting. Within a couple of years the overheated market collapsed, and all institutions paid severely.

Efforts to prevent such tendencies in inclusive finance are hampered by disagreement about the practical boundaries of appropriate restraint. Is it appropriate for consumers to pay 25 percent of their income for debt service? What about 40 percent? Rules vary widely around the world.

The Subprime Mortgage Crisis and Other Debacles

The subprime mortgage debacle in the United States provides an object lesson on the causes and consequences of failure to protect consumers. The crisis that sent shock waves throughout the world's economy began as a violation of fundamental consumer protection principles. Subprime borrowers with low incomes or poor credit histories were enticed into variable rate mortgages featuring very low—or even zero—interest rates for the first few years with sharply rising rates thereafter. Many borrowers signed up hoping (against prudence) that in a few years their incomes would rise enough to pay the higher interest costs. Mortgage originators glossed over the inadequate incomes or lack of significant down payments on the grounds that rising house prices would back up the loans. According to Martin Gruenberg, vice chairman of the U.S. Federal Deposit Insurance Corporation, as many as 40 percent of subprime mortgages were made without income verification.[1] When these loans predictably began to sour, the collapse of the subprime market unraveled the housing market, the broader financial sector, and even the world economy. The effect on the families who lost their homes was devastating.

What makes this outcome painfully ironic is that when subprime mortgage products were first developed, they were intended to make home ownership more accessible to lower-income clients. The law of unintended consequences struck with a vengeance, sounding a warning that speaks clearly to providers of inclusive finance.

Why, despite a highly regulated U.S. financial sector, with strong consumer protection legislation, were so many bad loans extended? Sadly, corporate enablers at several levels contributed to the problem. Financiers on Wall Street developed collateralized debt obligations (CDOs) that blended subprime mortgages carrying high interest rates with more conventional mortgages at lower rates. They stratified risk to appeal to various appetites and won the blessing of rating agencies. The CDOs became very popular with investors, so mortgage brokerage houses continued expanding their businesses. These brokerage houses made money from loan origination fees and bore little risk in the event of default. Thus, a chain of connections was developed which protected key actors from the consequences of bad decisions and inserted a wedge between the best interests of the borrowers and those operating the system—the mortgage brokers and CDO packagers. Regulators sat quietly by because they did not regulate mortgage brokers.

The lessons for inclusive finance of the subprime episode deserve and are receiving a rich exploration that goes beyond what we can do in this chapter.

Suffice it to say that we already knew enough about consumer protection to have prevented this crisis. Capacity to repay is a simple principle. It has been one of the "five C's" of credit since banking began. The subprime crisis teaches us that the danger lies in the structure of incentives determining whether lenders will apply these principles and whether consumers will go along.

Overlending Crises in Other Countries

The scale of the U.S. subprime crisis may be unprecedented, but it is certainly not the only time irresponsible lending has shaken an entire financial sector. The financial sectors of developing countries are at least as vulnerable to this kind of phenomenon as the United States. The rise and fall of consumer lending in South Africa and Bolivia during the past decade are examples.

In South Africa the government sought to open the economy to the newly enfranchised black majority, shut out during the apartheid era. It revamped the regulatory environment, removing interest-rate ceilings on small loans and providing room for new businesses to enter the market. Consumer credit companies swooped into the regulatory opening, providing easy credit at very high rates to anyone with a regular salary. They called it microfinance, though most loans were personal and consumer loans, differing substantially from the microenterprise loans of best-practice microfinance. The result was widespread overindebtedness among low-income workers, leaving microfinance linked in the public eye and among policy makers to preying upon the aspirations of the poor. Socially minded organizations that might wish to enter the South African market now have to overcome the tarnished image of BOP finance.[2]

In the Bolivian crisis, consumer lenders from Chile brought in lending techniques developed for middle-class salaried workers and applied them to loans for self-employed people. In a couple of years they pushed out as much debt as the microenterprise lenders of Bolivia had extended over a decade. Borrowers, unused to being courted, took multiple loans, often using one loan to pay off another. The consumer lending portfolios collapsed quickly when Bolivia entered an economic recession, and their collapse nearly brought down microfinance as well.

These examples demonstrate that overlending is by far the biggest consumer protection problem. It is the only problem with the capacity to cause systemic collapse. And it also brings the most serious consequences for the clients, whose lives can suffer in myriad ways if entangled in debt traps.

But overlending is not the problem that generates the hottest debates. That honor belongs to pricing policy.

Interest Rates and Pricing Transparency

Inclusive-finance providers sometimes hesitate to draw attention to the large gulf between the views of the general public and what they know to be necessary. This is certainly true about interest rates, the number one consumer protection issue in the public eye. Providers understand that interest rates for low-income people must be relatively high to compensate for small transaction size, but the public's intuition is that it is unfair to charge the poor higher rates than the rich. Add to this the fact that politicians often stand ready to make political points at bankers' expense, and inclusive-finance providers have strong incentives to deflect attention away from the question of fair pricing.

Compartamos Banco, a specialized microfinance bank in Mexico, takes its social commitment very seriously. The Compartamos staff are trained in the company's code of ethics and taught to treat customers with dignity. The institution has a strong complaint resolution program, reaches marginalized clients—poor rural women—is transparent about pricing, and dedicates resources to widen the range of services it offers. But the interest rates at Compartamos are high: about 86 percent overall in 2007, excluding the tax the government of Mexico levies in addition.[3]

As an explanation for its rates, Compartamos has claimed that it needed to generate retained earnings to finance rapid growth. And, indeed, Compartamos was the first microfinance bank in the Americas to reach 1 million poor women, a mark it hit in 2008. The hefty profitability and growth brought on by high interest rates were largely responsible for its highly successful initial public offering in 2007, with shares sold at 13 times book value. In the interest of full disclosure, ACCION, which sold half its shareholdings in Compartamos, was one of the main beneficiaries of the IPO.

The mainstream investors that bought Compartamos shares, and the investment banks that helped place them, did not pause over the interest rate. However, the microfinance community from which Compartamos came did. A highly vocal segment of that community, including its sole iconic figure, Mohammad Yunus, criticized Compartamos strenuously for interest rates that in their eyes made it equivalent to a moneylender. The critiques caught the attention of mainstream news media, including *BusinessWeek*, *Forbes*, the *Wall Street Journal*, and the *Financial Times*, prompting investors and the informed public to ask serious questions for the first time about appropriate rates for microfinance.

While this is not the place for a discussion about whether the interest rates set by Compartamos were too high (my personal view is that they could have come down further, sooner), we can learn a lot about the dynamics of consumer protection from this controversy.[4]

One lesson is that the reputation of Compartamos as a proclient organization, patiently built through many solid accomplishments, nearly evaporated over a single hot-button issue. The sudden deep shift in the public image of Compartamos underlines the seriousness of the reputation risk associated with client protection missteps.

Why did Compartamos overlook this risk or choose to keep rates high despite the risk? The stakeholders closest to Compartamos were either comfortable with the rates or willing to go along with them, especially since they generated enormous business success. The bank's rates were not seen as too high within Mexican banking circles, nor did the investors and investment bankers involved in the IPO have problems with them, and of course they stood to gain from high rates. Compartamos's monitoring of client attitudes did not pick up interest rates as a major concern. Those closest to Compartamos, including many of us at ACCION, were taken by surprise at the vehemence of the post-IPO criticism and media response. We did not fully anticipate the passion over interest rates or the potential media interest in examining a controversy in the otherwise relatively upbeat and uneventful microfinance sector.

The Compartamos case illustrates the need for distinct attention to transparency about rates (disclosure) and the rates themselves (fair pricing). Both matter, but in different ways. Compartamos has always prided itself on giving customers full and clear pricing information. Nevertheless, the controversy generated calls for improved pricing transparency. A new organization, MicroFinance Transparency, was founded by Chuck Waterfield, one of the most vocal critics of the Compartamos IPO, to promote rate disclosure among microfinance institutions. Transparency and disclosure have widespread support across the whole political spectrum.

The more divisive issue, and the issue that matters to the broader public, is the actual level of interest charged and the profits that result. Politicians find interest rates a handy card to play when they want to go after inclusive-finance institutions. Everyone agrees that lower rates are better for clients, and few people, including politicians, are willing to pay attention to tedious explanations about the cost structure for making small loans. While microfinance lenders pride themselves on being proclient, they may charge rates no different from the rates of more commercial actors, like Banco Azteca, who the lenders sometimes criticize as not proclient enough. In the United States, your take on whether payday lending is good microfinance or predatory lending will largely depend on your "philosophy" about wider social, economic, and political issues. The lines are not clear-cut.

Many BOP lenders deserve criticism for being complacent about high interest rates and preferring to enjoy the profits rather than trying to cut costs to bring down prices. Only competition seems to have sufficient power to reduce rates. Competition has dropped microfinance rates dramatically in Bolivia (but at the cost that fewer commercial lenders offer the very small loans needed by the poorest clients), and rates are coming down in many hotly contested Latin American microfinance markets. But an analysis from the Consultative Group to Assist the Poor of interest-rate trends complained that in most countries rates are stubbornly high even with competition.[5]

The attention paid to interest rates by government does not seem to be a function of the rates themselves, suggesting that financial institutions must supplement good practice with astute media and government relations. In the Indian state of Andhra Pradesh in 2006, the state government intervened to close down two microfinance institutions. The real issue concerned rivalry between MFIs and a government-run microfinance program that was losing clients to the MFIs. However, the media and politicians shone the spotlight on interest rates, despite the fact that microfinance interest rates in India, at around 20 percent, are among the lowest in the world. Immediate and intensive dialogue between microfinance leaders and banking authorities was necessary to forestall interest-rate caps.

Similarly, populist politicians across Latin America have seized on interest rates as a weapon for beating on microfinance. In Nicaragua in 2008, President Daniel Ortega castigated microfinance institutions for high rates, provoking a violent incident that left several people injured. Populists may see championing interest-rate caps as a vote-getting move. And as in India, many such politicians also favor government-owned peoples' banks.

Collections Policies. Though predatory lending and high interest rates are the chief consumer protection risks facing inclusive finance providers, one final issue requires a brief mention: fair collection practices. Both ICICI Bank in India and Banco Azteca in Mexico receive bad press from time to time regarding incidents of strong-arm collection practices. In June 2008 the television network France 24 skewered Grameen Bank for the same thing. In the news segment, a former Grameen Bank collections officer sits in a darkened room, face obscured like a criminal or terrorist, and "confesses" to using high-pressure tactics to recover loans.

Such reports, in the style of investigative journalism, may or may not reveal significant underlying problems. The ease with which institutions can be attacked, however, points to the importance for financial institutions of taking vigorous, proactive steps to ensure that they both endorse consumer protection principles and apply best practices.

Taking Responsibility for Consumer Protection

There is strong consensus around the basic principles of proconsumer financial services. In the microfinance industry several MFI networks have adopted statements of principles such as the one we present in the box on page 157, which was adopted by both the ACCION Network and Microfinance Network.

However, the level of active commitment to such principles by service providers is often weak and occasionally grudging. Many providers would prefer that regulators uphold proconsumer practice, freeing providers to do everything not specifically prohibited. Thus is born a cat-and-mouse game where providers seek to sidestep regulations and regulators become ever more restrictive.

Certainly, regulators have a key responsibility for consumer protection, especially because individual companies often find themselves at a competitive disadvantage when they take proconsumer stances, as when a bad practice infects the market as a whole. In many developing countries regulatory frameworks and the power to enforce them are very weak. But even in the most developed places, regulations run behind reality, as the U.S. subprime crisis demonstrates.

This means that providers must become guardians of consumer protection. Their responsibilities include promulgating strongly embraced norms and best practice standards. Yet quite often a narrow interpretation of social responsibility characterizes corporate attitudes. Market research guru Daniel Yankelovich argues that many corporations operate according to the "smell test," which treats as acceptable any practice that does not break laws or violate widely held ethical norms.[6] Yankelovich wants companies to embrace "stewardship ethics" in which they become leaders vis-à-vis larger societal challenges, like consumer welfare.

The Business Case for Consumer Protection. We have emphasized the reputation risk of consumer protection, which can hit institutions fast and hard. At a more operational level, the business case for consumer protection is also solid. It rests on the simple idea that what's good for customers is good for business. No institution interested in long-term business growth will knowingly lend more than clients can sustain. Consumer protection principles are, in essence, the principles of service quality. Treat customers fairly and with dignity. Strive to offer them as much value as possible, as if the welfare of the company depends on the value the company provides to customers. Because it does.

Ideas for Action. How can the private sector respond to the need to take leadership on consumer protection? Among many ideas are the following:

- Inside financial institutions:
  - Ensure that assessment of repayment capacity is central to determining loan amounts.
  - Scrutinize internal incentives to avoid rewarding staff for overlending.
  - Disclose all pricing and fees to clients in simple language when signing loan contracts.
- Among financial institutions as an industry:
  - Develop consumer protection certification processes that reward good practice providers with a seal of approval.
  - Agree on sectorwide pricing disclosure practices so institutions are not disadvantaged if they disclose when others do not.
  - Launch financial literacy campaigns to create savvy consumers who understand their rights and responsibilities.
  - Actively engage in dialogue with regulators, politicians, and the press to raise awareness.
- For investors in inclusive finance institutions:
  - Incorporate checks on consumer protection practice into due diligence.
  - Require investees to demonstrate consumer protection action plans or certification by third parties.

All these ideas are being pursued in the microfinance industry's Campaign for Client Protection in Microfinance. This is the bottom line for the social bottom line: companies that get involved in inclusive finance need to take a leading role in promoting proconsumer policies—among their executives, their front line staff, their customers, their competitors, and the general public. Consumer protection must become part of the DNA of inclusive finance.

Principles of Consumer Protection in Microfinance

As Adopted by the ACCION Network and the MicroFinance Network

1. **Quality of service.** Network members will treat every customer with dignity and respect. Members will provide services in as convenient and timely matter as possible.
2. **Transparent pricing.** Network members will give clients complete and understandable information about the true costs they are paying for loans and transaction services and how much they are receiving for savings.
3. **Fair pricing.** Network members will price their services at fair rates. Their rates will not provide excessive profits, but will be sufficient to ensure that the business can survive and grow to reach more people.
4. **Avoiding overindebtedness**. In order to avoid customer overindebtedness, network members will not lend to any customer more than that customer can afford to repay.
5. **Appropriate debt collection practices.** While debt collection practices must include energetic pursuit of defaulters, network members will treat customers with dignity and will not deprive customers of their basic survival capacity as a result of loan repayment.
6. **Privacy of customer information.** Network members will protect the private information of customers from reaching others who are not legally authorized to see it.
7. **Ethical behavior of staff.** Network members will hold their employees to a high standard with respect to conflicts of interest and unethical behavior, especially behavior that harms customers (such as taking kickbacks). Employees who breach these standards will be sanctioned.
8. **Feedback mechanisms.** Network members will provide formal channels of communication with customers through which customers can give feedback on service quality. These channels will include mechanisms for responding to specific customers regarding their personal complaints.
9. **Integrating proconsumer policies into operations.** Network members will make proconsumer orientation a hallmark of the way they conduct business, through efforts such as staff training and incentives, financial education for customers, customer satisfaction programs, and the like.

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MEASURING THE SOCIAL BOTTOM LINE

Among advocates of the double bottom line, the quest for accountability has focused on tools for measuring corporate social performance. To be taken seriously, the social bottom line needs compelling metrics that can stand alongside the key metrics for the financial bottom line. The challenge of developing metrics for social performance is daunting. Alas, there will never be a set of indicators to rival the balance sheet and income statement, nor a social return number to match the explanatory power of the financial return on equity.

Unlike financial results, social results differ from one business to another. A pharmaceutical company might look at lives saved while a timber company looks at trees planted. If social responsibility is to become genuinely integrated into business strategy, as proposed in Chapter 15, social metrics for internal use must be highly tailored to each company's unique pursuit of comparative advantage. More to the point, one bank may pursue outreach in remote areas while another offers services that help clients pay for health care. But standard metrics are needed for outside stakeholders such as investors, who want to compare the performance of different companies. Unfortunately, standard metrics are likely to miss out on some of the most important company-specific contributions to social goals.

The inherent difficulties do not suggest that the effort should be abandoned, however. The need for better measurement tools is too great. Rather, the task should be approached with flexibility and realism.

One obvious solution is to treat standard and tailored social metrics in two different ways. Standardized social metrics are in fact measures of good corporate citizenship. The first section of this chapter looks at some efforts to establish social-performance reporting frameworks for corporate citizenship that apply to all or nearly all companies. Tailored metrics address strategic contributions made by specific kinds of businesses or even specific companies. Later in the chapter we consider social metrics specific to inclusive finance. The overall aims of inclusive finance—to bring high-quality financial services to more people, especially low-income people, so they can improve their lives and contribute to economic growth—imply some similarities about tailoring measurement of social performance.

Indicators of Corporate Citizenship

Good corporate citizenship is a kind of minimum standard for all companies. A good corporate citizen does business in a way that fulfills basic social norms. In return it gains society's acceptance, even blessing. Corporate citizenship today encompasses four main mandates:

- Be a good employer.
- Protect the environment.
- Support your community.
- Treat your customers fairly.

These generic demands apply to financial institutions as much as they do to car makers and grocery chains. Since they apply to every business, some standardization of measurement becomes possible, though as we will see, selection and adaptation by sector, company, and country is still complex.

The Global Reporting Initiative

The Global Reporting Initiative (GRI) is a good approach to measuring social performance, and its shortcomings illustrate just how hard a nut social reporting is. The GRI began in 1997 in collaboration with the United Nations Environment Program to involve organizations in sustainability reporting under the banner "People, Profits, Planet," fundamentally a corporate citizenship agenda. With GRI's origins in the environmental movement, its "planet" indicators on energy use, waste, recycling, carbon emissions, and the like occupy center stage. The "people" indicators relate to employment practices, such as nondiscriminatory hiring, fair wages, and relations with the community.

GRI calls itself the "de facto global standard for reporting" and claims over 1,500 businesses and other organizations as users.[1] Included in its active list are more than 60 banks and financial institutions, including a number of banks that appear in this book: ANZ Bank, Banco Bradesco, Citibank, and Deutsche Bank. The GRI may one day fulfill its aims, but it still has a long way to go before it becomes a widely recognized and used global standard.

The GRI approach sensibly cuts through some of the greatest difficulties in social reporting. To cope with variation in social goals from one company to another, GRI allows each company to select the indicators it will report from a long list of possibilities. It provides guidance on a process for defining appropriate indicators with reference to key stakeholders. It supports the differentiation of goals by providing industry-specific supplements—lists of proposed indicators that are especially relevant for certain types of industries. A proliferation of indicators arises from GRI's attempt to incorporate not just corporate citizenship goals, but to respond to every variety of social purpose, a thankless task. Its financial sector supplement, now under revision, is considering a proposed list of indicators that addresses financial inclusion concerns.

The GRI also attempts to make sure that its process is more than just a public relations exercise. It requires that each reporting company provide narrative statements on social goals and strategies, as well as an explanation of how social-performance indicators are used in corporate management and governance.

A major challenge for the GRI and other social reporting frameworks is to make their reports useful to stakeholders. Ideally, reports would be pored over by management, board members, and investors. Customers, employees, media, and community leaders would read them, too—at least the executive summary. Unless social reports provide information that is compelling for these stakeholders, they will not add much genuine accountability. At present, however, there is so much flexibility that a company can present a glowing picture by selecting only indicators it scores well on. If a company wants to use GRI as window dressing rather than take a serious look at its social performance, it can.

GRI is among the best processes available for measuring corporate citizenship, but it remains flawed.

The Equator Principles

The Equator Principles get one step closer to inclusive finance. They were created by the International Finance Company and World Bank, which joined leading financial institutions to create voluntary guidelines for project finance. Project finance loans provide funding for major new installations such as power plants or factories, which are often controversial, especially on environmental grounds. The Equator Principles are social and environmental screens applied by financial institutions before approving project finance loans.[2] More than 60 leading financial institutions have signed on to the Equator Principles and the governing process that maintains them. These principles cover the environmental impact of businesses financed, prohibit the financing of certain socially detrimental businesses (vice, weapons), and examine labor practices (no sweatshops or child labor).

Efforts are under way, for example, by the Dutch development bank FMO to apply the same type of guidelines to inclusive finance. These efforts run straight into the problems of scale and informality that characterize most of inclusive finance. Microenterprise loans are too small to allow for individual policing, and the informal family businesses of the self-employed do not conform to formal-sector labor standards. Using the Equator Principles to measure the social value of inclusive finance is like putting on a shoe on the wrong foot.

Social Assessment for Inclusive Finance

When we move beyond corporate citizenship to strategic social goals for inclusive finance, we find recurring themes that allow some common measurement. The shoe may be a slightly better fit, but still far from perfect.

One of the best approaches is happening inside the GRI, which is considering a set of financial inclusion indicators within its general financial-sector supplement. Some of the indicators proposed are:

- Physical location of branches and customer service points
- Outreach to marginal populations, including low-income, disabled, and disadvantaged population groups
- Customer satisfaction among these groups
- Responsible lending practices and investment advice (following proconsumer policies)
- Financial literacy efforts
- Product range (microfinance, remittances, community investment)[3]

These indicators focus on the basic questions: whom do you serve and how well do you serve them? This is a common sense approach. It avoids the thorny issue of ultimate impact, which we will address later. It includes a combination of quantitative, objective indicators (people and products) and qualitative, subjective indicators (customer satisfaction, consumer protection).

Counting Clients

Counting clients is the single most important measure for institutions serious about inclusive finance. It is so basic that it almost goes without saying, and it is also dead easy to track. Microfinance institutions have long measured their success first by the number of active clients and second by some indication of how poor those clients are, usually using average loan size as a proxy. Mainstream financial institutions, however, prefer to track monetary volumes. Information technology can easily provide information on clients, sliced many ways, but habits of mind among managers and analysts are slow to change, and these indicators still lag in most financial reports.

Progress Out of Poverty Index

Counting clients does not give you much information on who a provider is reaching. One way to go deeper is to conduct periodic surveys of client socioeconomic status. The microfinance community embarked on a collective effort to develop ways to measure client poverty, coping with the absence of hard data on incomes and assets.[4] Some of the microfinance organizations most devoted to reaching the very poor have incorporated the resulting poverty data in their client intake process.

The Grameen Foundation, for example, has developed the Progress out of Poverty Index (PPI), a set of 10 questions that predict whether a family is very poor.[5] Given that poverty measurement is easily mired in academic complexity, a simple approach is essential if a tool is to make a difference in real life. Grameen has taken the detailed work of many researchers to devise this index, one of the most user-friendly poverty measurement tools now available for inclusive finance.

Loan officers apply the index when they sign up new clients and periodically thereafter, determining whether a family has moved out of poverty over time. The PPI asks about children, schooling, housing, land, energy use, employment, and consumer goods. Questions are tailored to each country, because while these elements are fairly universal indicators of poverty, they show up differently in each location. In Pakistan, the PPI researchers found that ownership of a motorcycle was a good predictor of a family's status, while in Bolivia furniture and telephones turned out to be better predictors.

It should be noted that what the PPI does not do is measure the impact of financial services on clients.

Social Ratings

Another approach, which recognizes the institution-specific nature of social goals, and skirts the lack of consensus on how to measure poverty, is the social rating. Social ratings examine an institution's processes, essentially asking whether the institution has credible ways of pursuing its stated social aims. ACCION International's social assessment framework, the "SOCIAL," attempts to incorporate both the generic corporate citizenship issues with finance-specific issues, all placed in the context of the company's own goals. Other specialized microfinance raters, such as M-CRIL and MicroRate, are walking a similar path. These ratings are highly subjective, however, which makes it difficult for them to set up comparative scoring. At present they are more useful as management tools than as ratings that speak clearly to investors and other external stakeholders.

Impact

Ultimately, we would like to know whether financial inclusion makes people better off. This is the question of impact. Clients do not use financial services as ends in themselves, but to achieve other goals, like higher income, financial security, or a better standard of living.

The impact question is particularly important for public donors and philanthropists who must decide whether to donate to inclusive finance or to something else—like primary education or rural roads. The question also matters for socially responsible investors. Microfinance investment vehicles like those described in Chapters 9 and 14 need evidence of social impact to report to their own investors. Triodos Bank, for one, has made major efforts to get the microfinance banks in which it invests to join the GRI.

Impact is the hardest nut of social-performance monitoring, because of the problem of attribution. With tools like the PPI, lenders can tell whether loans are reaching the poor, and even whether the poor are becoming richer. But they cannot attribute changes to the use of financial services. What if the economy was growing, and as a result everyone's income grew? What if the family's daughter moved to America and began sending remittances? How do we know whether the loans made a difference?

Formal studies that academics recognize as having sufficient statistical rigor to address attribution require control groups and measurement over time. The "gold standard" for impact evaluation, according to statisticians, is a randomized control trial (RCT), modeled after clinical drug tests and championed by the Massachusetts Institute of Technology Poverty Action Lab. Clients are randomly assigned to the treatment group (a loan) or the no-treatment group. If there is a statistically significant difference in outcomes between the groups, we infer that the loan made the difference. RCTs are expensive and time consuming, costing as much as $1.5 million and requiring years to complete. Moreover, this approach only demonstrates impact in virgin territory where no other service providers operate.

Anthropologist Ann Dunham Soetoro, better known today as Barack Obama's mother, dealt with this problem as far back as the early 1990s, when she worked for Bank Rakyat Indonesia. She saw that it was uninteresting to find out whether a loan from BRI had more impact than a loan from BKK, a provincial loan program.[6] When clients already have access to credit from another provider, it is impossible to construct a meaningful no-treatment group.

Qualitative studies are much more revealing. While quantitative studies zero in on a few key numbers, qualitative studies can provide a rich picture of how financial services affect clients. Such techniques—including focus groups, in-depth interviews, and other market research tools—help explain how impact happens, and at the same time provide useful insights for improving products and service delivery. Organizations like MicroSave and Microfinance Opportunities and projects like the Financial Diaries provide guides to adapting mainstream market research techniques to bottom-of-the-pyramid clients.

The Best Measure Is Face-to-Face

I want to end on a personal note by recommending an entirely unscientific approach to social indicators: visiting clients. Business executives who wish to develop a deep understanding of their market, and at the same time to increase their motivation to pursue social aims, can do nothing more important than talking with clients in their homes and workplaces. Each of the clients described in the beginning of this book is a real person whom I met and whose story moved and inspired me. I think back to them time and again when considering what paths make sense for building the inclusive-finance industry. Listening to clients puts the two bottom lines in proper perspective.

Cases 1

BANKING MODELS

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ICICI BANK: SHAPING INCLUSIVE FINANCE IN INDIA

ICICI Bank is the tiger of Indian finance. Launched in 1994, ICICI sprang quickly into the arena opened by India's financial-sector liberalization. It helped to awaken the sector from a decades-long slumber and bring it into the twenty-first century.

Capitalizing on policy changes throughout the 1990s that eased restraints on private-sector banking, ICICI has grown until it is poised to become India's first global bank, with branches in 20 countries.[1] Among many firsts in Indian banking, ICICI was first into the market with ATMs and today is the largest issuer of credit cards. Though it is sometimes criticized for aggressive practices,[2] India is deeply indebted to the bank's creative and energetic competition. It is hard to imagine India's economic boom taking place without it.

In inclusive finance the story is the same. ICICI's outsized ambitions outstripped many competitors. It adopted a goal of placing $1 billion into microfinance.[3] However, ICICI was not well-positioned for direct delivery of financial services to low-income clients; it needed an outsourcing strategy. This came in the form of the partnership model for the provision of credit, and the banking correspondent model for savings and payment services delivery. Implementation of this strategy required ICICI to collaborate with microfinance institutions (MFIs) across the country, and the resulting interactions between the bank and MFIs changed the sector significantly, helping it grow and develop.

Toward an Inclusive-Finance Vision

The government of India and the World Bank created ICICI as a public-sector industrial development bank in 1955, when the financial sector was almost completely nationalized. For the next several decades there were no Indian private banks, only government-owned banks and a few international banks serving foreign companies. In 1994, as India was starting to open the way for private banking, ICICI decided to launch a deposit-taking commercial bank. In 2000, the bank was privatized through a listing on the New York Stock Exchange. Today, ICICI's assets make it the second largest bank in India (State Bank of India, a public-sector bank, remains the largest), and the second largest listed company in India by market valuation. At the close of the 2008 fiscal year, the bank had 4.9 billion rupees ($121 billion) in total assets, 1,255 branches, and 3,881 ATMs throughout India.[4]

First Steps

Two major considerations, one external and one internal, motivated ICICI to move into inclusive finance. Externally, ICICI faced the Reserve Bank of India's priority-sector lending targets, requiring all banks to place 40 percent of their loans in agriculture and "weaker sections" of the population. Despite priority-sector lending targets, the Reserve Bank of India states that up to 41 percent of the country's adult population still lacks a bank account.[5]

Internally, ICICI's aspiration was to become "the largest provider of financial services in India with a ubiquitous presence,"[6] and that ambition encompassed all market segments, including the bottom of the pyramid. ICICI may also have wished to counteract critiques of its consumer finance operations, whose collections practices are a favorite target of the press.

Like other Indian banks, ICICI's first steps into microfinance involved women's groups as promoted by the government's Self-Help Group Bank Linkage Program. In this model, which is successfully used by public-sector banks throughout the country, an NGO or agent helps women form self-help groups (SHGs) that are then "linked" to banks first with group savings accounts and eventually through group loans. By 2001, ICICI had about 10,000 microfinance clients through the SHG model, an insignificant number in the Indian context.[7] Bank decision makers regarded the SHG program as unscalable, at least for a bank like ICICI, whose retail outlets addressed the better-off mainly in urban areas, and whose staff was likewise oriented toward the middle class.

ICICI's managers saw that the bank did not have the right attributes for a direct-to-BOP strategy and decided to develop different approaches.

Microfinance institutions offered an alternative route with greater scale potential and a better fit to ICICI's capabilities. At the time, there were an increasing number of MFIs, but only a handful had achieved significant scale. ICICI loaned funds to some of these MFIs, but was unable to lend as much as targeted due to a lack of MFI creditworthiness. Even the best MFIs were seriously undercapitalized, and only a few had solid financial performance tracking. ICICI's desire to solve this constraint inspired its first important contribution to inclusive finance in India—the partnership model.

ICICI's Partnership Model: Changing the Terms of the Sector

In 2002, ICICI launched a partnership model in which it lends directly to microborrowers, using MFIs as loan originators and collection agents. The MFI receives a fee for acting as ICICI's agent. In order to ensure that incentives are aligned and that the MFI will have an interest in maintaining a good portfolio, the MFI must provide a first loss default guarantee to ICICI (generally financed through a loan from ICICI).

Operationally, the partnership model was nearly invisible. For a woman borrowing from the MFI, nothing significant changed. She remained in the same group with the same loan officer, going to the same weekly meeting. She might not even have noticed the only difference—her loan documents now said that her lender was ICICI rather than her familiar MFI.

The partnership model solved several problems. ICICI did not have to be as demanding about assessing the creditworthiness of the MFI as it would if it were lending to the MFI rather than to the client. It did not have to be as strict regarding internal processes, governance, capital structure, financial management, etc., as long as portfolio quality was satisfactory. This focus on portfolio quality, which was consistently excellent in most Indian MFIs, allowed ICICI to proceed despite the often glaring deficiencies of the MFIs in professionalizing their institutions. ICICI could assist MFIs to professionalize as their partnerships deepened. For their part, MFIs did not have to worry about raising equity, as the loans did not appear on their books. MFIs that were previously held back by lack of equity could now grow at a much faster pace, and grow they did.

The partnership between ICICI and Spandana Sphoorty Innovative Financial Services demonstrates the dramatic effect of the model. Spandana, established in 1998 in Andhra Pradesh, entered a partnership with ICICI in 2003, initially for 500 million rupees in loans. Spandana's borrower base increased from approximately 35,000 at the outset of the partnership to over 1 million at the close of 2007.[8] Although Spandana's growth is a result of various factors, it is undeniable that the partnership with ICICI was central. Both parties benefited. ICICI reached a new market, while Spandana obtained a steady and cheaper supply of funds.

For the best of the Indian MFIs, ICICI also developed a loan securitization model, purchasing loans these MFIs had already made. In 2004, ICICI completed a securitization deal worth $4.9 million with Share Microfin Ltd., another important MFI in Andhra Pradesh. Grameen Foundation USA provided technical assistance and a collateral deposit of $325,000, while Share provided a guarantee amounting to 8 percent of the receivables in the portfolio. Another securitization deal was signed between ICICI and Bhartiya Samruddhi Finance Limited, for 42.1 million rupees ($957,000).[9] These securitizations have the same advantages as the partnership model: mezzanine financial support, removed from the balance sheet, allowing MFIs to scale up without raising more equity.

ICICI financed other large MFIs in India, fueling their growth and helping to catapult Indian microfinance, previously lagging behind that of other countries, into the international spotlight.

The MFIs that worked with ICICI were not entirely comfortable with the partnership model, as they disliked being overexposed to a single funding source. There was wariness about ICICI's long-run motives and concern that ICICI would exert too much control over the MFI's operations.[10] At the same time, however, the partnership model influenced other banks, which followed ICICI's lead and increased lending to the same MFIs.

The partnership model came to an abrupt end for a number of reasons, including the Reserve Bank of India's know-your-customer concerns. ICICI was compelled to stop lending under this model in January 2007. This move sent MFIs on an urgent search for funds, particularly for the equity they needed to leverage conventional debt. Equity deals at Share, Spandana, and SKS (see the Sequoia-SKS case) during 2006 and 2007 were prompted in part by the end of the partnership program. However, ICICI found other avenues for financing the bottom of the pyramid.

Investing in Inclusive Finance by Creating MFIs and Developing New Products

Even had the partnership model not ended, ICICI would have taken its inclusive-finance vision well beyond the financing of existing MFIs. The reality in India is that there are not enough MFIs to serve the unbanked in the country. As of 2005 there were about 15 large MFIs, but ICICI estimated that 200 such institutions would be needed in order to reach 40 million clients.[11] Moreover, MFIs have until very recently provided only a single product—a group-based working capital loan to self-employed women. ICICI's vision, however, encompasses the whole of inclusive finance, and so it moves on many fronts. We mention four here, each of which could be the subject of a case of its own.

New MFIs. ICICI created an MFI incubator to train social entrepreneurs to launch MFIs. It set up a team to identify organizations and individuals with desire and potential. The incubator provides training, technical assistance, finance, and other tools required by MFIs seeking to scale and commercialize. ICICI calls this "pollinating the countryside with entrepreneurs."[12]

Workers for MFIs. The microincubator team also works with the Internet-based employment agency microfinancejobs.com to ensure that there will be abundant supply of labor for the growing Indian microfinance industry.

Microinsurance. ICICI, together with the World Bank and ICICI Lombard General Insurance Company, have developed India's first index-based insurance product. The insurance serves to protect Indian farmers from inadequate rainfall, as determined by a rainfall index. The product is offered in addition to ICICI's life, health, and accident microinsurance policies, which together cover over half a million rural Indians.[13]

Commodity-Based Farmer Finance. Also known as "warehouse receipt-based finance," this product allows farmers to take out loans against crops stored in a warehouse. Farmers live on the loan proceeds and sell their produce when they choose rather than right after harvest when crops sell at their lowest prices. ICICI is promoting the establishment of derivatives trading surrounding commodity-based finance, furthering the ability of farmers to hedge their risks.

Using Technology to Reach Every Corner of India

ICICI aims to be available to every person on the subcontinent and looks to technology to make that happen. As part of its No White Spaces strategy, ICICI set a target of over 45,000 client touch points by 2008.[14] When this target is met, no Indian will be farther than three to four kilometers away from a service delivery outlet.[15] Besides low cost ATMs, three related initiatives illustrate how ICICI applies technology at the last mile: Internet kiosks, FINO, and banking correspondents.

Internet Kiosks. ICICI finances individual entrepreneurs to own and operate Internet kiosks that it hopes to use as points of sale for delivering microfinance products and services. The entrepreneur makes a down payment of 5,000 rupees ($100) and ICICI lends the entrepreneur the rest, about 55,000 rupees ($1,100).[16] Each kiosk includes a computer and applications such as e-mail, e-governance, agricultural extension, and even video conferencing that can connect the user to a hospital staff for a preliminary diagnosis. As of 2006, ICICI had over 5,000 kiosks.[17]

FINO. ICICI promoted the creation of a technology solutions company, Financial Information Network and Operations. FINO developed a biometric multifunction payment system based on cards and point-of-sale (POS) devices. The cards can be used for any transaction, from loan payments to microinsurance to remittances. Placement of FINO's POS devices with agents will increase the points of sale for banking services, as well as allowing information gathering that can be used to better understand clients.[18] The information gathered by the biometric card, combined with other technological initiatives FINO is pursuing, is also intended to facilitate the creation of a credit bureau, which is essential for advancing financial inclusion in India.

Banking Correspondents. ICICI advocated with the Reserve Bank of India for the creation of banking agent regulations based on the Brazilian model (see case on Banco Bradesco). The banking agent model does for savings and payment services what the partnership model did for credit: it outsources ICICI's customer relationships to MFIs that are closer to customers and can perform services cheaply. In the Indian version of banking correspondents, only MFIs are allowed to become agents for banks.

Swadhaar FinAccess, a new MFI in Mumbai, is using the banking correspondent program to boost its expansion. FINO's POS technology cuts the cost of setting up a new outlet (smaller physical space needed; lower equipment and security costs), and the fees generated by serving ICICI clients also help. Suddenly it is cheaper and easier for Swadhaar to open new outlets in the poorest sections of the city. Clients are attracted to the ability to borrow from Swadhaar and at the same time open and operate savings accounts with ICICI. On the other hand, some MFIs have been reluctant to use FINO devices, fearing that ICICI will gain access to data about their clients and woo them away.

Additionally, ICICI is in the process of encouraging the creation of a shared banking-technology platform that can be used by MFIs, cooperative banks, and commercial banks in various back-end transactions, allowing them to be more efficient. Some of the leading information-technology companies in India (including i-flex, Wipro, and Infosys) have been commissioned to create such a platform.[19] Finally, ICICI is setting up a network of very low-cost ATM machines to dispense cash in locations that would otherwise not have sufficient volume to warrant placement.

Research on Inclusive Finance

Although ICICI initiatives are addressing multiple financial-inclusion issues, the bank's leaders felt that too little was known, especially about prospective clients. They established the Centre for Microfinance Research (CMFR) to identify and eliminate obstacles to inclusive finance by answering questions such as: What is the impact of microfinance on poverty? What limits household productivity? What new products would make the greatest difference to low-income clients? What are the costs and profits for MFIs? Research on such questions exposes gaps in the current microfinance industry. The CMFR also offers training for practitioners in microfinance.

The ICICI Foundation

Created near the end of 2007, the ICICI Foundation for Inclusive Finance uses 1 percent of the bank's annual profits in various initiatives to increase access to markets, build human capacity, and promote sustainability for India's poor. Although noncommercial, the foundation plays a key role in fostering market-based strategies for moving commercial capital into the BOP market.

For example, in July 2008, the foundation, together with the Institute for Financial Management and Research Trust, and CRISIL, an Indian rating agency, launched an initiative to develop rating criteria for enterprises that build the income of the poor, both financial (such as MFIs and cooperatives) and nonfinancial (for example, vocational training institutes). It will work with the institutions to improve their performance, while at the same time informing prospective funders about highly rated entities.

Conclusion: Collaboration and Innovation

ICICI embraced inclusive finance with a vigor and creativity that made it an integral part of the bank's overall strategy. K.V. Kamath, CEO of ICICI Bank, speaking as cochairman of the 2008 World Economic Forum, called inclusion the top issue of the day. "To me the main issue is inclusion. How do you include the masses living in the poorer continents of the world into the mainstream economy? If we can achieve that, we will have done a lot to improve the world we live in." Kamath stated that the "old ways" would not solve the problem. "This cannot be done by you alone. You have to innovate and you have to collaborate."[20] Though he directed his comments at the world at large, he was implicitly describing his own bank's approach to financial inclusion.

CITIGROUP FOSTERS COMMERCIAL RELATIONSHIPS WITH MICROFINANCE INSTITUTIONS

Citigroup, one of the world's largest banking groups, provides financial services to clients in 100 countries and has over 200 million customer accounts.[1] The creation of the Citigroup Microfinance Group in 2004 distinguishes the bank as one of the few banking groups to incorporate microfinance into its business strategy, working in parallel with its foundation's philanthropic efforts.

In 2004, Citibank had already supported microfinance for decades through its corporate foundation. But as important as the foundation's grant making had been, it did not tap into the much larger reservoirs of value potentially available through the banking group as a whole, especially its global presence and banking expertise.

Why and how did Citigroup institutionalize microfinance as a business opportunity? How has this decision created opportunities for the banking group to serve the inclusive-finance industry? And what challenges and lessons can we draw from Citi's move?

Making Microfinance a Business Strategy

Inside Citi, the decision to create a separate microfinance business unit arose for several reasons. First, compared to other global financial giants, Citigroup had an insider's understanding of how the sector had emerged and evolved.

For nearly 40 years, since its first microfinance grant to ACCION International, the Citi Foundation provided financial support and banking services to microfinance organizations.

Furthermore, while corporate social responsibility was one clear motive, Citi decision makers also saw that inclusive finance could become part of Citi's business model. "The business case came out of a recognition that MFIs were emerging as viable, scalable, and specialized institutions," explains Bob Annibale, global director of Citi Microfinance.[2] MFIs seek access to wholesale finance in order to provide their clients retail financial services. When Citi opened its eyes to this demand, it saw a new set of potential business partners and clients.

The launching of Citi's microfinance unit just anticipated the United Nation's declaration of 2005 as the International Year of Microcredit. During 2004 and 2005 six global financial institutions established some sort of microfinance-related operations, including Standard Chartered, Rabobank, ING Group, Barclays, and AXA Group. Although Citi distinguished itself as one of the most deeply involved in microfinance, its decision reflected changing attitudes among bankers in global institutions, who began to view microfinance with a commercial and not only philanthropic lens.

Citi senior management established a microfinance business unit whose main activity would be to develop long-term commercial relationships with important microfinance institutions. This move was highlighted as a key initiative in Citi's 2005 annual report. The unit consists of teams based in London and New York, India, and, most recently, Colombia. The unit leverages Citi's product groups and network of branches throughout the world, which work with the microfinance unit on specific projects. These branches offer both local knowledge and local currency financing, including access to domestic capital markets. Since local currency is more appropriate for MFIs than hard currency this provides an advantage over many other international investors. MFIs can also obtain a broad range of financial services, such as transactional and hedging solutions, treasury products, retail partnerships, and insurance.

One early task of the unit was to increase the internal alignment of interests so that Citi's numerous and diverse branches would contribute to mainstreaming microfinance. Microfinance guidance was built into credit policies, and special rating models were created to rate MFIs and assess their capacity for debt and equity. These policies paved the way for branch staff to work directly with the new target sector. They could call on the microfinance unit for assistance as needed.

The microfinance unit spotted a wide variety of business opportunities in both wholesale and retail services. At the same time, the Citi Foundation continued to support microfinance with grants for activities that cannot be commercial. These include industry development, such as a program to strengthen national associations of microfinance institutions; educational activities, particularly in financial literacy; and experimental products, including research on microfinance loans for renewable energy. The microfinance group and the foundation do not work together directly, but they do share industry knowledge.

Wholesale Finance for Microfinance Institutions

The most prominent role of Citi Microfinance has been to finance sustainable MFIs, ranging from NGOs to microfinance banks. It has put together a number of high-visibility deals with leading MFIs. Citi Microfinance makes a point of offering a full range of banking services, from cash management to life insurance partnerships, which is one notable characteristic of its approach.

Risk-Sharing Financing Programs. In 2007, Citi Microfinance announced a $44 million (1.8 billion rupee) financing program for SKS Microfinance. Citibank India purchases loans that SKS originates and services. Citibank India shares the credit risk with SKS, while Grameen Foundation provides a limited guarantee, spreading risk more broadly.

Loan Syndication. In 2006, Citi Microfinance arranged the first local currency loan syndication in Romania for the microfinance lender ProCredit. The five-year facility is worth $63 million.[3] Also in 2006, Citigroup helped structure the first AAA-rated securitization of microcredit receivables for BRAC, the world's largest national NGO, located in Bangladesh. The securitization, which spans over six years and is worth $180 million, has won several financial awards.[4]

Local Currency Structured, Investment-Grade Bonds. In 2004, Citigroup and its Mexican subsidiary, Banamex, arranged the first issuance of investment-grade bonds to fund Compartamos, the Mexican MFI with the greatest number of clients. The five-year peso-denominated bond was worth $50 million.[5] The International Finance Corporation provided a 34 percent guarantee.[6] With the help of the funds raised, Compartamos grew at impressive rates and was already known in the Mexican market when it held its IPO in 2007.

Citi Microfinance seeks to be a valued financial advisor to its clients, which requires in-depth sector knowledge. Some of the institutions Citi has financed—BRAC, SKS, Compartamos, ProCredit, and others—are large, highly successful and viable institutions. Others are small- and mid-sized institutions, such as CARD Bank in the Philippines, Pride Uganda, and FinSol of Mexico. Citi selects for both size and sustainability.

The microfinance unit advises institutions on their overall financial structure, viewing wholesale and capital markets finance as part of the evolution of the MFI's funding base. Loan securitization, for example, is not for every MFI. "Securitization should be used very selectively. It brings capital relief and finance together with diverse funding. If you don't need both, you may want to look at other financing options," global director Annibale notes.[7] By helping client institutions to craft more mature financing strategies, they push the frontiers of the microfinance industry forward. The unit must manage both the costs and the fine details for each deal, such as those associated with aligning interest rates and allocating risk during a securitization, or transferring data from the MFI to Citi during a financing program. These details require complex processes and careful attention.

Retail Financial Services

Compared to its wholesale operations, Citi Microfinance's retail services for the BOP market are a newer frontier for Citi. The group is developing and delivering innovative microinsurance, savings, and remittances services for the poor, often in partnership with leading MFIs.

Microinsurance. In collaboration with its insurance subsidiary, Seguros Banamex, Citi Microfinance launched a life insurance product in 2005 for Compartamos clients. The policy is simple, with no exclusions, and features among the lowest claim-to-payment times in the insurance market.[8] The families of Compartamos clients are the beneficiaries. Simplicity and fast response has helped dispel the prevailing distrust of insurance among potential clientele. Through Seguros Banamex, Citigroup provides over 1 million policies to Compartamos clients.[9]

Savings. Recognizing technology as an enabler of financial inclusion, Citi Microfinance launched ATMs in 2006 for use by clients of its MFI partners in India—Basix and Swadhaar FinAccess. Designed to serve clients who have a "Citi Pragati" savings account, the ATMs answer a widespread demand by microfinance clients for a way to save, as well as to make payment transactions.

As a first-time savings account, Citi Pragati has no minimum deposit and no associated fees, making it a good fit for microfinance clients. The ATMs identify clients biometrically and speak to users in eight different languages, significantly alleviating the language and literacy barriers that contribute to financial exclusion. In addition to the biometric ATMs at partner MFI branches, clients can use any Citi ATM and over 15,000 ATMs that are part of a shared network in India.[10]

Remittances. In 2006, close to $300 billion in remittances were sent to developing countries by 150 million migrants worldwide.[11] It's estimated that about one-third of remittances travel via informal channels.[12] A Citi report in 2004 identified India and Mexico as the top two countries receiving remittances, while Latin America—the fastest growing remittance market—is projected to generate $500 billion in remittances between 2001 and 2010.[13]

In 2005, Citi Microfinance partnered with Banco Solidario, a specialized microfinance bank in Ecuador, to deliver a new remittance product for Ecuadorian immigrants living in the United States. The product allowed the sender to remit up to $3,000 a day to a beneficiary in Ecuador for a fixed fee of $5.[14] This fee was well below prevailing money-transfer organization rates at the time. Money sent to Ecuador can be picked up at a Banco Solidario branch after 24 hours, or at a branch of one of its rural affiliates in 72 hours.[15]

Product marketing was a first challenge. Citi's standard marketing and branding did not work with Ecuadorian immigrants. The elliptical, offbeat messages of Citi's mainstream ad campaign aimed at hip urbanites left Latin American audiences scratching their heads. Citi created a culturally adapted marketing and financial education campaign through local newspapers and community events.

Citi and its partners want customers to see remittances as part of a broader banking relationship involving multiple services, so they require senders to open savings accounts with Citibank in the United States. For most remittance senders, however, remittances have been handled separately from banking. In order to succeed, Citi must convince clients that it is worthwhile to change their behavior. It tells clients that if they send remittances through Citi they gain an entry point to banking. Nevertheless, the requirement to open an account slowed uptake, despite the ease of subsequent account-to-account transfers. Citi considered but decided against offering to send remittances for customers without accounts. Such a move might have brought the remittance service more customers more quickly, but it did not fit with Citi's longer-term commitment to a relationship banking approach.

"Know Your Customer" regulations require identification before opening an account, but many potential clients were unsure what kind of identification was appropriate and what this could mean for their status as immigrants. Citi took a proactive approach to this problem. Branch officers were encouraged to explain that many different identification methods are possible. Staff went to the Ecuadorian consulate to provide information about the process of opening a bank account.

All these steps helped make the product more attractive to the Ecuadorian community. Building on this investment in learning, Citi has expanded the remittance program and intends to replicate it in other remittance corridors.

In 2007, Citi Bangladesh and BRAC signed a distribution agreement through which BRAC will open remote areas of Bangladesh to remittances that flow via Citi from senders around the world. Given BRAC's extensive network of 3,090 branches, this partnership penetrates all corners of the country.[16]

Factors of Success

Citi Microfinance has succeeded in offering both wholesale and retail services in the microfinance sector in creative and pioneering ways. In addition to Citi's history of working in microfinance, its success derives from specific business decisions. By keeping the microfinance unit small and by institutionalizing microfinance into credit policies and institutional infrastructure, Citi leveraged its worldwide local offices, capturing local know-how and building local relationships. Each of Citi Microfinance's services is adapted for the place it serves, addressing customs, laws, languages, and financial realities. This would not be possible without the collaboration of Citi's local affiliates and without a strategic alignment of their interests with those of the microfinance unit.

The most important factor in Citi Microfinance's success, however, is its overall business approach. As Annibale explains, "If you really look at the institutions as your partner or client, you can do all kinds of things together that you could never do if you just thought of them as your beneficiary."

BANCO PICHINCHA AND THE SERVICE COMPANY MODEL

Banco Pichincha[1] is Ecuador's largest bank, with assets of $4 billion.[2] In 1997, after an economic crisis that withered the Ecuadorian banking sector, Banco Pichincha was looking to rebuild, and its leaders began thinking about possible new lines of business. They recognized the growth of Ecuador's informal sector and saw that some financial institutions were successfully serving that sector, notably Banco Solidario, a bank specialized in microfinance, and Ecuador's strong network of credit unions. They decided to investigate.

Banks entering microfinance make a common mistake, according to Marguerite Robinson, an advisor to banks around the world on commercial microfinance: "They don't realize that they don't know how."[3] Banco Pichincha did not make this mistake. It approached microfinance with caution, seeking technical expertise from ACCION, spending two years in preparation, and structuring its entry in a way that minimized risks.

Ten years later Banco Pichincha is one of the more successful examples of bank "downscaling." Credifé, Pichincha's microfinance service company, is a thriving operation with over 85,000 active borrowers. It provides a small but disproportionate contribution to the bank's total profit. The experience with Pichincha was also critical for ACCION, as it helped ACCION learn how to bridge perception and operating gaps to assist mainstream banks to launch microlending.

Advantages and Disadvantages of Banks in Microlending

Commercial bank "downscaling" to microentrepreneurs is good news for BOP customers because banks, unlike most MFIs, can offer a full range of services, including credit, savings, and payment services. With their extensive physical and human resources and low-cost access to funds, banks can potentially launch and expand microfinance operations more cheaply than the cost of building a stand-alone microfinance institution. If commercial banks become serious players in microfinance, they can offer very strong competition to traditional microfinance institutions.

However, there is a possibility that commercial bank entry into microfinance may be short-lived or shallow. Commercial banks will not move into microfinance in the first place if the time to recoup investment in a microfinance operation exceeds their standard investment time horizon. After entering microfinance, banks may move upmarket by increasing loan amounts to maximize profits—or worse, exit if they are unsatisfied with the level of profitability. There have been specific cases of commercial bank entry into microfinance and subsequent exit.

Despite such concerns, microfinance looked like a good fit for Banco Pichincha. During the early 1990s the bank had opened branches across the country to position itself as the leader in savings and consumer lending. However, starting in 1995, a deep economic crisis in Ecuador devastated the purchasing power of the Ecuadorian middle class, reducing the demand for consumer lending. In this environment, Banco Pichincha faced two alternatives. It could close branches, as other banks did, or it could add new customers and services in its branches to make them profitable.

A number of Pichincha's underused branches were in or near low-income areas where many microentrepreneurs lived. Microfinance operations would need very little new capital for physical infrastructure. Moreover, adding microfinance could raise profits by increasing branch staff productivity and absorbing excess liquidity. Conditions for microfinance in Ecuador were promising, with a high density of potential clients even in rural areas. Banco Pichincha still might not have taken the gamble on microfinance if not for initial subsidies from the United States Agency for International Development. Subsidies covered most of the cost during the exploratory stage. They were used mainly to convince Pichincha that microfinance could be a good business proposition and to introduce the bank to ACCION as technical assistance provider. The subsidies covered portions of a prefeasibility study, as well as start-up planning and technical assistance. But the bank carried most of the project costs: staff time, a significant share of technical assistance costs, equity investment, loan capital, and infrastructure.

Designing the Service Company: Credifé

After considering various models, Banco Pichincha and ACCION decided to create a service company because it required little start-up capital, had a lean structure, and could get regulatory approval quickly. The projections showed a break-even operation three years after project launch (two years after the start of lending) and an attractive rate of return on equity.

A microfinance service company is a nonfinancial company that provides loan origination and credit administration services to a bank. The service company Banco Pichincha and ACCION created—Credifé—does all the work of promoting, evaluating, approving, tracking, and collecting loans. However, the loans themselves are on Pichincha's books. In return for administering credit for the bank, the service company receives a fee (and vice versa, when the bank provides services to the service company). Credifé employs the loan officers and other microfinance program staff, while the bank furnishes supporting services, including teller transactions, human resources, and information technology.

The service company model seeks to draw on the best of the bank while addressing common drawbacks banks face when entering microfinance. A service company does not require a separate banking license, is not separately supervised by the banking authorities, and does not require a large equity base. It is thus easy to launch and operate. At the same time, it is a long-lived structure with its own governance and staffing that gives microfinance space to operate—and allows for the use of microfinance-specific underwriting techniques. Credifé takes advantage of Banco Pichincha functions. The parent bank handles processes that do not require specialized microfinance knowledge.Because transactions are between legally separate entities rather than internal units, a service company provides a transparent framework for operation. This makes it an attractive structure for involving technical partners as investors and participants in governance.

Credifé began as a majority-owned subsidiary of the bank, with ACCION as minority shareholder and strategic partner.

Great care was taken over the allocation of credit risk and reward to align incentives. Since Credifé's financial statements are ultimately consolidated into those of the parent bank, the bank is concerned about overall profitability of the operation more than the allocation of profits between companies. As an external investor, ACCION, however, had a strong focus on the risk-and-return formula for Credifé.

The agreement between Banco Pichincha and Credifé was carefully structured to provide incentives for efficiency and risk management. Credifé handles all the "face time" with clients, but since the loans are owned by Banco Pichincha, interest accrues directly to the bank. Credifé is responsible for delinquency management and collections. The bank pays Credifé a fixed percentage of the total loan portfolio. It ensures that Credifé staff make good lending decisions through an agreement that reduces Credifé's fee if portfolio quality falls below a stated threshold. The commission was calculated on the basis of expected interest income generated by the microfinance portfolio, less the cost of funds, expected provisions, and the cost of services provided by the bank. The fee can be reviewed from time to time, but in the meantime the bank absorbs short-term fluctuations in the cost of funds, provisioning, and its services, while the service company absorbs the risk of its own operating costs.

Operations

Credifé provides working capital loans to microentrepreneurs: family businesses and self-employed individuals (71 percent of the portfolio). Loans for business assets, purchase and expansion of commercial premises, consumption, and home improvement were added over time and make up the remainder of the portfolio. Credifé customers are offered special low-fee savings accounts. Credifé also offers its clients remittance services and is developing other services such as microinsurance. In order to build its portfolio quickly, Credifé marketed its loans to many low-income microentrepreneurs who already had savings accounts with Pichincha, and more than a quarter of these clients took out loans.

Credifé uses microfinance loan underwriting techniques, which are very different from the techniques Pichincha used in making consumer and corporate loans. The focal point of these techniques is the loan officer, who is trained in on-site analysis of microbusinesses to determine client repayment capacity. Loan officers are responsible for the entire client relationship, from initial promotion through collection. This is an unconventional practice, compared to most retail bank lending, and it results in high-quality portfolios, even while it helps overcome clients' mistrust of banks. More than anything else, it was the lending methodology and the operations to support it that ACCION contributed to the alliance with Pichincha.

Results

Credifé was established in 1998 and made its first loans in July 1999. It began breaking even on a month-to-month basis in 2001, after 18 months of operation, even as Ecuador's economic crisis continued. This crisis resulted in the dollarization of the Ecuadorian financial sector, which dramatically reduced the financial margin available to Credifé. Nevertheless, significant growth occurred when the portfolio rose from $783,000 at the end of 2000 to $3.5 million one year later. Thereafter, Credifé grew steadily. By April 2003 it had recouped all initial investment achieving a positive internal rate of return. ACCION's advisor to Banco Pichincha, Cesar Lopez, recalls, "Pichincha staff were not completely convinced until two years after we started, once the microfinance portfolio began to show a profit. Only then did they believe they could make money."

In 2004, ACCION analyzed the service company's contribution to Banco Pichincha's bottom line, consolidating the profit-and-loss accounts of Credifé with the income earned by Pichincha on the Credifé loans. This consolidation made the cost structure and net profit of Credifé's microcredit operations more transparent. It showed that although Credifé loans made up only 3.6 percent of the bank's portfolio, they generated 7.6 percent of the bank's net income for the year. This insight increased Banco Pichincha's commitment to remain in microfinance.

As can be seen in Table 1, at the end of 2008, Credifé had over 85,000 active borrowers, with a portfolio of $254 million. As of early 2009, it operates

Active clients	85,682
Portfolio (in thousands of U.S. dollars)	$253,682
Average loan size (in U.S. dollars)	$2,961
Portfolio at risk over 30 days	1.5%
Number of loan officers	368
Borrowers per loan officer	233
Portfolio per loan officer (in U.S. dollars)	$689,353
Return on equity	39.8%

Table 1 Credifé—Summary Results, U.S. dollars, December 31, 2008

Source: ACCION International, data provided by Banco Pichincha.

out of 101 locations. Pichincha has plans to carry microfinance with it as it expands to neighboring countries.

Operational Lessons

The experience of Credifé provides a number of lessons on the practical and corporate culture challenges of integrating microfinance operations into a bank.

High-Level Support and Governance. A key factor in the success of Credifé was the existence of an internal champion in the bank, and other strong supporters. From the beginning, one of the bank directors led the project, and three key executives were on the board of Credifé. A general manager from the bank's brokerage subsidiary became Credifé's general manager and worked with the technical assistance team. This support was necessary for overcoming internal challenges. Because Credifé had its own distinct board, it was assured of regular and focused attention from its board members, including several key Pichincha decision makers. ACCION's board seat allowed it to provide Pichincha with overall assessments of progress.

Transactions Processing. Clients of Credifé use Banco Pichincha to make payments on their loans and for all other banking transactions. The bank must cope with the flood of transactions generated by microfinance. Banco Pichincha has leveraged its strength in payment outlets to cope with the volume. All Credifé clients have debit cards and free access to the 500-plus Banco Pichincha ATMs and—with a 25 cent surcharge—to other Ecuadorian ATMs. In contrast, fewer than half of Banco Pichincha's mainstream customers have debit cards. Credifé's massive use of automation allows it to migrate transactions away from branches, diminishing operating costs. This use of automation has not yet extended to offering Credifé clients credit cards.

Staffing. Credifé has its own policies on hiring, staff salaries, and incentives. It develops its own operating manuals as well as credit policies and procedures. The independence to set such policies is essential for the success of microfinance operations. At the same time, Credifé uses bank know-how for information technology, human resources, marketing, legal issues, internal audit, and financial management. Banco Pichincha found that staff in these departments needed to develop some specialized microfinance knowledge in order to support Credifé effectively. Credifé staff sometimes complained that these departments gave traditional banking business higher priority; high-level support was essential to resolve such problems.

Branding. Credifé is a brand with its own clear identity, but all materials connect it to Banco Pichincha. The link to the bank enhances credibility, while the distinct identity welcomes low-income clients who may be intimidated by a bank. The main branding of the bank is undisturbed.

Branch Infrastructure. Banco Pichincha's underused branch infrastructure gave impetus to the creation of Credifé. Use of the branches greatly reduced start-up costs and made it easy to scale up operations quickly. Most of Credifé's 100 branches are inside Banco Pichincha branches, though in a few cases they are in separate buildings close to branches. (Proximity is needed to ensure that customers can conveniently carry out cash transactions.)

The support of a commercial bank has allowed Credifé to focus on perfecting credit methodology without worrying about obtaining funds or opening full-fledged branches. Even with the separate structure, however, problems with customer service, resistance to change, and competing priorities slowed expansion until they could be overcome. Today, Credifé gives Banco Pichincha the ability to tailor products, operations, staffing, and procedures to the distinct needs of the low-income client group. Because it took the task of setting up microfinance seriously, Banco Pichincha has built a solid line of business it is very unlikely to abandon.

BANCO BRADESCO: TWENTY-FIRST CENTURY POSTAL BANKING

Brazil now has one of the more sophisticated banking systems among developing countries, thanks in part to the economic turbulence of the 1970s and 1980s, with periods of high inflation that required banks to develop sound fiscal management. Brazilian banks are efficient and offer a full range of financial services. The banking sector is comprised of public, domestic, and foreign banks, and is prudently regulated by the central bank.

Brazil is also known for one of the greatest income-inequality gaps in the world. According to the World Bank, the richest 10 percent have almost 60 times greater wealth than the bottom 10 percent. In the United States, for example, this factor is 15; in India, it is 7.[1] Until recently the one-third of Brazil's population of 180 million that live below the national poverty line had very limited access to basic financial services.

Starting in 2000, the Brazilian government introduced a series of landmark regulatory measures that allowed banks to provide financial products through intermediaries such as retail outlets. Known as banking agents, these intermediaries were to help banks reduce expensive branch setup costs, making it easier to serve the vast majority of unbanked Brazilians.

Banco Bradesco and the Postal Network

Banco Bradesco is one of the pioneers of the Brazilian banking agent program. Founded in 1940 as Banco Brasiliero de Descontos in the state of São Paolo, Bradesco began with service to small businesses and farmers.[2] It has grown to become the second largest private bank in the country, serving all major personal and corporate banking segments. In 2001, Bradesco beat out two other banks, Banco Itaú and state-owned Caixa Econômica Federal, bidding $90 million (twice as much as its closest competitor) to secure a tender to offer services through the country's vast postal system.[3] This move has proved to be a wise social and business investment.

Banco Bradesco set up a distinct business division, Banco Postal, to manage operations and put in nearly $110 million to set up the implementation.[4] The bank division is small because most of the work is done by existing post office staff. In addition to their regular duties, post office workers become bank tellers, interacting directly with customers to offer all banking products. Banco Postal staff train the postal workers and oversee their handling of banking matters.

Clients receive a full range of products, including checking and savings accounts, deposits, withdrawals, transfers, tax and social-security collections, and welfare and bill payments. Small loans are also available. Products offered by Banco Postal are slightly cheaper than counterpart products offered at Banco Bradesco, as part of a market segmentation strategy. Nevertheless, customers of Banco Postal actually become customers of Bradesco and can carry out transactions at any Bradesco branch, ATM, or agent.

It cost Bradesco very little to reach the post offices because relatively little new technological infrastructure was required. Rather than installing point-of-sale devices, as is the practice in many banking agent relationships, the program leverages existing computer terminals. Bradesco installed its own teller software on the machines already in the post offices. Moreover, the postal service already had communication links to its offices through satellite technology. Banco Postal tapped into this channel, allowing real-time information flows and settlement of funds.

Double Bottom-Line Results

The effort has been a clear success on various fronts. From the first operations in March 2002, Banco Postal has widened the range of products, and as of late 2008 it counts 5,924 post offices as banking outlets.[5] By 2007, the operation reached 5.5 million customers—an impressive 33 percent of Bradesco's total client base of 17 million—and continues to add clients at a rate of 4,500 new clients every day. These clients conduct nearly 30 million transactions per month.[6]

In itself this is an impressive five-year growth rate; what is also noteworthy is the social impact. In 2002, out of the 5,561 municipalities in Brazil, 1,590 of them were not served by banks but were served by the post office, including 405 where the nearest bank was over 100 kilometers of unpaved road away.[7] Now, all the previously unbanked municipalities are served.[8] Moreover, the bank estimates that nearly 60 percent of its 5.5 million customers did not have any other accounts, representing a major success in terms of "banking the unbanked."[9] Most significantly, this client base is mainly low income: 58 percent had a monthly income below \$130; 32 percent earned between \$130 and \$400; and 10 percent earned above \$400.[10]

Transactions span a wide range of activities (see Table 1), and by 2006 Banco Postal had also developed a roughly \$640 million loan portfolio, with nearly 1.7 million loans. These loans are small, with an average balance of \$370.[11]

The main question, of course, is whether all this is profitable. Actual numbers are difficult to come by, but the answer certainly seems to be yes. According to an August 2007 report by BN Americas, Banco Postal generated nearly \$255 million in revenues. The communications minister of Brazil claimed that Banco Postal "made too much money from the government's distribution network."[12] These and other perceptions of profit prompted the government to briefly consider breaking the 10-year agreement with Banco Bradesco to set up a new postal banking structure with majority government ownership, thereby capturing more of the revenues from the banking operations.[13]

Type of Transaction	Percent of All Transactions
Bill payments	29
Accounts	23
Statement inquiries	18
Deposits	13
Withdrawals	6
Loans	6
Cards	1
Other	6

Table 1 Distribution of Banco Postal Transaction, by Type

Source: José Osvaldo Carvalho, "Mind the Gap: Bankable Approaches to Increase Access to Finance," presentation at conference, Netherlands Financial Sector Development Exchange, November 2006.

The Value of Opening Access

What is especially important about Banco Postal is its penetration into unserved communities. The use of the post office has been key to reaching locations that previously had no access. As a result of the banking agent program, by 2003 there were no municipalities in Brazil lacking bank services. Banco Postal was responsible for reaching many of the last unserved locations. Linking the country's postal network with a large bank has unequivocally increased access to finance.

To highlight its penetration to all corners of the country, Banco Postal staged a formal opening for one of its most remote branches, in Santa Rosa do Purus, deep in the Amazon basin on the Peruvian border. While the event was directed at the press (and hence full of lofty sentiment), the remarks made on the occasion reveal the importance of such access to this isolated settlement of about 2,000 people. One of the senators called the opening "a symbolic act of national integration, of social inclusion and consolidation of citizenship." The town's mayor described practical benefits, including the municipality's ability to pay government employees and collect taxes, as well as the ability of retirees to receive their pensions without having to travel. "Besides helping the local economy, the opening of the Banco Postal, and its technology, will be fundamental in removing the city from isolation."[14]

Trends and Replicability: Local and Global

Banco Postal is not the only successful banking agent initiative in Brazil. Caixa Econômica Federal, a state-owned bank, pioneered the use of banking agents in 2000 by partnering with almost 11,000 lottery outlets, primarily for distributing government benefits, and Banco Popular has about 5,000 agents. Based on such successes, a new private bank, Lemon Bank, was founded, using over 6,000 banking agents to provide bill payments and other services.[15] This bank has no actual branches.

Can Brazil's success be replicated elsewhere? Many European countries and Japan have large postal banks—where the post office itself offers financial services. The World Bank estimates that in developing countries there are almost twice as many postal branches and agencies as there are commercial bank branches, which represents opportunities for partnership between them. In India, the 150,000 postal outlets are one of the few types of banking agents that the country's regulatory body allows to offer financial services originating from a bank.

In Egypt, the postal network has about 3,700 branches, more than all the commercial bank branches combined, and most of these are connected electronically. This network already distributes government pensions (nearly $240 million per month to over 3 million pensioners), in addition to offering money transfers within the postal network, passbook savings, and bill payment services. Banque Misr, a commercial bank, has partnered with Egypt Post to offer an interest-bearing account.[16]

Brazil's central bank showed a balance of prescience and prudence in permitting cost-effective banking agents, and in the past few years its example is spreading. The governments of Chile, Peru, Bolivia, Colombia, and Guatemala have all passed legislation favorable for banks to leverage the physical outlets of retail agents.

Cases 2

NEW PLAYERS: RETAILERS, INSURERS, AND TELECOMS

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BANCO AZTECA: A RETAILER SURPRISES MEXICO'S FINANCIAL GIANTS

Mexico's exclusive banking system long ignored the 70 million potential customers at the base of the pyramid. That was before Grupo Elektra, a chain of home furnishing and electronics stores, created Banco Azteca and quickly captured the banking business of millions of low-income clients. What did a big-box retailer know about BOP finance that Mexico's biggest banks didn't? Quite a lot, as it turned out.

As Latin America's leading specialty retailer, Grupo Elektra sold household appliances to BOP customers for decades. It increasingly provided them with in-store credit for those purchases. In fact, Elektra made more profit from its credit operation than from merchandise sales. This appliance-financing business underpinned the success of Banco Azteca.

Elektra launched Banco Azteca in 2002, becoming the first retailer in Mexico to offer a full range of financial services through a commercial bank. Five years later, Banco Azteca was managing over 8.1 million active savings accounts and 8.3 million loans.[1] By 2007 it had sold over 10.3 million insurance policies,[2] as well as other services in a market that no Mexican bank thought was worth the effort. In fact, Banco Azteca, the first new Mexican bank licensed since the country's 1994 financial crisis, is already the nation's second largest bank as measured by the number of customers, and it contributes an estimated $1 billion to Grupo Elektra's annual revenue.[3]

Serving (or Not Serving) the Mexican BOP Market

Mexico's highly unequal income distribution has long troubled its economic policy makers. The World Bank asserts that the richest 20 percent of the population account for over half of the country's total earned income, while the poorest 20 percent earn only 4 percent.[4] Banking services tend to follow the money. For years, four elite- and corporate-oriented international banks accounted for more than three-quarters of all banking: HSBC, Banco Bilbao Vizcaya Argentaria (BBVA), Citibank's Banamex, and Santander Serfín. Some 16 million low-to-middle-income households—more than two-thirds of all Mexicans—had little or no access to financial services.[5]

But Grupo Elektra already did business with the BOP population. Its Salinas y Rochas stores had been selling furniture on credit since 1906. Elektra began manufacturing, selling, and financing radios and TVs in the 1950s. Today, Grupo Elektra sells computer equipment, electronics, cell phones, furniture, household appliances, motorcycles, and automobiles to low- and middle-income families. It brings in over $3 billion in annual revenue, even though the monthly incomes of its typical customers are only between $250 and $3,200.[6] By the late 1990s, Grupo Elektra was selling more than half of its goods on credit. Besides installment plans for store purchases, the company also offered savings accounts, remittances, and other services through the stores.

The Model: Leveraging Existing Knowledge and Infrastructure

Grupo Elektra made excellent use of its positioning to reach a vast, virtually untapped market for banking services.

- Half a century's experience serving the BOP market as a retailer
- Brand recognition and customer loyalty within its demographic and geographic targets
- An existing infrastructure of physical locations and retail operations
- Sophisticated data systems through which banking operations could be deployed

Elektra knew its existing customers are often unable to access the formal financial sector because they lack credit histories, proof of income, or collateral. Many Elektra customers are the working poor, often in informal-sector jobs.

Banco Azteca addresses specific financial needs among this customer base. It offers quick and easy access to consumer credit based on a simple application and minimal requirements. For example, it asks only for proof of address and either proof of income or a home visit. Banco Azteca branches are located in high-traffic areas near commercial centers or public transportation terminals. They remain open until 9 P.M., seven days a week, 365 days a year.

Azteca built its success on several innovations: distinctive delivery mechanisms, a first-rate technological platform, a seamless client-acquisition process, and a diverse product portfolio.

Abundant Touch Points and a Sophisticated Technological Platform

From its inception, Banco Azteca recognized that scaling profitably with low-income customers and managing their huge number of small transactions would require "powerful machinery and many points of contact."[7] Its growth formula combined an advanced technological platform and information system with the extensive network of Grupo Elektra stores.

Situating branches inside existing Elektra, Salinas y Rochas, and Bodega de Remates stores dramatically reduced start-up infrastructure costs and allowed Banco Azteca to jump-start customer acquisition. Few financial institutions can open from day one with 815 branches.[8]

Likewise, the bank capitalized on the retail chain's extensive management information system (MIS) and existing customer data. The technology infrastructure and information management capabilities gave it a big head start. Working with Accenture and its Spanish subsidiary Alnova, Banco Azteca connected existing data and systems, in-store terminals, and point-of-sale systems to banking software identical to systems already in use at top banks in the country.

All Banco Azteca branches, kiosks, and point-of-sale devices are linked to provide real-time information on accounts. Banco Azteca is particularly proud of its ability to mine client data through sophisticated customer relationship management (CRM). The CRM systems drive marketing to millions of customers, while the bank's front-end systems handle the tens of millions of transactions generated by its target marketing. In 2005, Grupo Elektra supplemented its client information by creating a credit bureau, registering 12.5 million clients in the database by 2006.[9] The Elektra Group is also creating a system to collect client credit-history information from other nonbanking lenders.

The bank sends out mobile loan officers and collection agents by motorcycle. These people are equipped with handheld computers loaded with customer information, financial models, and tables of collateral values. From the field, the agents can access and send updated information for efficient loan processing and collection.

Half a year after the launch, the management information system was handling more than 150 million sales, loan, and savings transactions per month. At times, Banco Azteca was adding 10,000 new savings accounts per day.[10] Overall, the system handles over 7 million retail, financing, and savings transactions per day at an average cost of only $0.03 each.[11]

Customer Acquisition and Diverse Financial Products

To launch its customer base, Banco Azteca converted Elektra's existing finance-related business: the Credimax consumer loan product, customer savings plans, and a thriving business in money transfers. It opened its doors in 2002 with nearly 3 million active accounts.[12]

From merchandise finance, Azteca's product line expanded to general consumer and personal loans, savings accounts, term deposits, debit and credit cards, money transfers, insurance, and pension fund management. Small businesses can also access Empresario Azteca loans for fixed assets. Banco Azteca offers clients a full complement of payment services, including Internet banking, telephone banking, ATM banking, utility payments, and interbank payments. In fact, Azteca can claim that its low- and middle-income clients have access to more financial products and services than most customers receive at either traditional banks or local microfinance institutions.

Savings. Prior to the start of Banco Azteca, in addition to 2.1 million installment savings plans for purchases, another 830,000 customers had savings plans at Grupo Elektra because many of them were ineligible for bank accounts at conventional banks. Minimum deposits to open savings accounts are 50 pesos, about $5. Within two months of opening, Banco Azteca added 400,000 new accounts.[13] By 2007, it managed over 8.1 million active savings accounts.[14]

Consumer Credit. According to Banco Azteca, only 10 percent of its loans are used for Elektra purchases, with 90 percent used for personal and household necessities. Banco Azteca charges an average interest rate of 50 percent annually. Eighty percent of all approved loans are disbursed in 24 hours.

With its digitized system, Azteca approves approximately 13,000 loans per day but can process up to 30,000 during peak holiday periods. In early 2008, the average term of the main credit portfolio was 60 weeks.[15]

Credit Cards. One of Banco Azteca's signature products is Tarjeta Azteca, an innovative Visa credit card for clients with monthly incomes between $250 and $2,700. The card can be used for purchases at any store affiliated with Banco Azteca or Visa. It uses biometric technology by DigitalPersona to authenticate customers and protect against identity theft, with the client's fingerprint and photo stored in the card's microchip. Biometric cards were easily accepted by Azteca customers because Mexicans already use fingerprints for voter registration. The cards were launched in 2006, and Banco Azteca has over 8 million clients registered in the biometric system.

Insurance. In early 2004, Grupo Elektra acquired and rebranded a private Mexican insurance company and began offering policies to its clients. Now, Elektra clients can buy a Seguros Azteca life insurance policy when they take out a consumer or personal loan with Banco Azteca. The policies cost between $0.46 and $4 per week and have benefits ranging from $692 to $8,300. Seguros Azteca issued 10.3 million policies during the first three years of operations, with an average of 55,000 new policies per week.[16]

Remittances. In Mexico, Elektra was historically the largest distributor of Western Union remittances, promising a rapid three-minute transaction waiting period. From 1994 to 2006, Elektra had completed more than 36 million transfer payments worth $9 billion. In 2006, Grupo Elektra handled 7.6 million remittance transactions, worth $2.4 billion and accounting for 10 percent of all money remitted to Mexico for 2005.[17]

Growth, Profitability, and Expansion

Banco Azteca has overturned previous assumptions about providing financial services to low- and middle-income clients in Mexico. Its return on equity has been consistently higher than that of the formal-banking sector (27 percent versus 21 percent in 2005), and it has earned a return on assets between 2.9 and 4.5 percent since the fourth quarter of 2003.[18] Growth has been strong and consistent, at approximately 42 percent annually. Azteca reported a 196 percent annual net income increase in 2007, and first quarter revenues of approximately $340 million in 2008, up 17 percent from first quarter revenues in 2007.[19]

In 2007, Banco Azteca became Mexico's second largest bank in total number of accounts, surpassing BBVA, according to data tracked by Mexican banking regulators. In just five years, the loan portfolio grew from $106 million to $2 billion. Banco Azteca administered 375,000 active loans in December 2002, and as of June 2007, managed 7.4 million active loans. Growth in deposit accounts was comparable, from 1 million accounts, totaling $123 million, in 2002, to 12 million accounts ($4 billion) in June 2007. Profits for the insurance company increased to $12.6 million in 2005.[20]

Expansion and New Channels of Delivery

The bank has recently focused on diversifying distribution channels, allowing clients to conduct transactions not only inside Elektra stores, but also in stand-alone and third-party branches (see Table 1).

Banco Azteca continues to open new branches in Elektra and affiliate stores as well as stand-alone branches around Mexico. More recently, in a pilot project, Banco Azteca provided commission-based, point-of-sale devices to 49 small-enterprise clients, making local mom-and-pop stores an additional transaction channel.[21] The diversification of distribution channels allows the bank to enter neighborhoods without Elektra stores and acquire new customers.

A Regional Strategy

Meanwhile, Banco Azteca and Seguros Azteca have exported their business models to Argentina, El Salvador, Guatemala, Honduras, and Panama via wholly owned subsidiaries. Further expansion is planned for Colombia, Costa Rica, Paraguay, and Uruguay. Elektra announced in early 2008 that banking operations would begin in Peru via 120 branches in 33 cities. It also began

Banco Azteca Channel Growth	2004	2005	2006
Banco Azteca branches in Elektra stores	973	995	1,083
Independent Banco Azteca branches	33	87	192
Branches at affiliate stores	351	395	405
Total Banco Azteca branches	1,357	1,477	1,680

Table 1 Banco Azteca Channel Growth

Source: "Banco Azteca Case Study and Commercial Ad," October 20, 2008, www.digitalpersona.com.

commercial and banking operations in Brazil, with the first outlets in Olinda and Recife. Azteca plans to expand into Brazilian states with low penetration of consumer loans and financial services.[22]

In each country, Elektra uses a mixture of independent Azteca branches, agents inside Elektra stores, and additional points of sale. This flexibility allows Banco Azteca to reach large numbers of customers in diverse regions, especially in such expansive countries as Brazil and Argentina. In some cases, marketing strategies and financial products require adaptation for cultural differences or regulatory frameworks. But Elektra's deep knowledge of the customers it already serves and the similarity of conditions throughout Latin America have simplified expansion and validated the business model.

Regulation and Competition

Grupo Elektra's biggest challenge in launching Banco Azteca was not to win customers, but to win over Mexico's banking regulators. The Ministry of Finance had not approved a new bank license since the 1994 financial crisis. Like many entrants to BOP finance in other parts of the world, Elektra found the regulatory environment unprepared to support financial services for poor customers. Banco Azteca worked with authorities to modify regulations to allow customers to do business without proof of income or credit histories. Regulators also accepted the provision of banking services through retail stores and allowed branches to open on weekends and holidays. The regulatory reforms Banco Azteca secured are now benefiting other retailers looking to provide financial services in the same market.

After witnessing the rapid growth and success of Banco Azteca's model, banks such as Banorte, IXE, HSBC, and Bansefi have started to focus on the same segment in Mexico. Microfinance leader Compartamos Banco also serves similar clientele in many of the same regions.

Retailers have noticed, too. In 2006, the Mexican Ministry of Finance granted 12 licenses to retail chains such as Autofin, Bancoppel, and Famsa to develop financial service units. Wal-Mart Stores, Mexico's largest retailer, received a banking license in 2006 and began offering credit through 16 of its 997 Mexican stores, which in total see an average of 2.5 million customers per day. Banco Azteca is watching the market carefully but is confidant it will remain dominant in the financial services sector, given its first-mover advantage and deep knowledge of the financial behavior of the BOP market.

Vulnerabilities: Transparency and Consumer Protection

A success as dramatic as Azteca's attracts scrutiny, and Azteca may have some important areas of vulnerability related to its transparency and treatment of customers. Numerous reports seek to turn over the rocks to see whether Azteca is glossing over problems in this area. One rock might be the loan default rate. Azteca reports a default rate of only 1 percent, compared to a mainstream industry average of 5.3 percent.[23] Whether this low loss rate reflects the nature of Azteca's business or harsh collection practices is difficult to determine. Azteca claims that it fires agents who cross the line between acceptable forms of pressure and public humiliation.

The media have also criticized Banco Azteca's reluctance to disclose interest rates. When a new law required full disclosure about total financing charges to customers, Azteca successfully appealed for an exemption. Azteca states that its loans carry an average annual percentage rate of 55 percent. However, *BusinessWeek* quoted an independent analyst's calculation using U.S. formulas for APR that the average is in fact 110 percent, due to Azteca's assessment of interest on the full amount borrowed, rather than the declining balance of the loan over its term.[24] Its high rates, however, are not out of line with the high prevailing interest rates in Mexico, especially among providers to the low-income market. Other Mexican lenders, such as the microfinance bank, Compartamos, have also been criticized for high rates.

The Banco Azteca Challenge

The growth and profitability of Banco Azteca poses challenges to mainstream banks that were inattentive to a huge potential market. Grupo Salinas chairman, Ricardo Salinas, has characterized Banco Azteca's success as a challenge to Mexico's "banking oligopoly."[25]

Azteca also speaks to microfinance institutions that pride themselves on commitment to social goals. Socially motivated providers often criticize Azteca's purely commercial approach. But Azteca's drive for profits, scale, and market appeal have enabled it to reach more people with a broader range of products, many of them of high quality (in terms of customer service, speed, and convenience), than any socially motivated player.

To other retailers, Azteca's challenge is that of a first mover with a dominant position in its marketplace. Other entrants may find it more difficult to understand low- and middle-income segments as quickly as Elektra did, but with tens of millions of underserved customers, the demand is there if other financial institutions decide to make the effort.

VODAFONE: A BOLD MOVE INTO FINANCIAL SERVICES FOR KENYA'S POOR

Of all the technological advances that have taken shape over the past two decades, none has affected the poor in developing countries as profoundly as the mobile phone. With inexpensive handsets selling for as little as $25 and the advent of prepaid mobile subscriptions, low-income people have eagerly taken up the new technology. The International Telecommunication Union estimates that over 60 percent of the nearly 4 billion mobile phones in the world can be found in developing countries.[1] In those countries cell phones are an integral part of life for the rich and the poor alike.

With so many phones in the hands of low-income people, the idea took shape to transform the phone into a channel to facilitate access to financial services. What emerged was M-Pesa—mobile money in Kenya.

Origins: DFID and Vodafone

In 2003, Nick Hughes, an executive at Vodafone's Social Responsibility Group at its headquarters outside London, believed that his company, with its global presence and social commitment, could create a mobile money platform with financial support from the UK's Department for International Development (DFID).[2] DFID's Financial Deepening Challenge Fund provided matching seed funding to corporations to broaden access to financial services.

The concept DFID and Vodafone initially envisioned was to create an alternate currency handled not by a bank but by a mobile operator, conveniently using the text message application already familiar to many customers. The pilot project focused on microloan repayment, enabling microfinance clients to repay their weekly loan installments by sending a text message from their mobile phones. In the rollout, the concept evolved toward a simpler money transfer.

Although the business economics of the program were far from clear, Hughes got Vodafone executives to agree to a pilot in Kenya, a target country for the Challenge Fund, through Safaricom, the local Vodafone affiliate. Safaricom was the first and largest mobile phone company in Kenya, started in 1999, and serving 11 million customers by 2008, three-quarters of the mobile subscriber market of 14.3 million.[3] Vodafone and DFID each contributed about $1.8 million to the project.[4]

The M-Pesa ("pesa" is the Swahili word for "money") pilot kicked off in October 2005. It was such an operational and technological success that Vodafone quickly launched the roll-out the following March. In the subsequent 18 months, over 4 million subscribers registered for the service, and growth rates remain strong at roughly 10,000 new subscribers a day.[5] Vodafone has since rolled out similar platforms in Afghanistan and Tanzania and is seeking opportunities in other countries.

Within a few years, M-Pesa was transformed from a corporate social responsibility project into a global line of business. Based on the product's success, Hughes now heads a new and rapidly growing mobile payments team.

Opportunity for Mobile Transfers

Despite its low per capita income ($680 according to the World Bank),[6] Kenya offered a favorable environment for a mobile payments pilot. At the time, it was politically stable and, like its neighbors, had seen impressive growth in mobile phone subscriptions. Today, nearly 40 percent of Kenyans have a mobile phone, and over 85 percent of the population lives in areas covered by a signal, according to Zain, the second largest mobile operator. Prices for handsets have dropped to about $25, and the country has a bustling market in used (and stolen) handsets, which cost roughly half the price of a new one. At the same time, according to market research firm Finscope, only about 27 percent of Kenya's 45 million citizens have access to formal financial services, so the market gap in financial services remains large.[7]

Due to Kenya's rapid urbanization and family structure, workers in urban areas often send earnings back to family members living in rural parts of the country. Crime rates in urban areas and vulnerability along highways make it dangerous for individuals to carry cash from one destination to another. Nevertheless, Finscope estimates that 58 percent of domestic transfers are sent this way, and another 27 percent are sent through a bus company.[8] The Safaricom team recognized that the potential market for moving money safely was immense, while options were few. Kenya's post office offers money-transfer services, but these are considered bureaucratic, slow, and unreliable. Money-transfer companies such as Western Union are expensive and have a limited retail presence, mainly in upper-class areas. Informal channels like friends or bus and truck drivers are cheaper but also slow and unreliable.

Version One: Mobile Microloan Repayments

After considerable research and preparation, Safaricom launched the M-Pesa pilot in cooperation with Faulu Kenya, a local microfinance institution, to allow Faulu customers to repay their group loans through their mobile phones. The pilot was capped at 1,000 subscribers in Nairobi, all of whom were microentrepreneurs and clients of Faulu. After exchanging cash for M-Pesa through 12 designated Safaricom airtime agents, clients could enter their PINs and send secure text messages to Faulu indicating the amount of their loan repayments. The M-Pesa balance on a customer's phone would be debited, while Faulu Kenya would be credited. Customers could also check their balances and make utility payments.

To simplify the pilot, all users were given a free mobile handset, because their phones needed a special, new generation Special Identity Module (SIM) card with embedded software that enhanced security and allowed for English and Swahili user interface. As the key motivations in the pilot phase were to prove the value to the customer and test client adoption, fees were kept low. Cash withdrawals were $0.50, deposits were free, and money transfers were in the range of $0.25 to 0.50—affordable for even low-income Kenyans.[9] Safaricom also offered a toll-free telephone number for inquiries, complaints, disputes, lost SIM cards, and other customer problems.

From an operational perspective, the one-year pilot went well, with few technological glitches, although a key challenge included integration with the MFI's back-office IT system. Clients made on average about two to three transactions per week, including weekly loan payments.[10] A minority of payments were person-to-person transfers, with an average of $4.50 sent.

At Faulu, as in many village banking microloan programs, loans are disbursed to individuals who belong to a group, typically comprised of 10 to 20 people. Loan repayments are collected at mandatory weekly group meetings.

An unexpected result of the M-Pesa pilot was that it offered such an easy way to repay loans that M-Pesa customers felt little need to attend the meetings. Even though it recognized that M-Pesa offered greater convenience, Faulu Kenya declined to participate in the M-Pesa rollout due to concerns that meeting attendance was crucial to maintaining the borrowing group's cohesion, and that meetings were a vehicle for achievement of social goals such as financial literacy and health education.

Version Two: Money Transfers

For the rollout, Vodafone decided to focus exclusively on domestic, person-to-person money transfers. This service works as follows: If a mother wants to send money to her son, she visits the licensed Safaricom dealer and pays the transfer amount in cash. The dealer gives her a secret transaction code, which she texts by SMS to her son. On receiving the SMS, the son goes to his closest Safaricom dealer. He sends an SMS to the Safaricom dealer with the secret code (verifying that he is the correct recipient), and the dealer hands over the money.[11]

Although the money-transfer service is not a "banking" product per se (usually defined as savings accounts, loans, insurance, etc.), Vodafone proactively approached and coordinated closely with the Central Bank of Kenya to ensure that it complied with all regulations, especially those regarding security of transactions and anti-money-laundering.

Vodafone launched the rollout of M-Pesa in March 2007. According to Hughes, early results were extremely positive; after only 18 months, there were over 4 million registered users and 3,500 agents across the country, including airtime sellers, petrol stations, and other retail outlets.[12] In September 2008, Vodafone worked with an ATM network, PesaPoint, to allow its users to withdraw cash from their ATMs by entering a code generated on their mobile phones (and thus no need for a card). Since then, Vodafone has initiated the pilot stages of direct salary deposit and microfinance loan disbursement through the M-Pesa account. We estimate that total revenues in 2008 were $52 million, which would account for almost half of Safaricom's nonvoice revenues. Such revenue was no doubt a factor in the success of Safaricom's IPO in May 2008, the largest of its kind in East and Central Africa.[13] Michael Joseph, Safaricom's CEO, voicing his confidence in M-Pesa, stated that it would be an important source of growth for the company.[14]

Versions Three and Beyond

Vodafone has partnered with Citibank to explore using its platform to offer remittances in the U.K.-Kenya corridor, where an estimated $200 million was sent in 2007, according to the World Bank. If successful, the potential for replication could be enormous. Costs to send transfers might decrease considerably if mobile phones were used in part or all of the process. (See G-Cash case.)

The M-Pesa platform is exciting mainly because it offers a transfer system with competitive pricing and easy access for a lower-income customer base. No bank is involved except for the holder of the float, and customers needn't have a bank account to use the service. While M-Pesa is not yet a mobile commerce (m-commerce) service, many merchants in Kenya have informally begun to accept M-Pesa as a form of payment, as trust develops in the concept of mobile money. If the network of agents expands, it would effectively provide a cheap and effective clearing and settlement system to rival the established payment networks such as Visa and MasterCard.

Challenges still exist, such as client financial literacy and ease-of-use. While most customers are familiar with mobile phones, many—especially those with less education—feel uncomfortable using them as a substitute for cash. Moreover, the mobile transfer system is not fully "interoperable" with other carriers. Many products operate exclusively within the mobile operator's own customer network. M-Pesa only recently allowed its customers to send to unregistered customers—such as those belonging to Safaricom's main rival, Zain.

Perhaps the largest obstacle is an ambiguous regulatory environment. Not only are regulators unsure about how to approach mobile banking (issues include minimum encryption standards and anti-money-laundering requirements), but they are also uncertain about how best to regulate the agents who sell air time when they begin to carry out banklike functions. Responsibility for the customer, branding, and liquidity thresholds are only a few of the knotty questions regulators need to address.

Replication prospects look promising. With recent launches in Tanzania and Afghanistan, Vodafone is on the lookout for markets in other countries. Nick Hughes remains cautiously optimistic about M-Pesa's global potential: "I'll say I have a 'product' when it rolls out successfully in two or three countries."[15]

G-CASH: FILIPINOS TEXT THEIR WAY TO MOBILE BANKING

Filipinos see themselves as a people who love to chat, and so it's fitting that breakthroughs in cell phone banking have come in the Philippines, via text messaging. One of the pioneers in mobile commerce (m-commerce) is Globe Telecom, the second largest mobile-service provider in the Philippines. In 2004, Globe launched a service called G-Cash, which allows subscribers to perform payment transactions through their cell phones. Once they load their phones with G-Cash, subscribers can use them to pay for certain products and services, even utilities.

The story of G-Cash is a good example of how a company adapted products to a market's characteristics and needs. The story started with several attributes of the mobile-services industry that turned out to be conducive to mobile banking. Building on favorable preconditions, Globe capitalized on market characteristics by adapting G-Cash to specific demands—such as international remittances and rural banking. This case explores the roles played by technology, partnerships, and regulation in the success of G-Cash, drawing lessons and implications for the future of mobile banking.

The G-Cash Product

G-Cash is operated by Globe's fully owned subsidiary, G-Xchange, and its services are offered to all 18 million subscribers of Globe and its bottom-of-the-pyramid brand, Touch Mobile. In 2007, G-Cash served over 1.5 million active users.[1]

To use G-Cash, a subscriber first activates the service through a series of text messages. Next, to place money on the phone, he visits one of the 6,000 accredited outlets to exchange pesos for G-Cash. These outlets include Globe offices and over 3,000 retailers that have completed an accreditation process allowing them to take deposits and issue G-Cash. Once G-Cash is loaded, the subscriber uses text messaging to transfer money to another G-Cash user or pay for purchases at a participating vendor. One percent of the exchanged amount is taken as a fee for transactions larger than $20 ($0.20 for smaller transactions).[2]

The transaction process is based on short message service (SMS) technology. A subscriber uses a menu-driven interface to send a text message stating the transfer amount, the recipient's number, and his PIN verification number. The electronic money is automatically sent to the recipient, along with the message containing a confirmation number. At the end of the day, G-Xchange settles all balances in accounts receivable and deposits the cash in the respective retailer bank accounts.

In addition to being a cashless and cardless form of payment, G-Cash is also bankless. A phone subscriber does not need a bank account to use G-Cash. However, because it works as a payment device and acts as a store of value, G-Cash resembles a bank account. This is advantageous for many Filipinos, given that up to 80 percent of them are unbanked or underbanked.[3]

Although uptake of the service was slow at first, it has made substantial gains, and by 2007 Globe was handling about $100 million in G-Cash transactions daily, far above the rate of only a year before.[4] Furthermore, Globe has evidence that the product decreases customer churn from 3 percent to 0.5 percent per month.[5]

Building the Market for G-Cash Success

Before G-Cash could become a popular service, clients had to be comfortable with cell phones, text messages, and making payments over the air. All these preconditions were present prior to the introduction of G-Cash.

- **Penetration of cell phones.** The falling cost of technology, combined with the availability of cell phones on the secondhand market, made it affordable for almost any Filipino to own a cell phone. Purchasing a new phone with Globe can cost between $15 and $30. As a result, mobile phone use has grown at a compound average rate of

68 percent in the Philippines,[6] and by 2008 nearly half of the population—about 40 million individuals—owned mobile phones.[7]

- **Comfort with SMS messages.** The Philippines is ranked first in the world for the number of text messages per capita, with close to 1 billion sent per day, an average of 15 messages per person.[8] Many mobile-service providers allow free and unlimited text messaging, sometimes for up to two years after initiation of service. It is far less expensive to text than to call. As a result, Filipinos are very comfortable using SMS technology.
- **Over-the-air payment services.** The use of over-the-air payment for mobile service—the precursor to G-Cash—began as an effort to adopt payment services to the characteristics of the low-income market. In the Philippines, as in many other developing nations, low-income customers prefer "sachet purchasing." With only a few pennies in their pockets, they prefer to buy the smallest available unit, even if it is cheaper to buy in bulk. Telecom providers have packaged and priced their products accordingly. When prepaid phone service was first offered, it required a scratch card that cost a minimum of $6 and was too expensive for most to afford. Telecom providers switched to an electronic, over-the-air system that allowed prepaid service to be renewed in units as small as a few cents. As a result, clients grew to trust over-the-air payments and later felt confident using G-Cash to transfer money.

Competitive motivation was added by the existence of another mobile-money product operated by Globe's chief competitor, SMART Telecommunications. Its product, SMART Money, links a client's phone to a cash account, allowing the subscriber to transfer and handle the money in this account through the mobile phone. If Globe were to successfully introduce a similar product, it would have to be as good or better.

Addressing Market Demands

While certain characteristics prepared the market for the successful launch of G-Cash, Globe's acumen regarding two other market characteristics propelled the product forward—turning it from a payment service into a platform for a full suite of financial services. First, most of the country is still largely unbanked—by some estimates, as much as 80 percent lack access to formal financial services. In rural areas, cooperatives and rural banks exist but struggle to reach the unbanked. Second, nearly 10 percent of Filipinos work overseas and send money back home, making the country one of the top receivers of international remittances. By understanding the needs created by these demographic realities, Globe tapped into latent business opportunities.

Rural Microfinance Through G-Cash

Rural and cooperative banks are a unique feature of the country's financial landscape. There are more than 750 such banks in the Philippines, with over 2,100 branches,[9] which together account for 8.5 percent of the country's banking system in terms of assets and 15 percent in terms of loans.[10] Located in rural areas, they provide microfinance, salary and agricultural loans, deposit services, bill payment, and remittances to clients at the bottom of the pyramid.

Although rural banks and cooperatives have long existed in the Philippines, most of them are small institutions that face major challenges in outreach, operational costs, and security. Recognizing the potential of G-Cash to address these problems, the Rural Bankers Association of the Philippines partnered with Microenterprise Access to Banking Service, a development project funded by the United States Agency for International Development, to create a mobile banking service using G-Cash. This service would go beyond payments and transfers to link customers with banks. The association and the project worked together to propose a set of microfinance products, which Globe agreed to test.

In 2004, after gaining approval from the Central Bank of the Philippines, the group ran a pilot in four rural banks, testing the performance of Text-A-Payment—a service that allows borrowers to make loan repayments using SMS technology. The success of this pilot encouraged other rural banks to offer the service. Soon, additional banking services were added, such as Text-A-Deposit, Text-A-Withdrawal, and Text-A-Sueldo (salary). Through the rural bank program, G-Cash expanded from payments into full-fledged banking services anchored around a bank account.

The outcome has been positive for the nearly 40 rural banks that offer the G-Cash microfinance products in over 364 branches.[11] These banks have witnessed a decrease in costs and an increase in efficiency, because the G-Cash technology replaces manual transactions with a faster and cheaper electronic method. Back-office operations across hundreds of participating branches have been cut, allowing both office space and staff to be deployed more productively. These savings can be passed on to clients in the form of lower interest rates and transaction fees. Mobile transactions are more secure and transparent, helping banks control fraud and minimize errors associated with the manual process. By providing a fast and cheap method to pay loan amortizations, G-Cash may help decrease delinquency rates.

The benefits for users of the G-Cash microfinance products are significant. The opportunity cost of traveling to the nearest bank branch and waiting in line to make a loan payment can be very high. It falls to near zero when a farmer can make her payment while standing in her own field. The added physical security of transporting money in a cashless manner, and the cost savings associated with the lower transaction fees, are also advantages.

The ability of the G-Cash microfinance products to meet the needs of the rural population has translated into greater financial inclusion as well as better business for rural and cooperative banks. In 2006, rural banks in the Philippines processed 43,000 transactions, whose value totaled at 132 million pesos ($2.8 million). A year later the number of transactions doubled, to 87,900, with a volume of 356 million pesos ($7.7 million).[12] With G-Cash, rural banks are becoming more competitive.

Remittance Services Through G-Cash

The Philippines has one of the most remittance-dependent economies in the world. It ranked fourth in 2007, after India, China, and Mexico, in the amount of U.S. dollars remitted; over 8 million overseas Filipino workers sent $17 billion home.[13] The most common methods to transfer money across borders have been international remittance companies and homeward-bound friends. Globe saw the opportunity to create a faster, cheaper, and more secure remittance service using G-Cash and has partnered with businesses in 15 countries to offer such a service to its clients.[14]

Globe's breakthrough in remittance services came through a partnership with Maxis Communications Berhad (Maxis), the largest mobile-service operator in Malaysia. Through this partnership, the two telecom companies offered the first international mobile-to-mobile remittance service in the world—allowing money to be transferred internationally without the presence of any bank accounts. Given that beneficiaries of remittances are generally underbanked, and that the two largest outbound remittance corridors for Malaysia lead to Indonesia and the Philippines (handling $4.3 billion), this service holds great potential.[15]

For users, the international remittance service works just like sending G-Cash domestically. The sender loads his phone with M-Money (from Maxis) or G-Cash. He follows a menu of instructions, types in the amount and the recipient's number, verifies the transaction with a PIN, and sends the SMS. The money is converted from the Malaysian ringgit to the Philippine peso, and the sender is charged five ringgits per remittance and the regular SMS transaction fee of 15 sens (.15 ringgits).[16] The Globe recipient, who is not charged for the transaction, instantly receives the message and the G-Cash, and can immediately cash it out or use it to pay bills, make loan payments, or purchase goods.

Financial institutions are increasingly interested in applying similar technology in their own remittance corridors. Citibank's Global Transaction Services (GTS) plans to partner with G-Xchange to allow G-Cash subscribers to receive remittances from any country where GTS is active.

Technology, Collaboration, and Regulation: Friends or Foes?

Technology, collaboration, and regulation have contributed to G-Cash success. A look at how this happened helps pinpoint challenges to the international growth and replication of mobile banking.

Technology. The mobile banking services of Globe and Maxis (G-Cash and M-Money) are run by the same technology provider, Utiba Pte Ltd., which specializes in creating mobile and Web products that facilitate micropayments and microremittances. Utiba developed the technology that supports over-the-air, prepaid phone service, which contributed to the uptake of mobile service in the BOP market. It then developed the mobile-to-mobile money-transfer technology for G-Cash. The fact that Globe and Maxis share a technology provider alleviated technological difficulties that can be encountered in international mobile-to-mobile remittances. This service is much more difficult to provide between two cell phones that operate on different platforms.

Collaboration and Partnerships. Branchless-banking channels such as debit cards sometimes encounter a chicken-and-egg dilemma: retailers refuse to accept a card because clients don't use it, but clients don't use it because retailers don't accept it. G-Cash surmounted this initial challenge because it had already built a retail network for its core mobile communications business, including its own outlets and partnerships with hundreds of retailers. When G-Cash was introduced, many retailers had trouble understanding the product and their role in selling it. Globe had to present them with a concrete business plan as well as fail-proof demonstrations of the technology in order to earn their trust.

As of the first quarter of 2007, Globe had linked with more than 3,500 different groups and businesses in the Philippines that accept G-Cash payments, including rural banks, utility providers, universities, and humanitarian organizations.[17] As more organizations employ G-Cash's services, even more retailers and clients are starting to use it.

Regulation. Before Globe could offer its mobile-to-mobile money-transfer service, it had to secure regulatory approval. Unlike its competitor, SMART, which offers a product similar to G-Cash, Globe takes full responsibility for managing the m-commerce. SMART has a partnership with Banco de Oro, which handles the accounts of SMART's m-commerce subscribers as it would its own. The retail bank is responsible for audit, fraud management, account security, and managing the money float created by the transactions. Globe, on the other hand, has gone to great lengths to gain the regulatory approval required to perform these banklike functions without a banking license.

The company secured this approval through dialogue and cooperation with the Central Bank of the Philippines. In order to reduce the risk associated with unregulated cash flow, the Central Bank requires G-Xchange to submit regular reports confirming that G-Cash is always backed peso for peso in a bank account.

The banking authorities were motivated to promote access to finance by the General Banking Law of 2000, which requires microfinance to be recognized as a legitimate banking activity. The central bank set up a special unit to oversee the use and development of m-commerce. This open-mindedness combined with the telecom's cooperation helped regulators accept G-Cash.

Similarly, a key step in setting up the international mobile-to-mobile remittance service was for Maxis to gain the approval of the Central Bank of Malaysia. In other countries, mobile providers may find roadblocks if regulators are concerned with money laundering and terrorism funding. In the case of Maxis and Globe, the providers set a ceiling of 10,000 pesos (approximately $208) for cash-in and cash-out transactions, complying with antilaundering regulations in the Philippines.[18]

Although Globe has partnered with other remittance companies—such as Western Union in the United States and Dubai—these partnerships do not involve mobile-to-mobile transactions but rather regular wire transfers in which a text messages notifies the recipient that money has been deposited into her bank account. In those partnerships, G-Cash's participation does lower the transfer fees, but not as much as with mobile-to-mobile remittances.

More broadly, G-Cash has raised important questions about the extent to which nonfinancial companies can safely manage financial transactions with the levels of accountability required from a regulated bank. In the case of the Philippines, so far, so good.

Conditions in the Philippines were very conducive for the success of G-Cash, including an extensive mobile infrastructure and a unique comfort with text messaging among Filipinos. Even so, successful product development required Globe to use those advantages to meet specific demands. Globe spotted needs for better service in the microfinance and remittance sectors and developed innovations to match.

Cases 3

INDUSTRY DEVELOPERS

VISA: SOCIAL BENEFIT SYSTEMS THAT BENEFIT EVERYONE

In many developing countries, governments distribute social benefits to recipients in the form of cash or staple goods. The administration of such social programs can be cumbersome, costly, and risky. Direct food aid has its advantages for emergency relief, but transportation and administration eat away at the budget. It is more efficient to distribute benefits as cash, but for a poor pensioner without a bank account, the need to keep a month's benefits safe at home or in his pocket is hardly social "security."[1]

Around the world, government agencies are looking for better ways. In many countries they have turned to private-sector payment system providers and banks to automate the benefit-payment process. Participation in government benefit payments is proving to be a shortcut to entry for the private sector into the BOP market. Government paves the way by providing connections to an enormous customer base and covering the costs of setting up systems.

Visa, the world's largest retail-payment system, is a partner in many of these efforts. With 16,600 financial institution customers and 1.6 billion cards, Visa manages $4 trillion in transactions around the globe each year.[2] Visa has launched electronic-payment systems for government benefit programs in the Dominican Republic, South Africa, Ghana, Mexico, Brazil, and the Philippines, among others. Once an electronic-payment system is operating, the marginal cost of each card transaction is significantly smaller than the cost of an equivalent cash transaction. Card-based payment systems such as Visa's are proving to be an efficient, effective, and economical alternative to in-kind and cash benefit distribution.

What we have here is a subsidy program for bank penetration of the BOP market that actually saves local taxpayers money.

Everyone Wins

When implemented successfully, card-based social payment systems provide benefits for all parties—recipients, government agencies, and private-sector partners.

- Governments can meet their social obligations while dramatically reducing the labor cost, waste, and inaccuracy of manual cash distribution.
- Beneficiaries get convenience and security. They don't have to lose a day's wages waiting in line for assistance payments, or worry about being robbed for the cash in their pockets, or bribe anyone for what they are rightfully entitled to.
- Private-sector partners—from international-payment networks to local banks and merchants—get government-subsidized new-customer acquisition and market development that opens business opportunities with new markets.

All of these things happen as benefit recipients gradually join the formal financial sector and the formal economy. There are subtler benefits, too. When card-based payment arrangements allow beneficiaries access to bank accounts, they may be more likely to save. As increasing shares of bottom-of-the-pyramid spending flow through the banking sector, the government can take credit for GDP growth and increases in tax revenue. Transparency is automated and corruption becomes more difficult. Analysis by Visa suggests a link between card-based payments and economic growth brought about by these features.[3]

Visa's Rationale

The benefits of using electronic-payment systems for social benefit distribution to government agencies and recipients are clear. But what is the business opportunity for Visa to participate in these national programs?

Visa's aim is to move as many transactions from cash to card as possible, building a card-based financial system in lieu of a cash-based one, and at the same time extending the coverage of the formal financial system to more people. In the short run, Visa earns fees from all merchants signed on to the various government programs. In some cases, such as in South Africa, Visa earns revenue from each additional transaction over the complimentary two transactions per month granted to benefit recipients. From this base, it is easier to extend card usage to nonwelfare beneficiaries, earning additional transaction fees. Eventually, as already seen in South Africa, cards will be used for additional purposes not related to social benefit transactions.

With a growing customer base and more transactions, Visa can build information systems to better predict the spending behaviors of clients. Clients previously outside the formal financial sector will begin to have credit histories, allowing Visa to develop scoring mechanisms. In the end, Visa will be able to create more client-appropriate products.

Dominican Republic: The Solidarity Card

In the densely populated Dominican Republic, with 9.3 million inhabitants and a per capita income of $2,800, some 43 percent of the population lives below the local poverty line. Of those, 16 percent are living in extreme poverty and many of them qualify to receive benefits under government welfare programs.[4]

In the past, the Dominican government distributed welfare benefits to the poor either in cash or in kind. One government welfare program organized truck deliveries of food baskets to poor neighborhoods. Its paper-based distribution system was difficult to manage, expensive, and inefficient. Often, the wrong people got the deliveries and the right people went hungry.

The Dominican Social Subsidies Administration (ADESS), together with and other Dominican agencies, joined forces with the United Nations Development Program and a Visa-issuing bank to develop a Visa prepaid card called the Solidarity Card to distribute funds to recipients of two welfare programs—Comer es Primero (Eating Is First) and, later, Incentivo a la Asistencia Escolar (School Attendance Incentive).

ADESS uses national census and other government information to identify eligible participants for both programs. Participants are automatically enrolled and issued an identification card plus the Solidarity Card bearing an individual identification number, the Solidarity logo, and the Visa acceptance symbol.

During the 2004 pilot phase, 6,000 Eating Is First beneficiaries received cards loaded with their food subsidy amounts, which they could use for government-approved purchases at 14 affiliated grocery stores and markets equipped with special point-of-sale terminals in neighborhoods around Santo Domingo.[5] ADESS launched a multimedia marketing campaign to promote the Solidarity Card program and educated beneficiaries on how to use the cards.

Based on the success of the pilot, the government rolled out the card-based system to Eating Is First beneficiaries nationwide in 2005. ADESS also extended the system to cover the School Attendance Incentive program, which provides grants to purchase supplies and other necessities at local pharmacies, groceries, and school supply stores.

ADESS chose four financial institutions to issue the Visa cards—Banco de Reservas, La Nacional, Popular, and Cibao—and used two merchant acquisition companies—VisaNet Dominicana and CARDnet—to identify and enroll merchants. Each month, ADESS transfers funds to the accounts of the card issuers, who then transfer funds to the beneficiaries' cards. Beneficiaries can pay with their cards at any affiliated merchant. Card issuers do not charge fees to the government or beneficiaries; instead, they recover program expenses through standard Visa merchant network fees.

The Solidarity Card streamlines the payment process for the Dominican government by centralizing and automating beneficiary identification and fund distribution. ADESS can monitor fund allocations across the country and access real-time data on program participants. The system is cheaper and more accurate, too.

Beneficiaries also win. Receiving their benefits automatically and electronically reduces the risk that welfare benefits will mistakenly go astray. Nor do beneficiaries have to waste time waiting in line for physical disbursements. Low-income families previously outside the formal financial sector now have government-issued identification cards and a new purchasing mechanism that prepares them for the formal banking sector.

Merchant inclusion and acceptance has been a critical factor for the program's success. Merchants provide card-use infrastructure and offer beneficiaries a place to put their cards to use. They have even been instrumental in helping train program beneficiaries in how to use their Solidarity Cards.

The number of Visa cards issued in the Dominican Republic increased from 6,000 in 2004 to more than 300,000 by September 2007. During the same period, the number of enrolled merchants grew to 1,300. At the end of 2006, $46 million was distributed through the Solidarity Cards.[6]

With strong advocacy from the Dominican Republic's vice president, who oversees the Social Protection Department, ADESS is evaluating which other government subsidy programs to add to the Solidarity Card system.

South Africa: The Sekulula Card

Although South Africa has a per capita income of $5,760, 40 percent of the country's 48 million people lack access to formal financial services.[7] Historically, the South African government distributed grants for pensions, child support, and other welfare programs to as many as 9 million citizens in cash payments handed out by officials in rural villages and urban townships. The system was unwieldy, expensive, and inefficient. The South African government wished to improve management of the benefits-distribution process, and at the same time it set out to help build financial literacy among low-income people.

At the end of apartheid, South Africa boasted strong financial markets but a dilapidated social infrastructure. One of the country's largest financial-services organizations, Absa Group, through its subsidiary AllPay Consolidated Investment Holdings, already had government contracts to disburse pension and social grants in cash in four provinces.[8] At the time, Absa had the most ATMs and one of the largest branch networks of any bank in the country, and 60 percent of the market for debit cards.[9]

In 2003, working with the government's Department of Social Development, Absa introduced the Sekulula debit card in Gauteng province and began issuing cards to recipients of benefits such as pensions, disability payments, and child support.[10] Allpay opens a transactional bank account for recipients of government grants and issues a Visa debit card, using smart card technology. Sekulula accounts have no minimum balance requirement, and the South African Social Security Agency covers Allpay's $2.25 per month maintenance fee for each account. Enrollment in the card program is not mandatory. Beneficiaries can still draw cash the old way if they prefer.

"Sekulula" is Zulu for "It's easier." On the first working day of each month, Sekulula cardholders receive their grant payments electronically in their accounts. They can withdraw cash at any ATM in amounts as small as they need during the month or make purchases at any Absa or Visa merchant. The maintenance fee covers two free transactions per month; fees for additional transactions are charged to the recipient. Recipients can also add value to their debit cards at any time by transferring funds or depositing cash into their Absa accounts. Cards are protected by a PIN and biometric fingerprint devices.

The program uses mobile units to reach remote villages on regular schedules. The vehicle includes an ATM, offices, a satellite connection to the data center, and a big-screen monitor and sound system to run financial literacy training while clients wait. Clients can open savings accounts and receive their cards through a portable, electronic account-opening system.

Sekulula cards can now be linked to mobile phone accounts so clients can purchase airtime at selected ATMs or local merchants. Funds are transferred from the client's debit account to his mobile phone account. The card can also be used for money transfers. Family members can add funds to a client's card by transferring funds into his account—an additional benefit for low-income, rural families whose relatives have migrated to urban areas.

Within the first 18 months of the Gauteng province pilot, two-thirds of all government grant recipients—nearly 500,000 people—opted into the Sekulula program. The program is now offered in the other three South African provinces where AllPay operates. AllPay has also extended the program to enroll unbanked South Africans who do not receive government benefits. These customers have to pay the monthly fee themselves ($2.25), but otherwise they receive the same program benefits as the grant-recipient clients. In addition, AllPay cross-sells other financial services to these recipients.

With the Sekulula program, the South African government eliminated costs in its budget for transportation, security, physical disbursement, and paper-based administration. Sekulula cards cut pension delivery costs in Gauteng province by late 2004 from $3.73 to $2.34 per beneficiary, a reduction of more than a third.[11] The card also stands ready to deliver onetime payments, such as relief payments in case of a disaster.

Education and financial literacy have proven critical at every level, including program staff, government agencies, and especially benefits card users. Some new cardholders are not familiar with the benefits—and risks—of financial products. And they may not trust financial institutions. This problem appeared when many recipients at first used their cards only once—to withdraw their entire payments in cash—rather than using the card as a cash substitute. In response, Visa and its member banks created financial literacy programs in Soweto and Soshanguve to educate students and train teachers about money management, card use, and budgeting, using traditional storytelling performances designed to entertain as well as educate.[12]

Conclusion: The First Step Toward the Last Mile

Inadequate infrastructure and market development have been major barriers to financial inclusion in many underdeveloped parts of the world. The cost to penetrate these markets, if borne by either the public or private sector alone would be prohibitive. The collaboration between government, banks, and Visa has enabled the cost of infrastructure and market development to be shared. It demonstrates that increasingly affordable, portable, and robust technologies make all the difference in the "last mile" of service delivery in the field.

Banking infrastructure may be as critical to economic growth as paved streets and highways. The use of Visa cards for social benefits payments creates a win-win-win for all parties, making possible an important first step into financial inclusion.

TEMENOS: CREATING CORE BANKING SYSTEMS FOR MICROFINANCE

When microfinance institutions (MFIs) grow, transform into regulated institutions, and compete with commercial banks, they begin to offer more than just individual and group loans. They need to provide their clients with an array of products, including insurance, payments, and savings. MFIs also need to improve their network coverage and find efficient ways to distribute their products. It is at this point that MFIs start looking at core banking systems.

Although more than 75 different core banking systems are available for microfinance, many of these solutions are either very local or provide limited microfinance functionality.[1] Only a few offer standardized applications and allow MFIs to add new financial services easily and increase outreach in innovative ways.

Temenos Spots an Opportunity

Temenos was perhaps the first mainstream core banking provider to take microfinance seriously. Founded in 1993, Temenos provides integrated core banking systems to almost 600 commercial banks and 100 microfinance banks and MFIs in over 120 countries. Headquartered in Geneva, Switzerland, the company has offices in 33 countries. Since the introduction of Globus, Temenos's first core banking system for commercial banks, the company has been one of main players in the core banking system industry.

In the late 1990s, Temenos became aware of the growing scale of microfinance. Recognizing a market opportunity, it acquired DBS, a small company that provided loan-tracking systems to MFIs. It used the microfinance market knowledge of DBS to build microfinance functionalities into its Globus system and marketed this first microfinance-oriented version as eMerge. Later, when the company upgraded and rebranded Globus as T24, it upgraded eMerge on the new technology platform, renaming it T24 for Microfinance and Community Banking (T24 MCB). The company tailored eMerge and then T24 MCB to serve the needs of MFIs. The systems integrate the standard characteristics of a banking system with microfinance functions such as group, village banking, and individual microenterprise loans. T24 MCB offers MFIs a "bank in a box" with a full set of predefined and standard parameters.

T24 MCB begins with the most common commercial-banking functionalities, such as the ability to handle deposits, loans, electronic payments, management information, and foreign exchange. As the MFI grows, it can enable additional functions, such as trade finance, treasury, work flow, and credit scoring. By integrating microfinance into a core banking system, Temenos can offer functional range, ability to scale, and adaptation to different types of institutions.

In creating T24 MCB, the company considered the limited resources of many MFIs. The modular structure is one response. It offers MFIs a preconfigured application. This enables fast, low-risk, and cost-effective implementations. T24 MCB's modular architecture allows for low initial pricing because MFIs can select only the modules they want to implement.

Early Challenges for eMerge/T24 MCB

As with any new enterprise, Temenos encountered some challenges at first. The earliest one was to build the internal buy-in needed to create and support a microfinance banking solution. Few Temenos technicians were aware of the microfinance industry. While the idea was well-received at the senior level, it was necessary to increase the internal knowledge about the importance of microfinance for the company's business.

Temenos's sales and services units were particularly important to convince. The company has offices or sales partners in 120 countries, and, although microfinance is a relevant portion of the financial sector in many of these countries, it was a challenge to educate staff and partners about the sector. In the beginning, Temenos partnered with a distributor to develop sales for microfinance, but this did not work well and the function was eventually brought in-house.

At the same time, the company found that few microfinance institutions were ready for a software application like T24 MCB. Temenos would have to convince them about the benefits of implementing a robust core banking system. Initially, MFIs had difficulties grasping the value proposition and miscalculated potential return on investment. Temenos found that most MFIs were small, offering only one product (a microloan), with limited internal technology capacity to implement and support a complex software solution. Unregulated MFIs in particular were a hard sell since they did not yet need the range of functionalities T24 MCB provided, such as deposits and reporting to regulatory bodies.

Sales were slow for the first couple of years. A global deal with Opportunity International, a microfinance organization with affiliates around the world, provided an important breakthrough for the product and a valuable entry into the market.

The Market Develops

The microfinance market is now more mature. Because of competition and the need to expand outreach, MFIs are looking to offer more products and to acquire clients in new ways. At the same time, as MFIs transform into regulated institutions, they need to report to regulatory bodies. These considerations make the choice of IT system an important strategic decision.

In addition, knowledge about microfinance has matured inside Temenos, and the company now better understands the value of this market. T24 MCB has become an increasingly important product line, alongside products for private, universal, and wholesale banking.

Lessons Temenos Learned

Both the market (MFIs) and the company (Temenos) have learned a great deal about the use and value of a core banking system for microfinance.

Pricing. Temenos initially underpriced its software, not realizing that sales to MFIs were as or more costly than sales to banks, because so much time was needed to communicate the value of the product to MFIs. Also, MFIs often insisted on a high level of individual customization that increased project costs and risks.

Technical Support. Similarly, it took time to find the right formula for postimplementation technical support. As some MFIs lacked the internal capacity to support the system, providing technical support was essential. But how and at what price? The company decided to use its existing network of Temenos country support offices and local technology partners in order to reduce the amount of technical support provided by Temenos headquarters and to allow for more competitive pricing.

Understanding the Market

The microfinance market is evolving as MFIs grow and become regulated institutions. As these changes occur, MFIs' demand for core banking systems increases. The business opportunity for providing MFIs with banking applications that can respond to these needs is evident.

Temenos took a long view of the microfinance industry, investing significant financial resources into the research and development of a microfinance product and growing sales slowly. Despite slow initial sales, Temenos recovered its investment relatively quickly, as the product proved profitable from the start.

As one of the first software companies to enter the microfinance market, Temenos learned that MFIs need a standardized system that is simple to implement and can grow more complex with the institution. It found the answer to the increasing transaction complexity and volume of MFIs in a modular solution that can easily incorporate new products and link to alternative distribution channels. Consequently, T24 MCB is currently used by more than 100 microfinance clients in 50 countries.

The solution has also helped establish a sense of corporate social responsibility at Temenos. Company insiders such as Murray Gardiner, manager of Microfinance and Community Banking, believes Temenos has a positive social impact by providing MFIs with technology tools to increase their outreach, outsmart competition, and improve operations.

Future Possibilities

Now that the microfinance market has evolved and MFIs are more aware of the value of core banking systems, there are new opportunities for providers of banking applications. Temenos has positioned itself well. A good portion of its microfinance clients are large- and medium-sized regulated MFIs. Such institutions have the human and financial resources to support a core banking system.

For the future, Temenos aims to help commercial banks that want to downscale or establish a microfinance subsidiary; some of these banks are already clients. Temenos considers working with large commercial banks a great business opportunity because they have the financial and infrastructure resources to provide microfinance services effectively but lack a detailed understanding of microfinance technology and operations management. Hence, Temenos plans to bring to commercial banks a combination of technology tools and microfinance management solutions through partnerships with microfinance organizations.

CREDITINFO: FIRST CREDIT BUREAU IN KAZAKHSTAN

When First Credit Bureau opened in Kazakhstan in 2006, Kazakh newspapers and business journals took note.[1] It had been a long process from the first concept in a U.S. Agency for International Development (USAID) program to the signing of an agreement that legally established the country's first credit bureau, to the entry of Creditinfo, a small Icelandic credit reporting agency as the owner and operator of the new bureau, and finally to the issuing of the first credit report. To most people, the formation of a credit bureau is hardly newsworthy, but Kazakhstan's business and banking community had been paying attention all along the way.

Why Credit Bureaus Matter

Credit bureaus tend to operate below the public's radar. Yet they are vitally important to the smooth functioning of credit markets. Credit markets, for their part, support the growth of businesses and contribute to households' abilities to acquire assets. A limited credit market can keep an economy from reaching its potential.

A credit bureau is a large database of individuals' borrowing and payment histories that banks and other lenders use to predict whether potential clients will pay their loans back. In economists' terms, it reduces "information asymmetry." Credit bureaus help lower banks' lending costs, and this can be passed on to borrowers in lower interest rates. Credit bureau information reduces banks' risks, including fraud and identity theft, and improves loan recovery. It can enable banks to reduce collateral requirements on loans and extend terms. Credit is disbursed faster when credit bureaus are at work. All of this is good for national economies, including Kazakhstan's.

Kazakhstan's Steep but Fragile Economic Ascent

In terms of landmass, Kazakhstan is the largest former Soviet republic. Its economy runs on oil and mineral extraction, followed by agriculture. After the demise of the Soviet Union, the government embarked on economic reform, liberalized the financial sector, and transferred assets to private hands. Between 2000 and 2008 the country's economy grew at 10 percent per year. This strong economic growth, combined with government investment in pensions and other social benefits, caused the poverty rate to drop from 39 percent in 1998 to about 20 percent in 2004.[2]

During this time the banking industry first blossomed, with commercial banks proliferating, and then consolidated. By 2003, three banks had a market share of 60 percent.[3] Commercial bank lending was steadily increasing, but loans to households were restricted due to lack of quality collateral, and loans to small and medium enterprises had actually decreased over the previous three years. Macroeconomists such as those at the International Monetary Fund and USAID were concerned that the financial sector was not operating efficiently and that risks were increasing.[4]

The Credit Bureau Project

Until this time, Kazakhstan's only credit history database was a rudimentary system managed by the National Bank, the country's central bank. Here, loan and borrower information from banks was collected on a monthly basis. Unfortunately, this information was collected without the permission of its subjects, against best practice standards in the developed world.[5] In 2001, USAID engaged the U.S. consulting firm Pragma Corporation to provide technical assistance to the Kazakh government for the formation of a credit bureau and rating agency. Pragma's initial feasibility study indicated that the market was large enough for a credit bureau to be financially sustainable.

Mistrust and Competition

One of Pragma's first tasks was building consensus among the banking community about the characteristics of the new credit bureau. Banks had to agree to consolidate their data, but they were reluctant to hand over their client databases to their prime competitors.[6] Pragma's experts argued that data-sharing would help banks increase market size, decrease delinquency, and build on-time payment habits among borrowers.[7]

Lacking a clear commitment from stakeholders to share data, Pragma sought to expose bankers and government officials to credit bureau best practices. Nowhere in the former Soviet Union was there a fully functioning, privately owned credit bureau, so Pragma searched farther afield. Representatives of the Kazakh Parliament visited Experian headquarters in London in May 2004. Key players attended the First Central Asian Credit Bureau Conference in January 2003.[8] The general manager of First Credit Bureau, Anvar Akhmedov, part of the credit bureau project from the beginning, recognizes that "studying international experiences allowed [the founders] to avoid many aspects and 'reefs' that could prevent the fast creation of the necessary legislative and technical base."[9]

Building a Legal Framework

At the time, there was no functioning credit bureau law in Kazakhstan. Pragma began working on a draft law together with the Financial Institutions Association of Kazakhstan, the National Bank, and the Agency for Regulation and Supervision of Financial Markets and Financial Organizations.[10] The group decided to follow the format of best practice credit bureau laws: defining what a credit bureau is, its functions, obligations, and rights; establishing the basis for independent private bureaus; and protecting the privacy and confidentiality of personal and corporate financial information.[11] The law also needed to be flexible enough to adapt to evolution of the financial system.

First drafts of the law reflected mistrust of the private sector. They were overregulating, threatening the financial viability of a future credit bureau, or had insufficient consumer protection. Nevertheless, it took only three years to develop and pass a law based on international standards—a speed record compared to many other countries.

Another sticking point was private versus public ownership. Private credit bureaus, the stakeholders understood, would cover more clients. Government officials gradually began to accept the idea that part of the credit bureau could be privately owned and another part owned by the government. But a branched credit bureau—with one branch responsible for legal and corporate entities, and the other for individuals—would not perform well. It also had the potential to create situations in which competing banks withheld information from one another.[12]

The National Bank proposed to become a major shareholder temporarily in order to make it easier for all the banks to come together. It suggested privatizing the bureau after three years with the sale of its shares.[13] But USAID and Pragma proposed a private credit bureau, with stable ownership, following the predominant model in developed countries. Eventually the National Bank agreed. The new Credit Bureau Law mandated 100 percent private ownership. This structure, Akhmedov notes, gives the credit bureau greater ability to resolve problems quickly and efficiently.[14] A public credit bureau could have been established faster but would not have met Kazakhstan's needs as well.

The Credit Bureau Law also addresses data sharing and consumer rights. It permits the sharing of both positive (good repayment) and negative (poor repayment) histories. It also mandates that all financial institutions share their data and allows other institutions such as government agencies, utilities, and telecommunications companies to contribute data on a voluntary basis. At the same time, the law allows customers to opt out of information sharing.

Investment Capital

Once the law was passed in 2004, it took only 23 more days for the credit bureau's founding banks to sign a formal agreement to establish First Credit Bureau. The original founders were the seven biggest Kazakh banks, covering the vast majority of the market. Early in the process, the banks agreed to invest equal amounts of start-up capital, $210,000 each. When this proved insufficient for a worst-case scenario, five of the seven banks raised their contributions. Just before First Credit Bureau opened, a nonbank financial institution and Creditinfo—the international credit reporting company that would run the bureau—bought in. The total amount raised was just under $2 million, projected to last until 2009, when First Credit Bureau should break even.

The credit bureau was established as a limited liability corporation—not a joint venture between banks. Consequently, there is no board of directors, only management and a shareholder committee. The idea behind this structure was to keep shareholders from interfering with operations, and to maintain control of the data, in order to give more credibility to the bureau. The internal investors—Kazakh banks—worried about the security of the database and the confidentiality of information. They decided not to search for outside investors.[15]

Enter Creditinfo

Credit bureaus need sophisticated software to share and analyze information. Shareholders decided not to develop their own software, fearing there would be too many problems. Equally important, they wanted fast implementation, since the banks were expanding rapidly.[16] They decided to hold an international tender for a technological partner. They were less concerned about the price than the quality and usefulness of the software and the technical support accompanying it. The tender attracted internationally respected credit reporting firms Dun & Bradstreet, Creditinfo, Experian, and Austria's KSV/SHUFA. First Credit Bureau's shareholders visited other countries to review systems in operation.

Creditinfo is a small Icelandic credit reporting firm specializing in emerging markets. While a newcomer to the field, it has pursued its core strategy of mergers and acquisitions aggressively in Eastern Europe, and it currently operates in Bulgaria, Czech Republic, Cyprus, Greece, Lithuania, Malta, Slovakia, Romania, Iceland, and Norway.[17] In 2005, Creditinfo was awarded the Kazakh contract and signed an agreement to supply the credit bureau with software, training, and advice. Creditinfo realized the profit potential of First Credit Bureau and thus was not content to be only a technical assistance provider. For a full year, the company asked repeatedly to become a shareholder, offering to purchase half of the credit bureau. The request was eventually approved.

In November 2005, First Credit Bureau received its license. Data loading from member banks' databases had begun several months earlier, requiring hundreds of people from dozens of organizations to enter credit information from existing data.[18] By September 2006, First Credit Bureau covered 5.5 percent of Kazakh adults, using information from 29 commercial banks.[19]

According to the World Bank's 2009 Doing Business Report, Kazakhstan's credit sharing environment rivals its neighbors and shows great improvement since 2004, as noted in Table 1. More than 6 million credit contracts are in the database.

	Kazakhstan 2004	Kazakhstan 2008	Regional 2008	OECD 2008
Public registry coverage (percent of adult population)	0	0.0	4.6	8.4
Private bureau coverage (percent of adult population)	0	25.6	17.6	58.4

Table 1 Coverage of Adults by Credit Bureaus

Source: World Bank's Doing Business Reports, 2004 and 2009.

In an effort to spur internal development, the credit bureau dedicated the year 2005 to infrastructure development and 2006 to growth. By 2008, First Credit Bureau had been profitable for over a year.[20] There were nearly 800,000 processed inquiries in 2007, up from 30,000 in 2006. This amounts to several inquiries every minute of the business day. By the end of 2007, 3 million credit histories had been generated, among them over 19,000 histories on legal entities (companies) and 2.8 million individual histories. The hit rate, a measure of the degree that a database covers the total market, has reached 70 percent, a level that corresponds to that of a developed country.[21]

In 2008, First Credit Bureau had 100 clients using its reports, with two to three new clients joining every week and no competitors. Banks are required to participate, while organizations such as leasing companies and microfinance institutions are permitted to access the credit bureau voluntarily. Some such institutions are clients of First Credit Bureau, but for smaller businesses, including some MFIs, the expense and infrastructure requirements are too high. The cost for a small MFI is approximately $4,000 annually.[22] In addition, MFIs need special software for information exchange and a dedicated staff person for transmitting and accessing information. Zhumagul Kharlibaeva, general manager of Bereke, a small MFI, sees the advantages of becoming a client, but for the moment says that the costs are out of reach.[23]

First Credit Bureau's Akhmedov believes that the credit bureau has helped low-income people. He argues that it helps prevent fraud and identity theft, especially among the poor, who are often victims of this crime. He also argues that the credit bureau's activities have helped tighten credit availability to borrowers with poor payment histories, preventing overindebtedness. On the flip side, credit has become cheaper for people with good repayment histories. When talking to MFIs, he suggests that those institutions that don't participate in the credit bureau will end up with the bad borrowers.[24] The MFI community is taking this argument under serious consideration.[25]

The establishment of First Credit Bureau and the demand for its services presented an opportunity for a small but aggressive private-sector actor, Creditinfo, to continue its expansion into Eastern Europe. The involvement of Creditinfo provided technical expertise and capital to the growing Kazakh credit bureau, making it easier to obtain credit in Kazakhstan.

Cases 4

FINANCING MODELS

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MF ANALYTICS AND CITIBANK: THE SECURITIZATION OF BRAC LOANS

On the face of it, it was an unlikely combination: BRAC, founded as the Bangladesh Rural Advancement Committee in 1972, by some measures the world's largest nongovernmental organization (NGO) in one of the poorest countries in the world; Citibank, one of the world's biggest banks; and MF Analytics, a one-year-old financial-services firm based in Boston, Massachusetts. These entities created a deal saluted by business publications around the world, from *Forbes* to the online *Economic Report*. The *International Financing Review* recognized it as the Securitization Deal of the Year in 2006.[1] The deal was the securitization of up to $180 million in BRAC's microloans to poor Bangladeshi women over six years.

Securitizations are complex financial structures that require a multitude of entities in different roles. BRAC made and serviced the original loans. But the transaction also needed analysts, arrangers, investors, a trustee, and guarantors. The government of Bangladesh also played a key external role. Being the first of its kind in Bangladesh, the securitization was greatly affected by each entity's expertise and commitment.

The Originator

BRAC is a conglomerate of nonprofit entities and for-profit social enterprises under an NGO umbrella. It has over 100,000 employees (mostly women),[2] more than 6 million active borrowers, and as of 2007, assets of $619 million.[3]

BRAC's combined activities touch the lives of over 110 million people in Bangladesh, where it began. It has opened international programs in Tanzania, Uganda, Sudan, Sri Lanka, and Afghanistan.[4]

BRAC's main business is microfinance. Its microfinance operation works through "village organizations," women (and a few men) who save, borrow, and participate in group meetings. Nearly 6.7 million village organization members are currently borrowers, resulting in an outstanding portfolio near $600 million as of April 2008.[5] Borrowers pay a flat 12.5 percent per year interest on loans, or nearly 30 percent APR. BRAC's integrated approach recognizes that poor rural women need a range of products and services. Through its savings services, its members have saved a cumulative $198 million,[6] in a country where in 2002, 82 percent of the population lived on less than $2 a day.[7]

BRAC also operates a bank aimed at small businesses of a higher economic profile than the microenterprises served by the NGO. Among BRAC Bank's accomplishments is the creation of a remittance service for transfers from abroad, which makes the bank one of the largest distributors of Western Union payments in South Asia.[8] On top of its financial products, BRAC provides health and education services, business skills training, and legal services. It runs primary and secondary schools, and is an Internet provider. Present in all 64 districts of Bangladesh and in 70,000 villages, BRAC is a major force for Bangladesh's development.[9]

In 2007, BRAC doubled the number of branches, reaching 2,867 offices by the end of December 2007, most in remote locations. Membership in the microfinance program increased by about 14 percent each year since 2002.[10] From 2006 to 2007, BRAC's gross loan portfolio grew from $350 million to more than $528 million.[11]

For the massive and rapidly growing BRAC microfinance program, funding the loan portfolio presents a big challenge. In 2004, the year in which it began considering securitization, BRAC, along with other MFIs, was under pressure from the government to reduce interest rates.[12] Donor funding had been volatile, dropping to less than 9 percent of BRAC's total funding in 2005 from 16 percent in 2002.[13] BRAC was looking for cheaper, more stable funding sources, as well as a way to reduce its dependence on the donor-supported government apex that lends to MFIs.[14]

BRAC's management began to look at securitization. A deal would provide additional funds for expansion, at lower cost. It would improve BRAC's returns on assets and equity by removing part of the loan portfolio from the balance sheet. In the long term, a successful deal would open BRAC access to more and cheaper funding through capital markets. Other benefits could include diversification of funding sources and decreased time spent on fund-raising.[15]

The Arrangers

MF Analytics is a young company, founded by its CEO Ray Rahman. At Lehman Brothers, Rahman built expertise in commercial mortgage-backed securities in the 1990s. He became intrigued by microfinance in his home country, Bangladesh, and the possibilities of securitization to help fund it.[16] Rahman established MF Analytics to provide structured credit services, especially portfolio risk analysis, to MFIs, starting with BRAC.

A securitization involves pooling a large number of smaller assets—in BRAC's case, thousands of tiny loans. These pooled assets are then sold to investors for a lump sum, and the cash flow from the loans is paid to investors as the individual loans are paid off. It is crucial to tailor a risk and cash flow prediction model to local conditions, and Bangladesh's susceptibility to floods, cyclones, political upheavals, and any number of other events made tailoring especially important. In addition, BRAC's own operations carried internal risks to repayments.

Securities buyers care about the timing of payments, requiring detailed modeling of both late payments and prepayments. Delays in collecting and transmitting loan payment information created potential risks. Especially in an industry like microfinance, where securitizations are rare, investor willingness to buy depended on ensuring that securitized loans were as good as or better than BRAC's microfinance portfolio at large (which has a solid track record).

MF Analytics developed a software tool called the Portfolio Analysis Expert System, which analyzes risk and forecasts scenarios for repayment.[17] The location of MF Analytics near MIT's Cambridge campus provided high-powered resources and expertise, contributing to the quality of the analytic system. This tool was critically important in the securitization process. The tool filtered all the potential risks and arrived at a pool of 275,000 loans (plus 50 percent more for additional collateral), which accurately reflected BRAC's portfolio.[18] To further satisfy investors, BRAC hired PriceWaterhouseCoopers to audit its management information systems and the algorithms used by MF Analytics. With its portfolio analysis in hand, MF Analytics turned to structuring the deal.

Officially, the lead arranger for the deal was RSA Capital of Dhaka, a firm set up by Rahman and a colleague to provide a local presence. Arrangers identify and conduct due diligence on the originator, coordinate with coarrangers to structure the deal, submit documentation to the authorities for review, arrange for the credit rating, and coordinate with sellers of bonds or certificates, among other tasks. Rahman and his colleagues did most of this work, assisted by three international financial institutions as coarrangers and investors: Citibank, FMO (Financierings Maatschappij voor Ontwikkelingslanden, a Dutch development bank), and KfW (Kreditanstalt für Wiederaufbau, a German development bank). All three coarrangers brought familiarity with both microfinance and capital markets. Citibank's central microfinance group worked in tandem with its local affiliate Citibank (Dhaka), making Citi at once a local and international presence.

Seeking Government Approval

The structure had to be approved by the government in an environment where securitization was still a new concept. The idea of a securitization market in Bangladesh originated with a joint World Bank and government of Bangladesh look at the problems nonbank financial institutions faced in mobilizing funds.[19] Under World Bank guidance, the first asset securitization in Bangladesh occurred in 2004, when the Industrial Promotion and Development Company of Bangladesh, the first private financial institution in the country, securitized 359 million takas of its portfolio.[20] A second securitization for another financial institution followed in 2005. But the concept remained new when BRAC began to engage the government.

The idea met with initial acceptance. Yet once the deal structure was submitted to the government, actual approval was a long time coming, and in the end the arrangers had to restructure the initial proposal.[21] The government was concerned about the involvement of foreign investors, insisting that their participation be reduced. It wanted to remove the guarantees after the first year, and it was worried about the effect on the value of the taka of income from the securitization paid to external investors. The coarrangers went back to the drawing table.

The Structure

After a year of negotiation, an agreement was reached that the government approved. The structure was a "true sale," rather than collateralized lending, and may have been the first true sale of microfinance receivables in the world.[22]

To set up the deal, BRAC sold $15 million of its portfolio to a special purpose vehicle (SPV), basically a trust fund, adding an additional $7.5 million of loans as additional collateral. A local bank, Eastern Bank Limited, administered the SPV, which converted the loans to certificates denominated in Bangladesh taka and sold them to investors.

In a true sale securitization like this one, ownership of assets (in this case, the loan repayments made by millions of BRAC borrowers) is transferred to the investors who buy the securities. There were four investors in the deal: Citibank (Dhaka), FMO, and two Bengali banks—Pubali and City Bank Limited. FMO, as the only foreign investor, bore its own currency risk. The Citibank portion was partially guaranteed (33 percent) by FMO, and then counterguaranteed by KfW. FMO bought $5 million of the securities, while the Bengali investors bought the other $10 million. By selling a similar amount of its portfolio twice per year for six and a half years, BRAC will raise $180 million over this period.

Other Players

Another critical role was that of rater. The rating should provide an independent, objective viewpoint on the quality, risk, and other factors of the pool of assets to be securitized. This transaction was rated by a local affiliate of Moody's, the Credit Rating Agency of Bangladesh, which was satisfied, giving the securities a AAA rating, the first in Bangladesh.

Citibank, FMO, and KfW approached this transaction from both a development and a commercial perspective, seeking out BRAC because of the potential poverty impact of its loans, and structuring the deal to provide adequate risk-adjusted returns. Their participation helped advance the access of microfinance institutions to capital markets.

Reflections for Future Securitizations

It is expensive to arrange a securitization. BRAC received funding assistance from FMO and KfW, which covered most of the cost of MF Analytics. BRAC pays for monthly maintenance costs and legal services, costs that decrease with subsequent transactions and with more experienced actors.

Securitizations are also complex. The experienced arrangers and investors helped get the job done, overcoming the inexperience of BRAC and the government of Bangladesh. The process is lengthy, this one in particular, with stakeholders around the world (Dhaka, Boston, The Hague, Frankfurt, Hong Kong, and London). BRAC's openness to learning and working through the process with the arrangers was a key success factor.

Securitizations for microfinance work only if MFIs are large enough to have a critical mass of transactions to structure the deal. BRAC met this criterion, but the number of "BRACs" in the world is limited. Other MFIs will have to reach critical mass to appeal to investors interested in securitization, or participate with other MFIs in pooling their assets, and they will have to offer top-quality loans with strong future-risk profiling.

Also critical were the database of loans and the management information system to manipulate the database. Even BRAC's comprehensive system—"robust," in the words of MF Analytics—had data problems to overcome. In this case, overcollateralization helped convince investors that this risk was manageable. MFIs that are considering a securitization, as well as their investors, need to consider information-system capacity as a possible bottleneck to a deal.

The deal worked well for BRAC. It lowers the bank's cost of funds by 250 basis points, and ensures a flow of funds over six years. The money raised will be used to lend to an estimated 1.54 borrowers.[23] The deal also diversified BRAC's funding sources, reducing its dependence on the government apex and donors, while opening access to capital markets. The high expense of completing this securitization means that, for BRAC, the real benefits will come with subsequent and larger deals. Ray Rahman notes that the bond is paying as it should and that the investors are quite pleased. At the end of 2007, BRAC was not delinquent in any payment to investors. As an added benefit, Rahman claims that the risk analysis system his company developed for the securitization has helped BRAC to decrease default, even while its growth rate has increased more than 25 percent in the last two years.[24]

The deal also worked well for the arrangers and investors. They are achieving their dual agendas of earnings and development and can claim leadership in this field as well.

The BRAC securitization was a landmark deal—the first true sale securitization in the world of microfinance, the third securitization in the country. It opened the door for securitization as another viable option for large microfinance institutions interested in raising capital to fund their growth.

CREDIT SUISSE: BRINGING COMPARTAMOS TO THE MARKET WITH A SUCCESSFUL IPO

On April 20, 2007, shares of Compartamos Banco of Mexico began trading on the Mexican Stock Exchange. Due to the handiwork of Credit Suisse, Compartamos became the first Latin American microfinance institution to sell its equity through an initial public offering (IPO). The resulting market valuation of Compartamos, roughly $1.56 billion at the time of sale, far surpassed expectations, and the book value multiple of the shares purchased stood at 12.8—unprecedented for a microfinance equity sale.[1] The overwhelming investor interest in the IPO marked a new stage in the arrival of microfinance into the mainstream capital market.

To the bankers at Credit Suisse, the past years of growth and high return on equity at Compartamos suggested immense potential for the future. The internal characteristics of the company, combined with a number of external factors, attracted Credit Suisse to the IPO and contributed to its ultimate success.

The Compartamos Path to Market Access

The Compartamos IPO represents the culmination of an ongoing strategy within microfinance—the enlistment of the private sector.

Compartamos began in 1990 as a pilot village-banking program of Gente Nueva, a youth organization that provided humanitarian aid in the impoverished states of Oaxaca and Chiapas. Its products and clients have remained substantially the same since the early days: primarily, group loans to poor, rural women for income-generating projects. Over the next 17 years Compartamos built itself into the largest microfinance institution in the Americas, as judged by the number of its clients.

In 2000, Compartamos converted from a nonprofit operation into a licensed finance company. During the following six years it averaged 46 percent annual growth. In 2004, Citigroup/Banamex helped Compartamos issue bonds totaling 500 million pesos (approximately $50 million) in a deal structured to attract Mexican institutional investors. Compartamos obtained a license to operate as a full-fledged commercial bank in 2006. By the end of that year, the bank was reaching over 600,000 clients with a gross loan portfolio of $271 million.[2] Its new legal/regulatory status, together with the successful bond issues, set the stage for the IPO.

The IPO Process and Results

An IPO is a significant step for any organization. It transforms a limited, private ownership structure into one that is widely held and traded—allowing the entrance of commercial investors. It also requires companies to meet the high transparency standards required for stock exchange listing, a process that infuses rigor throughout the organization.

For Compartamos, the impetus for the IPO was rooted in a natural process of ownership evolution. The Compartamos IPO was a secondary sale of 30 percent of outstanding shares, designed to allow founding shareholders a partial exit.[3] ACCION International, for example, needed to cash out a portion of its holdings to provide funds for investing in newer MFIs. The exit opportunity represented a significant step for investors in microfinance, since exits to public listing had not occurred in the past. Until recently, trading of microfinance shares has been rare, and all trades have taken place privately, generally among a small group of social investors. In this context shares are illiquid. Consequently, valuations of MFI shares have remained close to book value. A public listing would reduce or remove this illiquidity discount.

In a 2008 interview with Credit Suisse, the two Compartamos CEOs, Carlos Labarthe and Carlos Danel, noted an overall desire to promote financial inclusion: “We saw an IPO as another way to help microfinance and Compartamos connect with the financial sector and to empower microfinance institutions that still have a long way to go in terms of global scale and growth.”[4]

Compartamos board members sought to identify the best method for providing liquidity while maintaining the mission, vision, and focus of the bank’s operations. They looked for a solution that would not disrupt governance, management, or strategic direction, as abrupt ownership changes sometimes can. The board also requested that shareholders interested in selling shares act in unison. Ultimately, they decided that an IPO of 30 percent of all shares (with each seller cashing out only a portion of its holdings), would provide a diversified owner base while preserving the governance roles of existing shareholders.

Compartamos chose Credit Suisse as its underwriter from six other candidate investment banks based on its proposed sales structure, experience with IPOs, and knowledge of the microfinance industry. Credit Suisse partnered with two Mexican underwriters, Banamex (ACCIVAL) and Banorte, which handled the IPO's Mexican tranche. Credit Suisse was new to microfinance and approached Compartamos in the context of small Latin American financial institutions.

As underwriter, Credit Suisse had to determine the terms and structure of the offering. Isander Santiago-Rivera of Credit Suisse's Global Markets Solutions Group recalls the challenges presented by Compartamos during the evaluation process. The bank showed a tremendous track record—one of the highest growth rates in the region, as well as a return on average equity of 56 percent. The Latin American and Mexican average return on equity for banks hovered around 23 and 21 percent respectively.[5] But given the abnormal rate of growth and the lack of strong comparables in the microfinance sector, the Credit Suisse team suggested a prudent valuation. As interested investors responded to the offering pitch during international road shows, the Credit Suisse staff realized that market interest was far greater than initially expected and raised the offer price by 50 percent.[6]

In the final event, as can be seen in Table 1, the total number of shares demanded was 13 times the amount available for sale despite the sharp increase in price. In addition, about half of the institutional investors requested the maximum purchase permitted. Although the average order requested was 6.5 percent of the total offering, the average order filled was only 0.6 percent of the offering, or 0.2 percent of the bank.[7]

The IPO involved the sale of approximately 30 percent of the total capital of the company, at an initial price of \$3.65 a share. The offer yielded \$468 million, signifying a market value for Compartamos Banco of \$1.56 billion. The shares were sold in two tranches: 18 percent in the Mexican market, and 82 percent in the international market. All pre-IPO Compartamos shareholders sold part of their holdings, with the largest single seller being ACCION International, with 9 percent of shares sold, followed by Compartamos A.C.

Listing	First bank IPO in Mexico in recent years
Time to completion	17 weeks
Demand	13 times oversubscribed
Percent of total capital floated	29.9 percent
Total number of shares sold	128,308,412
Opening price per share (April 19, 2007)	$3.65
Opening price/book value ratio	12.8
Opening price/earnings ratio (based on 2006 earnings)	24.2
Offer value	$468,325,703
Tranches	18 percent Mexican;82 percent International

Table 1 **Outcome of the Compartamos IPO**

Source: Elisabeth Rhyne and Andres Guimon, "The Banco Compartamos Initial Public Offering."

(the original Compartamos NGO) and the International Finance Corporation, with 7.4 and 2.7 percent respectively.[8] A total of 5,920 investors bought shares, of which 158 were institutional investors, including roughly 90 hedge funds. The sale included investors from Mexico, the United States, Europe, and South America.

In the months immediately following the IPO, Compartamos shares performed well. The share price rose by 32 percent on the first day of trading, and after two weeks it was up 50 percent. The implied market valuation for Compartamos was over $2.24 billion, showing that the market has high expectations for the bank's future.[9] In 2008 the Compartamos share price fell in line with the overall drop in the stock market, which was especially precipitous for bank stocks. Nevertheless, Compartamos continued to demonstrate strong growth and profitability in 2008, reaching over a million clients and increasing its total profit.

Factors of Success

A number of factors, both internal and external, contributed to the Compartamos success and to Credit Suisse's interest in the IPO (see Table 2). Not only was Compartamos a uniquely attractive microfinance institution, but Mexican and world financial conditions also created high demand.

Compartamos stood out as one of the fastest growing MFIs in the region. With 187 service offices operating in 29 of the 32 Mexican states at the time of the IPO, and over 600,000 clients, Compartamos was (and still is) the largest MFI in Latin America.[10] Its history combines sustained growth, very low portfolio at risk, high profitability, and excellent management with a socially valuable operation, primarily serving poor women. In addition, the banking license that Compartamos obtained in 2006 gave it substantial future earning possibilities through development of deposit and fee-based activities. With the assistance of Credit Suisse, the Compartamos management team made an excellent impression on investors.

Undoubtedly the most important factor contributing to the popularity of Compartamos with investors was the company's high profitability. Initially, it was a challenge for the Credit Suisse team to explain to investors how a formerly nonprofit entity could become for-profit and create value for shareholders. But "at the end of the day," explains Santiago-Rivera, "it was the numbers that were of interest to investors."[11]

Factor	Conducive Conditions
Compartamos Banco	Excellent track record of profitability and growth Excellent future growth potential Superior management Social value of its operations Earnings potential resulting from banking license Relationship with huge numbers of clients
Mexican Microfinance Market	Mostly untapped Competition in its early stages High earnings expected in the market as whole
Mexican Financial Market	Well-developed stock market Conducive regulatory environment Lack of other banking IPOs Low number of IPOs in Mexico Strong trading of securities in financial services Solid Mexican peso
Mexican Environment	Positive reaction by market to new president Good market conditions
Global Factors	High liquidity levels in global capital markets Global IPO market recovery Financial services as "hot" sector for E.U./U.S. investors Microfinance gaining recognition among investors Mexico's magnetism as an investment destination
The IPO Process	Excellent commitment and execution from Credit Suisse, Banamex, and Banorte Ability to tap both Mexican and international markets Effective presentations by Compartamos road-show team

Table 2 Success Factors for the Compartamos IPO

Source: Elisabeth Rhyne and Andres Guimon, "The Banco Compartamos Initial Public Offering."

Credit Suisse also credits market conditions for the IPO's success. The microfinance market remains largely untapped, with microfinance loan penetration for Mexico at only 7 percent in 2007.[12] Competition was still in its early stages, promising strong earnings for the next few years. In terms of ability to capture the market, at the time of the IPO, Compartamos clearly stood out among direct and indirect competitors. The Mexican financial market was sound and liquid, with a strong currency and a well-developed stock market. On the international front, there were high levels of liquidity in the global capital markets, a gradual recovery of IPO markets worldwide, and a vogue toward investing in financial services. Growing international awareness of the microfinance industry undoubtedly helped. Additionally, Santiago-Rivera notes that at the time, much of the IPO activity was occurring in Brazil. This Mexican IPO presented a diversification opportunity for investors.

Finally, the Compartamos IPO was executed proficiently. Credit Suisse and its partners in Mexico showed commitment and talent in marketing and underwriting the IPO.

Interest Rate Controversy

The Compartamos IPO generated a controversy that rippled through the world of inclusive finance for months after the event. At issue was the role of profits in providing financial services to the poor, particularly if the source of profits is high interest rates. At 82 percent, the Compartamos interest yield in 2006 fell within the range of rates charged by MFIs in Mexico. Nevertheless, this interest rate was high in absolute terms and contributed directly to the 56 percent returns on equity that so attracted investors. Some critics—most vocally Mohammad Yunus of Grameen Bank—argued that it is inappropriate to earn high profits while serving low-income clients. (Words used by various critics included "unseemly," "unfair," and "immoral," to name only a few.)

Compartamos leaders Danel and Labarthe argued that the bank needed the profits generated by high rates to fuel rapid growth and allow it to reach hundreds of thousands, and as of 2008, more than a million clients. Moreover, they assert that the high valuation in the IPO will do more than any other strategy to attract the private sector into the Mexican microfinance market, thus making full financial inclusion a reality much sooner than any other path.[13] Indeed, many new players have entered the market since the IPO.

This explanation has not satisfied all critics and illustrates a need for greater consensus in inclusive finance regarding consumer protection and fair pricing. The trade-offs between reaching the unserved, pricing fairly, and making profits illustrate a basic bottom-of-the-pyramid challenge.

More Microfinance IPOs to Come?

The Compartamos IPO is the third public listing in the world of microfinance, preceded by that of Bank Rakyat Indonesia in 2003 and Equity Bank (Kenya) in 2006. It is the only IPO of an institution that originated with microfinance as its sole activity. Furthermore, while all three listings were successful, the Compartamos sale featured much higher returns and greater international uptake.

The IPO process is costly and time-consuming. Nevertheless, it may become a viable option for a select number of MFIs. Today there are roughly 20 shareholder-owned MFIs with total loan portfolios in excess of $100 million, a scale at which public listing on local markets begins to be relevant.

Now that Compartamos and Credit Suisse have shown that IPOs can be a viable exit option for microfinance investments, the illiquidity discount has been challenged. As market acceptance of microfinance increases, MFI shares will command higher valuations. In the future, it will become easier both to buy and sell MFI shares and to get attractive returns on such investments.

SEQUOIA CAPITAL: PRIVATE EQUITY AND INDIAN MICROFINANCE

Sequoia Capital is a top-tier venture capital firm investing in companies that, according to its Web site, offers "wonderful" products and "thrilling" services.[1] Of course, it helps that these products and services are profitable and growing. Profits, growth, and the thrill of making a social contribution convinced Sequoia Capital (India) to lead an $11.5 million investment (itself investing $6.5 million) in SKS Microfinance Private Limited.[2] SKS's clients borrow small amounts for raising livestock, small service activities, agriculture, and trading. As of 2008, SKS works in 36,000 villages across India, reaching 3 million women with microcredit and related services.[3]

What Did Sequoia See in SKS?

Sequoia is not a social venture capital firm, but a fully commercial investor, and this is what makes its choice of SKS very significant for microfinance. Sequoia invested in Apple Computer, Oracle, Cisco Systems, Yahoo!, Google, and YouTube, among others, proving its ability to seek out and fund exceptional entrepreneurial ventures before they become well known. Sequoia usually invests $100,000 to $1 million in seed capital to start-ups, then up to $10 million in early stage companies, and finally from $10 million to $50 million to companies in the growth stage.[4] The organization likes to ensure control by being the first investors and getting involved when there are still only a few people leading the venture.[5] It acts as the lead investor in most transactions, holding the largest stake and arranging financing.[6] In many companies, Sequoia holds a board seat to help guide the company's growth. Sequoia's Indian arm has several funds across various sectors with a total fund capital of $1.8 billion.[7]

As with many of its technology investments, such as Google, Sequoia became interested in SKS well before it showed significant profitability. SKS was one of the youngest of the large MFIs in India, having started operations in Andhra Pradesh in 1997. In 2004, SKS had only 24,800 clients, but it was growing so fast that by 2007 this number had climbed to nearly 600,000. SKS's portfolio growth rate was well over 100 percent in 2006. When the investment deal was developed, SKS had been profitable for only two years, earning a 27 percent ROE in 2006 and a 4 percent one in 2007.[8] Because the company's total equity was so small, the actual amount of profits these returns represented was insignificant. Nearly all Sequoia's interest in SKS arose from projected fast growth based on recent trends rather than on current profitability.

SKS's ability to earn profits while rapidly adding new clients impressed Sequoia's analysts, as did the prospects for massive growth in the underserved Indian market. Fast growth appeals to venture capitalists who want to take their profits out quickly, often as soon as two or three years. Social venture capitalists are willing to wait somewhat longer. Sequoia Capital India was attracted to SKS, according to its managing director Sumir Chadha, because of a good fit with Sequoia's growth-oriented investment philosophy. Although the social value unmistakably added to the attractiveness of SKS, Sequoia's decision rested on its rigorous evaluation of SKS's potential to generate significant returns.[9]

SKS had other attributes that appealed to investors. It is innovative beyond the norm for Indian microfinance organizations. Although it uses a standard Grameen Bank–style group-lending methodology, its commercial orientation and appetite for efficiency-enhancing innovations are unusual. SKS added larger and longer term individual loans to its portfolio of offerings. It rolled out life insurance to its client base, and is launching a health insurance product.[10] By connecting its clients to additional products like health insurance, SKS is opening up vast new potential markets. On the technology front, SKS was among the first Indian MFIs to equip loan officers with handheld computers in the field, and it has embarked on a pilot project using mobile phones for banking transactions in Andhra Pradesh.[11]

SKS's CEO, Vikram Akula, applied his Ph.D. in business from the University of Chicago to craft a threefold business strategy for SKS: use a for-profit approach, adapt best practices from the business world to overcome human resource constraints, and leverage technology to reduce costs.[12] He put his strategy to work, using a "factory-style approach to recruit and train field staff" and decentralizing management to area offices.[13] Akula's familiarity with the

American and Indian business scenes, honed through years in management consulting at McKinsey, undoubtedly contributed to his ability to convince mainstream players to work with SKS.

The Deal

In early 2006, the newly established social venture capital fund Unitus Equity Fund, along with SIDBI, an Indian government-owned social investor, and Silicon Valley venture capitalist Vinod Khosla, placed a total of $2.5 million in SKS.[14] This was the largest equity investment to date in an Indian microfinance institution, an amount so small it illustrates the serious undercapitalization among Indian MFIs at that time.[15] SKS used the investment to leverage more commercial debt for expansion. Its obvious success with this led to its second round of equity investment, with Sequoia Capital participating. Unitus, based in the Seattle area and with strong ties to the technology industry, was critical in connecting SKS to Sequoia (also based in Seattle).

During this second round of equity investment, valuing SKS proved to be very challenging. Until then, there had been no comparable private-sector investments in microfinance institutions in India, aside from SKS's earlier investment round. Without comparable numbers, SKS feared that investors were likely to offer only bargain-basement prices. To strengthen its position, SKS sought a lead investor through an auction. Ultimately, although Sequoia was not the highest bidder, its track record of supporting successful companies made it attractive to SKS.

The Sequoia deal in 2007 provided a total of $11.5 million of fresh equity. Participating in the round were Unitus, Khosla, and SIDBI for the second time, and new investors Sequoia Capital, Ravi Reddy, and Odyssey Capital.[16] While Sequoia's $6.5 million investment was relatively small, it was one of the largest investments in microfinance by a purely commercial venture capital company. CEO Akula projects SKS's return on equity as 23 percent, a figure in line with venture capital expectations.[17] One stipulation of the investment is that within three to five years SKS will either have an initial public offering (IPO) or be acquired.[18] An IPO is considered the likelier scenario.[19] There have been a limited number of IPOs in microfinance, such as Compartamos Banco (Mexico), Financiera Independencia (Mexico), BRI (Indonesia), and Equity Bank (Kenya), but the next few may well be in India.

Venture Capital and Indian Microfinance

The venture capital approach to investing makes sense for some microfinance institutions in markets with high growth potential. Investors like Sequoia bring expertise, contacts, and discipline. For MFIs with management open to this approach, the match can be ideal. Just as with high-tech companies, venture capitalists' involvement in corporate governance can help MFIs mature from founder-led organizations to large-scale companies with diversified management, a process undoubtedly at work today inside SKS. The presence of a venture capitalist lends credibility and increases access of MFIs to national and international capital markets.

From the perspective of the venture capital investor, the microfinance industry is similar to other fast-growing fledging industries. Currently, microfinance serves only a fraction of the potential demand for financial services. The potential client base for microfinance in India is estimated at around 75 million households.[20] With a goal of expanding service to over 5 million households by 2010,[21] SKS needs to double its scale every year. Venture capital will be a vital part of this expansion.

With the Sequoia deal in the lead, other venture capital investors are taking notice of the potential of Indian microfinance. In 2007, Share Microfin Ltd. received an equity investment from two investors: $27 million from Dubai's Legatum Capital, for a 51 percent stake, and $2 million from Aavishkaar Goodwell, an Indian microfinance equity fund. Share is planning an initial public offering in the next three or four years, according to Udaia Kumar, Share's founder and managing director.[22]

In July 2007, JM Financial India Fund, a mainstream investment fund, and Lok Capital, an Indian socially responsible microfinance fund, invested $12.25 million in Spandana Sphoorty Innovative Financial Services, another leading microfinance institution in India. JM Financial invested $10 million, while Lok contributed $2.25 million.[23] Both Share and Spandana had been very highly leveraged and urgently needed equity to qualify for more debt for expansion. Indian nonbank finance companies like SKS, Share, and Spandana are not authorized to take public savings deposits under Indian regulations. Without savings as a source of capital for loans, their appetite for commercial debt will continue to grow.

While mainstream venture capital firms are beginning to work with microfinance, specialized microfinance funds like Lok and Aavishkaar aim to develop the next generation of MFIs. These funds are financed largely by socially responsible investors and development banks. Aavishkaar Goodwell, for example, has participation from the International Finance Corporation (IFC), the Dutch development bank FMO, and Deutsche Bank, all three of which accept slightly below-market returns on investments. Aavishkaar Goodwell hopes to finance the launch of up to 60 new microfinance organizations, using a franchise approach ("IntelleCash") developed by Intellecap, an Indian social investment banking company, and Cashpor, an Indian microfinance organization.

New Challenges

Challenges remain for equity investing in microfinance organizations. One is "mission drift," where the involvement of private-sector investors is assumed to push MFIs toward larger, more profitable loans and, therefore, away from the original target market of low-income people. While the jury is still out, most research shows that what looks like mission drift in Latin America is instead changes in client demand or differences in target markets.[24]

There is some question of MFIs raising interest rates due to pressure to maximize profitability. The Indian political scene often embraces interest-rate caps, and significant competition also reduces this possibility. Indian MFIs are more likely to maximize profits through scale. A third concern is the quality of growth. With a number of MFIs in India receiving large equity investments and used to operating with very high leverage ratios, the worry is that expansion will lead to a loss of quality, credibility, and profits.[25]

SKS Since the Deal

Since the deal was closed, SKS has validated Sequoia's bet on its growth. Between March 2007 and March 2008, it tripled its clientele, more than tripled its staff, and quadrupled its outstanding loan portfolio.[26] Each month, SKS adds approximately 60,000 new clients and creates 30 new branches around India. SKS reached a gross loan portfolio in March 2008 of $261 million and is now by some accounts India's largest microfinance institution.[27] Its portfolio at risk rate remains an enviable 0.15 percent. In its annual financial report, released in March 2008, SKS demonstrated a 2 percent return on assets and a nearly 12 percent return on equity.[28] Since the deal with Sequoia, SKS has widened its product offer. It dramatically increased its life and health insurance (now reaching 1.5 million) and is supporting the rapid spread of cell phones and solar lighting among its clients. More new products are expected from its new innovation lab.[29]

The private sector continues to be enthusiastic about SKS. In 2007, SKS sold assets (loans) to Citibank and, later, to Centurion Bank of Punjab and HDFC Bank. Partially guaranteed by the Grameen Foundation, Citibank shares the risk of loan default with SKS. SKS received a third equity investment of $37 million in 2007, several months after the second round. The third round included the same four core investors, led by Sequoia, and two new mainstream investors, Silicon Valley Bank and Columbia Pacific Management.[30]

There is ample room and need for equity investment in the microfinance sector, in India and elsewhere. Sequoia Capital's investment in SKS signified that the private sector has recognized the potential of microfinance as an industry ripe for venture capital.

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Cases 5

SOCIAL RESPONSIBILITY

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ANZ BANK: IF THE MOUNTAIN WILL NOT COME TO US, THEN WE MUST GO TO THE MOUNTAIN

The Republic of Fiji is composed of 322 mountainous islands, and its highest peak, Mount Tomanvi, measures 1,324 meters. This mountainous terrain is home to the 400,000 Fijians who live in rural settings and lack access to banking services. Bias within financial institutions, geographical isolation, inadequate infrastructure, and financial illiteracy all combine to exclude 50 percent of Fiji's population from financial services.[1]

It is here that the Australia New Zealand Banking Group (ANZ) launched the program Banking the Unbanked in 2004. ANZ is the third largest bank in Australia and the largest in the Pacific and New Zealand. As a collaboration between ANZ and the United Nations Development Program (UNDP), this rural project is the first step toward reaching the 6.5 million Pacific Islanders who need access to banking.[2] Three years after its launch it is easy to identify the reasons for the program's success: a clear understanding of the potential clientele, customized solutions to specific challenges, and a mutually supportive partnership, all made possible by strong commitment from the bank's leadership.

Among the dozens of Pacific Island countries, Fiji is one of the most developed. In 2004, it ranked third in the region after Tonga and Samoa on the Human Development Index, with an adult literacy rate of 93 percent.[3] The World Bank's 2007 statistics put the Gross National Income (GNI) per capita of Fiji at $3,800.[4] However, unlike Tonga and Samoa, Fiji has a population in the hundreds of thousands, which meant that by launching the program there, ANZ ensured a large, relatively prosperous, well-educated clientele. In addition, ANZ has been operating in Fiji since 1880, giving it a century's insights into the country's political and economic conditions. Demands from influential village chiefs and Fiji's strong rural voice made it clear to ANZ that the rural areas needed better banking services.

Tailoring Products to Clients

Despite its tenure in Fiji, ANZ realized that it did not understand the prospective rural clientele; the rural population differs from the traditional urban ANZ client in more ways than simply average income and use of money. Therefore, ANZ would have to prepare a new set of products. Armed with a simple 10-question survey, ANZ workers traveled to villages to assess residents' banking needs.[5] The survey's results confirmed that the Fijian rural population did have money and that residents believed they would benefit from the opportunity to save. The survey also revealed a prevalent distrust of financial institutions, in part because of the entrenched prejudice by bankers who perceived the rural population as too poor for regular banking services.

Most important for subsequent product design, the survey exposed the susceptibility of the rural population to external risk, such as weather disasters. If a flood were to suddenly inundate a village, the consequences would be devastating for a resident with no savings. ANZ recognized the need for insurance from such shocks. Carolyn Blacklock, ANZ's leader for Banking the Unbanked, explained that "after a thousand of these surveys, we wanted to prepare them for catastrophe. The goal was to save for a month's worth of groceries."[6]

ANZ created three specialized products that would address the residents' financial situations. The products followed a "savings first, loans second" banking model,[7] which provided protection from external catastrophes and directly answered the residents' own desire to save. The Rural Banking Everyday Account addresses money management needs, where frequent deposits and withdrawals are the norm. Its only fee is a $3 monthly maintenance charge.[8] The Rural Banking Savings Account is meant to encourage longer term saving and comes with a $3 charge per withdrawal.[9] The third product is the microloan, launched in 2005. It is available to clients who have saved regularly for six months and have found a community leader to vouch for them.[10]

These three products are only available to Fijians living in rural areas because they are customized with features such as a lower minimum opening balance and fewer transaction fees. For microloans, eligibility requirements have been relaxed. Most important, by taking the time to understand their potential clients and then creating specific products to address their financial needs, ANZ demonstrates a victory over entrenched beliefs that rural populations are unbankable.

Tackling the Mountain

Once ANZ found the right combination of products to provide for the unbanked Fiji population, it had to find creative solutions to the geographic and infrastructure barriers that hindered service distribution. ANZ created a mobile banking system to bring the bank to the people. These "banks on wheels" consist of six armored trucks and 12 staff members who speak English, Fijian, and Hindustani.[11]

Every night, the trucks return to a branch to recharge and synchronize the books. ANZ staff travel daily throughout Fiji, serving over 1,600 communities, sometimes using airplanes and boats to reach extremely isolated settlements.[12] While most villages are visited within a fortnight, bigger towns such as Korovou and Navua have weekly service, and some small settlements are visited monthly. Timetables are provided so that clients can anticipate the arrival of ANZ. Because the trucks are self-sufficient, the widespread lack of electricity is never a problem. Furthermore, because the mobile banking system is regulated by the Reserve Bank of Fiji, there are strict requirements that ensure the money is safe at all times, which accounts for the armored trucks.

Partnership with UNDP for Financial Literacy

After creating customized products and finding innovative ways to deliver them, ANZ had to ensure that its clients could use them properly. Given the rural population's unfamiliarity with banking services, financial literacy was essential to the program's success. Undertaking its first partnership with a commercial organization, UNDP agreed to work with ANZ to research, design, and fund a financial literacy program that would accompany the ANZ effort.

ANZ program designers believed that financial education would increase productivity, decrease conspicuous consumption, and encourage investment. Moreover, the importance of financial education is inversely correlated with income; the smaller the income, the more costly a mismanagement of one's money can be. By offering financial training to everyone, from village leaders to schoolchildren, the program ensures that both current and future leaders have the skills to promote sound financial decision making throughout rural communities.[13]

Today UNDP-trained educators travel with the banks on wheels and teach residents about saving and budgeting. UNDP's international status made it excellent for the role of providing financial education. Blacklock explains that financial literacy should be "bank agnostic," that is, not biased in favor of any one bank. Thus, it is important that it be provided by a third party.[14] The ANZ-UNDP partnership combines the strengths of both organizations by allowing each to provide the services it is best suited for.

Outcomes and Challenges

Eighteen months after the start of the program, 54,000 rural accounts had been opened, and total deposits stood at $2 million for an average account size of about $40.[15] Of these rural accounts, 98 percent were first-time depositors, demonstrating ANZ's impact on serving the previously unbanked.[16] Five months after offering the microloan product, 400 loans had been approved, with loans outstanding of $200,000 and less than 2 percent arrears.[17] While these numbers show initial success in reaching rural clients, they do not yet establish profitability.

For ANZ, the costs associated with running the project are a long-term investment. As these villages develop, people's income will rise, and their participation in banking will also increase. Most will remember who gave them their first loan or savings account, and many will remain with ANZ. By being the first to enter this market, ANZ hopes to gain access to millions of potential clients throughout the region.

With economies of scale, the high costs of providing rural banking services should decrease, and the search is on for creative ways to lower the distribution cost to reach more people. John Velegrinis, ANZ's general manager of Regional Markets in the Pacific, says that ANZ "can only reach so much of the population with trucks, but if we get a more broad-based approach, we can increase scale and access."[18] Banking the Unbanked needs to be profitable to be sustainable. Progress to reduce the costs of mobile banking will influence the role Banking the Unbanked can play in the larger growth strategy for ANZ. Velegrinis explains that project is currently supported by the other banking activities within ANZ, but this support is not indefinite.[19]

The success of Banking the Unbanked in reaching remote populations has led ANZ to replicate it in the Solomon Islands, Papua New Guinea, Samoa, and Vanuatu.[20] When the program expanded to the Solomon Islands, ANZ employed an innovative technology to address infrastructural deficiencies—solar-powered ATMs. The ATMs are self-sufficient and allow clients to deposit and withdraw money at flexible times. Other technologies have also been deployed, like Internet banking and "bank-in-a-box," a device to connect remote locations to the main bank branches. Such expansion shows that ANZ finds the program to be a business-worthy endeavor.

Cambodia could be the next country for Banking the Unbanked. Blacklock explains that while the needs and attitudes of the Cambodian rural population are similar to those in Fiji, the country's size and population make the use of mobile banking inefficient.[21] ANZ will have to create another new set of distribution strategies.

There are internal challenges to be addressed, too, and these must be solved to ensure the bank's continued commitment. In keeping with standard bank staff rotation practice, a new ANZ manager is appointed to the Banking the Unbanked project every three years. Since it is still a relatively new area for the bank, this means that each new manager is likely to face a steep learning curve. Over time, more of the bank executives will come to understand inclusive finance, allowing it to become a core practice of ANZ's banking culture. By being perceived and operated as a business instead of a charity, inclusive finance can reach its full potential. In the words of Blacklock, "The flag we wave is business. We're not here to make you feel good."[22]

ANZ has shown initiative and determination by learning about the social, cultural, and economic needs of the rural island market and by investing in the capacity to serve that market. However, in order for inclusive finance to truly be successful in the Asia-Pacific region, other banks must also embrace the underserved population.

EQUITY BANK GOES TO SCHOOLS

Kenyans prize education, and low-income Kenyans often make great sacrifices to enable their children to attend school. Yet school fees are high, even while many schools struggle to stay afloat financially.

Equity Bank, a successful Kenyan bank that caters to the popular sector, developed an array of products to address the needs of owners, teachers, parents, and students at more than 3,000 client schools. These products are profitable for Equity because they are valuable to schools and the people associated with them. Equity's education activities illustrate mutual reinforcement between social and financial goals, made possible by a strategic approach to social responsibility.

The story unfolds in three steps. First, the bank finds a growing business in lending to the entrepreneurs who are creating hundreds of private-budget schools. Second, it develops these schools as nodes for delivering financial services to teachers, parents, and students. This is an efficient way to reach new customers, and it also contributes to the financial viability of the schools. Finally, the bank uses its foundation arm to channel even greater support to schools and students. The end result for Equity Bank is a profitable line of business that also wins it great loyalty and goodwill. And the end results for Kenya are stronger schools and more educated youngsters.

Similar opportunities exist in many developing countries for banks to support education at the bottom of the pyramid.

The Starting Point: Private Schools for Low-Income People

In Kenya, where income per capita was only $680, nearly one quarter of adults are illiterate, and only 42 percent of children attend secondary school.[1] Kenya's economic stagnation in the past two decades caused a drastic deterioration of public education. With a population intent on educating its children, the demand for high-quality education services has grown far beyond what the government can supply, which has led to the mushrooming of private schools—even for the poor.

James Tooley, professor of education policy at Newcastle University, documented the worldwide spread of private schools for the poor, which have come to be known as Tooley schools, or private-budget schools. Tooley showed that private schools for low-income families often perform better than their public counterparts. Private-budget schools are run as businesses by education entrepreneurs, making them responsive to parents and eager to invest in school improvements. In Kibera, the largest slum in greater Nairobi—and one of the largest in Africa—Tooley found that a large majority of children attended private schools.[2]

But these schools are financially no better off than their students. Often founded by a single educator, they operate as entrepreneurial ventures, with predictable struggles for finance. Many private schools in Kenya are solely dependent on tuition-fee income to survive and have difficulty meeting the capital requirements for start-up and growth.

Equity Bank Ltd. is among the top five commercial banks in Kenya, with more than a million clients. It finds its target clients among economically active low- and medium-income Kenyans. Its first loans to education entrepreneurs were small personal loans, since financial institutions were not allowed to bank private schools. When this restriction changed, in 2003, Equity was among the first institutions recommended by the Ministry of Education as financial-services providers for schools. Equity began offering more substantial loans for construction finance and to help schools manage the cash-flow shortage they often experience between the start-up of the school year and the receipt of tuition payments. Today, Equity Bank leads the market for private-school financing in Kenya. So far, more than 3,000 public and private schools have received financial services from Equity, most of them in poor areas.[3]

Equity's school development loans help private schools improve infrastructure, purchase educational materials, and train teachers. The average size for these loans is $16,000, with terms from 1 to 10 years. Schools pay commercial interest rates between 7.6 and 15 percent. The Equity school loans portfolio reached 1 billion shillings ($15 million) in 2007. Very few of these loans had overdue payments.[4] The bank's managers say that the business opportunity in education is growing and that Equity expects to finance hundreds of additional schools.

Turning Schools into Business Nodes

Equity's managers recognized that schools offer an excellent opportunity to build a market. Many people come together around schools: teachers, students, and parents—all potential customers. Equity developed products specifically to meet their needs, including teacher salary advances, parent saving accounts, and education loans. The bank has a wide network of 65 branches across the country, supported by 44 village mobile banks (banks-on-wheels that make weekly visits in rural areas). It uses its growing network to reach as many schools as possible, offering various products:

- A teacher salary advance is geared toward meeting the unforeseen needs of teachers before payday, with loans up to four times the average monthly net salary (see Table 1). The majority of schools also channel their payrolls through the bank.
- To help low-income parents with tuition fees and school expenses, Equity Bank offers education loans timed to the academic calendar.
- Saving services include a contract savings account for education (the Jijenge account) and the Super Junior Investment Account, a child savings account.

The bank's staff has substantial knowledge about its client schools, students, and their households, and this knowledge is augmented by a large database, built in collaboration with Hewlett Packard, Infosys, and Oracle. The bank uses this information to adapt its services to meet the varied demand, while keeping them commercially priced.

Applying Philanthropic Tools

In 2006, the bank established Equity Foundation, a nonprofit organization, to raise and channel charitable funds. Among the foundation's main activities are programs that supplement the bank's commercial services for private-budget schools and low-income students.

The largest of these activities is the pre-university sponsorship program for low-income students, which doubles as an employee development program. Every year since 1997, the bank selects top students from districts where it has a branch, focusing on low-income students who otherwise could not attend university. The students are provided an opportunity for a one- to two-year

Product	Purpose	Features	Scale
School development loans	To help schools improve infrastructure, purchase educational materials, and enhance quality	• Interest rate of 14 percent • Loan term from 1 to 12 years	• Over 3,000 schools • $15 million in loan portfolio • Average loan size: $18,136
Salary advance loans	To support teachers to meet unexpected social and economic needs	• Up to four times the average monthly net salary • Interest rate of 15 percent • Loan application fee of 3 percent	• Available at most of the 3,000 client schools
Jijenge savings accounts	To provide a means for parents to prepare for children's future	• Contract savings • No withdrawal allowed within contract • No opening balance; minimum balance of $7.50 • No ledger fees • Interest rate from 3 to 6 percent • Fast access to loans up to 90 percent of the Jijenge deposits	• 7,121 accounts • Total saving balance: $748,798 • Average account amount: $105
Super junior investment account	To introduce children to savings accounts and banking	• Opened and operated by the parent/guardian on behalf of the child • Three withdrawals allowed per year • No opening balance; minimum balance of $3.00 • No ledger fees • Interest rate from 3 to 6 percent • Free bankers check for payment of school fees • Access to school fees loan	• 7, 572 accounts • Total saving balance: $812,595 • Average account amount: $107
Education loan	To assist parents in financing school fees at all levels of education	• Interest rate 15 percent • Loan application fee 3 percent • Available for terms up to 12 months • No guarantors	• 1,655 (by the end of 2003) • Average loan size: $1,000

Table 1 Equity Bank Education Products

Sources: Kibiru P. Irungu (Business Relationship Manager, Equity Bank), and Graham A. N. Wright and James Mwangi, "Equity Building Society's Market-led Approach to Microfinance," *MicroSave*, September 2004, and Equity Bank, www.equitybank.co.ke.

internship with the bank, and successful interns can work with the bank after graduation. The program supports students financially during their stints at the bank and during their studies. Equity sponsored 102 students in 2007.

Equity plans to launch matching grants through Jigenge contract savings accounts to increase incentives to save for education. Grants from the Equity Foundation will match or add to the savings account. Based on the financial situation of the family, the bank might add loans to the above package.

Equity Bank professionals, working through the foundation, also provide capacity building services for schools. Financial literacy and business management training has proved popular with private-school owners and administrators. The foundation also organizes forums and networks for private schools to share information and discuss common issues. The bank staff works closely with schools to identify their critical needs in finance, marketing, and management, and to help them develop business plans and set priorities for capacity building.

In administering all these activities, Equity must of course avoid inappropriate mixing of charitable and business resources. For example, it cannot use grants to help clients repay loans. It is not always easy to see a bright line here, and vigilance is required.

Measuring the Social Bottom Line

Equity tracks the social impact of its education services to understand the intangible benefits in terms of youth empowerment and education. Its monitoring project identifies the social impact of school-based financial services at several of its client institutions, including a private primary school and two technical institutes. It tracks how much the bank has loaned, how many students graduated, how students performed in standardized tests, how many went on for further education, and whether school infrastructure, capacity, and education quality were improved by bank services.

Success Factors and Results

Equity Bank attributes success in providing financial products to private-budget schools to early entry into the market, large-scale commercial outreach, extensive information about clients, and products tailored to the needs of low-income clients. The linkage of commercial products and capacity-building services with charity funds increases the effectiveness of private-budget schools.

Equity's education programs and services meet a strong demand and provide profitability to the bank, while making a significant contribution to Kenya's schools and youth. They also pave the way for a loyal customer base for the future as those young people grow up. And Equity gains in stature as a bank that leads by contributing to an important national goal.

TRIODOS BANK AND THE GLOBAL REPORTING INITIATIVE

Businesses and investors that pursue inclusive finance may wish to find ways to measure and report on the social value they create. Triodos Investment Management, a Dutch fund management company with a portfolio of €140 million in microfinance funds, actively invests in inclusive financial institutions in developing countries. Through the Global Reporting Initiative (GRI) Triodos uses sustainability reporting to enhance social-performance management by its investee banks and finance companies. Triodos helps its equity investees in microfinance develop annual "sustainability reports" detailing their economic, environmental, and social performance (see Table 1).

GRI: People, Planet, and Profit

Sustainability refers to longevity, whether for the human race, the environment, or an organization. Global Reporting Initiative guidelines provide a mechanism for companies to disclose their annual activities in sustainability reports according to a triple bottom line, sometimes referred to as people, planet, and profit.

The first version of the GRI was developed by the U.S. nongovernmental organization CERES in 1997 in response to calls from a range of voices for greater corporate accountability, particularly in the environmental arena. The United Nations Environmental Program joined as a partner in 1999, providing funding and visibility for the initiative. A broad group of stakeholders—the business community, NGO representatives, and academics—developed guidelines. More than 30,000 stakeholders from 80 different countries have contributed to formulating GRI criteria.

Global Reporting Initiative	
Year Initiative Began	1997
Number of Institutions Producing Reports	2000
Number of Stakeholders Contributing to Reporting Guidelines	30,000+
Number of Countries with Stakeholders Contributing to Reporting Guidelines	80
Global Reporting Initiative, Use by Triodos Bank	
Year Initiative Began	2004
Number of Institutions Creating Sustainability Reports in 2006	11

Table 1 GRI and Triodos Bank, Key Indicators

Today, the GRI is headquartered in the Netherlands and works in cooperation with the United Nations Environmental Program and the United Nations Global Compact to encourage businesses to adopt sustainable and socially responsible policies. In 2006, according to GRI statistics, at least 2,000 organizations released sustainability reports (see Table 1). The GRI guidelines cover many industries, blending common and specialized indicators. Among the broad areas of attention are labor practices, use and disposal of natural resources, and economic footprint (see Table 2). A supplement is available with specialized indicators for the financial sector, including a set of indicators in development for inclusive finance.

Indicator Areas	Indicators Covered
Social	Labor practices and decent work Human rights Society (community, corruption, anticompetitive behavior) Product responsibility
Environment	Materials, energy, and water usage Biodiversity Emissions, effluents, and waste Products and services Compliance Transport
Economic	Economic performance Market presence Indirect economic impacts

Table 2 Performance Categories for Disclosure

Source: Presentation by Teodorina Lessidrenska, GRI, October 23, 2007.

Triodos Investments and Sustainability Reporting

Triodos Investment Management is a wholly owned subsidiary of Triodos Bank, a financial institution with assets of €3.7 billion. It manages three funds that provide finance, both debt and equity, to more than 80 microfinance institutions in developing countries, with a total portfolio of €140 million as of June 2008.[1] Triodos Bank provides banking services to organizations and businesses that embrace positive social, environmental, and cultural goals. Since 2001, Triodos Bank has formulated its own annual report according to the GRI guidelines. It views GRI as the most well-known and widely accepted of all social reporting frameworks and recommends the system to its equity investees engaged in inclusive finance. Most of the institutions Triodos invests in pursue both financial and social goals, and they welcome an internationally recognized framework to report on the values that are important to their businesses. It is easier and more cost-effective to report against an existing framework than to invent and research firm-specific criteria. Reports are likely to get more respect and attention if they conform to a recognized process.

Raising Awareness

Marilou van Golstein Brouwers, managing director of Triodos Investment Management, noted that the process of creating reports has raised awareness among financial institution leaders and staff at Centenary Bank, a Ugandan financial institution that has been working with GRI for more than two years. Stephen Nnawuba, chief accountant at Centenary, remarked that GRI introduced the bank to the concept of sustainability values, particularly regarding the environment. The bank plans to expand training on GRI to loan officers in every branch. With increased staff awareness, Centenary expects that changes in operations will occur, such as development of financial products that help clients reduce their environmental impact.

BANEX, previously the Nicaraguan nonbank financial institution Findesa, first initiated GRI reporting in 2004. Gabriel Solorzano, chairman of the board of BANEX and formerly president of Findesa, explained that although GRI reporting was initially promoted by external funders and mandated by senior management, environmental awareness has now permeated all levels of staff. "In new branches, our employees now are the ones to raise the issue regarding environmental impacts. We look at environmental impacts and try to use energy efficient appliances."[2] The need to report on social and environmental indicators also led BANEX to approve its first environmental policy and child-labor policy.

Such changes are typical of those seen by GRI associate Teodorina Lessidrenska who has worked to implement the GRI reports at many financial institutions. "The report is only one step in the GRI process. It is not a snapshot; it is about potential for improvement. First banks change their attitude, then they change their value system, and finally, after using this information year after year, changes in operations occur."[3]

How Global Reporting Initiative Reports are Developed

The microfinance institutions working with Triodos were early adopters of the GRI reporting system. Applying the system in this new industry required significant effort on behalf of both Triodos and the institutions reporting. Institutions interested in reporting according to the GRI guidelines generally follow these steps:

- **Prepare.** Institutions examine their own missions and identify their reasons for reporting, ensuring support and engagement from key stakeholders.
- **Decide what to report.** Institutions choose key reporting topics of greatest relevance to themselves and their stakeholders. These topics are matched with GRI areas and indicators.
- **Measure current performance.** Institutions identify and collect data and set targets for the following year.
- **Communicate findings.** Institutions write their reports in consultation with key stakeholders and then make them public.
- **Plan for improvement.** Institutions collect feedback on the current report, plan for a new report, and develop action plans for improvement that address operational practices as well as better reporting.

GRI offers handbooks on applying the guidelines for smaller companies, which simplifies the reporting process greatly. Reporting according to GRI standards is voluntary and designed to be incremental; that is, institutions report more information each year as they become more familiar with the process.

Triodos helps cover the costs of consultants who visit each institution reporting to GRI and even contributes some time from its own staff, who provide advice on GRI in their capacity as board members. This totals approximately 5 to 10 days of full-time support to help an institution implement GRI for the first time. Financial institutions interviewed estimated that they dedicated approximately 15 to 30 staff days per year to the GRI process, including reporting functions, trainings, and meetings surrounding this topic.

Van Golstein Brouwers noted, "Triodos could help some of its MFI investees do GRI reporting, but it would be very difficult for all 60 of our investees to implement such a system at this point. It should not be underestimated what it takes from organizations to collect and report on a number of basic indicators and systematically measure environmental and social aspects of MFI performance."[4]

Using GRI Information

In many cases, GRI reports are incorporated into an institution's annual report, as was Table 3, which summarizes the environmental and social indicators for one of Triodos's most successful investees, Acleda Bank in Cambodia.

Performance on individual indicators is disclosed in greater detail in a separate GRI report. Institutions report those indicators they believe to be relevant for their own operations. The Acleda report, as shown, is focused on energy use. It shows a reduction in energy per employee—possibly resulting from greater awareness through the GRI process—although total energy use is growing as the bank expands. Benchmarks are not available for financial institutions, so institutions are currently evaluated against their own targets.

Current Use of the GRI System

In 2007, 11 Triodos investees produced GRI reports: 5 in Asia and 3 each in Latin America and Africa. In the future, Triodos plans to play a role in suggesting common indicators for MFIs to report on, since the MFIs themselves have stated that they would like to compare performance among themselves. Triodos convenes annual meetings to discuss sustainability reporting. At these meetings participants exchange ideas and deepen their activities around social and environmental goals. Triodos is also seeking to encourage financial institutions that are not investees to learn more about GRI reporting and helping facilitate common reporting of institutions located in a specific region so that institutions can more easily learn from one another.

FTE = full-time employee		
Environmental Performance Indicators		
Materials	**2006**	**2005**
Paper (kg/FTE)	225.44	38.92
Tissue (kg/FTE)	1.30	1.23
Waste paper (kg/FTE)	2.32	3.18
Energy		
Electricity (kWh/FTE)	510.44	535.83
Gasoline (liters/FTE)	96.36	111.56
Diesel (liters/FTE)	45.66	40.43
Lubricant (liters/FTE)	4.03	4.54
Gas (kg/FTE)	0.53	0.78
Emission of CO2 (equivalents 000s kg)2		
Electricity	793	688
Gasoline	648	621
Diesel	354	259
Water		
Water (m3/FTE)	26.62	30.29
Commuting		
By vehicle (km/FTE)	335.02	-
By motorcycle (km/FTE)	4,336.23	-
Social Performance Indicators		
Employment		
Number of staff (FTE)	2,825	2,335
Male	2,151	1,840
Female	674	495
Training and Education		
Training career development	950	4,084
Training new recruits	686	562
Training to external students	638	282

Table 3 Summary of Environmental and Social Information: Acleda Bank, Cambodia

Source: Acleda Bank Annual Report, 2006

Tailoring the Global Reporting Initiative to Inclusive Finance

As the GRI is designed to be broadly applicable across sectors, it does not address some of the information important to the inclusive-finance community, particularly data on the socioeconomic characteristics of clients and the benefit of financial services to them. For institutions engaged in inclusive finance, this information is critical to assessing whether their mission is being fulfilled.

Some find the emphasis on environmental performance—so important to businesses like energy, chemicals, and transportation—to be less relevant for inclusive finance. The GRI, unlike the Equator Principles, a reporting framework designed for project finance, does not address the environmental impact of the businesses to which a financial institution lends.

GRI's goals are worthy, but it faces a daunting task to become relevant to a large number of businesses. Some interest exists in developing a subsector supplement of GRI guidelines tailored to the inclusive-finance industry, facilitated by the GRI Secretariat. This would enable institutions engaged in inclusive finance to report on outreach, client satisfaction, and customer profile. Reporting on more specialized indicators would assist GRI to achieve greater relevance and use for inclusive finance.

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ABOUT THE AUTHOR

Elisabeth Rhyne is the managing director of the Center for Financial Inclusion at ACCION International (www.centerforfinancialinclusion.org), where she oversees projects on client protection, investing in microfinance, and new financial products. As senior vice president of ACCION International from 2000 to 2008, Ms. Rhyne led ACCION's entry into Africa and India and directed the organization's research efforts.

Ms. Rhyne has published extensively on microfinance, including *Mainstreaming Microfinance* (Kumarian Press, 2001). She was director of the Office of Microenterprise Development at the U.S. Agency for International Development (USAID) from 1994 to 1998, leading USAID's Microenterprise Initiative. Ms. Rhyne lived for eight years in Africa (Kenya and Mozambique), consulting on microfinance policy and operations. She holds a master's degree and doctorate in public policy from Harvard University and a bachelor's degree from Stanford University.