

Focus Note

NO. 23

DECEMBER 2001



The Focus Note Series is CGAP's primary vehicle for dissemination to governments, donors, and private and financial institutions on best practices in microfinance.

Please contact FOCUS, CGAP with comments, contributions, and to receive other notes in the series.

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A MULTILATERAL DONOR TRIUMPHS OVER DISBURSEMENT PRESSURE: THE STORY OF MICROFINANCE AT BANCO DO NORDESTE IN BRAZIL

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- Most importantly, outcomes may be better when large lending follows, rather than precedes, the development of proven retail capacity.
- Freedom from dogmatic presuppositions (for instance, "large state-owned banks can never do good microfinance") allows an opportunistic approach that is more likely to yield results.
- After proper pilot work, a bank with a large pre-existing branch network can roll out microfinance much more rapidly than a new microfinance-only institution.
- Generalist donor staff working on microfinance activities should get a basic grounding in the elements of sustainable microfinance, preferably through training or, at a minimum, close work with specialists.
- Donors can be effective with a limited technical role—setting benchmarks consistent with international best practice, and putting the client institution in contact with top microfinance practitioners.
- When missteps occur along the way but the client's institutional commitment to the program's objectives is strong, keeping the focus on the commitment can prevent over-reaction to the missteps.

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As of November 30, 2000, after only three years of operation, CrediAmigo was already among the top microfinance institutions (MFIs) in Latin America in terms of geographical penetration, numbers of clients, and depth of outreach. The program had over 55,000 active clients in 358 municipalities throughout the northeastern region of Brazil. The average outstanding loan balance was R\$541.47 (US\$270), less than 6 percent of Brazil's per capita GNP.¹

CrediAmigo's portfolio quality and staff productivity are at international best practice levels. Only 2.5 percent of its loans are late, using a strict 30-day portfolio at risk measure. Its annualized loan loss rate is also 2.5 percent, even after fully provisioning all loans with any payment 90 days or more overdue. Loan officers with nine months or more of experience are each handling an average of 313 clients.

Profitability is developing well. About 85 percent of CrediAmigo's 108 branches are operationally sustainable, and the program as a whole reached full financial sustainability in mid-2001.² Thus, CrediAmigo is demonstrating that a "down-market" focus can be consistent with sustainability in commercial banking in Brazil.

BN managers have repeatedly said that the example of CrediAmigo is having a catalytic effect on the rest of the bank. BN is using the experience gained under CrediAmigo in areas such as the use of staff incentives and the development of a low-delinquency loan culture.

While continued expansion will bring new problems and challenges, CrediAmigo's performance so far has been impressive by any standard. This paper tells how it happened.

Background

Brazil has long been considered one of the world's great untapped microfinance markets. Because of the country's large population, high poverty rates, and open economy, it has the largest concentration of microenterprises in Latin America—estimated at more than 9 million, with at least 2 million in the Northeast Region alone.³ Despite this large potential market and scant outreach by the banking sector, in 1998 no Brazilian microfinance program had more than 5,000 clients. And only two programs, both nongovernmental organizations (NGOs), could even be considered to be on a path to full sustainability. A variety of reasons had been suggested for the weak development of microfinance in Brazil, including the country's history of hyperinflation, the pervasive role of public banks, and the small number of NGOs. Yet other Latin American countries with similar limitations had developed sustainable, high-outreach MFIs more rapidly. Brazil's laggard status was particularly odd given that the first "modern" microfinance program in Latin America, Proyecto Uno, was founded in Recife, Brazil, in 1971.

In 1996 the World Bank decided to explore the development of microfinance as part of its poverty re-

¹At the end of 2000, BancoSol in Bolivia had 61,000 loan clients, after 13 years of operation. Compartamos in Mexico had 64,000 clients, after about 10 years. The median outstanding loan balance for Latin American MFIs was 45 percent of per capita GNP, according to the April 2001 *MicroBanking Bulletin*. In Bangladesh, Grameen Bank's average outstanding loan is US\$140, or about 40 percent of per capita GDP.

²"Operational sustainability" is the ability to pay all operating costs *except* the cost of funds from interest income on loans. "Financial sustainability" is the ability to pay all costs, including financial costs, from interest income.

³For background on Brazil's microenterprises, financial sector, and microfinance industry, see Steven Schonberger, *Microfinance Prospects in Brazil* (World Bank, Latin America and the Caribbean Region and Economic and Socially Sustainable Development Unit, Washington, D.C. 2000).

Box 1: Reform sparks growth at Banco do Nordeste

Dr. Costa de Queiroz was appointed president of BN in March 1995 following a very successful career as a private businessman in the state of Ceara. Dr. Queiroz immediately began a major reform of the bank, with the objective of making it more modern, efficient, and responsive to the development needs of the Northeast. Since then loan assets have grown from R\$2.6 billion to more than R\$6.0 billion; the number of loans has grown from 68,000 to more than 404,000.

- BN's market share increased from 35 percent of all loans granted in the Northeast Region to 78 percent.
- Administrative expenses as a percentage of assets are less than half their 1995 level (3.4 percent in 2000 vs. 7.9 percent in 1995).
- Staff were reduced from 5,468 to fewer than 4,000.
- Lag time between loan request and approval has been reduced from an average of 217 days to a mandated limit of 21 to 60 days depending on loan size.
- BN has reorganized its structure and processes to make the client its central focus and reduce barriers to staff interaction across functional areas.
- BN has invested heavily in staff training and information systems.

duction efforts in Brazil's northeast region, the poorest in the country. Since NGOs were the only type of MFI operating in Brazil, the World Bank originally considered developing an apex (wholesale) institution to provide funding and technical assistance. But the number and strength of the NGOs were limited, and the Inter-American Development Bank was planning a US\$150 million microfinance apex operation based in Rio de Janeiro. The World Bank task team decided to pursue a complementary approach focused on developing the commercial bank model, rather than a competing approach focused on NGOs.

The task team spoke with private and public banks operating in the Northeast Region to gauge their in-

terest and capacity. Private banks viewed microfinance as charity work rather than as a commercial opportunity. Public banks were more interested, given their social mission, but seemed to provide a weak basis for a financially sustainable program.

Banco do Nordeste expresses interest, agrees on basic principles

In September 1996, BN's president Costa de Queiroz told the World Bank he was interested in developing a world-class microfinance program. Emerging from a major reform, BN had R\$6 billion (US\$3 billion) in assets and 176 branches throughout the Northeast Region (see box 1). To satisfy BN's regional development

mandate, Queiroz was looking for ways of reaching the poor that were more effective than the bank's directed lines of credit had been. He was particularly interested in the informal sector.

In November, 1996 a World Bank team met with senior management at BN's headquarters in Fortaleza to discuss microfinance experience and best practice. The two groups agreed on basic operating principles for developing a sustainable program, some of which would involve significant departures from previous BN policy and practice:

- Above-market interest rates to clients, in order to cover the relatively high cost of administering very small loans sustainably
- Compensation of microcredit staff based on the results they achieve (personal accountability)
- Management information systems that give microcredit staff immediate access to accurate transaction history and current repayment status for all clients
- Decentralized credit decisions, backed up by ex-post quality controls
- Commitment to very high levels of loan recovery
- De-linking microcredit operations from BN's politically tied lending programs
- Strong support from BN senior leadership, in the face of the pressures that microcredit would place on BN's operations.

At an early stage in the discussions, the World Bank sought technical help from experts on the staff of CGAP. In February 1997, a joint World Bank-CGAP mission visited BN to evaluate it as a potential microfinance platform. The team was well aware that microcredit programs in state banks seldom succeed. But they found that BN was not a typical state bank: its management was unusually business oriented and

seemed relatively free from external political interference. The bank was reorganizing to improve its efficiency through better staff incentives, information systems, client focus, and flexibility—all key elements for successful microfinance. The mission concluded that these factors, along with the strong commitment of BN senior management and BN's already significant outreach in the Northeast Region, outweighed the risk of political interference inherent in a public bank. Based on the mission's assessment, the World Bank agreed to provide minor funding for a pilot microfinance program at BN through an existing loan for technical assistance and training. The mission team was convinced that consideration of a large World Bank loan was premature before mounting and assessing the results of a small pilot operation. The leader of the World Bank team had the luxury of working for a manager who was prepared to measure his performance by something other than the amount of funding he was able to commit each year.

The World Bank trains its staff

It is clear in retrospect that the effectiveness of the World Bank's engagement with BN depended on the development of World Bank staff skills and the close involvement of successful microfinance practitioners. Once the Bank decided to support the CrediAmigo pilot, both the task manager and his division chief attended the three-week Microfinance Training Program in Boulder, Colorado. These officers say that the training helped them to focus the dialogue with BN on key elements of success, and to bring to the table specific technical advice from successful, experienced practitioners they contacted through the Boulder experience. A number of these practitioners were later recruited by the World Bank task team or by BN.

World Bank technical involvement is limited

During the pilot stage World Bank and CGAP assistance was limited to helping BN get high-quality international expertise and learning from similar experiences in other countries. BN used World Bank funding for senior manager study tours to successful MFIs in Bolivia, Chile, Columbia, and Indonesia. Based on these visits, BN was able to consider technical approaches and develop a short list of consultants. BN chose ACCION International, a group with strong experience in solidarity group lending. BN leaned from their old unsuccessful, highly subsidized individual lending program aimed at the same clientele.

With ACCION's assistance, BN surveyed informal enterprises and developed pilot loan products. It also prepared training materials and selection criteria for its microfinance loan officers. The bank chose to outsource the microfinance loan officer function because of the inflexible qualifications and salary levels of its unionized workforce. Throughout this process the World Bank's role was limited to administrative assistance in management of the funds. CGAP's role was limited to helping identify the requirements for program development, organizing study tours, and finding potential technical assistance providers.

In December 1997, BN initiated CrediAmigo in five of its branches. The pilot incorporated lessons from the study tours, market study, and technical assistance. Testing was restricted to a single loan product: 90-day loans to individual clients organized in "solidarity groups" of about five borrowers who cross-guaranteed each others' loans. Payments fell due every 15 days. The interest rates were considerably higher than BN's rates to its conventional borrowers, but far below the rates of informal money-lenders. Prompt repayment was encouraged by offering interest rebates and new loans within 24 hours

for groups that consistently repaid on time.

BN's cabinet chief was named general coordinator of the program, with freedom to recruit top staff from throughout the bank. In view of the high quality of the program's management and design, the World Bank decided to arrange a US\$900,000 Japanese grant to support loan officer training, information system development, and further technical assistance, all in preparation for a possible World Bank loan in support of CrediAmigo's later expansion.

During the pilot phase the World Bank focused almost exclusively on the potential sustainability of CrediAmigo. Day-to-day management of CrediAmigo was left to BN. The World Bank distanced itself from operational details and instead tried to help BN's management keep its focus on the key elements needed for sustainability. BN was clearly addressing pricing and administrative costs, but loan repayment did not get sufficient attention.

Overconfidence leads to disaster ...

The pilot seemed to be going well for the first four months. BN's management was excited by the program's potential and the positive response in high quarters of the government. In their enthusiasm, BN's senior managers decided to speed up implementation, expanding CrediAmigo from five branches to 50. They announced publicly that CrediAmigo would have 100,000 clients by the end of its first year of operation. The World Bank, CGAP, and the program's own TA advisors all warned that four months was far too short to test the repayment performance of the new loan product, because defaults typically rose in later loan cycles. But BN management felt committed to the expansion. The World Bank then indicated that further support, including the Japanese grant, would be contingent on

maintaining good portfolio quality, with 30-day portfolio at risk no more than 5 percent.⁴

As predicted, the expansion resulted in rapid deterioration of portfolio quality and heavy loan losses (figure 1). Poorly selected and trained loan officers were given quantity-based performance targets, so they rushed to lend without sufficient focus on repayment capacity and follow-up. The rapidly mounting loan losses took BN's managers by surprise.⁵ After two months of expansion, the President of BN told all regional managers to slow or stop new lending and focus almost exclusively on loan recovery. ACCION worked with BN on loan recovery strategies, and on retraining loan officers and branch managers. Despite these efforts, the episode cost BN more than US\$2 million in loan losses. It took another six months before portfolio at risk fell back within the agreed limits.

... but strong BN commitment gets CrediAmigo back on track

It would have been easy for the World Bank to walk away at this point—there were no deep or longstanding commitments, and BN seemed to have shown its inability to resist political imperatives. It had done precisely what naysayers had predicted at the outset of the project. Few in the informed microfinance community

thought the relationship was worth continuing. But the task manager and key members of the team sensed that BN management was still committed to making CrediAmigo sustainable, so they persevered with what from the World Bank's perspective had become a far riskier proposition.

Indeed, it is not unusual for large banks to underestimate the complexity of consolidating a microfinance program. BN's experience shows that the resulting problems don't have to be fatal, if the focus returns to sustainability. The problems and costs of their premature expansion convinced BN managers at all levels that microfinance portfolio quality was challenging and volatile, and that they needed to manage it much more carefully. Since this initial misstep, CrediAmigo has focused consistently on growth with quality. This commitment has been evident in a variety of ways:

- Growth in the number of branches and loan officers has been carefully controlled (figure 2).⁶
- Though it's a state-owned bank, BN has maintained a commitment to profitability in the design and management of CrediAmigo. The program was initiated with a 5 percent flat monthly rate, translating to a 6.9 percent effective monthly rate after adjusting for inflation.⁷

⁴“Portfolio at risk” is a measure that divides the remaining balance of loans that are late by the remaining balance of the whole loan portfolio.

⁵Because microcredit is unsecured, repayment discipline can collapse very rapidly. When a micro-borrower sees many of her peers defaulting on their loans, her motivation to repay plummets. The main reason she repays her loan is her expectation of future services; she knows that once people stop repaying, the service won't be available very long. She doesn't want to be the last one aboard the sinking ship.

⁶To increase its geographic outreach cost-effectively, CrediAmigo began establishing “individual branches” consisting of a single loan officer. These branches account for most of the growth in branch numbers since August 1999.

⁷In comparison with normal loans, microloans are tiny, yet staff intensive. Thus, administrative costs are high when measured as a percentage of the loan amounts. It takes a very high interest rate to recoup these costs, especially if management is committed to breaking even at an early stage. Experience has shown that clients value the loans so highly that they are willing to pay elevated interest rates; in fact, many of them have been paying much higher rates to informal money-lenders.

⁸When BN transfers funds to a CrediAmigo branch, it charges an internal transfer price equal to the prevailing rate on Interbank Certificates of Deposit.

Fig. 1: CrediAmigo Client Growth and Loan Losses, 1997–2000

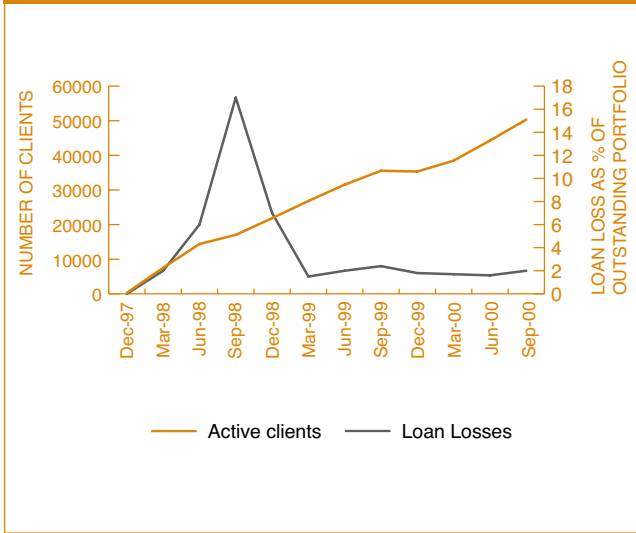


Fig. 2: Growth in Loan Offices and Branches

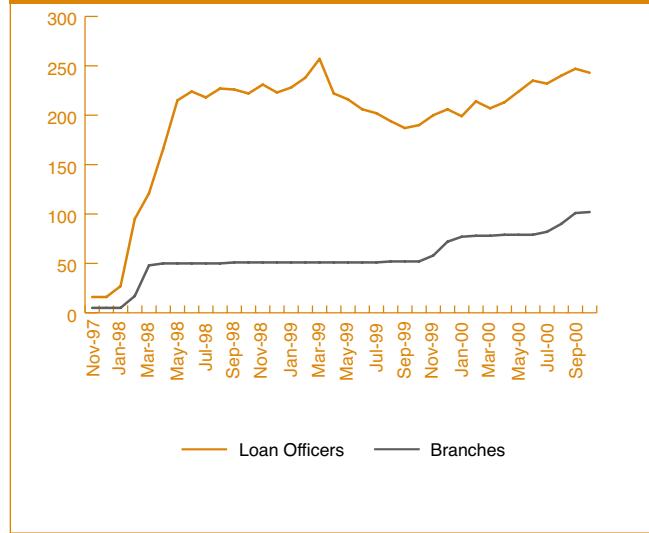


Fig. 3: CrediAmigo and Brazil Inter-Bank Loan Rates (Annual)

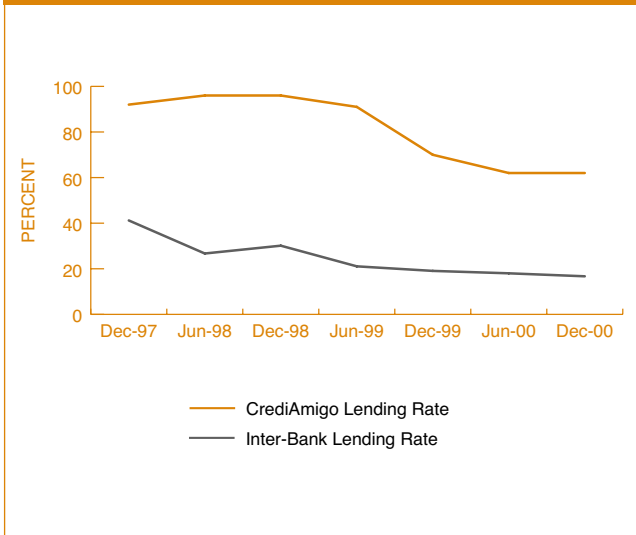


Fig. 4: CrediAmigo Employees by Source



Since then the interest rate has declined in proportion to the cost of funds in Brazil, but it has remained at levels consistent with achieving early profitability (figure 3).⁸

- Sustainability required a high-productivity model with low costs and an institutional culture that would be difficult in a large public development bank. BN cre-

ated a “bank within a bank,” first by outsourcing loan officers, and then by replacing BN staff branch managers with coordinators drawn from the loan officer pool (figure 4).

- Branches were evaluated as individual profit centers. But to maintain the benefits of scale in managing information, innovation, and human resources, BN

strengthened CrediAmigo's Central Technical Units and invested heavily in the management information system to permit better central monitoring of loan officer and branch performance.

- BN's nontraditional management style has always involved many top managers in decisions relating to the program. While it takes a significant effort by CrediAmigo staff to keep a large number of very busy managers educated about the special requirements of microfinance, it also wins a surprisingly high degree of buy-in for CrediAmigo, considering that the program barely affects the bottom line of such a large bank.
- Support from the BN's president has never wavered, nor has there ever been a question about whether the program should be run in a highly professional, non-political manner. The decision to expand prematurely was made for strategic rather than political reasons, and was driven by overconfidence, rather than a lack of concern for loan repayments.

Further challenges

As CrediAmigo's portfolio improved, BN was left with the challenge of managing an expanding microfinance business. With support from the Japanese funding, the CrediAmigo Central Technical Unit developed an incentive scheme for loan officers under which bonuses were tied heavily to repayment performance. The funding was also used for extensive training modules and for improvements in the portfolio information system.

Following an identification mission for a proposed loan, the World Bank hired external consultants to assess the CrediAmigo program. They found that although overall program performance was improving, the program continued to vary in performance among branches and loan officers, with a few top performers

compensating for the generally mediocre performance by the rest. The consultants thought this was a result of too much decentralization, but loan officers convinced CrediAmigo's Central Technical Unit that it was a result of market resistance to the solidarity loan product, with the result that the program began considering a move to individual loans.

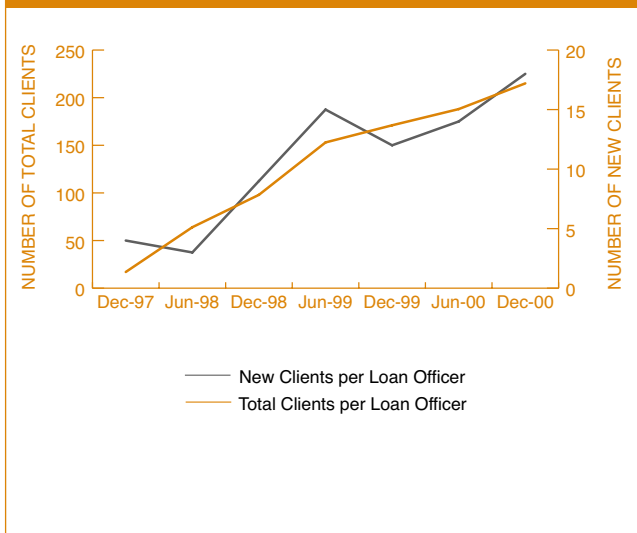
Concerned with CrediAmigo's inability to achieve consistently sound performance program-wide, the World Bank again delayed loan preparation, and asked CGAP to provide direct technical assistance on key issues. The Bank's decision to proceed further with the loan would depend on BN's success in solving performance problems.

A CGAP review in November 1998 recommended that CrediAmigo management maintain the current loan product, simplify the incentive system, and increase focus on several key variables related to loan officer productivity, particularly new clients per loan officer per month (figure 5). The World Bank and CGAP returned to Brazil after five months and found that CrediAmigo's management had made good faith efforts to implement CGAP's recommendations and that portfolio quality and productivity were improving. Based on these results, the World Bank agreed in May 1999 to proceed with the preparation of a loan to support the program's expansion.

Finally, the World Bank makes the big loan

Because of the World Bank's historical knowledge of the CrediAmigo program, and the high quality of CrediAmigo's information systems, the Bank needed only a single preparation/appraisal mission to prepare a US\$50 million loan to support the program's expansion over the next five years.⁹ The mission agreed with BN management on performance targets that kept the loan

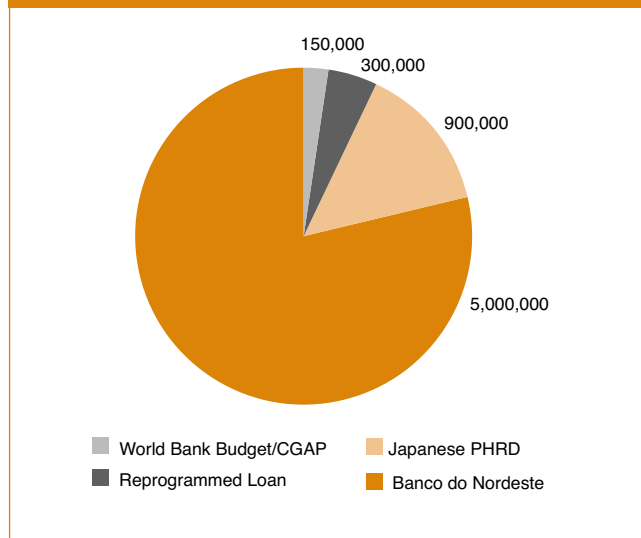
Fig. 5: CrediAmigo Staff Productivity



and its disbursement tied to portfolio quality, efficiency, and sustainability. The World Bank’s involvement with BN had looked very risky two years earlier; but by the time the large loan was prepared, the risk had lessened dramatically, because BN now had a proven micro-finance business and had demonstrated the management commitment needed to keep that business sound as it expanded.

The World Bank’s Board of Directors approved the loan in May 2000. As was the case throughout the BN-World Bank relationship, the loan agreement left BN with full control of, and responsibility for, the operations by which the targets were to be achieved. An annual external review would be contracted, permitting the World Bank to limit its direct intervention to assistance with administration of its loan (procurement and disbursement management) and assistance in developing an impact evaluation program to be carried out by a separate department of BN. As the World Bank’s role became more narrowly defined, CGAP’s role evolved from one of support for the World Bank in its relationship with BN to a more direct advisory role to BN focused on program strategy and capacity building.

Fig. 6: Funding for Development of CrediAmigo (US\$)



Reflecting on the elements that led to success

The activities most critical to CrediAmigo’s development into a world-class microfinance program included conceptualization, design, piloting, and initial consolidation. The most notable aspect of these activities is that they required limited external funding and occurred before any disbursements from the World Bank loan. Though these processes required significant investment from BN over almost three years, external as-

⁹ In fact, BN could have funded the five-year expansion from its own resources. The World Bank loan was still attractive to the Brazilian Government because it brought in needed foreign exchange.

sistance costs were relatively low. From 1996 to the loan appraisal in 1999, the World Bank spent about US\$150,000 of its own budget, including the costs of participation in the initial seminar, short (usually two-day) observation missions, the Boulder training, one identification mission and the project appraisal mission. CGAP provided about US\$50,000 of technical support, including its own staff time and external consulting. BN received US\$1.2 million in external financial assistance (US\$300,000 of reprogrammed funds from a prior World Bank loan and US\$900,000 from the Japanese). It spent about US\$5 million of its own funds on the salaries of the BN personnel who designed the program, training costs, full financing of the loan portfolio, and accumulated losses including the US\$2 million write-off of bad loans (figure 6).¹⁰

The BN experience suggests that donors may need to be opportunistic rather than dogmatic in their approach to microfinance. At first the World Bank was reluctant to support a large state-owned development bank, even one that had undertaken significant internal reforms. But the demonstrated strength of BN senior management's commitment, along with a pressing need to develop substantial microfinance retail capacity in the northeast region, and the Inter-American Development Bank's "preemption" of the NGO arena, all combined to persuade the World Bank to take a risk and support CrediAmigo. Though the Bank was advised to withdraw its support, particularly after the ill-advised expansion in 1998, the clear commitment of BN's senior managers to develop a world-class program kept the World Bank engaged.

In comparison with other recipients of donor support, managers of competent banks are particularly skeptical of, and resistant to, technical advice from

donors or from consultants selected by donors. Recognizing this, the World Bank team limited its direct role to providing focus rather than technical advice. Nevertheless it took the unusual step of investing in a three-week training program for two of its key staff. In retrospect the team members felt that this training was critical to the success of the engagement. Recruiting outside experts is important but cannot substitute for the role of a donor's staff as the authoritative interlocutors for their institution. Donor staff lacking some basic technical literacy in microfinance will not usually be able to identify good consultants or use them well, and may not have the credibility that is essential for an effective dialogue with the implementing institution.

The most important contribution of World Bank management was its patience in allowing development to proceed at its own pace. The process of developing, piloting, and consolidating the CrediAmigo program, particularly with the need to recover from the early rapid expansion, took three years before a loan was appraised. This required exceptional patience from the World Bank's country management in Brazil, which was under pressure from various sources to move more quickly with the loan. Although there was some consideration of moving more quickly with a smaller

¹⁰One can argue that BN did not need to spend this amount of money, that it could have achieved the same results with a third of the up-front investment. But perhaps these types of "mistakes" are normal parts of working through very large institutions. The alternative might have been heavy-handed (and expensive) technical assistance, which the Brazilians would not have accepted. There is evidence of banks that have spent far less, such as the Banco del Estado in Chile, which made virtually no mistakes after spending a few years looking for the right model, and banks that have spent far more, such as Bank Rakyat Indonesia, which had to turn around the performance of 3,500 branches.

loan, management continued to support the task team's assessment of the program's readiness for a major World Bank loan.

As a result of this patient approach, a larger loan was provided with less risk of undermining the program's focus on sustainability. The initial development process allowed BN to develop its expertise and confidence in managing a large microfinance program. Even the early missteps, based completely on BN decisions with consequences financed by BN resources, were an important element in establishing the program's low arrears culture in a public bank environment. BN's success in resolving its early problems and developing a sense of how to manage the trade-off between growth and portfolio quality without the pressure of disbursing a World Bank loan has brought the program to a level where neither BN nor the World Bank see the US\$50 million loan as an incentive to "supply-led growth."

The CrediAmigo experience suggests that the World Bank and other multilateral donors can play a catalytic role in microfinance development if they:

- Pursue the best available opportunities in a country rather than impose a universal model (all capacity-building approaches involve substantial risks).
- Allow programs to develop their capacity to manage growth with portfolio quality before providing significant funding for program expansion, even when this may delay lending targets (the biggest constraint to the spread of microfinance services is a shortage, not of funding, but rather of competent retail capacity).
- Limit donors' technical role to setting benchmarks consistent with international best practice and putting institutions in contact with top microfinance practitioners.
- Ensure that donor staff working with MFIs have a grounding in the basic elements of sustainable microfinance, preferably through training or at least close work with high-quality specialists.
- Maintain focus on program objectives rather than on short-term performance issues and the missteps that are inevitable during program development, especially in large organizations.

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While continued expansion will bring new problems and challenges, CrediAmigo's performance so far has been impressive by any standard. This paper tells how it happened.

Background

Brazil has long been considered one of the world's great untapped microfinance markets. Because of the country's large population, high poverty rates, and open economy, it has the largest concentration of microenterprises in Latin America—estimated at more than 9 million, with at least 2 million in the Northeast Region alone.³ Despite this large potential market and scant outreach by the banking sector, in 1998 no Brazilian microfinance program had more than 5,000 clients. And only two programs, both nongovernmental organizations (NGOs), could even be considered to be on a path to full sustainability. A variety of reasons had been suggested for the weak development of microfinance in Brazil, including the country's history of hyperinflation, the pervasive role of public banks, and the small number of NGOs. Yet other Latin American countries with similar limitations had developed sustainable, high-outreach MFIs more rapidly. Brazil's laggard status was particularly odd given that the first "modern" microfinance program in Latin America, *Proyecto Uno*, was founded in Recife, Brazil, in 1971.

In 1996 the World Bank decided to explore the development of microfinance as part of its poverty re-

¹At the end of 2000, BancoSol in Bolivia had 61,000 loan clients, after 13 years of operation. Compartamos in Mexico had 64,000 clients, after about 10 years. The median outstanding loan balance for Latin American MFIs was 45 percent of per capita GNP, according to the April 2001 *MicroBanking Bulletin*. In Bangladesh, Grameen Bank's average outstanding loan is US\$140, or about 40 percent of per capita GDP.

²"Operational sustainability" is the ability to pay all operating costs *except* the cost of funds from interest income on loans. "Financial sustainability" is the ability to pay all costs, including financial costs, from interest income.

³For background on Brazil's microenterprises, financial sector, and microfinance industry, see Steven Schonberger, *Microfinance Prospects in Brazil* (World Bank, Latin America and the Caribbean Region and Economic and Social Sustainable Development Unit, Washington, D.C. 2000).

Box 1: Reform sparks growth at Banco do Nordeste

Dr. Costa de Queiroz was appointed president of BN in March 1995 following a very successful career as a private businessman in the state of Ceara. Dr. Queiroz immediately began a major reform of the bank, with the objective of making it more modern, efficient, and responsive to the development needs of the Northeast. Since then loan assets have grown from R\$2.6 billion to more than R\$6.0 billion; the number of loans has grown from 68,000 to more than 404,000.

- BN's market share increased from 35 percent of all loans granted in the Northeast Region to 78 percent.
- Administrative expenses as a percentage of assets are less than half their 1995 level (3.4 percent in 2000 vs. 7.9 percent in 1995).
- Staff were reduced from 5,468 to fewer than 4,000.
- Lag time between loan request and approval has been reduced from an average of 217 days to a mandated limit of 21 to 60 days depending on loan size.
- BN has reorganized its structure and processes to make the client its central focus and reduce barriers to staff interaction across functional areas.
- BN has invested heavily in staff training and information systems.

duction efforts in Brazil's northeast region, the poorest in the country. Since NGOs were the only type of MFI operating in Brazil, the World Bank originally considered developing an apex (wholesale) institution to provide funding and technical assistance. But the number and strength of the NGOs were limited, and the Inter-American Development Bank was planning a US\$150 million microfinance apex operation based in Rio de Janeiro. The World Bank task team decided to pursue a complementary approach focused on developing the commercial bank model, rather than a competing approach focused on NGOs.

The task team spoke with private and public banks operating in the Northeast Region to gauge their in-

terest and capacity. Private banks viewed microfinance as charity work rather than as a commercial opportunity. Public banks were more interested, given their social mission, but seemed to provide a weak basis for a financially sustainable program.

Banco do Nordeste expresses interest, agrees on basic principles

In September 1996, BN's president Costa de Queiroz told the World Bank he was interested in developing a world-class microfinance program. Emerging from a major reform, BN had R\$6 billion (US\$3 billion) in assets and 176 branches throughout the Northeast Region (see box 1). To satisfy BN's regional development

mandate, Queiroz was looking for ways of reaching the poor that were more effective than the bank's directed lines of credit had been. He was particularly interested in the informal sector.

In November, 1996 a World Bank team met with senior management at BN's headquarters in Fortaleza to discuss microfinance experience and best practice. The two groups agreed on basic operating principles for developing a sustainable program, some of which would involve significant departures from previous BN policy and practice:

- Above-market interest rates to clients, in order to cover the relatively high cost of administering very small loans sustainably
- Compensation of microcredit staff based on the results they achieve (personal accountability)
- Management information systems that give microcredit staff immediate access to accurate transaction history and current repayment status for all clients
- Decentralized credit decisions, backed up by ex-post quality controls
- Commitment to very high levels of loan recovery
- De-linking microcredit operations from BN's politically tied lending programs
- Strong support from BN senior leadership, in the face of the pressures that microcredit would place on BN's operations.

At an early stage in the discussions, the World Bank sought technical help from experts on the staff of CGAP. In February 1997, a joint World Bank-CGAP mission visited BN to evaluate it as a potential microfinance platform. The team was well aware that microcredit programs in state banks seldom succeed. But they found that BN was not a typical state bank: its management was unusually business oriented and

seemed relatively free from external political interference. The bank was reorganizing to improve its efficiency through better staff incentives, information systems, client focus, and flexibility—all key elements for successful microfinance. The mission concluded that these factors, along with the strong commitment of BN senior management and BN's already significant outreach in the Northeast Region, outweighed the risk of political interference inherent in a public bank. Based on the mission's assessment, the World Bank agreed to provide minor funding for a pilot microfinance program at BN through an existing loan for technical assistance and training. The mission team was convinced that consideration of a large World Bank loan was premature before mounting and assessing the results of a small pilot operation. The leader of the World Bank team had the luxury of working for a manager who was prepared to measure his performance by something other than the amount of funding he was able to commit each year.

The World Bank trains its staff

It is clear in retrospect that the effectiveness of the World Bank's engagement with BN depended on the development of World Bank staff skills and the close involvement of successful microfinance practitioners. Once the Bank decided to support the CrediAmigo pilot, both the task manager and his division chief attended the three-week Microfinance Training Program in Boulder, Colorado. These officers say that the training helped them to focus the dialogue with BN on key elements of success, and to bring to the table specific technical advice from successful, experienced practitioners they contacted through the Boulder experience. A number of these practitioners were later recruited by the World Bank task team or by BN.

World Bank technical involvement is limited

During the pilot stage World Bank and CGAP assistance was limited to helping BN get high-quality international expertise and learning from similar experiences in other countries. BN used World Bank funding for senior manager study tours to successful MFIs in Bolivia, Chile, Columbia, and Indonesia. Based on these visits, BN was able to consider technical approaches and develop a short list of consultants. BN chose ACCION International, a group with strong experience in solidarity group lending. BN leaned from their old unsuccessful, highly subsidized individual lending program aimed at the same clientele.

With ACCION's assistance, BN surveyed informal enterprises and developed pilot loan products. It also prepared training materials and selection criteria for its microfinance loan officers. The bank chose to outsource the microfinance loan officer function because of the inflexible qualifications and salary levels of its unionized workforce. Throughout this process the World Bank's role was limited to administrative assistance in management of the funds. CGAP's role was limited to helping identify the requirements for program development, organizing study tours, and finding potential technical assistance providers.

In December 1997, BN initiated CrediAmigo in five of its branches. The pilot incorporated lessons from the study tours, market study, and technical assistance. Testing was restricted to a single loan product: 90-day loans to individual clients organized in "solidarity groups" of about five borrowers who cross-guaranteed each others' loans. Payments fell due every 15 days. The interest rates were considerably higher than BN's rates to its conventional borrowers, but far below the rates of informal money-lenders. Prompt repayment was encouraged by offering interest rebates and new loans within 24 hours

for groups that consistently repaid on time.

BN's cabinet chief was named general coordinator of the program, with freedom to recruit top staff from throughout the bank. In view of the high quality of the program's management and design, the World Bank decided to arrange a US\$900,000 Japanese grant to support loan officer training, information system development, and further technical assistance, all in preparation for a possible World Bank loan in support of CrediAmigo's later expansion.

During the pilot phase the World Bank focused almost exclusively on the potential sustainability of CrediAmigo. Day-to-day management of CrediAmigo was left to BN. The World Bank distanced itself from operational details and instead tried to help BN's management keep its focus on the key elements needed for sustainability. BN was clearly addressing pricing and administrative costs, but loan repayment did not get sufficient attention.

Overconfidence leads to disaster . . .

The pilot seemed to be going well for the first four months. BN's management was excited by the program's potential and the positive response in high quarters of the government. In their enthusiasm, BN's senior managers decided to speed up implementation, expanding CrediAmigo from five branches to 50. They announced publicly that CrediAmigo would have 100,000 clients by the end of its first year of operation. The World Bank, CGAP, and the program's own TA advisors all warned that four months was far too short to test the repayment performance of the new loan product, because defaults typically rose in later loan cycles. But BN management felt committed to the expansion. The World Bank then indicated that further support, including the Japanese grant, would be contingent on

maintaining good portfolio quality, with 30-day portfolio at risk no more than 5 percent.⁴

As predicted, the expansion resulted in rapid deterioration of portfolio quality and heavy loan losses (figure 1). Poorly selected and trained loan officers were given quantity-based performance targets, so they rushed to lend without sufficient focus on repayment capacity and follow-up. The rapidly mounting loan losses took BN's managers by surprise.⁵ After two months of expansion, the President of BN told all regional managers to slow or stop new lending and focus almost exclusively on loan recovery. ACCION worked with BN on loan recovery strategies, and on retraining loan officers and branch managers. Despite these efforts, the episode cost BN more than US\$2 million in loan losses. It took another six months before portfolio at risk fell back within the agreed limits.

... but strong BN commitment gets CrediAmigo back on track

It would have been easy for the World Bank to walk away at this point—there were no deep or longstanding commitments, and BN seemed to have shown its inability to resist political imperatives. It had done precisely what naysayers had predicted at the outset of the project. Few in the informed microfinance community

thought the relationship was worth continuing. But the task manager and key members of the team sensed that BN management was still committed to making CrediAmigo sustainable, so they persevered with what from the World Bank's perspective had become a far riskier proposition.

Indeed, it is not unusual for large banks to underestimate the complexity of consolidating a microfinance program. BN's experience shows that the resulting problems don't have to be fatal, if the focus returns to sustainability. The problems and costs of their premature expansion convinced BN managers at all levels that microfinance portfolio quality was challenging and volatile, and that they needed to manage it much more carefully. Since this initial misstep, CrediAmigo has focused consistently on growth with quality. This commitment has been evident in a variety of ways:

- Growth in the number of branches and loan officers has been carefully controlled (figure 2).⁶
- Though it's a state-owned bank, BN has maintained a commitment to profitability in the design and management of CrediAmigo. The program was initiated with a 5 percent flat monthly rate, translating to a 6.9 percent effective monthly rate after adjusting for inflation.⁷

⁴“Portfolio at risk” is a measure that divides the remaining balance of loans that are late by the remaining balance of the whole loan portfolio.

⁵Because microcredit is unsecured, repayment discipline can collapse very rapidly. When a micro-borrower sees many of her peers defaulting on their loans, her motivation to repay plummets. The main reason she repays her loan is her expectation of future services; she knows that once people stop repaying, the service won't be available very long. She doesn't want to be the last one aboard the sinking ship.

⁶To increase its geographic outreach cost-effectively, CrediAmigo began establishing “individual branches” consisting of a single loan officer. These branches account for most of the growth in branch numbers since August 1999.

⁷In comparison with normal loans, microloans are tiny, yet staff intensive. Thus, administrative costs are high when measured as a percentage of the loan amounts. It takes a very high interest rate to recoup these costs, especially if management is committed to breaking even at an early stage. Experience has shown that clients value the loans so highly that they are willing to pay elevated interest rates; in fact, many of them have been paying much higher rates to informal money-lenders.

⁸When BN transfers funds to a CrediAmigo branch, it charges an internal transfer price equal to the prevailing rate on Interbank Certificates of Deposit.

Fig. 1: CrediAmigo Client Growth and Loan Losses, 1997–2000

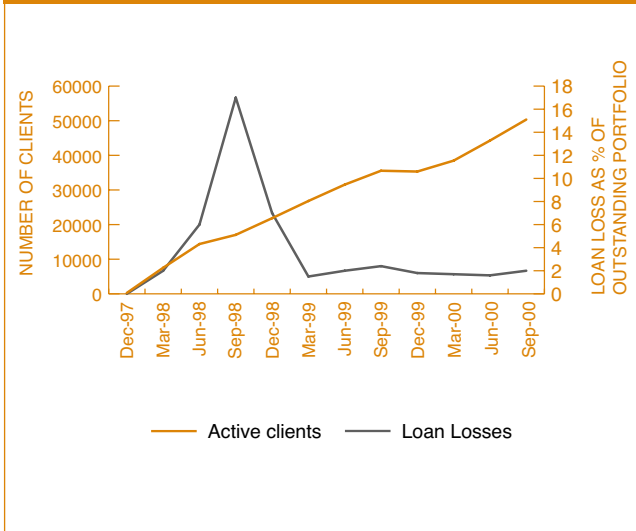


Fig. 2: Growth in Loan Offices and Branches



Fig. 3: CrediAmigo and Brazil Inter-Bank Loan Rates (Annual)

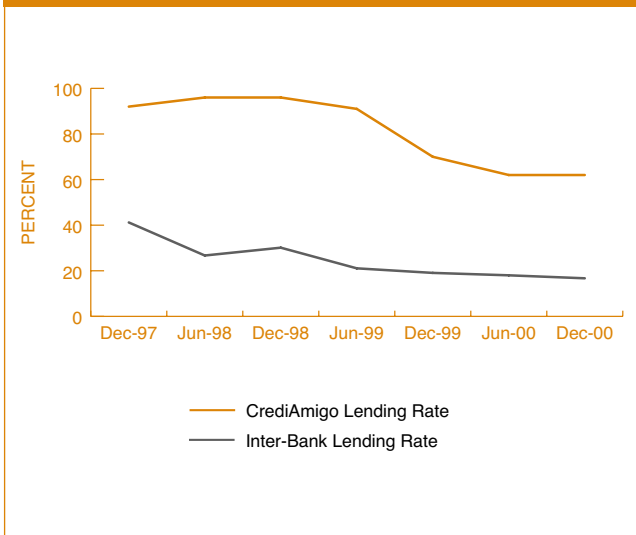
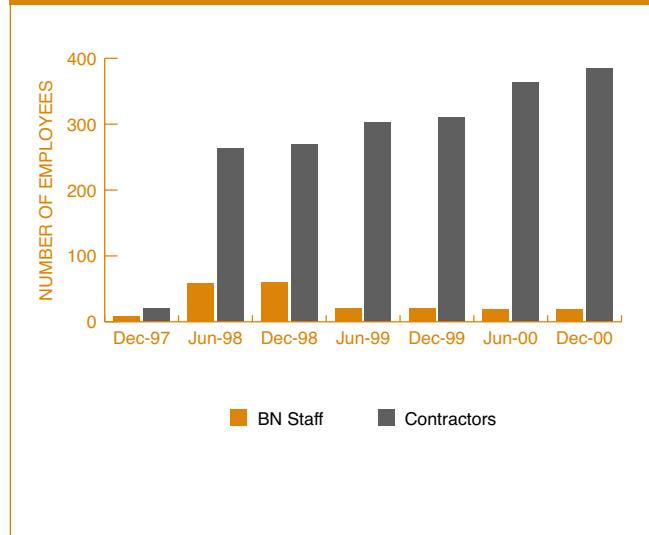


Fig. 4: CrediAmigo Employees by Source



Since then the interest rate has declined in proportion to the cost of funds in Brazil, but it has remained at levels consistent with achieving early profitability (figure 3).⁸

- Sustainability required a high-productivity model with low costs and an institutional culture that would be difficult in a large public development bank. BN cre-

ated a “bank within a bank,” first by outsourcing loan officers, and then by replacing BN staff branch managers with coordinators drawn from the loan officer pool (figure 4).

- Branches were evaluated as individual profit centers. But to maintain the benefits of scale in managing information, innovation, and human resources, BN

strengthened CrediAmigo's Central Technical Units and invested heavily in the management information system to permit better central monitoring of loan officer and branch performance.

- BN's nontraditional management style has always involved many top managers in decisions relating to the program. While it takes a significant effort by CrediAmigo staff to keep a large number of very busy managers educated about the special requirements of microfinance, it also wins a surprisingly high degree of buy-in for CrediAmigo, considering that the program barely affects the bottom line of such a large bank.
- Support from the BN's president has never wavered, nor has there ever been a question about whether the program should be run in a highly professional, non-political manner. The decision to expand prematurely was made for strategic rather than political reasons, and was driven by overconfidence, rather than a lack of concern for loan repayments.

Further challenges

As CrediAmigo's portfolio improved, BN was left with the challenge of managing an expanding microfinance business. With support from the Japanese funding, the CrediAmigo Central Technical Unit developed an incentive scheme for loan officers under which bonuses were tied heavily to repayment performance. The funding was also used for extensive training modules and for improvements in the portfolio information system.

Following an identification mission for a proposed loan, the World Bank hired external consultants to assess the CrediAmigo program. They found that although overall program performance was improving, the program continued to vary in performance among branches and loan officers, with a few top performers

compensating for the generally mediocre performance by the rest. The consultants thought this was a result of too much decentralization, but loan officers convinced CrediAmigo's Central Technical Unit that it was a result of market resistance to the solidarity loan product, with the result that the program began considering a move to individual loans.

Concerned with CrediAmigo's inability to achieve consistently sound performance program-wide, the World Bank again delayed loan preparation, and asked CGAP to provide direct technical assistance on key issues. The Bank's decision to proceed further with the loan would depend on BN's success in solving performance problems.

A CGAP review in November 1998 recommended that CrediAmigo management maintain the current loan product, simplify the incentive system, and increase focus on several key variables related to loan officer productivity, particularly new clients per loan officer per month (figure 5). The World Bank and CGAP returned to Brazil after five months and found that CrediAmigo's management had made good faith efforts to implement CGAP's recommendations and that portfolio quality and productivity were improving. Based on these results, the World Bank agreed in May 1999 to proceed with the preparation of a loan to support the program's expansion.

Finally, the World Bank makes the big loan

Because of the World Bank's historical knowledge of the CrediAmigo program, and the high quality of CrediAmigo's information systems, the Bank needed only a single preparation/appraisal mission to prepare a US\$50 million loan to support the program's expansion over the next five years.⁹ The mission agreed with BN management on performance targets that kept the loan

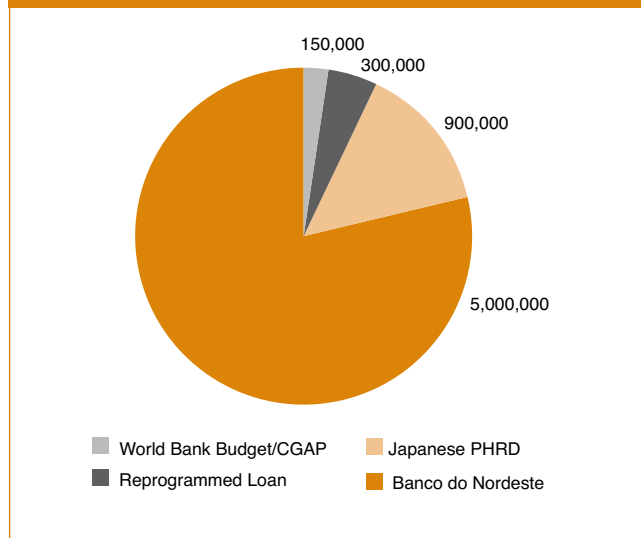
Fig. 5: CrediAmigo Staff Productivity



and its disbursement tied to portfolio quality, efficiency, and sustainability. The World Bank’s involvement with BN had looked very risky two years earlier; but by the time the large loan was prepared, the risk had lessened dramatically, because BN now had a proven micro-finance business and had demonstrated the management commitment needed to keep that business sound as it expanded.

The World Bank’s Board of Directors approved the loan in May 2000. As was the case throughout the BN-World Bank relationship, the loan agreement left BN with full control of, and responsibility for, the operations by which the targets were to be achieved. An annual external review would be contracted, permitting the World Bank to limit its direct intervention to assistance with administration of its loan (procurement and disbursement management) and assistance in developing an impact evaluation program to be carried out by a separate department of BN. As the World Bank’s role became more narrowly defined, CGAP’s role evolved from one of support for the World Bank in its relationship with BN to a more direct advisory role to BN focused on program strategy and capacity building.

Fig. 6: Funding for Development of CrediAmigo (US\$)



Reflecting on the elements that led to success

The activities most critical to CrediAmigo’s development into a world-class microfinance program included conceptualization, design, piloting, and initial consolidation. The most notable aspect of these activities is that they required limited external funding and occurred before any disbursements from the World Bank loan. Though these processes required significant investment from BN over almost three years, external as-

⁹ In fact, BN could have funded the five-year expansion from its own resources. The World Bank loan was still attractive to the Brazilian Government because it brought in needed foreign exchange.

sistance costs were relatively low. From 1996 to the loan appraisal in 1999, the World Bank spent about US\$150,000 of its own budget, including the costs of participation in the initial seminar, short (usually two-day) observation missions, the Boulder training, one identification mission and the project appraisal mission. CGAP provided about US\$50,000 of technical support, including its own staff time and external consulting. BN received US\$1.2 million in external financial assistance (US\$300,000 of reprogrammed funds from a prior World Bank loan and US\$900,000 from the Japanese). It spent about US\$5 million of its own funds on the salaries of the BN personnel who designed the program, training costs, full financing of the loan portfolio, and accumulated losses including the US\$2 million write-off of bad loans (figure 6).¹⁰

The BN experience suggests that donors may need to be opportunistic rather than dogmatic in their approach to microfinance. At first the World Bank was reluctant to support a large state-owned development bank, even one that had undertaken significant internal reforms. But the demonstrated strength of BN senior management's commitment, along with a pressing need to develop substantial microfinance retail capacity in the northeast region, and the Inter-American Development Bank's "preemption" of the NGO arena, all combined to persuade the World Bank to take a risk and support CrediAmigo. Though the Bank was advised to withdraw its support, particularly after the ill-advised expansion in 1998, the clear commitment of BN's senior managers to develop a world-class program kept the World Bank engaged.

In comparison with other recipients of donor support, managers of competent banks are particularly skeptical of, and resistant to, technical advice from

donors or from consultants selected by donors. Recognizing this, the World Bank team limited its direct role to providing focus rather than technical advice. Nevertheless it took the unusual step of investing in a three-week training program for two of its key staff. In retrospect the team members felt that this training was critical to the success of the engagement. Recruiting outside experts is important but cannot substitute for the role of a donor's staff as the authoritative interlocutors for their institution. Donor staff lacking some basic technical literacy in microfinance will not usually be able to identify good consultants or use them well, and may not have the credibility that is essential for an effective dialogue with the implementing institution.

The most important contribution of World Bank management was its patience in allowing development to proceed at its own pace. The process of developing, piloting, and consolidating the CrediAmigo program, particularly with the need to recover from the early rapid expansion, took three years before a loan was appraised. This required exceptional patience from the World Bank's country management in Brazil, which was under pressure from various sources to move more quickly with the loan. Although there was some consideration of moving more quickly with a smaller

¹⁰One can argue that BN did not need to spend this amount of money, that it could have achieved the same results with a third of the up-front investment. But perhaps these types of "mistakes" are normal parts of working through very large institutions. The alternative might have been heavy-handed (and expensive) technical assistance, which the Brazilians would not have accepted. There is evidence of banks that have spent far less, such as the Banco del Estado in Chile, which made virtually no mistakes after spending a few years looking for the right model, and banks that have spent far more, such as Bank Rakyat Indonesia, which had to turn around the performance of 3,500 branches.

loan, management continued to support the task team's assessment of the program's readiness for a major World Bank loan.

As a result of this patient approach, a larger loan was provided with less risk of undermining the program's focus on sustainability. The initial development process allowed BN to develop its expertise and confidence in managing a large microfinance program. Even the early missteps, based completely on BN decisions with consequences financed by BN resources, were an important element in establishing the program's low arrears culture in a public bank environment. BN's success in resolving its early problems and developing a sense of how to manage the trade-off between growth and portfolio quality without the pressure of disbursing a World Bank loan has brought the program to a level where neither BN nor the World Bank see the US\$50 million loan as an incentive to "supply-led growth."

The CrediAmigo experience suggests that the World Bank and other multilateral donors can play a catalytic role in microfinance development if they:

- Pursue the best available opportunities in a country rather than impose a universal model (all capacity-building approaches involve substantial risks).
- Allow programs to develop their capacity to manage growth with portfolio quality before providing significant funding for program expansion, even when this may delay lending targets (the biggest constraint to the spread of microfinance services is a shortage, not of funding, but rather of competent retail capacity).
- Limit donors' technical role to setting benchmarks consistent with international best practice and putting institutions in contact with top microfinance practitioners.
- Ensure that donor staff working with MFIs have a grounding in the basic elements of sustainable microfinance, preferably through training or at least close work with high-quality specialists.
- Maintain focus on program objectives rather than on short-term performance issues and the missteps that are inevitable during program development, especially in large organizations.

Focus Note No. 23

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