Why microfinance institutions in Bolivia have virtually ignored savings

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The Private Financial Fund is a category of regulated microfinance institution (MFI) in Bolivia that is allowed to accept deposits from the public. This article examines Bolivia's four main regulated MFIs – BancoSol, Caja Los Andes, FIE and Prodem – and finds that they have mobilized few deposits compared to banks, or compared to similar institutions elsewhere. It suggests that the availability of cheaper and easier donor funding is a disincentive to raising capital from depositors, and explains the internal obstacles to savings mobilization on the part of the MFIs. Recommendations for reform are suggested, in view of the fact that all regulated MFIs in Bolivia are likely eventually to become licensed banks.

WITHOUT A DOUBT, savings mobilization is costly and risky. Since non-bank microfinance institutions (MFIs) struggle to control costs and are highly risk averse, many have preferred to recapitalize their loan portfolio with abundant 'easy money' such as donor funds and concessionary loans. This is a seemingly logical business decision. However, some MFIs in Bolivia are now beginning to realize that, while savings services seem to be more costly and risky relative to other sources of financing, they are handicapping themselves by not developing robust deposit-taking services and the systems to support them.

The benefits of savings mobilization to the institution are plentiful:

Savings mobilization increases customer loyalty

- Public deposits provide a sustainable source of funding for a financial institution. Savings mobilization increases customer loyalty by creating a relationship of reciprocal confidence.
- Savings mobilization instils greater discipline in the institution as the risks are much higher.
- Financial intermediation requires outstanding customer service, since the institution is trying to win the confidence of its clients.

For poor clients, the benefits of savings mobilization are also vast, including the following:

- Institutional deposit services provide clients with a safe and liquid means by which to save.
- Access to deposit services allows the poor to earn positive returns on excess liquidity, and to lower their transaction costs when they are able to save in and borrow from the same institution.

Despite these positive effects, regulated MFIs in Bolivia have moved very slowly to mobilize deposits from the public. To explain the different types of MFI in Bolivia: private financial funds (FFPs) are regulated financial institutions that are permitted to capture savings but prohibited from other banking transactions, such as conducting foreign trade or

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international transfers. There are several microfinance FFPs and several FFPs that act as housing brokers (not exclusively microfinance). Among the regulated MFIs discussed in this paper, three are FFPs (Prodem, Caja Los Andes and FIE) and one, BancoSol is a commercial bank. FFPs capture only 3.5 per cent of total savings deposited in the financial system, while banks capture 85 per cent. Perhaps even more revealing is the number of liquid savings accounts per institution type. The regulated MFIs (Caja Los Andes, FIE, Prodem, and BancoSol) claim 10 per cent of the existing market for liquid savings accounts, while banks, credit unions and '*mutuales*' reported 38, 29 and 23 per cent, respectively.

Only about 68 per cent of BancoSol's loan portfolio is financed by savings

Most importantly, the regulated MFIs are still dependent on donor funds or concessionary loans for funding. About 68 per cent of BancoSol's loan portfolio is financed by savings; Caja Los Andes, 58 per cent; FIE, 48 per cent. Compare these with three other mature deposit-taking institutions in other countries – Banco Caja Social (Colombia), BRI (Indonesia), and Rural Bank of Panabo (Philippines) – all of which report a savings-to-loan ratio of between 70 and 90 per cent. Among the Bolivian deposit-taking MFIs, Prodem has the highest savings-to-loan ratio with slightly more than 77 per cent of its loans financed by deposits.

In the light of these statistics, this article poses a simple question: why have the Bolivian regulated MFIs been slow to mobilize savings in any significant way? Principally, there are three reasons:

- The abundance of 'easy money' from donors (as well as the Bolivian Government and second-tier institutions) has created a powerful disincentive to mobilize savings, since savings are more expensive to mobilize and risky than concessionary loans or grants.
- The MFIs have not cultivated an image for themselves as solvent, reliable deposit-taking institutions.
- Finally, the regulatory environment in Bolivia impedes deposit-taking among the poor and in rural areas.

The regulated MFIs lack the image required to mobilize savings on a large scale

In the next five to ten years, it is highly likely that the regulated MFIs will either transform into commercial banks, or enter into a merger with a transformed, regulated MFI, so that only full-fledged microfinance banks will be operating in the market. This is the logical result of the evolution of the microfinance industry. The legislation that created the FFPs sought to allow microfinance NGOs to transform into regulated institutions that could accept deposits without the hurdle of a high capital reserve, but would not be permitted to conduct all the transactions permitted of a bank (e.g. checking accounts). The regulated MFIs are now finding, however, that they lack the image required to mobilize savings on a large scale.

While the subject of this paper is the Bolivian microfinance market, the lessons to be learned are applicable to almost any microfinance institution that mobilizes savings. The Bolivian experience may very well be a harbinger of pitfalls and perils in other markets.

The 'easy money' paradox

While a protracted macroeconomic crisis in Bolivia has certainly hindered the growth of savings mobilization at all socio-economic levels (see later section), another perilous impediment has been the steady inflow of donor funds – especially those earmarked for loan portfolio capitalization – which has indirectly or directly thwarted deposit services for low-income clients. The quantity and asymmetry of subsidies has introduced damaging distortions into the Bolivian microfinance market,

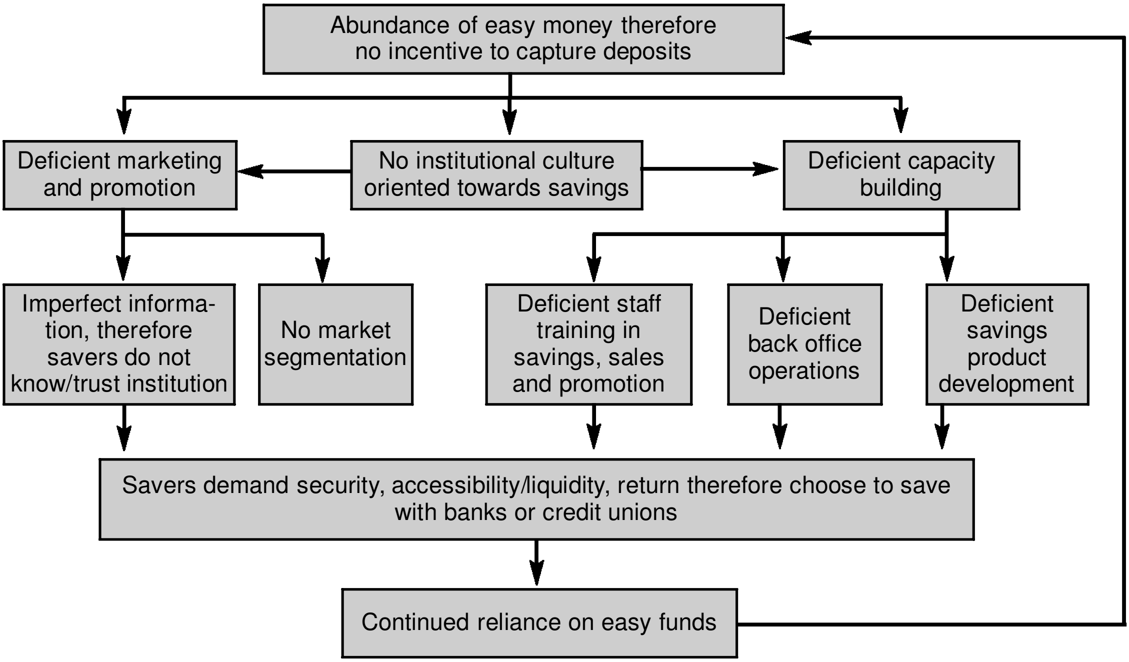

Figure 1. The vicious cycle of weak savings mobilization

particularly for the growth of savings mobilization. There are two principal effects of these subsidies on savings mobilization:

> Donor funding is easier and cheaper than mobilizing savings

The 'easy money' effect. Regulated MFIs that are permitted to capture savings choose not to promote their deposit-taking activities because they have nearly unfettered access to easier, and often cheaper, sources of capital through the donors. These funds come in the form of (interest-free) direct grants, concessionary loans, or subsidized technical assistance. As long as there is 'easy money', there is no reason to invest in training, marketing and product development in order to generate sound financial intermediation practices on a large scale. Without the capacity to mobilize savings, MFIs then continue their reliance on 'easy money' (see Figure 1). This same effect has been found Thailand and Mali in which institutions with access to 'easy money' had low savings-to-loan ratios (Wisniwski, 1998). There is an administrative cost implied in all forms of donor financing, but the financial cost is lower than mobilizing deposits.

Unfair competition effect. Asymmetrical subsidies reduce the profitability of those MFIs that are not equal recipients of these funds, which are at times the most robust institutions (González Vega, 2002). If a regulated MFI operates in the same market as heavily subsidized NGOs, the regulated MFI – which is often more risk averse than its non-regulated counterpart since it has to answer to private shareholders – is then forced out of the market and tends to retreat into familiar markets and products, mainly credit. In the long run, therefore, these subsidies thwart the expansion of the financial frontier into under-served markets and into underdeveloped product areas such as savings. When it is the deposit-taking institution that benefits from donor funding, the result on savings mobilization is the 'easy money' effect.

It is important to clarify that it is not desirable for financial institutions to rely completely on savings for on-lending. Other sources of financing, such as lines of credit and bond issues, are critical to the health of a financial institution. These other sources of funds allow the MFIs to diversify risk, and provide longer-term loans, such as loans for investment in fixed assets or housing loans. Finally, institutions cannot meet the demand for credit with public deposits alone, and second-tier banks and donors are able to fill these gaps and allow institutions to diversify risks. The term 'easy money' in this document refers mainly to the abundant below-market financing that has allowed the regulated MFIs to virtually ignore savings mobilization as another critical source of liquidity.

Between 1995 and 2002, almost US$60 million in donor funds flowed to microfinance institutions through FONDESIF (Fondo de Desarrollo del Sistema Financiero y de Apoyo al Sector Productivo), which is a decentralized public entity originally created in September 1995 to inject equity into those commercial banks at risk of bankruptcy.

To date, about 86 per cent of funds that have flowed through FONDESIF since 1995 have been dedicated to recapitalizing loan portfolios through loans and lines of credit. About 15 per cent of FONDESIF loans for portfolio capitalization carried an interest rate of 3 per cent or less, as compared to 4.5–5 per cent for similar commercial loans. Almost 30 per cent of FONDESIF loans had an interest rate of 4 per cent or less. Appropriately, the loans to the regulated MFIs for loan capitalization were at or above market rates. However, FONDESIF encourages non-regulated MFIs to expand financial services with concessionary loans, and discourages regulated MFIs from competing in the same markets since their financial costs are higher. When regulated MFIs are pushed out of certain markets because of unfair competition, there are fewer options for deposit services in those markets. In the end, depositors suffer because they have fewer choices of institutions, and in some cases, are faced with a monopolistic provider.

Regulated MFIs have been pushed out of certain markets because of unfair competition

Even allowing for the interest rate, 'easy money' from apex institutions and donors implies lower administrative costs than deposit mobilization. Clearly, it is cheaper to administer one loan from a single institution than to mobilize savings from thousands of clients and to invest in the product development, marketing, and administration required in order to support the savings products.

Donor funding involves lower administrative costs than deposit mobilization

Despite the deleterious effects of 'easy money', there remains an appropriate role for subsidies and second-tier banks in the development of sustainable financial institutions. Subsidized credit to MFIs should only be provided when MFIs are in their infancy, as well as in challenging environments where the problem is not competition but, rather, that no institutions can afford to work there.

MFIs' internal barriers to entry

When it comes to successful savings mobilization, the regulated MFIs have, in some ways, been their own worst enemy. There are two principal areas in which the regulated MFIs have faltered in terms of developing robust financial intermediation services: transformation to a regulated institution, and investment in capacity building.

Transformation to a regulated institution

The transition from an NGO to a regulated MFI carries with it a burden specific to the mobilization of deposits. Often, the new entity must overcome its image as a credit-only institution, and redefine itself as a solvent,

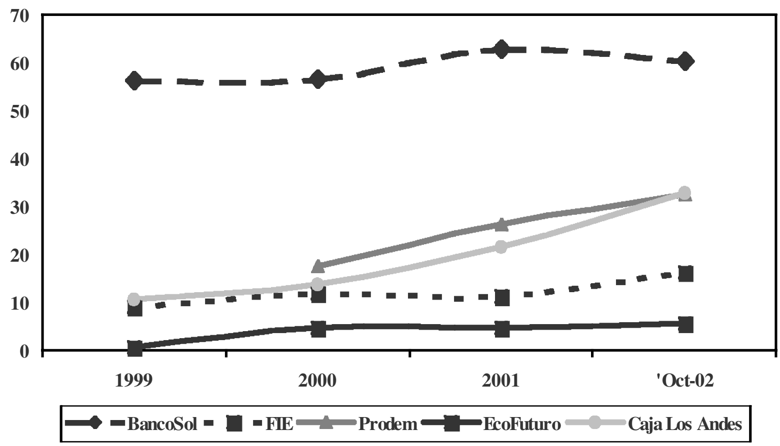

Figure 2. Evolution of deposits among Bolivian MFIs (US$ millions)
Source: Superintendence of Banks, Bolivia.

reliable financial intermediary. All three FFPs considered in this study underwent a transformation from an NGO to a regulated institution, and as a result are not considered to be as reliable as banks by depositors. The only MFI that earns higher ratings among clients in terms of image and perception is BancoSol, because it is a fully fledged commercial bank. The positive externalities of 'Banco Prodem' instead of 'Prodem FFP', for example, in terms of their image as a solvent institution are immense.

By contrast, the '*mutuales*' began as deposit-taking institutions, in which depositors are motivated by the promise of a housing loan. This strategy has been tremendously successful for the *mutuales*, and has generated strong customer loyalty. In addition, the credit unions have offered savings services since their inception – in fact, deposit mobilization is a key part of their philosophy – and have fostered an almost evangelistic zeal among their members. Many began as social programmes of the Catholic Church, which is partially the root of this fervour.

The FFPs cannot compete with the *mutuales* or the credit unions in terms of client fidelity. Under the Bolivian banking law, FFPs fill a perceived institutional gap between an NGO and a commercial bank. FFPs are permitted to capture and mobilize public savings, and therefore are regulated by the Superintendence of Banks and Financial Entities (SBEF). FFPs have a lower capital requirement than commercial banks, but are not permitted to finance foreign trade or conduct international wire transfers (without a partnership with a licensed institution). Few clients understand the institutional form of an FFP, and assume it is less trustworthy or solvent than a bank.

Credit unions have offered savings services from the start, and benefit from strong customer loyalty

Only recently have the FFPs begun to take steps to revamp their operations and image in order to attract savers. Prodem and Caja Los Andes have begun to overhaul their operations and refurbish their images to become trusted savings institutions. Transformation to a commercial bank may help here: it would allow Prodem and Caja Los Andes to benefit from the image of solvency and reliability that is associated with the word 'bank'. Failure on the part of Prodem and Caja Los Andes to nurture their corporate image now will severely handicap their ability to compete effectively for the hearts and minds of depositors large and small when these institutions dive into the larger pond where bigger fish abound.

Investment in capacity building and organizational development

A large share of assets must be held in liquid investments

While failure of a credit-only institution can have damaging effects on the financial sector of a country, the loss of public savings (without a bailout) is almost certainly disastrous. For this reason, a deposit-taking institution must have sound risk management and liquidity management. This is especially true for MFIs that serve the poor, given that low-income households with high liquidity preference demand savings accounts that are easily accessible, that do not restrict withdrawals, or that do not require high minimum balances. Empirical evidence from BancoSol and Cajas Municipales in Peru has indicated that due to the high volatility of small deposits, a large share of assets must be held in liquid investments, which are very volatile and thus impose a high degree of liquidity risk on the MFI (Fiebig, et al., 1999).

The most successful institutions offered interest rates that increased with the savings account balance

Product development has also lagged far behind the loan products. While all the FFPs have relatively sophisticated credit products based on comprehensive research and market segmentation, on the whole the savings products remain rudimentary. None of the FFPs, for example, offer differentiated prices in different markets. Each FFP has a standard menu of interest rates on its products and all branches, rural or urban, offer the same rates on the same products.

In a study of six deposit-taking MFIs in Asia, Africa and Latin America, Sylvia Wisniwski found that the most successful institutions offered interest rates that increase with the savings account balance (1998). 'Low savings balances are exempted from interest payments in order to partially compensate for higher administrative costs of very small accounts'.

Some argue that the FFPs should consider increasing the interest rates on savings in order to attract more deposits. Currently, the regulated MFIs offer interest rates from 3.9–5.7 per cent on fixed deposits from 30 to 370 days. The banks on average offer interest rates of 3.2–5.6 per cent on fixed deposits with the same terms. It is only logical that the regulated MFIs pay a premium to attract and maintain depositors given their risk profile and image. While the most compelling point of competition for the FFPs is customer service, competitive pricing is an under-utilized tool among the FFPs when vying for the loyalty of depositors.

Another aspect of the product development process that has faltered is marketing. Successful savings mobilization depends upon the depositor perceiving not only that the institution is solvent but also that the products are suitable, and this requires meticulous market research (see Figure 1). All the FFPs except FIE have in-house marketing staff, but branding and the promotion of savings products remain weak. Very few regulated MFIs label their various products. Trade marks and product labels are often highly effective in attracting depositors because it is easier for depositors to select the product that is right for them (Wisniwski, 1998).

The cost barrier

The cost of mobilizing savings in Bolivia is compounded by the following factors:

- low population density outside the main cities;
- the poverty of most potential clients;
- the small size of their transactions; and
- the risks associated with the business activities of marginalized clients.

These factors impede the provision of virtually all financial services, but make the costly enterprise of savings mobilization even more costly. There is very little empirical evidence on the precise cost of mobilizing savings within an MFI, but in the case of the Cajas in Peru, Fiebig et al. (1999) found that administrative costs were estimated to be 10 per cent p.a. of the average savings deposit volume, and 40 per cent p.a. for savings deposits below US$500. Most of the costs incurred are fixed overheads; therefore, the mobilization of high volumes of small deposits is more costly than the mobilization of large deposits. However, other institutions, such as Bank Rakyat Indonesia (BRI) have made a success of their Unit Desa system by relying on an extensive decentralized branch system to support the mobilization of simple savings products on a massive scale. BRI has demonstrated that deposits can be a viable source of financing that generates other positive externalities such as customer loyalty resulting from the provision of safe, profitable deposit services, and opportunities for cross-selling asset products, among others. Presumably, the Cajas in Peru could lower costs by increasing both the volume and the size of the savings accounts i.e. achieving economies of scale and scope.

Savings products need to increase scale and scope before they become profitable

While the cost data in Bolivia is preliminary, the results to date show administrative costs of savings mobilization around 15 per cent of average deposits for liquid savings accounts. (This represents an average of the estimated costs provided by several regulated MFIs in Bolivia). Of course, the more liquid deposits demanded by the poor are more costly because of the frequency of transactions, and more expensive than borrowing in the commercial sector. However, given that the FFPs only mobilize 3 per cent of deposits in the market and have savings-to-loan ratios of 50–60 per cent, they have yet to achieve economies of scope and scale that will permit them to lower administrative costs as a percentage of total deposits.

External barriers to entry

The institutions themselves are not the only ones to blame for weak financial intermediation among low-income Bolivians. There are three principle external barriers to entry for the MFIs: the macroeconomic crisis, telecommunications, and the regulatory environment.

Macroeconomic crisis. Bolivia has endured a protracted macroeconomic crisis that has hurt all sectors of the economy. The principal causes of the crisis are both the worldwide economic slowdown and regional macroeconomic collapse (e.g. external debt default in Argentina and devaluation of the Brazilian Real, etc.) that have reduced demand, a subsequent fall in the international terms of trade and climatic changes that have negatively affected crop production.

Inflation has remained very low (2.45 per cent in 2002), illustrating the trend in the last few years towards increased price stability. However, some of the forces behind the low inflation are at the root of the poor macroeconomic performance, namely the contraction of internal demand, and the nominal depreciation of the national currency.

MFIs cannot submit daily financial reports in areas where there are no telephone lines

Telecommunications. Less than 1 per cent of the population of Bolivia has a fixed telephone line in their homes (Benoit, 2002) and more than one-third of the 304 microfinance branches throughout the nine departments of Bolivia, has no access to traditional telecommunication services. Regulated entities, which are required to submit daily financial reports to the Superintendency of Banks, simply cannot operate in regions where there are no telephones. In addition, clients increasingly demand complementary services along with savings accounts, such as transfers and remittances, which are also dependent on telecommunications. The poor telecommunications coverage in Bolivia severely impedes the geographic expansion of financial intermediation services outside the main cities.

Regulatory environment. Despite the sophisticated nature of Bolivian norms and regulations that govern microfinance, there are several factors in the regulatory environment that impede financial intermediaries from mobilizing savings, particularly among the poor and in rural markets.

The tax effectively penalizes informal workers for depositing their savings

The government imposes value-added tax (IVA) of 13 per cent on the interest earned on savings. 'Formal' clients – those who have registered with the government and have been assigned a tax identification number – are able to claim a tax rebate at the end of the fiscal year. However, most poor clients are 'informal' and do not have an identification number, therefore they are not eligible for a tax refund. The tax effectively penalizes informal workers for depositing their savings.

In addition, the Superintendency compels regulated institutions to require an official ID card from clients wishing to open a savings account. For many 'informal' poor, they either do not have an ID card or the card has expired.

Conclusions

While savings mobilization among the regulated MFIs is on the rise, these institutions have a long way to go in order to compete for the confidence of depositors. This is especially true for those institutions that seek to become fully fledged commercial banks. There are several steps at the level of the MFIs, the government, and the international donor community that need to take place in order to facilitate the development of robust deposit-taking microfinance banks.

At the institutional level, first and foremost there must be a commitment to capture savings, and to diversify away from soft money toward deposits in the capital base of the MFI. Without this commitment, attempts at savings mobilization will fail. Secondly, MFIs must invest in human and financial resources:

- *Market intelligence.* MFIs need to conduct comprehensive market research in order to design demand-driven products; and they must design targeted marketing and promotion strategies for the products.
- *Risk and liquidity management.* As regulated MFIs diversify their sources of funds to include a higher proportion of deposits, they require rigorous monitoring of their cash-to-asset ratio as well as a range of risks, including liquidity, credit, inflation and political risk.
- *Training.* The regulated MFIs need to build a human resource base that is: knowledgeable in the savings products and services; committed to exceptional customer service; and trained in cross-selling.

The government, especially the Superintendency of Banks, will also play an important role in facilitating savings mobilizations by the regulated MFIs, especially among the poor. The SBEF and the legislature need to consider and enact the following reforms:

Savings could be made in the branch of a non-regulated MFI and deposited with regulated MFIs

- Relax the reserve and reporting requirements for branches in rural areas that maintain total deposits below a pre-determined threshold.
- Support strategic alliances between regulated and non-regulated entities, whereby the regulated institution captures savings in the branch of

a non-regulated institution. This is a low-cost way of expanding deposit services into under-served markets.

- Eliminate the 13 per cent value-added tax on interest earned. This tax serves as a powerful disincentive for the poor to save.
- Deposit-taking institutions should be permitted to accept an ID number of a client in order to open an account, regardless of whether the card is expired.

Finally, the international donor community must make important reforms in its strategies in order to lift the impediments to savings mobilization that, paradoxically, restrain the financial institutions.

There continues to be an appropriate role for subsidies even in highly competitive and developed microfinance markets such as Bolivia. However, the use of subsidy must be more narrowly and strategically defined than it has been in the past:

In competitive markets, donor funds should not be directed towards the recapitalization of loan portfolios

- In competitive markets, donor funds should not be directed towards recapitalization of loan portfolios. Instead, subsidies should be provided for institution building, such as human resource development and financial management. However, even this type of support must take into account the unfair competition effect that the subsidies may have in the market.
- Donors and industry leaders should develop benchmarks to determine when institutions are in their infancy or operating in environments where subsidies might be appropriate.
- Subsidies should also be used to support policy dialogue and regulatory reform in order to create an environment that is conducive to savings mobilization by non-bank institutions among the poor.
- The donor community should take an active role – through policy dialogue and direct financial injections – to develop strategic alliances between regulated and non-regulated institutions. These alliances are new but promising solutions to overcome the high costs of savings mobilization in peri-urban and rural areas.

In sum, there is still a need for donor funding to be made available for loan portfolios. However, these funds must be priced appropriately, which means at rates at or above deposit rates with similar terms. The pricing of these funds must be set in order to avoid the creation of powerful disincentives for deposit mobilization.

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