MICROFINANCE IN THE NEW MILLENNIUM

Efficiency, Customer Satisfaction, and Commercialization of Microfinance Institution

Edited by
Sahra Halpern

2000
FOREWORD

The MicroFinance Network is a global association of leading microfinance practitioners. One of the primary purposes of the Network is to provide advanced microfinance institutions with a forum to learn from each other’s experiences. Each year, Network members assemble for three days of presentations and discussions about important issues regarding the operation of their institutions. The evolving microfinance industry is experiencing significant developments in technology, methodology, and outreach, all of which are fueling exciting changes for MFIs. At the turn of this century and millennium, as the world makes leaps and bounds in many fields, the microfinance industry is poised to affect revolutionary advancements of its own.

The three themes of this year’s conference reflect the changes that are taking place. Efficiency, Customer Satisfaction, and Commercialization (the application of market-based principles to microfinance) were identified by Network members as being relevant and timely subjects, important to their current operations. Together, these themes create a web of new possibilities for the field: a focus on efficiency can lead to enhanced services and customer satisfaction, and commercialization can serve as a vehicle to increase the outreach of services in a sustainable manner. Network members and a handful of special guests provided quality presentations on these topics, which were followed by extensive discussions. This document presents a summary of the conference proceedings so that others may benefit from the expertise within the Network. Anyone who is interested in the sustainable provision of microfinance services will find this document useful.

The Seventh Annual Conference of the MicroFinance Network, Microfinance in the New Millennium, was held in Dhaka, Bangladesh, one of the original foundations of microfinance activity. This site was an ideal location for the annual conference for several reasons. Not only has Bangladesh made important contributions to modern microfinance, but after making remarkable advancements in efficiency, the Bangladesh environment is now ripe to move toward greater customer satisfaction and commercialization.

Related to developments in these three areas, the microfinance sector in Bangladesh is also considering plans to define a regulatory framework for MFIs, thus creating higher standards for operations. Microfinance practitioners in Bangladesh took the opportunity to discuss such plans with other microfinance experts who attended the conference. As a result of their discussion, the Bangladeshi microfinance practitioners concluded that a framework primarily based on self-regulation and supported by the central bank would be the most beneficial. The increasing recognition of MFIs’ potential for economic impact was underscored by the willingness of Dr. Farashuddin, Governor of the Bangladesh Central Bank, to speak at the conference and offer his critical assessment of the state of microfinance in Bangladesh. The Network extends its sincere gratitude to the Governor for his opening remarks.

The two generous hosts of the conference, BRAC (formerly Bangladesh Rural Advancement Committee) and the Association for Social Advancement (ASA), are members of the MicroFinance Network that have been at the forefront of advancing microfinance services in Bangladesh and serve as models in the field. They are two of the most efficient MFIs in the world, and are also making strides in customer satisfaction and commercialization. BRAC has its own research arm that tracks levels of customer satisfaction and adjusts policy accordingly in order to serve the evolving needs of its growing customer base. ASA informally tracks the changing needs of its customers, and has recently moved from group lending to individual...
lending in response to its customers’ preferences. Moreover, BRAC recently received a license to create BRAC Bank, which will serve small and medium enterprises (SMEs). The creation of BRAC Bank will test the country’s possibilities for commercialization of other microfinance NGOs in the future.

The Network greatly appreciates the hard work and dedication of Fazle Hasan Abed (Executive Director, BRAC) and the staff at BRAC’s Centre for Development Management (BCDM), as well as Md. Shafiqual H. Choudhury (Chief Executive, ASA), for their excellent planning and commitment to making the event a success. The Network would also like to thank BRAC and ASA for planning field visits for conference participants to meet with branch staff and clients and to learn from their experiences.

Special thanks go to those individuals who contributed to the conference by speaking on topics and sharing their institutions’ experiences. Many thanks also go to Anita Campion, Director of the MicroFinance Network, and Craig Churchill, Director of the Washington office of Calmeadow, for providing substantive edits to this Conference Summary.

On behalf of the Network, I want to welcome four new members to the MicroFinance Network: Caja Los Andes (Bolivia), Compartamos (Mexico), FINCA Kyrgyzstan, and PRIDE Tanzania. We look forward to their future participation and contribution to the Network, and to furthering our mutual objective of increasing access to financial services for low-income communities.

Finally, I want to take this opportunity to thank the supporters of the MicroFinance Network. Calmeadow continues to do an excellent job serving as the institutional sponsor of the Network. The Department for International Development (DFID) provided resources toward the Conference. The Consultative Group to Assist the Poorest (CGAP) provides generous assistance that helps the Network increase the scope of its activities. Through the Network’s Staff Exchange Program, Citigroup contributed travel funds, which covered some of the travel costs of Network members. The efforts of our supporters helped make the conference possible.

Maria Otero
Chair, Steering Committee
MicroFinance Network
Washington, DC, USA
January 2000
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LIST OF ABBREVIATIONS

ABA    Alexandria Business Association
ASA    Association for Social Advancement
BCDM   BRAC Centre for Development Management
BRAC   Bangladesh Rural Advancement Committee
BRI    Bank Rakyat Indonesia
CAMEL  Capital Adequacy, Asset quality, Management, Earnings, and Liquidity management
CEO    Chief Executive Officer
CGAP   Consultative Group to Assist the Poorest
DFID   Department for International Development
IFC    International Finance Corporation
MBA    Masters in Business Administration
MFI    Microfinance Institution
MIS    Management Information System
NBFI   Non Bank Financial Institution
NGO    Non-governmental Organization
PFF    Private Financial Fund
PRODEM Fundación para la Promoción y Desarrollo de la Microempresa
SME    Small and Medium Enterprise
SOFOL  Limited Scope Financial Company (Spanish acronym)
UNDP   United Nations Development Program
THEME 1: EFFICIENCY

One of the great challenges of microfinance is to reduce the delivery costs associated with providing small loans with little or no collateral. Due to traditionally high costs of providing small loans, it is essential that MFIs deliver their services in the least costly manner possible while maintaining quality services. One way many MFIs have improved efficiency is by significantly increasing client outreach to achieve greater economies of scale. However, there are countless other ways an MFI can reduce costs in its daily operations. The key is to discover creative ways to reduce costs and improve employee productivity.

MFIs have developed and implemented successful efficiency innovations, but before an MFI determines how it can become more efficient, it must learn how to measure its current efficiency levels and expose areas for improvement. Once those areas are identified, the MFI can establish methods to reduce associated costs, thus improving the efficiency of its operations.

MEASURING EFFICIENCY

Anita Campion, The MicroFinance Network, Washington, D.C., USA

To minimize costs and maximize efficiency, the MFI must first measure its current costs to be able to analyze its level of efficiency. The MFI can look at some common efficiency indicators to gain a general understanding of how efficient its operations are. The MicroBanking Bulletin uses the following efficiency indicators, which can be useful for self-assessment as well as for peer group comparisons:

- **Operating Expense Ratio** (total operating expenses / average total assets). The operating expense ratio gives a general overview of how efficiently the MFI uses assets. The use of average loan portfolio in the denominator suffices in MFIs that only offer lending services, but the use of average total assets is more appropriate for MFIs that mobilize savings. This is because average loan portfolio reflects the majority of the assets in a lending-only MFI, whereas MFIs that mobilize savings have assets and expenses that relate to services other than loans. Efficient MFIs in the MicroFinance Network have operating expense ratios between 10 and 25 percent of their average total assets.

- **Administrative Expense Ratio** (total administrative expense / average loan portfolio). The administrative expense ratio provides a good idea of relative efficiency when comparing MFIs because non-productive guarantee funds and year-end spikes can cloud comparisons between operating expense ratios. This ratio presents a clearer picture when comparing savings mobilizing institutions with lending only MFIs. Successful MFIs tend to have administrative expense ratios between 7 and 20 percent of their average loan portfolio.

- **Salary Expense Ratio** (salary expense / average loan portfolio). It is useful to track the salary expense ratio, which includes staff benefits as well as direct salaries, since salary

1 The MicroBanking Bulletin, a bi-annual publication of microfinance performance indicators funded by CGAP, is an output of the MicroBanking Standards project, which is managed by Calmeadow.

2 Operating expense includes administrative expense, loan loss provisions, and financial costs.
expense tends to be the largest expense in MFIs. Staff time spent on servicing clients often represents one of the biggest costs to an MFI. Most MFIs in the Network have salary expense ratios between 5 and 20 percent.

- **Staff Productivity Ratio** (number of active borrowers / number of employees). This is the most commonly used indicator for MFIs to monitor their changing efficiency. Using total number of employees rather than number of loan officers provides a better comparison between MFIs, because loan officers’ responsibilities vary across MFIs. Nonetheless, the MFI’s size and level of development influence this ratio and should be taken into consideration when used to compare ratios across MFIs. Network MFIs’ staff productivity ranges from 46 to 442 active borrowers per employee, but the majority have a staff productivity ratio near the Network average of only 141.

- **Average Cost Per Client or Per Loan** (total administrative expense / average number of clients or loans over period). If the MFI only looks at one efficiency indicator for self-monitoring, this is perhaps the best because it identifies transactions costs, which are significantly higher in microfinance than in traditional finance. It is therefore essential to control these costs. One way to do so is by expanding outreach for increased economies of scale: beyond a certain number of clients, approximately 10,000 to 20,000, the institution sees diminishing marginal returns and must become more creative in its efforts to improve efficiency. The chart in **Box 1** plots the average cost per loan client of MicroFinance Network members. It demonstrates that as MFIs expand outreach, they tend to simultaneously reduce their cost per client.

**Box 1: Network Members’ Average Costs per Client**

<table>
<thead>
<tr>
<th>Cost per Client by Number of Active Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost per Client (US$)</td>
</tr>
<tr>
<td>Active Clients</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>10,000</td>
</tr>
<tr>
<td>20,000</td>
</tr>
<tr>
<td>30,000</td>
</tr>
<tr>
<td>40,000</td>
</tr>
<tr>
<td>50,000</td>
</tr>
<tr>
<td>60,000</td>
</tr>
<tr>
<td>70,000</td>
</tr>
<tr>
<td>80,000</td>
</tr>
<tr>
<td>90,000</td>
</tr>
<tr>
<td>100,000</td>
</tr>
</tbody>
</table>

If an MFI finds itself performing poorly on any of these indicators, it should evaluate the operations associated with the ratio. Indicators tell different stories for different institutions as demonstrated in **Table 1**, which compares efficiency indicators for MicroFinance Network members. BancoADEMI and Bandesarrollo have good indicators in the total administrative expense and staff expense ratios. However, both these MFIs reach small business clients, which boosts their loan portfolios significantly, thereby improving the ratios. On the other hand, Compartamos in Mexico does not look competitive in terms of those ratios, but is fairly efficient considering that its average loan balance is much smaller than other Latin American institutions. Kafo Jiginew in Mali has very good efficiency

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3 Excludes three MFIs (ASA, BRAC, and BRI) whose large number of clients distort the chart’s scale.
ratios, in part because it operates in an economically challenged environment, which leads to lower staff costs. There, each staff member manages approximately 442 active clients. It is unlikely that even the most efficient MFIs would have good results for all of these ratios, so it is important to recognize that each indicator gives only one perspective on the efficiency of the institution.

Table 1: MicroBanking Bulletin Efficiency Indicators for Network Members 1998

<table>
<thead>
<tr>
<th>MFI Name</th>
<th>Operating Expense / Total Assets (%)</th>
<th>Admin Expense / Loan Portfolio (%)</th>
<th>Salary Expense / Loan Portfolio (%)</th>
<th>Staff Productivity (no.)</th>
<th>Cost per Loan Client (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fundación Chispa</td>
<td>56.2%</td>
<td>48.5%</td>
<td>26.0%</td>
<td>86</td>
<td>130</td>
</tr>
<tr>
<td>BancoADEMI</td>
<td>20.4%</td>
<td>8.6%</td>
<td>6.7%</td>
<td>46</td>
<td>NA</td>
</tr>
<tr>
<td>Banco Solidario, S.A. (BancoSol)</td>
<td>25.2%</td>
<td>17.2%</td>
<td>10.6%</td>
<td>129</td>
<td>146</td>
</tr>
<tr>
<td>Bandesarrollo</td>
<td>20.4%</td>
<td>8.9%</td>
<td>8.4%</td>
<td>117</td>
<td>184</td>
</tr>
<tr>
<td>FED</td>
<td>52.0%</td>
<td>34.1%</td>
<td>11.9%</td>
<td>89</td>
<td>91</td>
</tr>
<tr>
<td>Financiera América, S.A.</td>
<td>42.7%</td>
<td>23.8%</td>
<td>13.8%</td>
<td>62</td>
<td>265</td>
</tr>
<tr>
<td>Mibanco</td>
<td>27.6%</td>
<td>31.5%</td>
<td>19.8%</td>
<td>127</td>
<td>114</td>
</tr>
<tr>
<td>PRODEM</td>
<td>21.9%</td>
<td>24.2%</td>
<td>14.6%</td>
<td>161</td>
<td>97</td>
</tr>
<tr>
<td>Compartamos</td>
<td>71.1%</td>
<td>74.1%</td>
<td>39.3%</td>
<td>198</td>
<td>45</td>
</tr>
<tr>
<td>Caja Los Andes</td>
<td>24.5%</td>
<td>13.4%</td>
<td>9.3%</td>
<td>142</td>
<td>113</td>
</tr>
<tr>
<td>Africa:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Centenary Rural Development Bank Ltd.</td>
<td>26.9%</td>
<td>42.6%</td>
<td>19.1%</td>
<td>34</td>
<td>377</td>
</tr>
<tr>
<td>Kafo Jiginew</td>
<td>18.8%</td>
<td>19.1%</td>
<td>6.7%</td>
<td>442</td>
<td>31</td>
</tr>
<tr>
<td>Citi Savings &amp; Loans</td>
<td>34.0%</td>
<td>25.5%</td>
<td>13.4%</td>
<td>63</td>
<td>NA</td>
</tr>
<tr>
<td>ACEP</td>
<td>10.4%</td>
<td>7.9%</td>
<td>5.0%</td>
<td>89</td>
<td>133</td>
</tr>
<tr>
<td>ABA</td>
<td>11.3%</td>
<td>6.8%</td>
<td>4.2%</td>
<td>72</td>
<td>54</td>
</tr>
<tr>
<td>PRIDE Tanzania</td>
<td>61.0%</td>
<td>91.2%</td>
<td>48.3%</td>
<td>144</td>
<td>NA</td>
</tr>
<tr>
<td>Asia:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASA</td>
<td>19.4%</td>
<td>10.5%</td>
<td>8.4%</td>
<td>149</td>
<td>7</td>
</tr>
<tr>
<td>BRAC</td>
<td>15.8%</td>
<td>14.1%</td>
<td>10.0%</td>
<td>384</td>
<td>7</td>
</tr>
<tr>
<td>BRI, Unit Desa</td>
<td>32.0%</td>
<td>12.4%</td>
<td>7.4%</td>
<td>117</td>
<td>28</td>
</tr>
<tr>
<td>ACLEDA</td>
<td>33.1%</td>
<td>32.4%</td>
<td>20.2%</td>
<td>229</td>
<td>49</td>
</tr>
<tr>
<td>FINCA Kyrgyzstan</td>
<td>55.7%</td>
<td>89.5%</td>
<td>57.2%</td>
<td>78</td>
<td>67</td>
</tr>
<tr>
<td>Europe:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fundusz Mikro</td>
<td>34.8%</td>
<td>34.9%</td>
<td>22.6%</td>
<td>91</td>
<td>302</td>
</tr>
</tbody>
</table>

These efficiency indicators are appropriate for measuring the efficiency of an MFI’s lending operations, but additional indicators are necessary to measure efficiency of micro-savings mobilization. Centenary Rural Development Bank uses return on assets and return on equity to measure efficiency. As more MFIs

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4 To promote increased transparency in the microfinance industry, Network members waive their confidentiality agreement with the MicroBanking Bulletin and grant permission to the MicroFinance Network to publish their financial data.
begin to mobilize savings, they should track additional indicators that measure the efficiency of their savings operations.

**Activity Based Costing**

Once the MFI has a general idea of where it can reduce its costs, this idea can become more detailed and precise by using a method called activity based costing, or ABC. ABC can help an institution become familiar with the costs involved in each step of providing products and services. Such familiarity lets the institution identify areas for potential cost reductions. Other valuable applications of this unit costing methodology are:

- To establish benchmarks that can be compared to peers and industry averages
- To establish budgets that are more realistic and aligned with goals
- To modify incentive systems

One example of activity based costing involves determining the costs associated with the loan cycle. There are six activities within the loan cycle for which costs can be disaggregated:

1. **Marketing/Promotion**: product marketing, including the cost of materials, advertising, and staff time to make site visits to identify potential clients.

2. **Application**: cost of printing the application forms, staff time spent helping the client to understand and complete the loan application.

3. **Client Screening**: staff time of credit manager, branch manager, and/or credit committee spent on verification of client information supporting the request for a loan including income, business activity, collateral or other guaranties, as well as credit and reference checks.

4. **Approval**: staff time to review application and supporting documents and to determine the soundness of the loan request.

5. **Disbursement**: staff time spent to create the account and disburse loan funds, including bank fees if the MFI uses a bank to disburse funds.

6. **Repayment/Collection**: staff time to maintain the account and oversee the repayment of the loan, including extra efforts in cases of delinquency.

In addition, the logistical costs affiliated with staff traveling to meet with clients should be factored into each of the relevant activities above. In these examples, staff time (spent with the client, reviewing applications, processing requests, etc) represents the largest cost associated with the loan cycle; therefore, it is referred to as a cost driver.

Below is an example of the calculation of the unit cost of collection for a particular loan product:

The MFI estimates that in order to ensure prompt repayment for most loans, one follow-up site visit must be made to each client. This visit requires an average cost of one hour of the loan officers time ($20) plus the cost of transportation to and from the client’s location ($2), for a total of $22. The MFI maintains an on-time repayment rate of 95 percent of the portfolio. The remaining 5 percent requires, on average, two additional visits by the loan officer (2 x $22) and additional paperwork estimated to cost $6. The following formula calculates the average cost of conducting the repayment/collection activity:
$22 + 0.05(44 + 6) = 22 + 2.5 = 24.50$

This analysis concludes that the average cost of the repayment/collection activity is $24.50 per loan. Further analysis could be done based on the average cost of overseeing the repayment of repeat loans or the cost of collecting loans once they become delinquent.

In identifying and selecting areas for potential cost reductions, MFIs should keep in mind the inherent trade-offs between reducing costs and maintaining sound operations and quality service. For example, cutting costs in the area of client screening could potentially lead to higher costs in terms of increased defaults.

A similar analysis can be applied to the activities involved in the collection of savings deposits: marketing/promotion, account opening, cost of collecting savings (many MFIs have agents that go out and collect deposits in the market), cost of managing accounts and overseeing withdrawals/transfers, and account closings.

In order to understand efficiency, the MFI must be able to measure it. Once the MFI can measure efficiency levels, it can optimally employ a variety of tools to maximize efficiency.

**MAXIMIZING EFFICIENCY**

Institutional efficiency can be broken down into three basic categories: structural, management and operational efficiencies. There are several tools that can lead to increased efficiencies in each of these areas.

1. **Structural Efficiencies.** Decentralization and standardization of institutional structure can be used to improve the efficiency of an MFI.
   a. **Decentralization.** Decentralization includes the use of profit or cost centers, delegated loan authority, and a flat organizational structure. Avoiding bureaucratic systems allows processes to be carried out with greater speed, eliminates unnecessary paperwork, and allows employees to focus on their most important duties (i.e. loan officers can have more time in the field if they are not overwhelmed with bureaucratic tasks).
   
   b. **Standardization.** If an institution creates branch systems and processes that are easily replicable, the MFI can easily transfer staff members from one location to the next, identify and remedy operational problems, and expand (by creating more branches).

2. **Management Efficiencies.** Incentive systems, good communication between staff, and clearly defined responsibilities can enhance the efficiency of an MFI’s management.
   a. **Staff incentives systems.** Staff incentives encourage employees to operate at optimum performance and link benefits and bonuses to levels of performance.
   
   b. **Client incentives systems.** Client incentives, like privileges for good clients, encourage customers to pay their loans on time and to remain loyal customers.
   
   c. **Clear communication.** Clear communication of institutional mission, individual job descriptions, and lines of authority, reduces staff time spent resolving issues. For instance, a widely distributed procedures manual helps eliminate confusion as to the roles and responsibilities of employees, thus streamlining operations.
3. **Operational Efficiencies.** An effective management information system (MIS), linked computer systems and uncomplicated processes, typified by product specialization and simplicity, can yield increased operational efficiencies.

   a. **Efficient use of computers.** Some MFIs use local and wide area networks that link computers to one another, and some are experimenting with small, portable computers, such as PalmPilots, to improve the efficient flow and use of information.

   b. **Core MIS system.** A lean management information system (ideally with no more than ten key indicators) promotes timely and efficient decision making.

   c. **Product specialization.** Product specialization allows an MFI to focus on becoming the best at what it does, and to create simple systems that lead to economies of scale.

The following sections discuss how Network MFIs have applied a combination of the approaches and tools above to maximize their structural, management and operational efficiencies.

**Improving Efficiency at ABA**

*Nabil El Shami, Alexandria Business Association (ABA), Egypt*

ABA has implemented client and employee incentive systems, as well as transparent hiring and promotion processes within a decentralized structure, to become one of the most efficient MFIs in Africa. According to MicroBanking Bulletin statistics for 1998, ABA had an administrative expense ratio of 6.8 percent and a salary expense ratio of only 4.2 percent, which are much lower than the ratios of other leading MFIs in Africa presented in Table 1. In addition, ABA’s low cost per loan client of $54 at the end of 1998 demonstrates that ABA’s efficiency is not simply a function of larger loan sizes: the cost per client ratio is an indicator that reflects relative efficiency independent of average loan size, and $54 is very low compared to ABA’s Latin American and African peers.

**Decentralization.** After years of being a centralized institution due to Egyptian legal requirements, ABA is now fully decentralized. Until 1995, only the board chair and treasurer had the legal authority to sign loan checks. Accordingly, all applications had to be processed centrally, after which they were returned to the branches for disbursement. This process added administrative time for staff and increased the turnaround time for client loans. After negotiating with legal authorities, branch managers now have the authority to sign individual checks, as long as the name of the borrower appears on a page with a batch of borrowers’ names and loan sizes to be signed by the executive director and treasurer. The signing can take place by fax and be sent to the bank within a half-hour.

**Client Incentives.** ABA recently adopted a new policy toward late-paying loan clients that has resulted in increased client retention and reduced the cost per loan client. Traditionally, ABA has had a policy of zero tolerance for arrears. In the past, ABA classified clients even one day late on a loan payment as bad risk clients who were therefore ineligible for a future loan. While this strict policy encouraged timely repayments, it discouraged clients who missed a payment from repaying the balance of their loans. Now ABA allows clients with good repayment records to shift all loan installments ahead one month without having a negative impact on their repayment status. The criteria to receive an installment shift are as follows: the client must 1) come to the branch before the due date of the installment, 2) already have received at least three successive loans from ABA, and 3) have a clean track record. By allowing clients to shift installments, ABA does not forfeit any interest income, because clients pay one month’s interest at the time of the installment shift. This new policy
reduces the loss of clients due to occasional short-term hardships, making it more likely that ABA will recover the loan principle and retain a profitable client.

Staff incentives. ABA recently implemented an enhanced staff incentive system that has resulted in higher productivity and efficiency of its branch managers. In the past, ABA used the same incentive system with branch managers as with loan officers, which focused solely on new loans and portfolio quality. Now ABA’s managers receive bonuses based on six incentives tailored specifically to their job: 1) The number of loans disbursed by the branch during the month; 2) the repayment record for the branch, which must be at least 97 percent; 3) the branch’s portfolio at risk, which must be less than 2 percent (bonuses increase incrementally as the portfolio at risk decreases); and 4) the branch’s average cost per loan, which must be below the ABA average. Additionally, 5) the extent to which the branch manager assists ABA’s lawyers with reclaiming written-off loans impacts the branch manager’s incentives, and 6) if the branch suffers from weak oversight, resulting in fraud, the branch manager’s bonus is affected. By implementing a specialized incentive system for managers, ABA has reduced branch expenses, increased collections and improved internal control.

Staff recognition. Beyond the staff incentives scheme, ABA evaluates the performance of loan officers and branch managers based on a point system as presented in Table 2. Loan officers with the highest points are excellent performers, and those who have the lowest are considered weak and usually leave ABA. At a yearly celebration, the five top ranking field officers are honored, as well as the “field officer of the year,” who receives an extra bonus and a certificate of honor. ABA also honors the best branch manager, as well as some of the best clients, who receive gifts and certificates. This evaluation system factors in client retention, which is not considered in the staff incentive systems.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Point Evaluation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of new loans</td>
<td>Multiplied by two</td>
</tr>
<tr>
<td>Number of repeat loans</td>
<td>Divided by two</td>
</tr>
<tr>
<td>Number of active clients</td>
<td>One point each</td>
</tr>
<tr>
<td>Repayment rate</td>
<td>For 100 percent repayment, 100 points, reduced by five points for every 0.1 percent less than 100 percent</td>
</tr>
</tbody>
</table>

Streamlined hiring and staff retention. To reduce staff turnover, ABA recently streamlined its system for hiring and training loan officers, which should result in improved productivity and eliminate the cost of hiring applicants who do not have a long-term commitment to the job. First, ABA advertises openings in the newspaper, and then calls in 60 to 100 of the applicants. ABA briefs the applicants on the institution and tells them about the procedures that the loan officer has to follow. Finally, prospective loan officers watch a video explaining exactly what the officer does and the terms of employment, at which point about half of the prospective staff withdraw their applications. Those who stay must sign a statement in which they agree that if they leave the job before two years they must reimburse ABA for the cost of training, which is about $500.

Transparent promotion process. ABA offers a clear career path to new loan officers. A loan officer can soon head a group of loan officers, and later be promoted to deputy branch manager, and finally to branch manager or operations manager. By clearly explaining this process to staff, ABA encourages loan officers to remain with the institution and to work hard toward a promotion.
**PRODEM’s Approach to Efficiency**  
*Eduardo Bazoberry, PRODEM, Bolivia*

PRODEM maximizes efficiency by offering employees competitive benefit packages and ensuring a high level of morale within a decentralized institution. PRODEM’s approach is unique in that it attempts to proactively address potential areas of concern to employees, clients and shareholders instead of dealing with concerns only once they have become problems.

*Profit-based staff incentives.* By implementing profit-centers and profit-based staff incentives, PRODEM has increased its efficiency and profitability. In the past, PRODEM had an incentive system based on arrears, growth, and desertions. However, the institution found that one year it gave a loan officer the employee of the year award, and the next year it caught him stealing money. Now PRODEM calculates incentives based on profit. If the company makes money, then every employee earns a bonus. Employees know that the greater the arrears, the more the provisions, which leads to less money for employees. To increase its share of profits, each branch now makes cost decisions based on its income statements and balance sheets; instead of buying a new automobile, a branch manager will buy a used vehicle or a motorcycle.

*Benefits.* PRODEM reduces the cost of hiring and training new employees by offering benefit packages superior to those offered by its competitors. PRODEM gives employees several benefits that deter them from leaving the organization, including stock options, health insurance, and more vacation days than the state requires. Employees in rural branches receive 12 extra days per annum, and workers in urban areas receive six extra days per annum. When a teller retires, he or she retires with an average of $35,000 from the company; when a mid-level manager retires, he or she can leave the company with about $170,000, assuming PRODEM had a 20 percent average return on investments for about 15 years. Employees know that if they move to another company, they will lose these benefits and will not likely be offered similar ones. PRODEM avoids letting the good benefits retain poor performers by setting standards for achievement levels at each branch. If a branch notices that an employee is performing poorly, branch management will dismiss that employee. PRODEM operates on the premise that it must constantly change in order to better serve its clientele; if one employee hinders that process, he or she will not remain with the company for long.

*Institutional morale.* PRODEM believes that there are three factors to maintaining morale in an institution: employee satisfaction, customer satisfaction, and shareholder satisfaction. If all three groups are satisfied, then the organization will have a strong competitive advantage. The benefits of having satisfied employees, customers, and shareholders are difficult to measure, but intuition suggests that high levels of institutional morale reduce the time and costs associated with resolving disputes and installing replacements.

**ASA’s Competitive Edge**  
*Md. Shafiqual H. Choudhury, Association for Social Advancement (ASA), Bangladesh*

According to MicroBanking Bulletin statistics for 1998, ASA is one of the most efficient MFIs in the world, with a cost of only $7 per loan client. In a highly competitive environment, ASA maintains a competitive edge in Bangladesh based on two factors that yield this level of efficiency: simplicity and standardization. Simple and standardized processes make ASA’s methodology an easy target for replication. Save the Children/USA has replicated ASA’s approach to microlending through its Group Guaranteed Lending Scheme (GGLS) in several countries throughout Africa and Asia; UNDP-
Philippines is replicating ASA methodology in 18 MFIs, and an NGO in India, NBJK, is replicating the ASA approach in the Bihar state.

Simplicity. The basic philosophy of ASA rests on simplicity, which is why the institution specializes only in microfinance services: credit, savings, and insurance. The following are some manifestations of ASA’s simplicity:

• All systems and procedures are standard, and are clearly documented and detailed in the ASA manual, which helps to limit errors by minimizing the decision load. For example, interest is standardized so that any employee can easily calculate payments.

• All forms are simple and require little paper work; i.e. the loan application is one page that can be filled out in five to ten minutes.

• Borrowers used to have to wait six months for a loan, but now they can receive a loan within two days, though loan officers tend to be cautious and often take up to two months to observe a client before issuing a loan.

• The accounting system is transparent and straightforward. In the past, each client’s account required a full page of information. Now, each client’s account occupies only one line on a page, which increases the transparency of the overall portfolio. Furthermore, the system eliminates the need for specialized MIS personnel.

• Staff are recruited within five to seven days through group interviews. Often, those who ask the most questions are hired because loan officers need to have an inquisitive mind. Those who are selected are notified in front of the ASA gate, and the notification tells them where to go for training. Then, the new staff member receives on-the-job training by shadowing an experienced staff member for nine days. ASA trains four staff members at each branch at very little cost, but it insists that prospective staff members cover the training costs (a reasonable $6).

Standardization. Standardization allows internal control measures to be carried out efficiently. As ASA’s systems are uncomplicated, auditors must track only a limited number of transactions, which facilitates internal control. Interest is also standardized, as is the amount of money clients save. Although ASA is highly standardized, it is still flexible. However, flexibility is not something that comes about at the field level; change comes about through a monthly meeting of managers in Dhaka. In Dhaka, managers decide if a new approach is necessary and subsequently implement the change throughout the institution.

Compartamos’ Experiment with PalmPilots

Carlos Danel, Compartamos, Mexico

Compartamos hopes to improve the productivity of its loan officers by experimenting with a new technology, the PalmPilot. The PalmPilot is a personal digital assistant, which is a small computer with limited functions and limited capacity. The lower end of these devices can be bought in the United States for $150; they are portable and lightweight. If successful, the use of the PalmPilot will reduce the time and cost involved with making loan decisions, which should improve the efficiency of Compartamos. Improving efficiency is especially important to Compartamos because it maintains a portfolio of loan clients with an average loan balance of only $66 at the end of 1998, which is relatively small compared to other MFIs in the region. In addition, Compartamos is in the process of transforming into a regulated financial institution, a process that is discussed in more detail in the

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5 This innovation is being developed with technical support from ACCION International, and ACCION will develop the capacity to use personal digital assistants with some of its other affiliates in the future. ACCION has had resident staff in Mexico for over one year working with Compartamos on the PalmPilot initiative.
section on *Commercialization*. Higher levels of efficiency will help to attract and retain the interest of potential shareholders.

The goal of Compartamos’ PalmPilot project is to provide the MIS with a remote terminal that works as a tool for credit analysis on site, and will result in better customer service at a lower cost. Once the system is fully integrated with the MIS, loan officers will benefit from a more efficient decision-making process while using sophisticated credit-scoring models. This efficiency should lead to faster loan approval and disbursement, allowing each loan officer to manage more clients. Additionally, when a loan officer collects data for a balance sheet or an income statement on a client business, the PalmPilot expedites the process, as loan officers can calculate ratios quickly and without errors. As the client database grows, the credit committee can make almost any credit decision, including the loan amount and terms, by going through three or four screens on the PalmPilot. Box 2 summarizes the potential benefits of using the PalmPilot in an MFI.

**Box 2: Benefits of the PalmPilot Application**

<table>
<thead>
<tr>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher quality information on site, which is fully integrated into the MIS</td>
</tr>
<tr>
<td>More efficient loan decisions resulting from the use of credit scoring</td>
</tr>
<tr>
<td>Faster loan approval and disbursement</td>
</tr>
<tr>
<td>Increased capacity of loan officers to manage more clients, resulting in lower costs per loan</td>
</tr>
<tr>
<td>Better use of available information for the development of future models and an improvement of current credit methodology</td>
</tr>
</tbody>
</table>

Compartamos’ PalmPilot project has two parts: the application of the PalmPilot and the interface with the MIS. Compartamos thought that developing the application of the PalmPilot would be the difficult step; however, integrating the PalmPilot with the MIS has been the greater challenge. The development of the PalmPilot application was relatively simple because it is easy to use, making it simple to train the loan officers. Compartamos had to address employees’ natural resistance to change, but after understanding the potential benefits, loan officers were receptive to the concept. Creation of Compartamos’ PalmPilot application included the development of the following useful components:

- A client database that can hold up to 250 clients
- A credit analysis module with quantitative and qualitative client data
- A reporting module that includes client current loan and delinquency information
- Other applications, such as employee time reports and performance indicators

The use of the PalmPilot only makes sense if it is integrated with the institution’s MIS. As a stand-alone solution, the device is complicated and expensive. The institution should not use the PalmPilot if it will only act as a fancy financial calculator that will likely frustrate the loan officers who use it. It is by interfacing the application with the MIS that the PalmPilot becomes a powerful tool that
brings the MIS out to the field staff in a portable fashion. By following a simple decision tree developed in the Palm Pilot, the loan officers can make a decision and disburse a loan within two days. However, the MFI must have a well functioning MIS, since the PalmPilot can only replicate what the MIS already does.

Compartamos has completed the development of the PalmPilot application, but is still in the process of linking it to its MIS. Compartamos currently has 12 loan officers using the PalmPilot who do their own credit analysis and collect client data in the field, but the PalmPilot does not yet communicate with the loan tracking system. These loan officers are developing the database of information that will be useful for credit analysis in the future. Once the project is fully implemented, the PalmPilot will eliminate the need for loan officers to transport unwieldy client files. Compartamos expects to have the first quantitative assessment of the PalmPilot’s impact on operations by sometime late in the year 2000.

Compartamos began experimentation with the PalmPilot when it decided to enter new urban markets, in particular the Federal District of Mexico City. The project aims to empower loan officers to make better and quicker loan decisions, reducing the time and steps involved and resulting in higher productivity. It provides easy access to thorough and precise information, especially in remote areas where it can communicate with the MIS via telephone line and modem. However, the technology must fit the product. For example, Compartamos does not use the PalmPilot in rural areas where its lending is based on village banking. The village banking methodology requires simple credit analysis and therefore is not an appropriate application of the technology.

CLIENT INCENTIVES TO ENHANCE EMPLOYEE PRODUCTIVITY

Henry Jackelen, United Nations Development Program, New York, USA

Thus far, the microfinance industry has focused primarily on outreach, the provision of financial services to the maximum number of clients, but has placed little emphasis on the quality of service to individual clients. Perhaps this has been true because to break even on services, the MFI must spread its costs over a large number of clients, which demands a focus on reaching the maximum number of clients rather than fully satisfying the needs of individuals. MFIs are now beginning to see how client incentives can simultaneously accomplish the objectives of reducing costs and increasing satisfaction.

When a client first takes a loan from an MFI, there is a huge initial cost to administer the loan, but this cost decreases over time. The rate of this decrease depends on the amount of services and products purchased, which in turn yields income to the MFI. The main cost reduction happens with the growth of the loan portfolio, which means the MFI has more assets over which to amortize its expenses.

Microfinance represents the means by which capital becomes part of the organic growth of a country. In some ways microfinance institutionalizes many of the longstanding (often ancient) informal sector practices, and in several developing countries more capital is “banked” in the informal sector than in the formal sector. Much informal capital is owned and used by poor people, and for them, the cost of both lending and savings services is very high. Microfinance has to modernize and improve the services if it is to reach the bottom echelons of the economic pyramid. In the modernization process, one should not forget the origins of and the need to understand grassroots innovations for this market. One such innovation is a new reliance on the individual client to bring about efficiency.
Microfinance represents a distinct “breakthrough” in terms of the manifold strategies that have been used to target benefits toward the poor. Most of these strategies over the past half century have been dominated by what could be considered as a “victim paradigm” where the poor, as weak victims, are unable to help themselves without substantial outside intervention. While other development efforts, in particular “participatory” approaches, have attempted to define a new paradigm, this paradigm is still unclear. With microfinance, the clarity is absolute and can be best understood as the “client” or “customer” paradigm. It is a radical shift in that borrowers who were once simply “poor people” are now microfinance clients. Some of the most successful industries have grown and broken through by investing in clients for the long term. But long-term relationships cannot be developed on the terms of the MFI, they have to be on the clients’ terms, and the MFI should involve the client in the evaluation of its services.

A mix of services, plus incentives within the services, has the power to connect microfinance institutions to the client paradigm. MFIs can offer clients a variety of incentives to repay their loans, take out subsequent loans and remain loyal to the organization. The following are some examples of Network members’ client incentives:

- **Lower interest rate on subsequent loans.** Centenary Rural Development Bank offers a reduced interest rate with subsequent loan renewals. When a client has established a good repayment record, Centenary can afford to offer lower fees because it takes less employee time to monitor the loan. The client retains the lower interest rate as long as he or she repays promptly.

- **Interest rate rebate to encourage repayment.** Bank Rakyat Indonesia (BRI) gives a rebate to borrowers who pay on time. If borrowers pay their loans on time during a six-month period, they get a return of 4.5 percent of the interest they paid. This reduction amounts to a nine-percent reduction in effective annual interest rates, from approximately 42.0 percent to 32.5 percent.

- **Interest rate diversification – matching rates to risk.** Fundusz Mikro allows the branch manager to determine the interest rate on each loan. The interest rate depends on the number of borrowers in the group: a group of four members receives the lowest interest rate, and interest rates for individual borrowers are higher. Subsequent loans can have the lowest interest rate, but the reduction depends on the size of the loan and the client’s or group’s previous repayment record.

- **Preferred loan terms.** FINCA Kyrgyzstan extends loan repayments from weekly to biweekly or monthly once a client has proven the ability to repay on time. This repayment schedule is attractive to the client, and it reduces transaction costs in terms of loan officers’ time.

- **Access to other products or services.** PRODEM now has an arrangement with Western Union to offer international wire transfer services to its clients. This facilitates foreign transfer payments to the accounts of PRODEM’s clients, which offers clients an additional service as well as increases PRODEM’s capital resources from savings. Bandessarrollo offers checking accounts to its best clients, as well as tickets to cultural events.

To be effective, client incentives must motivate the client to act in a way that is conducive to the MFI’s profitability. To understand what motivates its clients, the MFI must have a good relationship with the clients as well as methods for collecting and analyzing information on client preferences. Effective client incentives not only increase the productivity of microfinance employees, but can also increase customer satisfaction, which is the focus of the next chapter.
THEME 2: CUSTOMER SATISFACTION

As the microfinance industry grows, matures, and operates in increasingly competitive environments, MFIs are focusing less on satisfying donors and more on pleasing clients. The ever-increasing tilt toward customer satisfaction creates numerous advantages, including a greater competitive edge, increased client retention, and more attention to client needs.

Increasingly, practitioners are adapting traditional marketing practices to microfinance methodologies to improve customer service. Many MFIs are working toward minimizing client desertion and enhancing client retention by identifying and serving specific market needs and introducing new products, such as the savings and insurance schemes offered by DFID/UNDP’s MicroSave Africa project. These efforts lead to increased levels of customer satisfaction, as well as increased returns for MFIs and their shareholders.

MEASURING AND MINIMIZING CLIENT DESERTION

Richard Rosenberg, CGAP, Washington, D.C., USA

The term “desertion rate” refers to the probability that an existing borrower will never take out a subsequent loan. It can be surprising to see how strongly an MFI’s financial viability is tied to its desertion rate. First time microfinance loans incur higher administrative expenses than subsequent loans, but yield less interest income. Each time a successful borrower leaves the program, she has to be “replaced” by a new and much less profitable borrower. In a spreadsheet model of a hypothetical MFI with a one percent net profit and a zero percent desertion rate, increasing the desertion from zero to ten percent changed the one percent profit to a three percent loss. Where real-life MFIs have spreadsheet models that allow them to look at the effect of different desertion rates, they find similar results.

Understanding Client Desertion

Desertion rates can be a valuable measure of client satisfaction, and may be useful for product design. At the very least, tracking desertion keeps institutions on their toes and helps them to focus attention on providing better service to their clients. But simply tracking one overall desertion rate may not be enough. The institution should take into account the differences in the percentages that drop out in early cycles as opposed to late cycles, differences between male and female deserters, and differences that correspond to various business sectors that the MFI finances. When the institution takes these variables into account, it can make sense of the true nature of the desertion. For instance, if the majority of dropouts occur after the first loan cycle, then it is possible that the institution does not adequately screen clients.

Some desertion is inevitable, and may even be desirable. Some institutions see high drop-out levels associated with the initial loan as a useful screening process, and think it is less costly than more intensive client screening. Of course, client dropout is always worrisome when it involves default, where the MFI loses some or all of its principle and expected interest income.

Common economic reasons for desertion are forced savings requirements, the client’s transaction costs to access a loan, and competition, as described in the following examples:
• **Forced savings structures.** One African MFI found its clients were dropping out well below the maximum loan levels. For the first loan of 200,000 Ushs (Ugandan shillings), the MFI required the client to have forced savings of 50,000 Ushs, so that the real addition to the client’s cash position was only 150,000 Ushs. For the next loan of 300,000 Ushs, savings had to be 150,000 Ushs; thus, the net addition to the client’s cash position did not increase with the second loan. The same was true for subsequent loans. Furthermore, the effective interest rate the client paid on her net credit climbed with bigger loan sizes, assuming the interest rate paid on savings was less than the interest rate collected on loans. In Mexico, Compartamos discovered that these same dynamics were discouraging many of its customers from moving on to bigger loans.

• **Client transaction costs.** One Latin American MFI found that its most successful clients were the ones most likely to desert. This trend was a result of the client’s relative value of time and money. For example, when a woman begins to take loans, she usually has relatively little income-producing activity outside of her home, so her time has low economic value; thus the two hours a week she spends in village bank meetings is a small cost to her. However, if she has a flourishing business after two years of borrowing, spending two hours at a meeting can have a very high cost, leading the client to quit the program.

• **Competition.** Some MFIs expect that long-term successful clients will stay loyal to them even when other institutions begin offering competing services. Experience in Latin America casts considerable doubt on this expectation.

**Tracking Client Desertion**

Desertion can be tracked by “exit” interviews with clients who have failed to renew their loans, and by statistical measures. Table 3 lists a variety of formulas used to measure client retention and desertion.

Exit interviews can be highly useful. One potential danger occurs if the interviews are conducted by MFI staff who have incentives to shade the results. One African MFI found that the results of its own internally-conducted exit interviews looked much more favorable than the results of an independently conducted survey.

There is not yet a consensus on a “perfect” formula to use in statistical measurement of desertion rates (or retention rates, which are simply the inverse of desertion rate: a 95 percent retention rate is equivalent to a five percent desertion rate). Part of the challenge lies in developing a formula that accommodates three different kinds of desertion: i) clients who are “resting” between loans, ii) clients who are forced out due to bad repayment performance, iii) and clients who drop out due to dissatisfaction. Any formula which gives the MFI “credit” for borrowers who are returning after a “rest” will occasionally produce negative desertion rates (and retention rates over 100 percent). In deciding among possible formulas, the MFI is constrained by the kind of information available from its MIS, because the various formulas require different input data. Whatever formula is used, results will probably be most meaningful if they are disaggregated according to relevant factors, such as loan cycle, tracked over time to detect trends.
Table 3: Formulas for Measuring Client Retention and Desertion

<table>
<thead>
<tr>
<th>Formula</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chuck Waterfield/CGAP</td>
<td>RR = retention rate</td>
</tr>
<tr>
<td>RR = FL / LP</td>
<td>FL = number of follow-up loans made during the period</td>
</tr>
<tr>
<td></td>
<td>LP = number of loans paid off during the period</td>
</tr>
<tr>
<td></td>
<td>This formula produces a retention rate per loan cycle, so it must be annualized to look at it on a yearly basis. For instance, an 80 percent retention rate on three-month loans means that only ((0.80)^4 = 41) percent of the clients who are active at the beginning of the year are still active at the end of the year. The formula does not include effect of default, because the denominator is loans paid off.</td>
</tr>
<tr>
<td>Variation of Waterfield/CGAP:</td>
<td>RR = retention rate</td>
</tr>
<tr>
<td>RR = (L - NC) (\frac{AC_{begin} + L - AC_{end}}{AC_{begin}})</td>
<td>L = number of loans made during the period</td>
</tr>
<tr>
<td></td>
<td>NC = number of first time clients entering during the period</td>
</tr>
<tr>
<td></td>
<td>(AC_{begin}) = number of active clients at the beginning of the period</td>
</tr>
<tr>
<td></td>
<td>(AC_{end}) = number of active clients at the end of the period</td>
</tr>
<tr>
<td></td>
<td>This formula restates the above formula in a way that is more complex but uses information that may be easier for some MFIs to produce.</td>
</tr>
<tr>
<td>Default Formula:</td>
<td>RR = retention rate</td>
</tr>
<tr>
<td>RR = (\frac{FL}{LP + WO})</td>
<td>FL = number of follow-up loans made during the period</td>
</tr>
<tr>
<td></td>
<td>LP = loans paid off during the period</td>
</tr>
<tr>
<td></td>
<td>WO = loans written off during the period (or otherwise classified as unlikely to be repaid)</td>
</tr>
<tr>
<td></td>
<td>This formula reflects the effects of default by producing a retention rate for performing borrowers. It is imperfect in some other respects. It would be useful only if the MFI has a sound write-off policy and applies it consistently.</td>
</tr>
<tr>
<td>ACCION Formula:</td>
<td>DR = desertion rate</td>
</tr>
<tr>
<td>DR = (\frac{AC_{begin} + NC - AC_{end}}{AC_{begin}})</td>
<td>(AC_{begin}) = number of active clients at the beginning of the period</td>
</tr>
<tr>
<td></td>
<td>NC = number of first time clients entering during the period</td>
</tr>
<tr>
<td></td>
<td>(AC_{end}) = number of active clients entering during the period</td>
</tr>
<tr>
<td></td>
<td>This formula will not work for a start-up program, where (AC_{begin}) is zero. To obtain a retention rate, subtract the desertion rate from one.</td>
</tr>
<tr>
<td>Mark Schreiner Formula:</td>
<td>DR = desertion rate</td>
</tr>
<tr>
<td>DR = (\frac{AC_{begin} + NC - AC_{end}}{AC_{begin} + NC})</td>
<td>(AC_{begin}) = number of active clients at the beginning of the period</td>
</tr>
<tr>
<td></td>
<td>NC = number of first time clients entering during the period</td>
</tr>
<tr>
<td></td>
<td>(AC_{end}) = number of active clients entering during the period</td>
</tr>
<tr>
<td>RR = (\frac{AC_{end}}{AC_{begin} + NC})</td>
<td>DR = desertion rate</td>
</tr>
<tr>
<td></td>
<td>This formula is similar to the ACCION formula, but it can be used for start-up operations.</td>
</tr>
</tbody>
</table>
**Minimizing Client Desertion**

The better an institution understands the dynamics of its desertion, the better it will be able to improve the situation. However, minimizing desertion often involves a trade-off between the convenience of clients and the needs of the institution, as ASA in Bangladesh learned the hard way. At one point, ASA determined that its monthly 15,000 to 20,000 desertions were due either to forced savings, inconvenient loan size, or the strictness of ASA rules. ASA’s response was to allow more flexible withdrawal of savings in half of its branches. A run on deposits developed, causing serious cash shortages. In addition, some clients not only withdrew their savings but also abandoned their unpaid loans. In retrospect, a small pilot test of the change might have indicated the repercussions of this approach.

To reduce desertion, ABA in Egypt also relaxed its strict policies. In the past, ABA refused to issue repeat loans to clients who were even one day late on a repayment. But because it was losing too many clients, ABA began a program allowing clients who were up to 10 days late to pay late charges and to have a second chance. More than 35 percent of the clients rejoined and were successful with the program. Due to the success, ABA extended the program to include those who were ten to fifteen days late on repayment. By gradual implementation, ABA grew more confident of success as it extended the offer to more clients.

In Bangladesh, BRAC has used its research abilities to better understand its clients’ needs, and used the results to benefit both BRAC and its clients. When research showed that clients were unhappy with the small loan sizes, BRAC decided to allow loan sizes up to two and a half times client savings, which simultaneously attracted more savers and minimized desertion.

**MEASURING CLIENT SATISFACTION AND ENHANCING CLIENT RETENTION**

*Craig Churchill, Calmeadow, Washington, D.C., USA*

Monitoring customer satisfaction becomes a pressing concern for all MFIs, regardless of the level of competition they face. MFIs should not wait until desertion is a problem before they take an interest in their clients’ preferences. Because there are appropriate tools to monitor customer satisfaction in a cost-effective manner, all MFIs should make some attempts to understand their clients’ needs and preferences. Knowing how to measure and enhance customer satisfaction is key to client retention and can help an MFI become more competitive and cost-effective. Equally as important, measuring client satisfaction has important implications for the social mission of microfinance institutions.

Before describing several tools for measuring customer satisfaction, it is useful to demonstrate how important this process is to a microfinance institution and to define what is meant by customer satisfaction.

**The Cost Savings of Client Retention**

The long-term success of microfinance depends on continued effort to reduce the costs of delivery. The retention of repeat clients is a fundamental strategy for reducing costs, and the primary reason for measuring customer satisfaction is to enhance client retention. Retaining clients can reduce costs in the following ways:

- Servicing repeat clients lowers costs by eliminating marketing and reducing screening costs for the loan, as well as by amortizing client acquisition costs over the life of the client.
- Repeat clients are less risky, which should reduce delinquency management and loan loss expenses.
• Veteran customers usually borrow larger sums of money and have bigger account balances, which leads to greater income for the MFI.

• If satisfied, repeat clients provide inexpensive, word-of-mouth marketing, which is a powerful and cost-effective marketing tool.

In fulfilling the social mission, repeat clients may also benefit from greater economic impact than one-time borrowers.

On a similar note, losing clients or not satisfying them can be very costly to the MFI:

• In business, the general rule of thumb is that it costs five times more to gain a new customer than to retain an existing one. The US banking industry estimates that five to ten times as much expense is incurred enlisting a new customer than is spent on maintaining an existing one.

• Statistics from North American banks suggest that an institution increases profits between 25 and 80 percent by reducing desertion by five percent. For every one percent improvement a bank makes to its client retention rate, it improves its operating earnings by 20 percent if it can sustain the increase over five years.

• The “one bad apple” issue particularly hurts organizations that rely on word-of-mouth marketing. Customer service research has shown that customers are dissatisfied with approximately one out of every four transactions, but only five percent of dissatisfied customers actually complain to the institution. However, dissatisfied customers tell an average of ten other people about their negative experiences. One bad apple spoils the whole bunch.

• Customer dissatisfaction may have a negative effect on staff retention: most employees do not enjoy interacting with unhappy clients.

**Customer Satisfaction Defined**

Customer satisfaction can be defined as the difference between the services a customer expects and those he or she receives. This model requires the client to not only evaluate how good the service was, but also to compare services to expectations. If the MFI can manage client expectations, then it can enhance the quality of service from the clients’ perspective.

Customer service can also be defined as the value that customers receive from the service. Value can be broken down into product value and the actual cost of the service. Product value includes product details that can enhance satisfaction, such as quality of service, personnel value, and image value. Actual costs include interest rates, transaction costs, time and psychological costs. The greater the perceived value relative to the perceived cost, the greater the level of satisfaction. **Box 3** illustrates the comparison of value and costs of customer service.

In order to increase the customers’ real and perceived value of the service, the MFI can research and respond to customer preferences, as discussed in the last section, but it can also provide services that go above and beyond client expectations. For instance, ABA offers good clients membership in its Clients’ Club. For $6 a year, the client can attend two free training sessions, exhibit products in ABA’s Small Business Center, borrow catalogs and pamphlets from the ABA library, and receive and advertise in quarterly newsletters. Finally, some doctors and hospitals provide reduced rates on medical services to the best clients and their families. Programs like this one greatly enhance customer satisfaction by increasing the value of affiliation with ABA in very real terms. Bandesarrollo achieves the same result by providing a checking account to its preferred clients.
Tools to Measure Customer Satisfaction

Below are nine tools MFIs use to measure customer satisfaction, which are summarized in Table 4:

1. **Questions on loan applications**: Collect information with each loan application from both new and old clients. The institution can collect information about why clients selected this MFI, what they want to gain from the relationship, and what they like and dislike about the products and services. From this method, the institution might discern a pattern of how clients hear about the organization and focus advertising efforts based on the results. In a competitive environment, the MFI can get a sense of why people choose one institution over another, rather than discovering why when the client leaves the program. These customer service loan application questions also send a message that the institution is trying to collaborate with the client. One disadvantage might be that since the questions are not anonymous, clients will write what they think their loan officers want to hear, making it difficult to get objective feedback.

2. **Complaint and suggestions system**: Incorporate customer comment cards, a customer satisfaction desk or a consumer advocate. Centenary Rural Development Bank of Uganda has installed a suggestion box in every branch. Results often unearth simple suggestions that may be obvious to clients but do not filter up to senior management, such as that branches should be cleaned more regularly. From the beginning, the institution should be clear about the kinds of suggestions to which it can respond.
Table 4: Tools to Measure Customer Satisfaction

<table>
<thead>
<tr>
<th>TOOL</th>
<th>EXPLANATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Questions on loan applications</td>
<td>Collect information with each loan application that can be gathered on a daily basis from both new and old clients.</td>
</tr>
<tr>
<td>2. Complaint and suggestions system</td>
<td>Incorporate customer comment cards, a customer satisfaction desk or a consumer advocate.</td>
</tr>
<tr>
<td>3. Customer satisfaction surveys</td>
<td>Send a short questionnaire to a representative sample of clients, or to all clients who recently purchased a service along with a thank you note from the loan officer.</td>
</tr>
<tr>
<td>4. Individual interviews</td>
<td>The institution individually calls or visits a sample of customers.</td>
</tr>
<tr>
<td>5. Focus groups</td>
<td>The institution gathers a cross-section of clients who offer feedback on how the institution provides its services.</td>
</tr>
<tr>
<td>6. Client advisory committee</td>
<td>Branch managers meet regularly with client representatives to give feedback on customer service.</td>
</tr>
<tr>
<td>7. Mystery shopping</td>
<td>Hire professional “mystery shoppers” to pose as customers and evaluate customer service, or pay actual bank customers to perform this function.</td>
</tr>
<tr>
<td>8. Exit interviews</td>
<td>Further analyze desertion by interviewing or surveying former clients.</td>
</tr>
<tr>
<td>9. Staff feedback loop</td>
<td>On a regular basis (often daily), branch staff document the feedback they hear, both positive and negative, from clients.</td>
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</tbody>
</table>

3. **Customer satisfaction surveys**: Send a short questionnaire to a representative sample of clients, or to all clients who recently purchased a service along with a thank you note from the loan officer. Centenary Rural Development Bank in Uganda hired local university students to conduct client surveys, which cost approximately $200 per branch. The resulting changes will be incorporated in the near future including the addition of new branches to reduce overcrowding and the amount of time customers have to wait in line. Citi Savings and Loan in Ghana also hired external consultants to prepare a marketing plan, the results of which were used to improve the quality of services. Contracting outside consultants is often more effective than doing surveys internally, because clients who want future loans may be inclined to give MFI employees only positive feedback. BRAC, because it is so large, has a separate monitoring department which conducts customer service assessments and has had good results.

Are customer satisfaction surveys cost-effective? Considering the level of expertise required for designing effective and appropriate tools, surveys may or may not be cost-effective. An expert must develop statistics and a scientific set of assumptions that have been elaborated over a period of time. Many times, information that is collected from surveys is misinterpreted or misused, and steps must be taken to ensure an accurate reading of results. But once the information is gathered and properly assessed, MFIs can gain a wealth of knowledge from it, and make changes based on customer needs.

4. **Individual interviews**: The institution individually calls or visits a sample of customers. Many MFIs conduct client visits as part of their regular operations monitoring. Some MFIs, such as Mibanco of Peru, incorporate questions related to customer satisfaction in these visits. This is a
cost-effective way to acquire useful customer data as well as to assure clients that the MFI is looking out for their interests.

5. **Focus groups:** *The institution gathers a cross-section of clients who offer feedback on how the institution provides its services.* One important element of a successful focus group is to have a catalyst initiate lively discussion. This “catalyst” could be a professional market researcher, whose business is getting people to talk comfortably; a loan officer, who knows the customers and can make them feel at home (though in some instances clients will avoid open conversation with staff for fear of future punishment); or a comfortable environment to hold the meeting, such as the lunch meetings that FINCA Kyrgyzstan holds with clients. In conducting focus groups, the researcher should take into account the characteristics of the clientele, such as level of education. When the customers are comfortable, they are more likely to speak freely, providing better information to the MFI.

6. **Client advisory committee:** *Branch managers meet regularly with client representatives to give feedback on customer service.* PRIDE Tanzania has a client advisory committee of group representatives from each branch. The group is responsible for reporting what the clients want to the head office. This sort of institutionalized empowerment can encourage clients to be forthright with their requests for improved service.

7. **Mystery shopping:** *Hire professional “mystery shoppers” to pose as customers and evaluate customer service, or pay actual bank customers to perform this function.* ACCION has used this technique in the United States with outside professionals, and Banco del Desarrollo found it useful (but expensive) for standardizing quality in its branches in Chile. If staff know that mystery shoppers are a possibility, they know they can be evaluated at any time, and accordingly act on their best behavior. A properly conducted mystery shopper service can provide staff with suggestions to improve their work, and in this way, the service can be approached constructively. A disadvantage is that a mystery shopper may find it difficult to pretend to be a microentrepreneur; another is that this technique may be less effective in assessing customer service of group lending methodologies.

8. **Exit interviews:** *Further analyze desertion by interviewing or surveying former clients.* This process can help assess desertion at the point of greatest customer dissatisfaction, when clients are most willing to give frank feedback. From this kind of research, ASA learned that many clients left because they had to travel from their villages to the main branch office to withdraw savings, which might cost up to one fifth the amount of the money they planned to withdraw. In response, ASA implemented a change allowing members to withdraw savings at the group meetings in the villages. One disadvantage to exit interviews, as FINCA Kyrgyzstan found, is that clients who dropped out regarded an interview as a waste of time. To prevent similar problems, Fundusz Mikro conducts an interview toward the end of each loan cycle with all clients.

9. **Staff feedback loop:** *On a regular basis (often daily), branch staff document the feedback they hear, both positive and negative, from clients.* When this information is aggregated, management can develop an accurate picture of customer satisfaction. Management can use this information to implement positive change when staff feedback overwhelmingly agrees it is necessary, but should be careful not to make changes based on the feedback of only a few out-spoken employees.
With each of these tools, those in charge of gathering information must ensure that their questions are not “leading,” i.e. the questions themselves should not suggest the answer. For example, “Does the institution quickly respond to your needs?” is a leading question, whereas “How does the institution respond to your needs?” is not.

The goal of customer satisfaction research is to understand the true needs and preferences of clients, and to respond appropriately, thus encouraging client retention. Since each of these approaches has advantages and disadvantages, an effective system for measuring customer satisfaction requires an array of tools that complement each other. In determining which tools to use, cost is a factor. The more costly tools, such as surveys, individual interviews, and mystery shoppers, should be implemented when the staff feedback loop, focus groups, or other less costly tools indicate that more thorough research is necessary. In addition, measuring customer satisfaction should be conducted on an ongoing basis. Occasional surveys can only give a snapshot and cannot show trends over time.

For customer satisfaction research to be integrated into an organization’s information flow, the responsibility for developing an appropriate measuring system and analyzing the results needs to be built into an employee’s job description. Organizations that have market research or product development departments should have a person designated as the customer satisfaction expert with sufficient authority to implement appropriate data collection methods. For smaller organizations that do not have a full-fledged department for these activities, they should consider customer satisfaction teams that can champion a measurement initiative.

TAILORING PRODUCTS TO SPECIFIC MARKET NEEDS

Istiaq Mohiuddin, BRAC, Bangladesh

Market segmentation, the process of segregating clients according to certain market characteristics, may be necessary to simply keep track of clients and operations for a large institution, such as BRAC. However, market segmentation can benefit institutions of all sizes by enabling them to supply clients with products specific to their individual needs. Even small MFIs can apply the principles of market segmentation to gain an edge in a competitive environment.

Market Segmentation in BRAC

BRAC categorizes all clients, 95 percent of whom are women, as either regular clients or graduates. Graduates have been with the program five to ten years, have a significant asset base, and require larger loans ($400 to $5,000) for various activities. Regular clients are those who have not reached graduate status. Within the regular and graduate categories, BRAC segments its clients into the following sectors: poultry, agriculture, food processing, fisheries, forestry, rural trading and rural farm activities. BRAC differentiates loan sizes for each activity and its sub-activities. The predetermination of loan sizes diminishes time spent on loan processing and streamlines operations. Market segmentation also includes specialization of staff: loan officers are assigned to specific sectors, which increases their familiarity with the associated activities. This familiarity is beneficial because for many sectors BRAC provides additional services, such as packing and selling clients’ vegetable crops to European markets, or providing quality control for handicraft workers and exporting their products on a wide scale.

Targeting Small and Medium Businesses through BRAC Bank

In the near future, the new BRAC Bank plans to capture the market sector of small and medium enterprises (SMEs) with loan sizes above $5,000, which presents a new challenge. SMEs currently face barriers to traditional financial markets, and BRAC Bank will be the first financial institution in Bangladesh to serve this market. These client businesses will include stores, restaurants, and
manufacturing facilities, which call for more sophisticated loan analysis than microcredit activities require. For microcredit, the loan officer needs only to judge the character of the borrower, but for SME loans, loan staff will have to conduct a market appraisal to analyze the risks involved, especially if the client has never borrowed from BRAC before. BRAC Bank may have to hire fresh MBA\(^6\) graduates and provide rigorous loan officer training. Furthermore, BRAC anticipates that the risks will be greater with small business lending than in microfinance, as discussed below:

- BRAC’s operational risk is higher in the larger loan brackets, which necessitates loan officers who can assess business and credit risks.
- Fraud and the safeguarding of money are concerns when large sums of cash are involved.
- Since few small businesses use standard systems for accounting and record keeping, it will be difficult for external auditors to classify assets according to their appropriate risks.

Through the use of market segmentation, BRAC has learned to better identify target markets and to serve their specific needs. By tailoring products to market segments, BRAC has improved its ability to foresee and address market risks, and to reach a greater number of clients with quality, customized services.

\(^6\) Masters in Business Administration.
THEME 3: COMMERCIALIZATION

Over the past 20 years, NGOs have been the primary providers of microfinance services. By applying commercial principles, such as the use of market interest rates, NGOs have been able to develop sustainable institutions with methodologies to reach an unprecedented number of poor entrepreneurs around the world. When NGOs first adopted commercial principles of operation, including the use of profit and loss statements and traditional profitability measures, the first phase of the commercialization of microfinance began. By demonstrating high repayment rates and achieving scale, microfinance NGOs have proven the commercial viability and economic potential of a microfinance industry.

World-wide policy reforms in the last ten years, including the deregulation of interest rates and liberalization of financial systems, have additionally contributed to the financial viability of MFIs. These changes have encouraged microfinance NGOs to consider taking the next step toward commercialization by transforming into regulated commercial institutions. Transformation of microfinance NGOs marks the second phase of microfinance commercialization. Simultaneously, traditional banks have begun to enter the microfinance arena, but few have demonstrated the long-term commitment and technical capacity to achieve sustainable and significant impact. The majority of regulated MFIs remain primarily owned by public and non-profit institutions. The final phase of microfinance commercialization will begin when microfinance attracts a significant number of pure private investors, whose investments are motivated by the MFI’s profit potential, to become shareholders of commercial MFIs.

DEFINITION AND FRAMEWORK FOR THE COMMERCIALIZATION OF MICROFINANCE

Maria Otero, ACCION International, USA

Profitability is the natural step forward from financial viability. Following this model, most commercial microfinance entities have developed from financially viable NGOs that specialized in microfinance. By demonstrating the ability to attract client savings and resources from the capital market, the MFI can also attract potential shareholders who respond to its established capacity to be profitable. Contributing to the successful move toward profitability is the MFI’s increased ability to measure performance, with tools like the ACCION CAMEL, the Private Sector Initiatives Corporation’s ratings service, and the data collection and benchmarking of the MicroBanking Bulletin. These tools help create transparency and measure performance to demonstrate profitability in a credible manner. Once microfinance proves itself profitable, it can begin to attract new players that have profit motivations, as opposed to the social objectives of the NGOs that gave rise to this work. While many MFIs will continue to have a social dimension in their work, many banks will enter the field driven by the profit motive. The addition of players with profit motives to the existing pool of players with social objectives will likely encourage market segmentation.

7 ACCION’s CAMEL is a financial assessment instrument adapted for microfinance institutions that uses the five traditional measures of a financial institution: Capital adequacy, Asset quality, Management, Earnings, and Liquidity management.
The entry of Latin American commercial banks into the microfinance sector

Interest rate deregulation has allowed commercial banks to look into new market niches, and since MFIs have demonstrated profitability, large banks are looking to enter traditional microfinance territory. Hand-in-hand with interest rate deregulation, increased globalization has also encouraged foreign banks to compete for traditional markets, which in turn encourages local banks to reach down to the microenterprise and informal sectors.

Many commercial banks are entering microfinance as consumer lenders, providing small loans to salaried clients that are secured by the employer. Unfortunately, fierce competition in consumer credit is bringing in a set of operating principles that can be damaging to microfinance as we know it. First, consumer lenders rarely check whether clients have other outstanding loans or a bad credit history when assessing their repayment capacity. Second, the availability of alternative consumer lenders reduces clients’ motivation to repay, thus assailing one of the founding principles of sustainable microfinance. Since consumer lenders can tolerate higher delinquency than MFIs can, MFIs and clients suffer. Competition can cause MFIs to be more lenient in their lending policies, which increases delinquency and results in clients suffering from over-indebtedness.

As a complement to commercial banks, development banks that experienced financial failure are now seeking financial viability and commercialization, and are applying commercial principles to their operations. Development banks, such as Banco Nordeste in Brazil, can reach tens of thousands of people if they work under financially viable commercial principles.

Commercial banks will continue to enter microfinance not only in Latin America, but all over the world, and traditional MFIs will undoubtedly continue their shift toward commercialization. As the two players converge, all MFIs will need to overcome the many challenges that commercialization presents.

How commercialization will change the face of microfinance

The areas that will likely see the greatest amount of change for the field in the near future are regulation and supervision, ownership, competition, and the effects commercialization will have on clients.

- **Regulation and supervision** presents one of the biggest challenges to NGOs transforming into regulated MFIs, because management and staff will have to make their current policies accommodate new regulations, which necessitates relinquishing some degree of authority and possibly changing key elements of the MFI’s procedures and customs.

- **Ownership** is in a transitional phase for MFIs. Most transformed MFIs in Latin America are primarily backed by investments from the public sector, including bilateral organizations. In addition, specialized equity funds, such as Profund, IFC, and ACCION’s Gateway Fund, are mostly funded publicly, but their mission is to operate as commercial investors of MFIs. The use of public sector investments is an initial stage that is moving the sector toward attracting commercial investors who will gain increasing ownership of the MFI. The biggest challenge associated with the entrance of commercial investors is to maintain investors’ focus on microenterprise, therefore preventing the MFI from moving up market to a loan level that is beyond the realms of microfinance.

- **Competition** and pricing is the predominant issue that will influence the way in which MFIs function and frame their operations. Because microfinance clients are economically savvy, they will choose services that make the most economic sense.

- **The effect of commercialization on clients** may have several possible results: The drive toward profitability could push MFIs to upscale by targeting wealthier clients, or microfinance could divide according to market segments, with some targeting rural areas and others focusing on...
urban clients, some focusing on high-end clients and some focusing on low-end clients. MFIs could also develop and offer a greater variety of services and products, such as insurance and pension products.

**OVERCOMING BARRIERS TO COMMERCIALIZATION OF MFIs**

*Martin Connell, Calmeadow, Canada*

Any microfinance institution has the ability to become commercialized, but effective management and governance are essential elements of the process. To manage the tedious process of commercial transformation, determination and commitment is crucial.

A “commercialized” institution refers to one that is regulated by the local bank superintendent and is for-profit. It has mobilized equity investment capital, received a license to operate, and can access commercial sources of funds, such as interbank loans, savings deposits, and debentures. These institutions can be transformed NGOs, commercial MFI start-ups, or microfinance windows or subsidiaries of regulated financial institutions.

Success in the commercial market can be initially elusive. The vagaries and realities are a bit like the childhood game of “Snakes and Ladders,” following a circuitous pathway of adventures and pitfalls. “Snakes and Ladders” is a game that originated in Asia more than two thousand years ago. The game is an up and down struggle to get to the top, with various elements both facilitating and hindering the journey, which can play out as follows in microfinance:

- Bank reforms or a good chair of the board make the start of the game easy. A blow-up on the board is a setback. A positive response to a pitch at a big conference signals a huge jump up, and increased capital and an affirmative response from the IFC does the same. But new usury laws cause a fallback. If the IFC defers, it is another slip. When the general manager quits, the MFI experiences another setback. But then the stock gets listed, and the MFI advances.

This unpredictable, sometimes frustrating scenario is why determination, commitment, and patience are the cornerstones to achieving commercial success.

Commercialization involves the ability to expand and grow enterprises, which necessitates the capacity to access capital. The key elements of capital are savings, term deposits, bank loans, long-term debt and equity, and retained earnings. One preconditions for commercialization is internal sustainability, which implies consistent profitability over a number of years. The MFI must also remain competitive, demonstrate its ability to reduce costs, grow, and produce market returns on capital. Market returns must be sufficient to meet the test of the market place, i.e. offer better returns on capital than alternative investments.

**Causes for vulnerability in the commercial market**

Microfinance is at a juncture in its history where it is at risk of losing its momentum. This is due to several vulnerable aspects of the field, including the following:

1. **There are too few successful practitioners to attract commercial investors.** Until there are a significant number of successful commercial MFIs, microfinance will not appear on the radar screen of commercial investors or receive the attention it deserves.

2. **Public focus has been on development impact, not financial success of MFIs.** Microfinance has been written up in the *Wall Street Journal* for its social impact rather than for its financial achievements. The industry is not getting the message to investors that microfinance presents a
commercial opportunity. Practitioners and advocates must orient communications to reach the financial media and counteract the conflicting messages communicated by some high profile non-commercial institutions that focus more heavily on client outreach than institutional sustainability.

3. **Microfinance is too dependent on donor capital.** Donors get tired of certain themes, and when new themes arise, funds starts to shrink. The profit ratios of MFIs are improving, but costs are still too high, even though returns on capital and assets are positive. MFIs need to lower costs to a range of five to seven percent of portfolio before they will be able to move away from donor dependency and attract private capital.

To overcome these barriers, greater efforts must be made toward efficiency and transparency, governance best practices should be internally integrated, and the institution must hire smart and train well. To bring to the fore the financial impact of success and failures, MFIs need to learn to accept the criticism and compliments that accompany increased transparency. To further the commercialization movement, the microfinance sector has to command the attention of secondary markets and pure private investors, and of big banks moving down sector that can offer clients an array of products. MFIs must overcome donor dependency, move on to the private sector, and make great efforts to become more service-oriented.

**Commercialization in Africa**

The greatest limitation to commercialization in Africa is the lack of private investors in the region. Because it is unlikely that an investor from another country will put money into a transformed NGO in Africa, the full commercialization of MFIs may be slowed in the region. For now, transformation efforts will have to be satisfied with the conversion from an NGO structure to a public equity based structure. Nevertheless, the region is experiencing a growing commercial interest in microfinance.

In east and south Africa, several commercial banks have demonstrated an interest in microfinance: (1) an investment bank recently approached Centenary Rural Development Bank for support in the privatization of a finance company in southern Africa that would become a private bank with a microfinance loan portfolio of over $15 million for rural finance; (2) in the past year, the Cooperative Bank of Kenya started a microfinance program; (3) a consultant in Kampala, who promotes microfinance, surveyed all commercial banks in Uganda regarding their interest in learning more about the sector, and nine out of 18 banks responded positively. Early experience suggests that it is easier to convince an African banker to get involved in microfinance than it is to convince an NGO that it should go up market and become a finance company or a commercial bank. Perhaps the primary impetus for microfinance commercialization in Africa will come from traditional banks’ efforts to move down the market and expand outreach to the microenterprise sector.

In Ghana, three commercial banks moved into the informal sector in the past year as the country experienced a considerable drop in interest rates. The bank rate, which used to be over 40 percent, is now 27 percent, and the treasury bill rate has come down to 26 percent. Because treasury bills are now unprofitable, banks are moving into the informal sector, where they can charge anything between 30 to 36 percent on loans. As traditional financial institutions expand into the informal sector, microfinance NGOs face increasing competition to retain their microenterprise clients.

**Commercialization in Asia**

In India, it is impossible to charge borrowers the market interest rate, which is 12 to 13 percent. Instead, the Indian government limits interest rates charged to the poor to seven percent, because it focuses on social welfare, not the cost structure of an MFI. As demonstrated by this example
others, the general values and conventions of the Asian region could impede the commercialization of microfinance.

In many parts of Asia, the prevailing attitude opposes profit. In Bangladesh, Islamic fundamentalists oppose microfinance because it charges high interest rates, which is forbidden according to some interpretations of the Koran. In addition, Islamic fundamentalists also oppose the independence that microfinance affords to women entrepreneurs. The cultural resistance could be a barrier to formalizing and commercializing the sector, even though some Asian MFIs demonstrate high levels of efficiency, which is a strong component of commercialization.

Another barrier to commercialization in Bangladesh is the prevalence of grants and soft funds from international donors and other organizations. For instance, the World Bank lends at five percent, allowing an institution like ASA to charge clients only nine percent on loans and still be able to cover its costs. The availability of donor funds to MFIs makes commercialization seem unnecessary. Another barrier to commercialization in Asia is the common practice of nepotism in NGOs, and the fear that transformation would force management changes to the detriment of the existing board and management.

Profit, based on a Marxist analysis, is generally suspicious in Southeast Asia. A company that shows a 60 percent dividend is immediately criticized, because such a profit is understood as the exploitation of workers or consumers. For instance, BRAC has reduced its costs substantially, but it will not show high profitability from microfinance on the balance sheet. Instead, management reallocates profits to subsidize other programs, such as health or education programs. The cost structures of Asian MFIs is much smaller than that of Latin American MFIs, which have focused very little on efficiency until now.

**Commercialization in Latin America**

In Latin America, increasing competition in the microfinance sector is driving MFIs to take efficiency more seriously than ever before. By forcing institutions to reduce costs, competition is effectively reducing the penalty customers were paying for inefficiency in the past. In Bolivia, for example, competition has worked to increase efficiency and reduced excess profits. Latin American MFIs that do not offer variable loan pricing are being forced to lower interest rates, causing them to slowly increase average loan sizes and abandon smaller loan clients.

In Latin America, until now efficiency has been overshadowed by an emphasis on self-sufficiency in environments with little competition. Also, donor money was readily available, which further undermined the drive toward efficiency. MFIs are no longer judged on outreach and profits alone, but also on their efficiency, which becomes increasingly important now that information is more transparent and donor funds are scarcer. Potential investors evaluate the institution’s average costs over portfolio and compare it to other MFIs to determine whether it is a good long-term investment.

**Table 5** categorizes the key barriers to microfinance commercialization in Africa, Asia, and Latin America. The lack of a supportive macro-economic and policy environment is an issue in all three regions.
Table 5: Regional Barriers to Commercialization

<table>
<thead>
<tr>
<th>REGION</th>
<th>BARRIERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>Lack of private investors, few sustainable MFIs, inappropriate macro-economic and policy environments.</td>
</tr>
<tr>
<td>Asia</td>
<td>Social and cultural resistance, accessibility of donor funds, NGO nepotism, inappropriate macro-economic and policy environments.</td>
</tr>
<tr>
<td>Latin America</td>
<td>Insufficient emphasis on efficiency, lack of competition, accessibility of donor funds, inappropriate macro-economic and policy environments.</td>
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</table>

The future of MFI commercialization around the world

The future of microfinance commercialization is at stake unless MFIs convince the private sector that the sector is full of worthwhile investment opportunities. As costs decrease, competition will increase, hopefully attracting more commercial investors to microfinance. Practitioners and microfinance advocates must convince investors that microfinance is becoming increasingly efficient and therefore profitable, without charging usurious interest rates.

The mythology of the microfinance industry is often described in romantic language; the mission and vision of the early leaders depicted in rosy terms. Though they had a difficult start, at last the seeds of the microfinance industry have taken root. Loosened parameters allowed for the creation of a few local microfinance monopolies that were able to set prices high enough to cover costs until they achieved scale and sustainability. Today, the “rose” of microfinance still blooms brightly, but the challenge is becoming more complicated. We have moved from the greenhouse into the garden.

REGULATION AND SUPERVISION COUNTRY UPDATES

The debate continues as to whether and when MFIs that accept deposits should be regulated and supervised under existing legal frameworks, and in which cases they should create their own legal category. Some MFIs convince authorities to write laws that accommodate the small size and unique nature of their operations and products; others change themselves and their products to fit the law. Each institution must examine the short and long term possibilities of both options, as well as how other MFIs operate in the region, before making the choice.

Regulating Microfinance in Uganda

Dirk Van Hook, Centenary Rural Development Bank, Uganda

Although Ugandan officials have been talking about developing special regulations for MFIs for five years, the country has seen little progress toward that end. NGOs were initially interested in licensing and registration to attain legal status so they could take legal action against employees found guilty of fraud or clients in cases of default.

On July 12, 1999, the Bank of Uganda introduced a policy statement that outlined a course of action for the regulation of microfinance activities. In essence, if an institution can prove to the central bank that it has a high quality loan portfolio, the central bank will allow it to operate as a formal financial institution. According to the policy, microfinance services could be offered by any of the four following institutions:
1. **Commercial banks.** Commercial banks can have special microfinance windows that help them move down market. By January 1, 2000, commercial banks will have to have paid-up capital of $1.3 million and by January 1, 2003, of $2.6 million, which will affect what kinds of institutions will be able to enter as commercial banks. Right now, the third draft of revised banking regulations contain specifications for microfinance services, and if the Bankers’ Association accepts the draft, it will go to Parliament for approval. In the past few years, Centenary Bank has operated conservatively to meet the central bank’s capital requirements. Currently, Centenary has capital in excess of the minimum capital requirements for commercial banks in Uganda (the requirement is 12 percent as of January 2000), and at the end of June 1999, its loan portfolio quality was the third best of all banks in Uganda. From September 1997 to September 1999, its arrears dropped from 15.3 to 3.5 percent. However, it may be difficult for other less mature MFIs to meet the new commercial bank requirements.

2. **Non-bank financial institutions (NBFIs).** In Uganda, NBFIs can accept savings accounts and fixed deposits. They cannot hold current accounts, checking accounts, or handle foreign exchange, which limits services they can provide to clientele. The paid-up capital of NBFIs must be $667,000 by January 1, 2000, a requirement that would be difficult for many existing NGOs to reach. Also, the Bank of Uganda supervises NBFIs, which could cause MFIs to resist this option for fear of very strict regulations. Despite the draw-backs, NBFIs can provide specialized services to poor entrepreneurs, and the capital requirements help ensure that clients are banking under safe conditions.

3. **Microfinance deposit-taking institutions (MDIs).** This specialized category is completely new for Uganda, and the policy paper is still being debated. What is known, though, is that the institution would work as a miniature bank with some amount of paid-up capital, approximately $200,000. The capital base would reflect risk-weighted assets, which means the more loans the bank disburses, the more equity it must have. Liquidity requirements would be more conservative than for banks, which have a liquidity reserve requirement of about 14 percent of risk weighted assets. Various requirements, such as for loan loss provisions, will be stricter because MDIs are designed to serve smaller savers than traditional banks. Ugandan banks currently provision 20 percent after six months, 50 percent after a year, and 100 percent after two years. The Bank of Uganda would set accounting standards, and loans would have to be written off after 90 days. However, it is unlikely that many MFIs will choose this classification, because few MFIs will have the level of sustainability necessary to manage client deposits.

4. **Institutions not regulated by the Bank of Uganda.** Two types of institutions, non-deposit-taking and small member-based institutions, would be part of this proposed category. Institutions belonging to the category would be regulated by an umbrella organization of microfinance lenders.

**Defining deposits**

The main unresolved issue in determining categories for microfinance service providers is the definition of a deposit. In Uganda, a deposit is commonly due on demand or has a fixed maturity. Most Ugandan NGOs use forced savings as security, and can use those savings for a variety of purposes. The biggest concern is when MFIs collect deposits from the general public and then use those deposits for lending. In the past year, three Ugandan banks failed, and the Bank of Uganda was criticized particularly for the mistakes of deposit taking institutions. Now that it has issued a microfinance policy statement, the Bank will most likely dominate the discussion about the definition of a deposit. Once deposits are categorically defined, microfinance providers will be able to more easily delineate themselves as belonging to one of the four types of institution that the Bank of Uganda has included in its framework.
The treasury function
The treasury function becomes extremely important once an MFI is licensed to take deposits, because the MFI must efficiently allocate reserves to both investment returns for depositors and liquid assets for borrowers. At Centenary, the treasury committee meets every Monday afternoon to make decisions regarding liquidity and returns that are based on the investment portfolio and reserves. The deputy chief executive, who has a degree in accounting and an MBA, oversees the process. Many other banks contact Centenary in search of excess liquidity, which shows that Centenary has a strong handle on its cash management. In microfinance, one thing that makes this management easier is that there is a steady stream of installments coming in all the time. However, institutions that are now accepting deposits must take special care to ensure their assets are being used wisely.

Transformation of Compartamos in Mexico
Carlos Labarthe, Compartamos, Mexico

Mexican law clearly states that only formal financial institutions may provide credit services and collect savings, and the strictness of this law has prompted Compartamos to initiate transformation into a formal institution. Furthermore, to grow, increase outreach, and remain sustainable requires stable and efficient financial systems, which formalization can help accomplish. In Mexico, there are three options for MFIs seeking formalization:

1. **Transform into a bank.** Banks require $15 million in equity and must provide numerous services in order to be competitive. These criteria are beyond the means of institutions wishing to provide microfinance services.

2. **Open as a credit union.** Credit unions have fewer requirements, but the government has excessive control over the structure, and the credit union itself can make few decisions regarding its composition and organization.

3. **Create a limited scope financial company (SOFOL).** A SOFOL cannot collect deposits from the public, but it qualifies for commercial loans and issuing debt instruments in the market.

Creating a SOFOL was the most desirable option for Compartamos, especially because it could leverage itself in order to attain greater outreach than would be possible as an NGO. Also, by choosing to create a SOFOL, Compartamos would be able to continue acting solely as an MFI, without having to provide the additional services required by a bank or having to relinquish control as required by the credit union structure. As a SOFOL, Compartamos wanted to prove the effectiveness of the MFI model and generate competition in order to increase the amount of people microfinance currently reaches in Mexico. The institution requested a SOFOL license in September 1998, and expects to be licensed to operate in early 2000. In the beginning, the portfolio will be funded from equity and subordinated debt; later it will be funded with commercial loans and finally, in approximately three years, it will be funded by commercial stocks and bonds.

The institution learned the following lessons from four common components of the transformation process:

1. **Managing expectations.** Both clients and employees expected that due to the new SOFOL license, their services and benefits would change. For instance, staff expected salary raises. To correct expectations, management held regional workshops to explain that despite the new license, the job would include the same responsibilities and clients. Management also talked about Compartamos’ mission, vision, and philosophy, which would remain essentially unaltered. For the benefit of the clients, Compartamos has retained its original loan officers and services (though officers now wear uniforms).
2. **Educating authorities.** Because they lacked knowledge of the field, financial authorities could not understand why a non-profit organization was one of the shareholders; Compartamos staff had to spend a great deal of time orienting them with the basics. However, the president of the board is a banker in the formal sector, so he has been able to help Compartamos smooth its relationship with the authorities.

3. **Changing ownership and governance.** The change from an NGO governance structure to a commercial governance structure necessitated several procedural changes. Because the new board includes people who are investing their own money into the institution, there are more precautions the board must take while making decisions. The NGO board was able to make quicker decisions, but fewer peoples’ personal investments were at stake. Now, the Compartamos NGO owns 40 percent of the new SOFOL, Gateway and Profund together own 26 percent, and private Mexican investors own 34 percent, so the interests of all investors must be accommodated.

4. **Increasing costs.** Administrative costs increased as staff began to support bigger workloads. Also, legal fees, time spent with bureaucrats, and time spent facilitating investors’ due diligence are just a few of the other new costs associated with the transformation.

**PRODEM’s Creation of a PFF in Bolivia**  
*Eduardo Bazoberry, PRODEM, Bolivia*

Lay-offs resulting from economic reforms in state-owned enterprises in the 1980s generated the rise of the Bolivian informal economic sector. As the government shrank, unemployment grew. Microenterprise became an increasing source of employment, and over time MFIs became experts at serving the smallest enterprises in the informal sector. But recent market changes have altered and increased the needs of microfinance clients. MFIs that can keep up with changes and exceed client service expectations will stay successful and contribute to the economic growth and social stability of the country. When an MFI provides an array of services, it not only breaks even, but it achieves profits, and its customers profit, too.

The growth in demand for microfinance presented Bolivian officials with two options: Let the informal sector flourish or restrict it by limiting its role in the economy. To allow for further growth of the sector was a sound political decision, because it reduced unemployment, social upheavals, crime, and other negative side effects of economic decline.

In 1992, PRODEM helped reform Bolivia’s financial structure by creating the first microfinance bank, BancoSol, which now independently governs itself. The creation of BancoSol required $5.6 million, which was a large sum of money at the time. Originally, BancoSol was to operate in urban areas while PRODEM was to operate in rural areas, and eventually BancoSol planned to absorb PRODEM. However, in 1997 BancoSol decided that it did not want to take on the additional risk associated with absorbing 27 PRODEM branches. Since BancoSol would not incorporate PRODEM’s branches, PRODEM initiated its own financial formalization process in 1999 to leverage its equity and keep up with the increasingly competitive market.

With new Bolivian bank laws, PRODEM plans to transform into a Private Financial Fund (PFF) to gain legal status with a small equity investment, which will allow it to grow and later become a bank. Traditional laws limit unsecured loans to 10 percent of the loan portfolio, but the new laws are more favorable for microfinance. Laws concerning PFFs now allow up to 100 percent of the loan portfolio to be unsecured for solidarity loans to borrowers who each owe less than $2,000. Officially, an institution can become a PFF with capital of about $1 million. However, if an institution applies for a PFF license, the government might ask for $3.5 million in equity, because other PFFs are already...
capitalized up to this amount. Although capital adequacy requirements mirror those of banks, PFFs cannot hold current accounts, engage in foreign trade, or issue credit cards. Now, many PFFs have the ability to be as profitable as BancoSol is.

PRODEM will launch its PFF with a capital base of $5 million. While assembling these resources, PRODEM sought investors that embraced both the social and profit elements of the business. The institution rejected certain NGOs and international groups as potential investors because they did not strongly support both the social and profit objectives. Table 6 presents the PRODEM’s proposed shareholder breakdown for the PFF.

**Table 6: PRODEM’s PFF Proposed Shareholders**

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Ownership (%)</th>
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<tbody>
<tr>
<td>PRODEM NGO</td>
<td>51%</td>
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<tr>
<td>Private Sector Investors</td>
<td>28%</td>
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<tr>
<td>Andean Corporation</td>
<td>10%</td>
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<tr>
<td>PRODEM Employees</td>
<td>10%</td>
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</tbody>
</table>

In the early 1990s, MFIs were offering credit and savings, but now, as the Bolivian market matures, MFIs are beginning to serve a complex market that demands a variety of options and solutions to deal with the intermediation of money. To transform into a PFF, PRODEM had to update and improve its infrastructure, as its former infrastructure was only designed to accommodate credit. As a PFF, PRODEM must expand services to include savings, wire transfer, and investments. To do this, it must increase its telecommunications capabilities, which is a tedious process. PRODEM adapted 27 of its 57 branches to the new telecommunications systems in the first year. In addition, PRODEM heightened security systems, installing cameras and alarms in each branch, because the branches now have responsibility for more assets.

Another infrastructure improvement was technological expansion. PRODEM created an intranet for improved communication between branches. Because the computers are leased, PRODEM can benefit from new software and computer technology every two years. In addition, PRODEM upgraded MIS and other information systems. After staff were trained to input the correct information, computers were able to make all financial calculations. Now, staff calculate closing balances twice a day in every branch, whereas many competitors close out only once a week. Such attention to detail has improved PRODEM’s public relations. To further enhance its image, PRODEM bought highway billboards that say “All Roads Lead to PRODEM.”

It takes more than technology and infrastructure to remain competitive in the Bolivian market. Through the transformation process, PRODEM’s management learned that the following elements are critical to remain cost-effective, efficient, and preferred by customers:

1. **Strong leadership in human resources.** One of the most important elements of success is a group of staff members who have an attitude toward service and a culture of accountability. Staff members such as these are tuned in to customer needs and form the foundation for customer relationships that promote loyalty.

2. **Software and hardware investments.** Security, computer systems, and updated telecommunications systems are essential to success because they encourage efficiency, rapid movement of information, and safekeeping of customer assets.
3. **Control mechanisms.** The President of PRODEM is a 20-year veteran of Citibank who brought best practices from the formal financial sector into the institution. Under his direction, PRODEM created the following new committees: the asset liability committee, risk committee, and internal audit committee. The creation of these committees was not intended to promote bureaucracy, but to uphold a commitment to assets protection and rapid response to issues. During bi-annual visits, the committees rate each of the branches. If the branch performs below a certain score for two visits in one year or two, branch managers can lose their jobs. Bolivia has also recently introduced external auditors and risk rating agencies, which complement the efforts of PRODEM’s new committees.

**Lessons learned**

The transformation process demands time and resources, and the result is an institution that not only focuses on loans, but also focuses on client services. To this end, people with banking experience were hired to manage assets, liabilities, and the relationship with the Superintendency of Banks, but not to handle loan disbursal. Even though the bankers do not have much contact with customers, PRODEM sought potential staff with the right attitude and profile to work with its current customers. The new staff had to adapt, innovate, and undergo training. Training of new staff is essential to their integration.

As a formal financial institution, PRODEM faces competition from NGOs who disburse subsidized loans. But client loyalty does not always result from cheaper loans – it results from a mixture of sound economics and good customer service. Bolivia represents a large and competitive market for microfinance. An MFI can only capture a large part of that market if it offers a variety of quality services to those who demand them.
# LIST OF CONFERENCE PARTICIPANTS

## Network Members

<table>
<thead>
<tr>
<th>Organization</th>
<th>Name</th>
<th>Position</th>
<th>Country</th>
</tr>
</thead>
<tbody>
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<td>Executive VP</td>
<td>USA</td>
</tr>
<tr>
<td>Alexandria Business Association</td>
<td>Nabil El Shami</td>
<td>Executive Director</td>
<td>Egypt</td>
</tr>
<tr>
<td>Association for Social Advancement</td>
<td>Shafiquel Choudhury</td>
<td>Chief Executive</td>
<td>Bangladesh</td>
</tr>
<tr>
<td>Banco del Desarrollo</td>
<td>Mauricio Rojas</td>
<td>Chair</td>
<td>Chile</td>
</tr>
<tr>
<td>Bank Rakyat Indonesia (BRI)</td>
<td>Loefty Wahjoe</td>
<td>Operations Manager</td>
<td>Indonesia</td>
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<tr>
<td>BRAC</td>
<td>Fazle Hasan Abed</td>
<td>Executive Director</td>
<td>Bangladesh</td>
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<tr>
<td>BRAC</td>
<td>Aminul Alam</td>
<td>Deputy Exec. Director</td>
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<tr>
<td>BRAC</td>
<td>Atiqun Nabi</td>
<td>Program Coord., RDP</td>
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<tr>
<td>BRAC</td>
<td>Istiaq Mohiuddin</td>
<td>Managing Dir., MIS</td>
<td>Bangladesh</td>
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<tr>
<td>BRAC Bank</td>
<td>Aziz Ahmed</td>
<td>Managing Director</td>
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<tr>
<td>Calmeadow</td>
<td>Martin Connell</td>
<td>President</td>
<td>Canada</td>
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<td>Calmeadow</td>
<td>Craig Churchill</td>
<td>Director, Washington</td>
<td>USA</td>
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<tr>
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<td>Dirk B. Van Hook</td>
<td>CEO</td>
<td>Uganda</td>
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<tr>
<td>Citi Savings and Loan</td>
<td>Peter Ocran</td>
<td>Executive Director</td>
<td>Ghana</td>
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<tr>
<td>Compartamos</td>
<td>Carlos Labarthe</td>
<td>Co-Director</td>
<td>Mexico</td>
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<td>Compartamos</td>
<td>Carlos Danel</td>
<td>Co-Director</td>
<td>Mexico</td>
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<td>Cooperativa Emprender</td>
<td>Claudio Higuera</td>
<td>Manager</td>
<td>Colombia</td>
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<td>FED</td>
<td>César Alarcon</td>
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<td>Ecuador</td>
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<tr>
<td>FINCA Kyrgyzstan</td>
<td>Jason Meikle</td>
<td>Executive Director</td>
<td>Kyrgyzstan</td>
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<tr>
<td>Fundusz Mikro</td>
<td>Jan Mynarczyk</td>
<td>Dir. Loan Operations</td>
<td>Poland</td>
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<tr>
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<td>Kimanathi Mutua</td>
<td>Managing Director</td>
<td>Kenya</td>
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<td>Anita Campion</td>
<td>Director</td>
<td>USA</td>
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<tr>
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<td>Rashid Malima</td>
<td>General Manager</td>
<td>Tanzania</td>
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<tr>
<td>PRODEM</td>
<td>Eduardo Bazoberry</td>
<td>Executive Director</td>
<td>Bolivia</td>
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<tr>
<td>TSPI</td>
<td>Dennis Isidro</td>
<td>Chairman</td>
<td>Philippines</td>
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<tr>
<td>TSPI</td>
<td>Cornelio Villareal</td>
<td>President</td>
<td>Philippines</td>
</tr>
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## Special Guests

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<th>Organization</th>
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<tbody>
<tr>
<td>CGAP</td>
<td>Richard Rosenberg</td>
<td>Senior Advisor</td>
<td>USA</td>
</tr>
<tr>
<td>DFID</td>
<td>David Cracknell</td>
<td>Field Manager</td>
<td>Bangladesh</td>
</tr>
<tr>
<td>UNDP</td>
<td>Henry Jackelen</td>
<td>Unit for Microfinance</td>
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</tr>
</tbody>
</table>
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