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Latin America and Caribbean Region
Sustainable Development Working Paper No. 12

Microfinance Prospects in Brazil

September 2001

Steven N. Schonberger

The World Bank
Latin America and Caribbean Regional Office
Environmentally and Socially Sustainable Development
Sector Management Unit
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This working paper series is produced by the Environmentally and Socially Sustainable Development Sector Management Unit of the Latin America and Caribbean Regional Office. Paper No. 12, *Microfinance Prospects in Brazil*, was produced in conjunction with the Brazil Country Management Unit.

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Cover: Microfinance Clients in Brazil

Photos courtesy of Banco do Nordeste

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Abbreviations and Acronyms

Note: All organizations and terms listed in italics are Brazilian

BNDES	*Banco Nacional de Desenvolvimento Econômico e Social* National Bank for Economic and Social Development
CAS	country assistance strategy
CEAPE	*Centro de Apoio aos Pequenos Empreendimentos* Center for Assistance to Small Enterprises
CGAP	Consultative Group to Assist the Poorest
FENAPE	*Federação Nacional de Apoio aos Pequenos Empreendimentos* (National Federation for Small Enterprise Support)
GDP	gross domestic product
IBGE	*Instituto Brasileiro de Geografia e Estatística* Brazilian Geography and Statistics Institute
IDB	Inter-American Development Bank
NGO	nongovernmental organization
OECD	Organisation for Economic Co-operation and Development
PNAD	*Pesquisa Nacional por Amostra de Domicilios*
PRODEM	Fundación para la Promoción y Desarrollo de la Microempresa (Bolivia)
PROGER	*Programa de Geração de Emprego e Renda* Development Program for Employment Generation and Income
PRONAF	*Programa Nacional de Fortalecimento da Agricultura Familiar* National Program to Strengthen Family Agriculture
SEBRAE	*Serviço Brasileiro de Apoio às Micro e Pequenas Empresas* Brazilian Small Enterprises Support Service
SDI	subsidy dependence index
TJLP	*Taxa de Juros de Longo Prazo* Official Long-Term Interest Rate

Currency units used in this paper are the Brazilian real (R$) and the United States dollar (US$).

Microfinance Prospects in Brazil

BACKGROUND

Brazil is the largest country in Latin America in terms of land area, population and gross domestic product (GDP), but is well behind most other countries in the region in the development of its microfinance industry.[1] This is particularly surprising given that Brazil has a large and dynamic microenterprise sector, and many microfinance practitioners point to Recife in northeast Brazil as home of the first "modern" microfinance organization in Latin America.[2]

The most common explanations for the slow growth of microfinance in Brazil are (a) the country's macroeconomic instability until fairly recently, (b) the "crowding-out" effect of subsidized government credit lines, and (c) legal and regulatory impediments faced by nonbank institutions. While all of these factors likely create constraints on microfinance development, international experience suggests that no single factor is sufficient to account for Brazil's relative lag in the supply of microfinance services. However the combination of macroeconomic stabilization, recent elimination of several restrictions on nongovernmental organizations (NGOs), reform of public banks to emphasize sustainability of operations, and proactive government programs to support the initial learning phase are providing the enabling environment required for rapid development of the microfinance industry in Brazil.

Basic Indicators

Brazil has the world's fourth-largest land area (8.5 million square kilometers), fifth-largest population (168 million), and eighth largest economy.3 It's GDP—more than US$750 billion in 1999—approaches that of China and is more than 50 percent greater than that of Mexico, the second-largest economy in Latin America. The Brazilian economy is highly diversified, with services and industry representing the highest share of GDP (Table 1). Agriculture represented only 9 percent of GDP in 1999 but is the basis of Brazil's important agroprocessing industry, which accounted for an additional 20 percent of GDP in 1997 according to the Brazilian Geography and Statistics Institute

Table 1. Growth Rate and Share of GDP by Sector in Brazil

Sector	*Share of GDP, 1999 (percent)*	*Average annual growth, 1990-99 (percent)*
Agriculture	9	3.0
Industry	31	2.7
Services	61	3.0
Total	100	3.0

Source: 2001 World Development Indicators. World Bank. Washington, D.C. 2001

1. For the purposes of this paper, microfinance is defined to include a wide range of financial services—including savings credit and payments—normally provided by banks and other regulated financial institutions. The emphasis in this paper is on the development of sustainable, or unsubsidized, microfinance programs rather than just the number of programs in existence or clients reached.
2. "*Projeto Uno,*" an NGO founded in 1973, was a predecessor of the current Center for Assistance to Small Enterprises (CEAPE) programs in Brazil.
3. Unless otherwise indicated, all figures in this section are from World Bank, *2001 World Development Indicators* (Washington, D.C.: World Bank, 2001).

(IBGE). Furthermore, food and agricultural raw materials constitute 34 percent of the value of Brazil's total exports.

While Brazil is a relatively prosperous country in overall terms, it has the dubious distinction of leading the Latin America region in number of people below the poverty line, and is a world leader in income inequality as measured by the Gini index. The poorest 10 percent of Brazil's population earns only 1 percent of national income, while the richest 10 percent receives almost 47 percent. While measures of poverty vary, the World Bank conservatively estimates the poverty rate in Brazil at 22 percent, or roughly 37 million people.

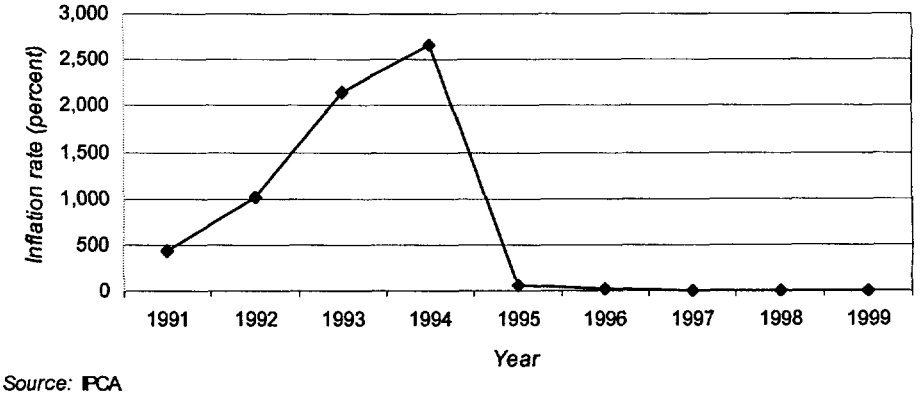
Poverty is not distributed equally throughout Brazil. The poverty rate ranges from 6.9 percent in São Paulo, to almost one-third in the Northeast Region. The Northeast accounts for only about a quarter of Brazil's total population and 20 percent of its land area, but is home to more than half of Brazil's poor.[4] Despite the much higher poverty rate in the countryside, rural and urban areas have about the same number of poor people due to Brazil's rapid urbanization.

Basic education remains a major challenge in Brazil and there is considerable inequity in educational expenditures. The Bank's 1997 country assistance strategy (CAS) for Brazil noted that annual spending on education can range from as little as US$130 per student to as much as US$1,000 per student. Although primary school enrollment has improved steadily—from just over 60 percent in the late 1960s to well over 80 percent today—high dropout rates result in low school completion. The enrollment rate for secondary school is only 45 percent in Brazil, compared to an average of 53 percent for the Latin America region and 60 percent for middle-income countries worldwide.

Macroeconomic Management

For many years Brazil was synonymous with high inflation. At its peak in 1994, annualized inflation reached 2,668 percent. Brazil was able to adapt to high inflation rates better than most countries through widespread indexation of prices. However, the additional costs to the economy of price instability and the inequitable burden of the "inflation tax" on the poor led the government to institute an aggressive stabilization program—the *Real* Plan—in mid-1994. The *Real* Plan introduced an exchange rate anchor within a fairly rigid band. This measure, combined with deindexation of the economy and tight credit and monetary policies, resulted in a rapid decrease in annual inflation to 10 percent by 1996 (Figure 1), a rate which has remained relatively stable to date despite the recent devaluation.

Figure 1. Annual Inflation in Brazil, 1991-99



Source: IPCA

4. World Bank, *Brazil: A Poverty Assessment* (Washington, D.C.: World Bank, 1995).

Economic stability contributed significantly to acceleration of the annual growth rate from almost zero in 1992 to an average of nearly 4 percent since 1994. International financial markets reacted favorably, with direct foreign investment increasing to US$9.2 billion in 1996 compared with US$1.3 billion in 1993. Spreads on new public borrowings declined from about 530 basis points more than U.S. Treasuries in 1993, to less than 200 basis points in 1997, and maturities lengthened significantly.

The *Real* Plan suffered its first serious test in late 1998, when the financial crisis in East Asia and Russia resulted in massive withdrawals of short-term foreign capital by investors fearful of a devaluation. To stem capital outflows the government allowed the *real* to float outside the band and initiated a number of reforms aimed at reducing the fiscal deficit. This swift action by the government appears to have stabilized the *real*, which lost about 36 percent of its value in early 1999, going from 1.25 to 1.95 *reals* per dollar.

The Informal Sector

High poverty rates and an open economy are generally consistent with large numbers of microenterprises. Nationwide statistics estimate there are almost 9.5 million microenterprises in Brazil, with over two million nonagricultural microenterprises located in the Northeast Region alone.[5] The Brazilian Small Enterprises Support Service (SEBRAE) uses a relatively broad definition of microenterprise—industrial firms with up to 19 employees, and service and commerce firms with up to 9 employees. According to this definition, as many as 90 percent of all firms are microenterprises (Figure 2), and they account for 35 percent of employment (Figure 3) and 16 percent of gross receipts. These "microenterprises" are most prevalent in commerce and services, where they represent 94 percent and 91 percent of firms, respectively (Table 2). But even if a stricter definition is used, defining microenterprises as being firms with up to four workers irrespective of sector, they still account for 46 percent of firms in the industrial sector, 78 percent in commerce, and 82 percent in services.

Figure 2. Distribution of Enterprises by Size of Firm

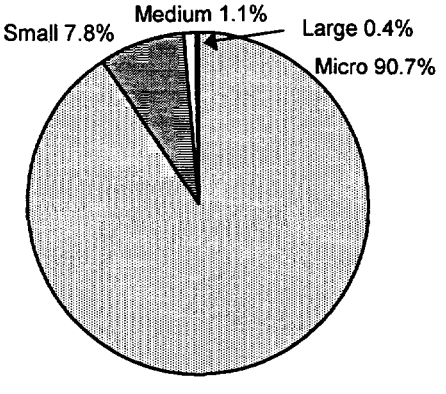
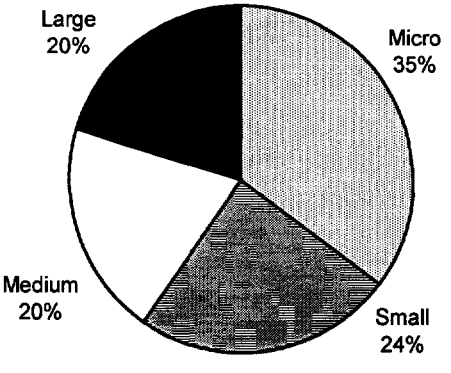


Figure 3. Share of Total Employment by Size of Firm



Source: SEBRAE 1997 based on IBGE – 1985 Economic Census

5. SEBRAE 1997 based on IBGE – 1985 Economic Census

It is not surprising, given its economic profile, that in the Northeast Region 61 percent of the economically active population works in firms with five or fewer employees. Small firm size is particularly prevalent in the agriculture, commerce, and services sectors (Table 3 and Box 1).

There is little information in Brazil to provide a profile of both microentrepreneurs and microenterprises. One survey that did cover both was carried out by the *Banco do Nordeste* in late 1997 as part of market research in preparation of its microfinance program *CrediAmigo.*[6] The survey included 1,381 interviews with microentrepreneurs in five locations throughout the Northeast Region, as well as interviews with key sources in the community (church leaders, police, merchants, etc.). The survey locations included two large state capitals (Recife and Fortaleza), a smaller state capital (São Luis), a medium-size commercial town in the interior (Picos), a smaller commercial town (Limoeiro do Norte), and an agricultural marketing town (Timbauba). The average number of workers, including the owner, in each microenterprise was less than two, suggesting that SEBRAE's larger size categories for microenterprises may not be at all representative of the informal activities normally supported through microfinance programs.

Table 4 summarizes the main survey results related to microentrepreneurs, of whom 77 percent worked in commerce, 15 percent in services, and 8 percent in production. The sample

Table 2. Distribution of Enterprises by Size and Sector in Brazil

Sector	*Share of firms by sector (%)*	*Composition of sector by size of firm (%)*				
		Micro [a]	*Small* [b]	*Medium* [c]	*Large* [d]	*Total*
Industry	15.0	81.3	13.7	4.4	0.6	100.0
Commerce	52.5	91.3	7.9	0.6	0.3	100.0
Services	32.5	93.6	5.4	0.5	0.4	100.0
All sectors	100.0	90.7	7.9	1.1	0.4	100.0

a. Microenterprises have up to 19 employees in industry or up to 9 employees in commerce or services.
b. Small enterprises have 20–99 employees in industry or 10–49 employees in commerce or services.
c. Medium enterprises have 100–499 employees in industry or 50–99 employees in commerce or services.
d. Large enterprises have more than 499 employees in industry or more than 99 employees in commerce or services.
Source: SEBRAE 1997 based on IBGE – 1985 Economic Census

Table 3. Share of Sectoral Employment by Firm Size in Northeast Brazil

Firm size	*Percent of total employment in sector*					
	Overall	*Agriculture*	*Manufac-turing.*	*Construc-tion*	*Commerce*	*Services*
1–5 employees						
Northeast Region	61	77	37	54	74	85
Brazil	*50*	*74*	*17*	*55*	*57*	*81*
6–10 employees						
Northeast Region	7	10	10	6	6	5
Brazil	*7*	*10*	*8*	*5*	*10*	*6*
> 10 employees						
Northeast Region	32	13	54	40	21	10
Brazil	*43*	*16*	*76*	*40*	*33*	*13*

Source: SEBRAE/PNAD—Pesquisa National por Amostra de Domicilios

6. Banco do Nordeste, "Relatorio de Sintese" in *Demanda por Microecredito No Nordeste Brasileiro* (Fortaleza: Banco do Nordeste—ETENE, September 1997).

Box 1. The Agricultural Sector as a Particular Case of Microenterprises

Defined on the basis of number of employees, agriculture is the sector with the greatest percentage of microenterprises. According to information from SEBRAE, micro and small agricultural enterprises primarily produce for subsistence purposes and for sale to intermediaries. The primary limitation to expansion of production, according to small farmers, is access to credit. The second limitation cited was lack of product marketing. Over 75 percent of small farmers surveyed indicated that they have no access to credit. To the extent it is available, small farmers are most likely to obtain financing from public banks, followed by loans from individuals and rural syndicates. Private banks and cooperatives are the least likely sources of credit.

Table 4. Social Profile of Microentrepreneurs in the Northeast Region

Location	*Male (%)*	*Average age*	*Family size*	*Native to locale (%)*	*Years in location*	*Education level* [a]	*Years in business*
Fortaleza	62.1	35	4	54.1	>5	First	10
Recife	62.7	33	4	76.4	>5	First	12
São Luis	56.9	32	5	43.8	>5	Primary	8
Picos	74.7	34	5	66.0	>5	First	9
Limoeiro do Norte	74.2	35	5	76.1	>5	First	8
Timbauba	56.7	45	5	83.1	>5	First	11

a. "First" refers to the *primeiro grau*—the eight years that constitute basic education in Brazil. "Primary" refers to *primário*, which are the first four years of the *primeiro grau*.

Source: Banco do Nordeste, 1997

included a surprisingly high proportion of men, which is inconsistent with many other countries where microenterprise activity is dominated by women.[7] Despite the common perception of the poor as transient in the Northeast Region, São Luis was the only location where the majority of those interviewed had migrated from elsewhere. Most microentrepreneurs had completed the first four years *(primário)* and at least part of the second four years *(ginasio)* of basic education in Brazil, though up to 11 percent said they were illiterate. Educational level did not vary with respect to gender, but there was some positive correlation between educational level and sales volume. Those who had established microenterprises tended to have lived in the location for more than five years, and generally had close to ten years experience in their business.

The survey also provides information on the origin and frequency of purchases and payments for stock and raw materials—important determinants of the potential savings in financial and transaction costs from use of an efficient, microfinance loan product. The majority of microentrepreneurs (over 80 percent) purchased their stock and raw materials from commercial suppliers in the same municipality. Only in the case of the rural market town, Timbauba, did a majority of businesses (57 percent) indicate that their purchases came from another city or state.

Table 5 shows that while the frequency of purchases demonstrated some variability between locations, payments for purchases were more consistently done on a cash basis. This suggests that

7. This may be explained by the fact that women entrepreneurs often work from home businesses which are not easily identified by an interviewer.

Table 5. Frequency of Purchases and Payments

	Frequency (percent of transactions at each location)				
Location	*Daily (Cash)*	*Weekly*	*Biweekly*	*Monthly*	*Other*
Fortaleza					
Purchases	27.5	35.1	14.3	19.9	3.3
Payments	*48.2*	*8.4*	*6.3*	*35.6*	*1.6*
Recife					
Purchases	18.5	25.6	9.4	40.1	6.4
Payments	*86.0*	*3.6*	*2.0*	*7.4*	*1.0*
São Luis					
Purchases	17.4	38.4	9.3	31.1	3.9
Payments	*81.8*	*4.4*	*2.4*	*7.1*	*4.4*
Picos					
Purchases	2.7	54.8	12.3	26.7	3.4
Payments	*100.0*	*0.0*	*0.0*	*0.0*	*0.0*
Limoeiro do Norte					
Purchases	4.7	39.5	5.8	48.8	1.2
Payments	*1.8*	*8.2*	*0.0*	*4.7*	*85.9*
Timbauba					
Purchases	5.0	43.3	15.0	28.3	8.3
Payments	*68.4*	*0.0*	*5.3*	*14.0*	*12.3*

Source: Banco do Nordeste, 1997.

supplier credit is unavailable or too expensive for most microentrepreneurs who finance their inventory with their own funds or by borrowing. In addition, since almost half of all microentrepreneurs purchase their stock on a daily or weekly basis, access to longer-term financing may reduce the transaction costs represented by the time spent traveling to and from suppliers. Except in the case of highly perishable goods, this time away from the business of selling represents a high, avoidable opportunity cost for the microentrepreneur.

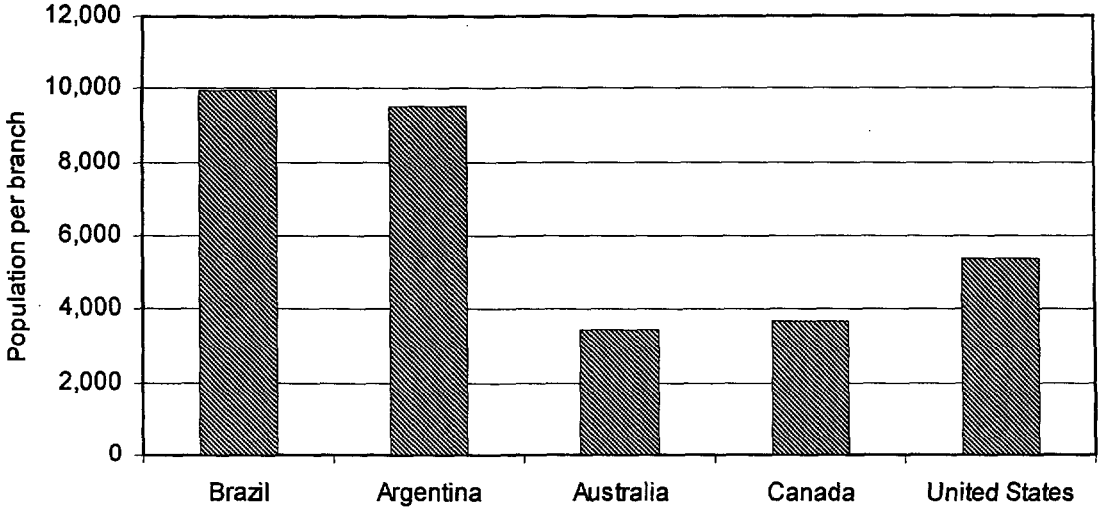
Frequency of sales and monthly cash flow provide a good indication of the ability of microentrepreneurs to potentially service a formal loan obligation. In the case of the microentrepreneurs interviewed, almost all of those in large cities (Fortaleza, Recife, São Luis) were able to turn over their inventory within a week. In the case of Picos, Limoeira do Norte, and particularly Timbauba, turnover tended to be much slower, requiring up to a month or more. In all locations October, November, and December were the months of greatest sales.

Access to Formal Financial Services

Compared to many of its Latin American neighbors Brazil is a relatively well-banked country both in terms of the geographical coverage of its retail infrastructure and the variety of financial institutions operating in the market. Brazil's financial sector is comprised of 223 banks and a total of 1,936 financial institutions authorized by the Central Bank, with combined assets roughly equivalent the country's GDP. Brazil's bank branch density is just under 10,000 inhabitants per branch, which is comparable to other upper-middle-income countries in Latin America, but well below that of OECD countries (Figure 4).8 These branches are divided between both private and public commercial and multiple banks, public savings banks, investment banks, and development banks (Table 6).

8. Bank branch density is becoming a less accurate indicator of access to financial services, which increasingly are provided through the internet, smart cards, and ATMs throughout both developed and developing countries.

Figure 4. Population per Bank Branch



Source: Calculations based on *World Development Indicators* and information from each country's Central Bank.

Table 6. Number of Banking Institutions and Branches by Type (August 31, 1999)

Type of Bank	*Institutions*	*Branches*
Commercial Banks	24	3,923
Federal Government Owned	2	2,986
State Government Owned	1	256
Brazilian Private	1	1
Brazilian w/Foreign Control	3	622
Foreign w/Brazilian Subsidiary	15	53
Cooperative	2	5
Multiple Banks	172	10,735
Federal Government Owned	4	982
State Government Owned	11	1,593
Brazilian Private	97	4,905
Brazilian w/ Foreign Control	46	2,446
Brazilian w/ Foreign Participation	14	809
Savings Banks	1	1,692
Federal Government Owned	1	1,692
Development Banks	5	8
Federal Government Owned	1	2
State-Government Owned	4	6
TOTAL	202	16,358

Source: Central Bank of Brazil

The number of branches declined between 1994 and 1998, reflecting the ongoing consolidation of the banking sector (Table 7). The reduction in branches has been uneven across regions, with the poorer regions of the North, Northeast, and Central West accounting for a disproportionate share of reduced banking infrastructure.

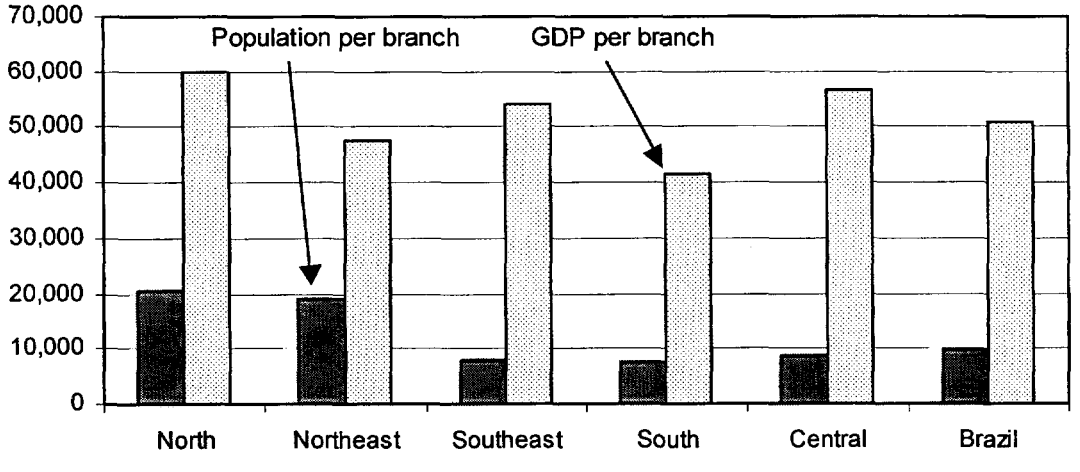
This has aggravated the interregional disparities in banking infrastructure, whose presence reflects economic activity more than population density. Figure 5 shows that from the public policy perspective of access to financial services as measured by the rough proxy of population per bank branch, the North and Northeast Regions are significantly underserved relative to other parts of Brazil. However from the commercial banker's perspective of potential funds intermediated as measured by the rough proxy of GDP per bank branch, the North and Central Regions may represent opportunities for profitable expansion of branches relative to the rest of the country, while the Northeast is relatively better served. This suggests that the opportunities for private banks to increase their presence in the Northeast are limited, unless they can significantly reduce their overhead and operational costs or identify lines of business with superior profitability to those in other regions.

Table 7. Bank Branches by Region

Region	*1994*	*1998*	*Percent change*
North	704	552	-21.5
Northeast	2,857	2,360	-17.3
Southeast	8,684	8,527	-1.8
South	3,724	3,363	-9.6
Central West	1,431	1,200	-16.1
Total	17,400	16,002	-8.0

Note: Figures as of December 31 of each year.

Figure 5. Population and GDP per Bank Branch, by Region



Source: Author's calculations based on figures from Central Bank of Brazil and IBGE.

Despite the presence of a dynamic, innovative, and retail-oriented private banking sector, and increasing privatization, public banks continue to play an important role in Brazil's financial sector. Public banks account for 46 percent of bank branch infrastructure and 55 percent of financial sector assets. In the Northeast Region, the primary government-owned development bank, Banco do Nordeste, accounts for 86 percent of all bank financing. The continued privatization of public banks has raised public policy concerns regarding the maintenance of branch infrastructure in low-income areas

While most private banks and other private financial entities, to the extent they are permitted under their Central Bank charter, provide a broad range of financial services including savings and payments, public banks tend to have more restricted functions. For example, the National Bank for Economic and Social Development (BNDES) works essentially as a second-tier bank that supplies funds to public and private institutions at preferable rates consistent with its economic and social development orientation. The *Caixa Econômica Federal* (Federal Savings Bank) is the principal lending agent of the national housing system. *Banco do Brasil*, which is the largest government-owned bank, is the main lender to the agricultural sector. While many of these entities offer multiple banking services, they tend to be focused on the administration of credit lines, with few incentives to provide customer-oriented savings or payment services.

Lending Services

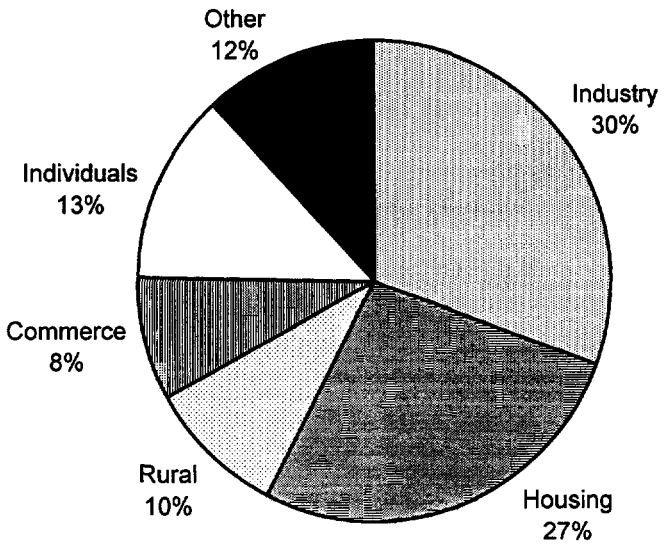
Credit to the private sector in Brazil, representing 30.7 percent of GDP in 1996, is equal to or higher than in most Latin American and middle-income countries, but is well behind the high-income countries and the faster growing lower- and middle-income countries. Lending by private banks is concentrated in loans to industry and for housing, while agriculture loans are primarily handled by the public banks, and individual and commercial lending is mostly provided by nonbank financial and nonfinancial institutions (supplier and retail credit). Despite the dominance of the public sector (and in particular the Caixa Econômica Federal) in housing finance, private bank participation is also significant due in large part to incentives provided through requirements on the application of savings (Figure 6).

In the short-run the ability of Brazil's private banking sector to assume an increasing share of financial services provision from the public sector is limited by the high cost of private credit. Real interbank rates have remained in the range of 16 to 24 percent on short-term borrowings despite macroeconomic stability over most of the past five years. Real-denominated commercial term-lending by private banks is generally limited to 60 days at typical interest rates of more than 65 percent per year. Annual rates for consumer loans, while declining, currently average from 95 percent for personal and direct consumer credit, to 178 percent for check overdrafts.[9] This compares to an average funding cost of 21 percent per year, implying an average annualized spread of 62 percent.[10]

The Central Bank, concerned about the high cost of borrowing for both businesses and individuals, has undertaken a thorough review of the cost of bank credit in the Brazilian financial system. The study has extended the traditional view that large spreads reflected the relative inefficiency of Brazilian banks (Table 8). The Central Bank review verified high administrative costs, particularly in the case of individual loans,[11] which in part reflects the low leverage of

9. Consumer loan rates are the rates for retailer financing, overdrafts, and personal loans.
10. Average funding cost is based on 30-day certificates of deposit (CDB)
11. Administrative costs account for 29 percent of the spread for individual loans compared to 19 percent for loans to companies.

Figure 6. Lending by the Private Banking System



Source: Central Bank of Brazil

Table 8. Operating Costs of Commercial Banks

Country	*Operating expenses as percent of total assets*
Brazil	8.0
Argentina	5.7
Chile	2–4
Germany	2–3
United States	1–2.5

Source: Brazil CAS

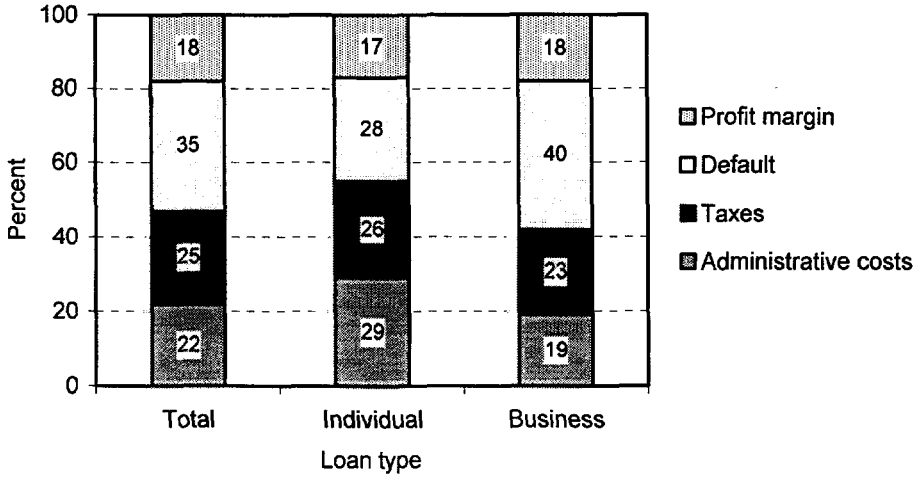
Brazilian banks (15 percent average capital to asset ratio). However it also identified taxes on financial transactions and bank profits, and high default rates, as equally significant sources of costs (Figure 7).

To address these issues, the Central Bank announced several measures on October 14, 1999 aimed at reducing the cost of credit. First, the tax on financial transactions (IOF) for individual loans was reduced from 6 percent to 1.5 percent per annum, equivalent to the existing IOF for business loans. Further tax relief through elimination of the turnover tax (COFIN) is included in the general tax reform program expected to become effective in 2001.

The Central Bank has also focused on the largest individual component of banking spreads—the high level of default. Default costs account for an average of 28 percent of the spread on individual loans, and 40 percent of the spread on commercial loans. Past due loans[12] for the 50 largest banks in Brazil in December 1998 averaged 3.2 percent of loan assets, although in the

12. Sixty-day portfolio at risk measure.

Figure 7. Composition of Banking Spreads



Source: Central Bank of Brazil

largest public banks (Banco do Brasil, Banco do Nordeste, and Banco do Estado de São Paulo) this ratio ranged from 14 percent to 22 percent.[13] The Central Bank is providing banks with greater recourse for credits with real guarantees in the case of client bankruptcy, and the right to continued collection of principal payments during judicial proceedings concerning the interest portion of the loan.

Accompanying these efforts to reduce the costs incurred by the banks, the Central Bank has also taken measures to ensure that final borrowers benefit from lower lending rates. The Central Bank intends to facilitate comparison of the cost of credit by disclosing the lending rates charged by each bank on the Internet and requiring banks to post all rates and fees in their branches. Loan contracts will also have to present detailed information regarding the full cost and conditions of the loan.

Almost all *real*-denominated term lending is provided by the public banks, largely through specially designed lines of credit intended to promote specific economic activities or socioeconomic groups. The BNDES provided more than US$7.6 billion in term credit in 1995. Banco do Nordeste lent almost R$1.4 billion in 1998 alone on directed credit programs (Table 9) funded by the Constitutional Fund for the Northeast (FNE), the Worker Assistance Fund (FAT), and funds provided by BNDES.

PROGER is targeted to households with annual incomes below R$48,000. PROGER finances working capital for up to two years, and investment capital for up to five years with a two-year grace period. Borrowing is limited to a total of R$48,000 for both working and investment capital, and both are charged a nominal annual rate of 8.75 percent.

PRONAF limits borrowing for working capital to R$5,000 per household for up to two years at a 5.75 percent nominal annual rate. Investment loans of up to R$15,000 per household are provided for up to eight years, with a two-year grace period, at the Official Long-Term Interest Rate (TJLP) plus 6 percent. Other directed credit programs have similar characteristics in terms of loan size, interest rate, term, and grace period.

13. *Analise de Risco, Bancos Brasileiros* (São Paulo: Atlantic Rating, July 1999).

Table 9. Banco do Nordeste Credit Lines, 1998

	Number of loans	*Value (R$ thousands)*
PROGER [a]	44,737	276,416
PRONAF [b]	156,343	671,326
PROTRABALHO [c]	22,871	299,783
PROCERA [d]	35,185	94,585
Cédula [e]	207	30,298
TOTAL	259,343	1,372,408

Source: Banco do Nordeste, Financial Statement 1998

a. Development Program for Employment Generation and Income (PROGER)
b. National Program to Strengthen Family Agriculture (PRONAF)
c. Program to Promote Employment and Improve the Quality of Life of Workers (PROTRABALHO)
d. Land Reform Program (PROCERA-FNE)
e. Pilot Project to Assist Land Reform (*Cédula da Terra*) with World Bank

Savings Services

Brazil's savings rate of 24 percent of GDP, while consistent with that of other middle-income Latin American countries, is below that of OECD countries (Figure 8). As expected, savings per unit of GDP are higher in the wealthier regions of Brazil than in the poorer regions (Figure 9), though among the poorer regions the Northeast demonstrates the highest propensity to save.

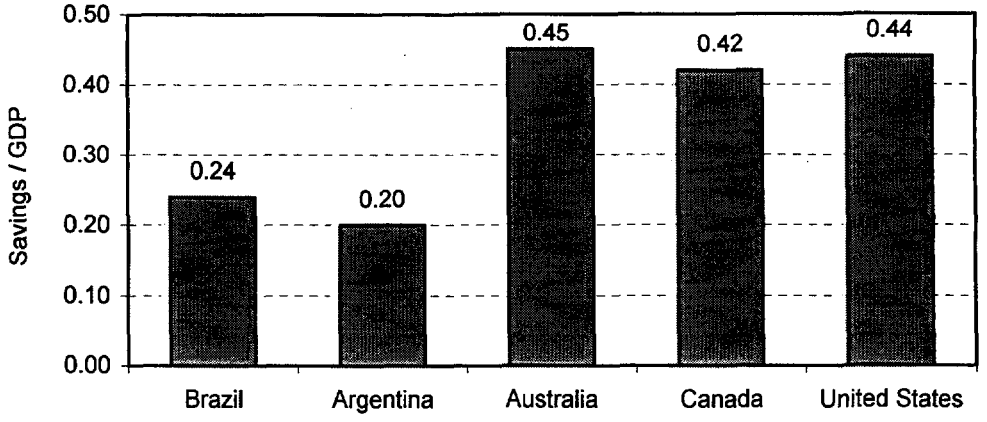
Savings are captured by both private and public financial institutions, with the Caixa Econômica Federal (public), *Bradesco* (private), *Itaú* (private), *Nossa Caixa* (public), and *Cia Real* (private), representing the top five "savings mobilizers" in Brazil. Since Brazil is a country of small savers, it is not surprising that these five institutions also have the largest branch networks. More than 75 percent of savings accounts have a balance of R$500 or less (Figure 10). However, while only 2 percent of accounts are larger than R$10,000, they hold more than 55 percent of total savings (Figure 11).

In addition to these efforts to reduce costs directly associated with lending, the Central Bank is also taking measures to reduce costs associated with mobilizing funds from the public through demand deposits, time deposits, and investment funds. The reserve requirements on demand deposits were reduced from 75 percent to 65 percent, and more recently to 55 percent. Reserve requirements for time deposits have been reduced from 20 percent to zero. Reserve requirements for investment funds were also reduced to zero from 50 percent for deposits of less than 30 days and 5 percent for deposits of 30 days or more.

These measures are not expected to have an immediate impact on availability of funds. Increased savings depends on continued macroeconomic stability, confidence in the banking sector, and development of attractive, longer-term, contractual savings instruments, which in turn is dependent on developments in the pension, insurance, and housing finance sectors. The World Bank is assisting the Central Bank of Brazil in addressing issues of banking supervision and wider financial sector development issues through its Central Bank Modernization Technical Assistance Loan.[14]

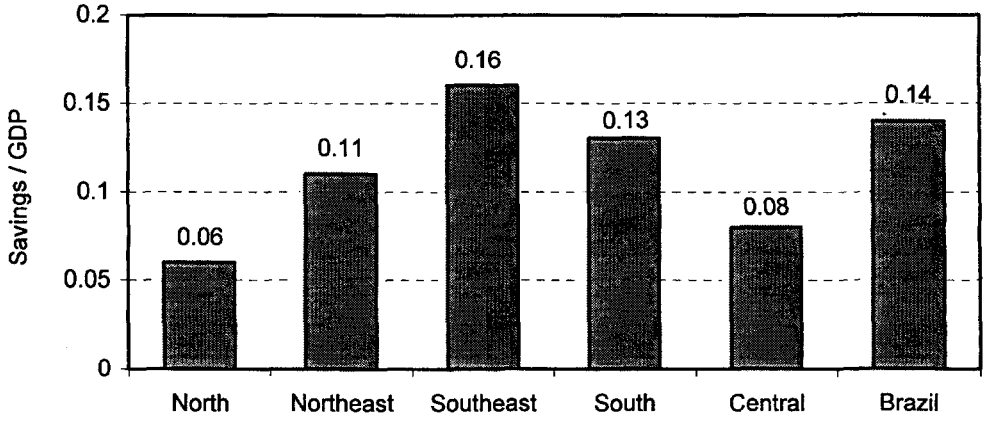
14. World Bank, "Brazil: Central Bank Modernization Technical Assistance Project," Report No. 16867-BR (Washington, D.C.: World Bank, October 23, 1997).

Figure 8. Savings as a Proportion of GDP



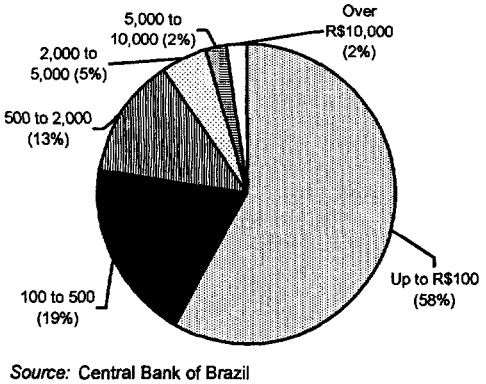
Source: "A New Database on Financial Development and Structure" by Thorsten Beck, Asli Demirguc-Kunt, and Ross Levine. Unpublished manuscript dated June 1999.

Figure 9. Savings per GDP by Region



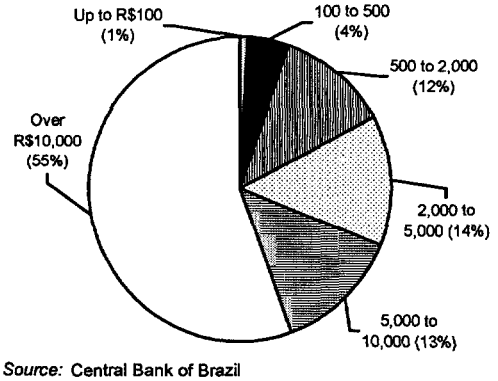
Source: Author's calculations based on information from the Central Bank of Brazil and IBGE. Note that Figure 8 includes savings, foreign currency, and time deposits, but Figure 9 only includes savings.

Figure 10. Size of Savings Accounts (in R$)



Source: Central Bank of Brazil

Figure 11. Distribution of Total Savings by Size of Account (in R$)



Source: Central Bank of Brazil

Access of Microenterprises to Financial Services

Despite Brazil's extensive banking infrastructure and the large number of government-sponsored credit lines, few microenterprises have access to bank credit. According to SEBRAE statistics, 84 percent of micro- and small enterprises in commerce and 88 percent in the service sector do not receive credit. It should be remembered that this definition of microenterprises includes firms much larger than the traditional microenterprise working in the informal sector.

For smaller microenterprises the 1997 Banco do Nordeste study gives a more accurate picture, at least for those operating in the Northeast. According to the survey, as few as 2 percent of micro-entrepreneurs have access to bank credit. Most microentrepreneurs do not borrow at all, and those that do depend more on suppliers, family, and moneylenders (*agiotas*) than on banks (Table 10).

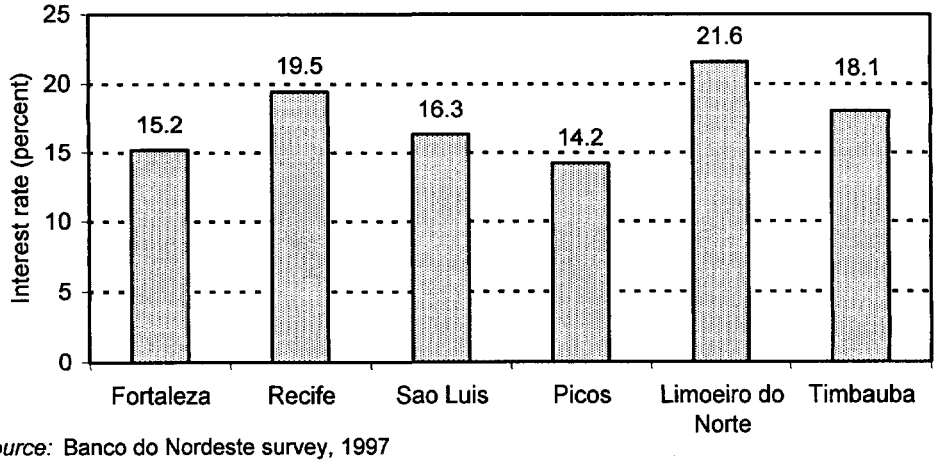
Average *monthly* interest rates paid, primarily to suppliers and moneylenders, are very high in real terms, particularly in relation to the directed credit lines offered by the public banks (Figure 12). The primary reasons given by microentrepreneurs for not obtaining bank credit is their difficulty in meeting documentation and guarantee requirements. In addition, suppliers and moneylenders tend to provide a more flexible lending environment and greater convenience.

Table 10. Principle Sources of Financing in the Northeast

	Credit source (percent)				
Area	*Bank*	*Money-lender*	*Supplier*	*Family*	*No Credit*
Fortaleza	3.0	9.7	17.9	2.2	63.8
Recife	2.5	2.3	14.0	18.0	63.2
São Luis	1.9	0.8	7.8	1.2	88.7
Picos	4.8	2.4	23.0	10.6	58.5
Limoeiro do Norte	5.7	1.1	12.5	10.2	70.5
Timbauba	3.3	3.3	6.7	3.3	83.3

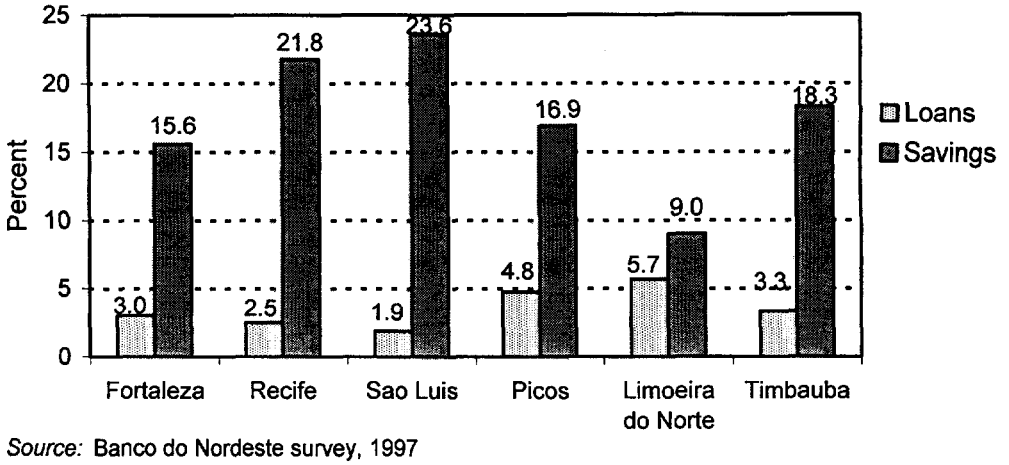
Source: Banco do Nordeste, 1997

Figure 12. Monthly Interest Rates on Loans in the Informal Sector in Northeast Brazil



Source: Banco do Nordeste survey, 1997

Figure 13. Microentrepreneurs with Loans and Saving Accounts with Commercial Banks in Northeast Brazil (%)



Source: Banco do Nordeste survey, 1997

While the "intimidation factor" of banks and bank branches is often suggested as a major impediment to microentrepreneurs seeking bank credit, the survey indicated that a much higher proportion of microentrepreneurs have savings accounts in banks (Figure 13). This suggests that it is the lending service provided, as well as the application requirements, which discourage many microentrepreneurs from seeking bank credit.

MICROFINANCE IN BRAZIL

Microfinance Programs

Given the huge, potential market for microfinance services, the high interest rates paid to informal lenders, and the lack of penetration by the formal financial sector, it is not surprising the there are several microfinance programs operating in Brazil. The list of programs included in Table 11, while representing many of the best-known programs in Brazil, is not exhaustive. The market for microfinance services is evolving very rapidly in Brazil with new programs emerging almost monthly. With the exception of the *Federação Nacional de Apoio aos Pequenos Empreendimentos* (FENAPE) network, the microfinance programs have been operating for three years or less and therefore are still developing and refining their methodology.[15] In order to contrast these programs with a mature, "international best-practices" experience in Latin America, similar information is provided for *BancoSol* in Bolivia.[16] Given the short history of most of the Brazilian microfinance institutions, information for PRODEM (the NGO predecessor of BancoSol) at a similar stage of development (32 months of operation) is provided in parentheses.

15. The Federação Nacional de Apoio aos Pequenos Empreendimentos (FENAPE) is the national network of Centros de Apoio aos Pequenos Empreendimentos (CEAPEs).
16. Information for PRODEM is for December 1988, and for BancoSol it is for June 1995 from Claudio Gonzalez-Vega and others, "BancoSol: The Challenge of Growth for Microfinance Organizations," in *Microfinance for the Poor*, ed. Harmut Schneider (IFAD/OECD).

Table 11. Overview of Selected Microfinance Programs in Brazil

	Microfinance Program				
	CrediAmigo	*VivaCredi*	*PortoSol*	*FENAPE*	*BancoSol (PRODEM)*
Institutional type	Bank division	NGO	Civil association [a]	NGO	Private bank *(Former NGO)*
Operations began	November 1997	March 1997	January 1996	May 1987	March 1987 *(32 months)*
Source of funds	Transfers from parent Banco do Nordeste, IBRD	Equity, IDB, govt. loans, private financial company donation	Grants, govt. loans, international grants (GTZ, IAF)	Equity, IDB, govt. loans, UNICEF	Equity, USAID, govt., commercial loans, deposits
Geographic area	Northeast Region	Municipality of Rio de Janeiro	Municipality of Porto Alegre and suburbs	Urban—South, Southeast, Northeast, North Regions	Urban towns throughout Bolivia, with focus on La Paz
Estimated market	2.5 million	15,000	19,000	6.8 million	1.0 million
No. of branches [b]	51	3	1	45	42 *(2)*
Guarantees	Solidarity group	Cosigner, collateral, proof of salary	Cosigner, collateral, or solidarity group	Cosigner or solidarity group	Solidarity group
Avg. term (months)	3	6	6	4	9.6 *(4)*
Nominal interest rate (monthly)	5%	3.9% plus 1% administration fee.	3.5%	5.5%	4.0% *(4.0%)*
Frequency of repayment	Every 15 days	Weekly, biweekly, and monthly	Weekly, biweekly, and monthly	Monthly	Mainly monthly, but some weekly and bimonthly
Total disbursed	US$39.1 million	US$2.6 million	US$7.8 million	US$68.2 million	US$448.7 million *(US$3.7 million)*
No. of loans disbursed	121,444	2,798	8,751	152,797	936,953 *(15,245)*
Outstanding portfolio	US$8.2 million	US$631,000	US$1.2 million	US$7.3 million	US$67.3 million *(US$684,868)*
No. of loans outstanding	34,085	951	1,864	23,310	76,679 *(5,288)*
Avg. outstanding balance	US$241	US$654	US$660	US$314	US$878 *(US$131)*
Portfolio quality [c]	4.0%	5.1%	3.7%	4.0%	5.0% *(less than 2.0%)*
No. of loan officers	213	6	14	75	246 *(20)*
Clients/loan officer	153	158	133	311	312 *(267)*
Loan officer education level	Secondary grads & college students	Secondary grads & college students	Secondary grads	College students	Secondary grads & college students
Loan officer base salary	US$211	US$368	US$326	US$289	US$438 *(US$275)*
Incentive (% base salary)	Average 40%	Average 30%	Average 60%	Average 70%	Average 15% *(none)*
Other services	Training	None	Training	Training	Savings *(Training)*

Note: Figures are as of July 31, 1999.

a. The PortoSol civil association includes the Municipality of Porto Alegre, the State of Rio Grande do Sul, the Federation of Commercial Associations, and the Association of Young Business Owners of Porto Alegre.

b. "Branches" refers to any permanent physical location used as an operational base by the microfinance institution.

c. Thirty-day portfolio-at-risk measure.

Source: Author's interviews with program managers.

The four Brazilian programs can be divided into two categories. *VivaCredi* of Rio de Janeiro, and *PortoSol* of Porto Alegre, are focused exclusively on their local markets. CrediAmigo (a program of Banco do Nordeste) and the FENAPE network define their markets as regional or national, and accordingly have pursued high-growth strategies. Unlike BancoSol, none of the programs is leveraged with funds from deposit accounts or private bank loans, though several receive subsidized loans from the BNDES.

Based on a comparison of the information presented, several characteristics emerge as common to most, if not all programs:

Institutional Model

CrediAmigo is the only program within a regulated financial institution with its own disbursement and repayment windows. The other programs, similar to PRODEM/BancoSol are NGOs, and disburse through checks that are cashed at banks, which also accept repayments. This is representative of microfinance development to date in Brazil, where the dominant institutional model has been the NGO, with or without government participation. Programs are funded primarily by their own equity, based on grant funding, in some cases, by low-interest, long-term loans. CrediAmigo has accessed commercial funds through its parent Banco do Nordeste, and VivaCredi has equity investment from *Finivest*, a financial corporation associated with *Unibanco*. All programs received grants from international institutions for institution-building activities and have benefited from international technical assistance in the design of their programs.

Geographic Area

PortoSol and VivaCredi define a relatively restricted geographic area based on the area in and around the municipality where they currently operate. This is in contrast to CrediAmigo, which is pursuing a market that mirrors that of Banco do Nordeste. FENAPE has developed an interesting strategy to provide NGOs with some of the benefits of the economies of scale enjoyed by banks by linking individual *Centros de Apoio aos Pequenos Empreendimentos* (CEAPEs) NGOs throughout Brazil to ensure consistency in the quality of administration and training support.

Loan Period and Solidarity Group Lending

All programs emphasize shorter-term (up to 6 months) working capital loans. Solidarity group lending is the dominant means of addressing the absence of "real guarantees" for microlending. VivaCredi, whose lending technology was developed based on an individual loan product, is considering moving into solidarity group lending as there has been greater than expected acceptance of this requirement by the microfinance market in Brazil. Unlike PRODEM/BancoSol which has emphasized solidarity group lending throughout its development, the Brazilian programs all offer or plan to offer individual loans for solidarity group customers and new customers who qualify for larger loans than those of typical group members.

Interest Rates

While interest rates vary in nominal terms, they are similar in real terms once administrative fees, prompt payment rebates, and repayment calculation differences are accounted for. These rates are consistent with the 4 percent real effective monthly rate charged by PRODEM/BancoSol and demonstrate that there is considerable demand for credit at interest rates well in excess of those

charged by government-financed lines of credit. Also, similar to PRODEM/BancoSol, all programs currently provide or plan to provide flexibility in repayment frequency to better match client cash flow. These interest rates are consistent with those charged by Brazilian banks for personal loans to individuals who, unlike microentrepreneurs, can provide proof of adequate, salaried income.[17]

Lending Volume and Loan Size

The historic volume of funds and number of loans disbursed shows that VivaCredi and PortoSol have approached or far exceeded PRODEM's cumulative volume of lending at a similar point in its development, but have fallen far short in terms of loans disbursed. This reflects a historic average loan size of just over US$900 for these programs compared to US$243 for PRODEM. CrediAmigo's historical average of US$322 is closer to that of PRODEM and well below the US$479 average for BancoSol. FENAPE's much slower growth than BancoSol is reflected in a significantly lower cumulative number of loans and total disbursements, despite a similar average historic loan size of US$446. The increasing historic average loan size between PRODEM and BancoSol, and between CrediAmigo and FENAPE demonstrate the tendency for average loan size to increase as borrowers establish repayment capacity and demand larger loans.

Outstanding Loan Portfolios

The current, outstanding loan portfolios of the Brazilian institutions reinforce the distinctions between the localized NGO programs and the more expansive programs. Both VivaCredi and PortoSol have relatively small portfolios in terms of number of loans relative to PRODEM. Their average outstanding loan balances are equivalent to 14.5 percent of per capita GDP in Brazil compared to PRODEM's 17.8 percent of per capita GDP for Bolivia in 1989. Despite its longer history and much larger historical lending, FENAPE's current lending portfolio is smaller than CrediAmigo's both in terms of the number and value of outstanding loans. The average outstanding balance for FENAPE (6.9 percent of per capita GDP) and CrediAmigo (5.2 percent) are much smaller than that of the two localized NGO lenders or BancoSol (81.8 percent of per capita GDP). Even if adjusted using the much lower per capita GDP of the Northeast Region, the average outstanding balance for CrediAmigo (17 percent) and FENAPE (22 percent) suggest that the Brazilian programs have a greater focus on lending to the poor than does BancoSol.[18]

Gender Balance of Lending

All of the Brazilian programs lend about equally to women and men. This is in sharp contrast to BancoSol, more than 70 percent of whose clients are women. While all of the Brazilian programs emphasized that they consider women clients to be easier to work with and more reliable in repayment, they indicated that in Brazilian society many women allow their husbands to sign for their loans. All programs are developing strategies to improve their outreach to potential women clients.

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17. The personal loan program of *Banco Fricrisa Axelrod* in Porto Alegre charges an effective interest rate of 81.8 percent per year (6.8 percent per month) and does not incur the cost of group formation or evaluation of microenterprise cash flow.
18. Per capita GDP for Brazil according to the Atlas method was US$4,550 in 1998, while for the Northeast it was US$1,423. Per capita GDP in Bolivia was US$734 in 1989 and US$1,073 in 1998. FENAPE is also adjusted using the Northeast GDP figure because more than 70 percent of its affiliates' portfolio is in the Northeast Region.

Loan Officer Productivity

Only one Brazilian program, FENAPE, has been able to attain loan officer productivity consistent with PRODEM/BancoSol. The average numbers of clients per loan officer in the other three programs is well below both PRODEM and BancoSol (for which the PRODEM figure represents a historical minimum). All the Brazilian programs provide salary incentives to loan officers for making new loans (both new clients and renovations). Most programs consider 15 to 20 new clients per month for each loan officer to be achievable on a regular basis.

Salaries for Loan Officers

Low average salaries for loan officers are due, in part, to low productivity. CrediAmigo salaries and incentive payments typically are US$300 per month—about 80 percent of Brazil's per capita GDP on a monthly basis. The other three programs typically provide salary and incentives equal to about US$500 per month—roughly 130 percent of monthly per capita GDP. In the case of FENAPE, the higher salary is primarily due to larger incentive payments resulting from the greater productivity of its loan officers. In contrast, the average monthly salary of BancoSol loan officers is US$504, which is equivalent to 564 percent of monthly per capita GDP in Bolivia. Even when adjusted using the Northeast Brazil per capita GDP, the average salaries for CrediAmigo (250 percent of monthly GDP) and FENAPE (420 percent) are still low compared to BancoSol.

Client Services and Training

Additional client services in the Brazilian programs are limited to training, which is provided by all the programs except VivaCredi. The Brazilian programs generally believe that client training will improve management of microenterprises and create greater capacity for growth and therefore repayment. Training is not a condition of loan approval or disbursement, and in most cases clients are required to pay for the training.

Nonlending Financial Services

Because CrediAmigo is a program of Banco do Nordeste it is the only regulated financial institution and therefore the only one authorized to provide deposit, savings, and other financial services in addition to lending. CrediAmigo is currently considering development of a savings product. Voluntary savings has become an important source of funding and loan clients for BancoSol and was a primary motivation for PRODEM's conversion into a regulated financial institution.

Operational Self-Sufficiency

Due to the wide range of accounting practices used by the Brazilian programs it was not possible to calculate comparable financial ratios.[19] For example, operating expenses are accounted for quite differently, particularly in cases such as the training and support services that the CEAPEs receive from the FENAPE network, the central management and "back office" services that CrediAmigo receives from Banco do Nordeste, and the external technical assistance and participation of board members in the operations of the PortoSol and VivaCredi programs.

19. Consultative Group to Assist the Poorest (CGAP), "Format for Appraisal of Microfinance Institutions," Technical Tools Series No. 4, (Washington, D.C.: Consultative Group to Assist the Poorest, July 1999).

Nonetheless, all the programs focus on achieving operational and financial sustainability. Based on the information available, CrediAmigo, PortoSol, and a number of the CEAPEs, have already achieved operational self-sufficiency (defined as operating income greater than operating expenses), while VivaCredi is quite close.

Financial Sustainability

Similarly, comparative analysis of financial sustainability—such as adjusted return on assets or the subsidy dependence index (SDI)—would have required thorough accounting of all explicit and implicit subsidies received by the programs.[20] However, as part of a loan appraisal for CrediAmigo, the World Bank calculated the program's SDI as 15 percent in June 1999 with a trend toward full subsidy independence (SDI less than or equal to zero) by the end of calendar year 2000 or within four years of initiating operations.[21] This compares favorably with PRODEM/BancoSol, which had an SDI of 17 percent after four years of operation and only became subsidy independent after eight years. Given the higher productivity of their loan officers, along with similar portfolio quality, number of active clients, and outstanding loans, it is likely that a number of the CEAPEs also are already subsidy independent or nearly so. In the case of PortoSol and VivaCredi, full financial sustainability is likely to depend on their ability to significantly increase loan officer productivity and/or significantly expand their portfolios while maintaining loan quality.

Government and Donor Support of Microfinance Development

Throughout the world, new microfinance initiatives have been dependent on government and donor support for financing and technical assistance. This is particularly true during the initial development period when lending technologies are adapted to specific country contexts and track records are established to attract commercial financing and eventually deposits from the general public. In Brazil this support has only emerged in the past two years (with the exception of the FENAPE network, which was supported by UNICEF and is affiliated with ACCION International).

The largest assistance program is the Popular Productive Credit Program of BNDES, supported by a US$300 million loan from the Inter-American Development Bank (IDB). The program has two lines of assistance: BNDES Worker, and BNDES Solidarity.

BNDES Worker assists in the establishment of productive credit programs in each interested state or municipality based on the PortoSol mixed public/private institutional model. The program requires that at least 40 percent of the funds for establishing credit programs comes from local government and the private sector. The amount of BNDES participation depends on the number of municipalities in the state, and varies from R$6 million to R$15 million. BNDES funds are lent to the state government for seven years with nine months grace period at a rate equal to the TJLP. Individual credits to final borrowers must be between R$150 and R$5,000, with a maximum term of 18 months and a maximum grace period of 3 months. BNDES monitors portfolio quality, and if arrears over 30 days exceed 6 percent for any two consecutive quarters, or 8 percent in a single quarter, BNDES can request immediate reimbursement of the funds it lent to the program.

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20. For a thorough discussion of the SDI, see: Mark Schreiner and Jacob Yaron, "The Subsidy Dependence Index and Recent Attempts to Adjust It," *Savings and Development*, Quarterly Review No. 4, 1999.
21. Susana Sanchez and Steven Schonberger, "CrediAmigo: Financial Evaluation" (draft working paper dated November 15, 1999, Washington, D.C.: World Bank).

BNDES Solidarity is targeted to NGOs that already have at least six months experience in providing microcredit services. The NGO must demonstrate that it was able to mobilize at least 25 percent of its capital from Brazilian or international public or private donors. BNDES can provide up to R$3 million per loan, limited by the size of the NGO's existing loan portfolio. The loan to the NGO is for eight years with six months grace period and quarterly interest payments equivalent to the TJLP. The NGO is required to establish a risk fund by retaining 1 percent of repayments from final borrowers until the fund reaches a total equal to 15 percent of the funds lent by BNDES. Controls on loan portfolio quality are similar to those for BNDES Worker.

The Community Solidarity Program under the direction of the Office of the First Lady has taken a proactive stance in microfinance development in Brazil. This organization recently convoked a high-level panel including the Central Bank, BNDES, Banco do Nordeste, microfinance NGOs, and private sector bankers to review the legal and regulatory framework for microfinance development.

Among international donors, UNICEF was an early supporter of microfinance in Brazil, providing much of the start-up capital to the FENAPE network, which is the longest running and most successful program to date. FENAPE has received significant international technical assistance as an affiliate of ACCION International.

The IDB has also provided support to NGO programs through its small-grants program, which provides grants of up to US$500,000 to NGOs that have demonstrated superior technical performance. Grant recipients include PortoSol and a number of the CEAPEs in the FENAPE network.

The World Bank has focused its support on development of Banco do Nordeste's CrediAmigo program. Using funds reassigned under an existing loan, Banco do Nordeste was able to undertake study tours to successful microfinance institutions in Latin America and Asia, and to contract international technical assistance from ACCION International. The World Bank also helped Banco do Nordeste to obtain a Japanese PHRD (Policy and Human Resources Development Fund) grant for training and development of their management information systems in anticipation of loans from the World Bank and IDB.

VivaCredi was initiated with private donations and financing from the community assistance foundation of UniBanco. Technical assistance was provided by International Project Consult, a German firm which specializes in the development of microfinance programs.

Policy Environment for Microfinance in Brazil[22]

The development of microfinance institutions involves regulatory and legal issues in areas such as the emergence of NGO "start-ups," the transformation of NGOs into regulated financial intermediaries, the movement of commercial banks into microfinancing, and other matters related to both NGOs and commercial banks. Among the most commonly encountered issues are:

- Legal status of NGOs
- Usery laws and interest rate restrictions (NGOs)
- Financial sector entry requirements (NGOs and regulated institutions)
- Prudential supervision (regulated institutions)
- Loan-loss provisions (regulated institutions)

22. This section provides an overview of issues related to regulation and supervision of microfinance in Brazil. For a more complete review of regulatory issues and the experience in Bolivia and Peru, see Rachel Rock and Maria Otero, eds., *From Margin to Mainstream: The Regulation and Supervision of Microfinance* (Boston: ACCION International, 1997).

- Capital adequacy requirements (regulated institutions)
- Treatment of nontraditional collateral (regulated institutions)
- Framework for secured transactions (NGOs and regulated institutions)
- Loan documentation requirements (regulated institutions)
- Operational restrictions (regulated institutions)
- Deposits and savings (regulated institutions)
- Restrictions on public banks
- Credit reporting (NGOs and regulated institutions)

Given the present stage of development of the microfinance industry in Brazil, few of these issues currently constrain the industry's growth. Nonetheless, rapid development of NGO programs such as the FENAPE network, as well as the commercial bank–based CrediAmigo program, suggest that many of these issues may become relevant within the next few years.

Legal Status of NGOs

NGOs play an important role in the development of a country's microfinance industry. As altruistic, nonprofit institutions with relatively low overhead costs, NGOs generally are more willing to test alternative lending technologies focused on the poor, long before commercial banks or other formal financial intermediaries enter the market. The laws regulating NGOs, and in particular their ability to mobilize donor funds for lending, can have an important impact, particularly in the early years of microfinance development. Programs that are unable to mobilize funds effectively cannot grow at rates sufficient to demonstrate potential commercial viability and may not be able to even serve the growing requirements of existing clients. Brazil traditionally has restricted the ability of NGOs to receive microfinance funds from foreign donors; Central Bank approval is required on a case-by-case basis, which has caused delays and often resulted in loss of funding.

Usery Laws

Brazil's usery law is often mentioned as the most obvious impediment to development of the NGO microfinance industry. Although the law—which restricts nominal interest rates to 2 percent per month and 12 percent in real terms per year—is not systematically enforced, it does create a climate of uncertainty for actual and potential microfinance service providers and investors.

Financial Sector Entry Requirements[23]

Entry regulations, such as minimum capital requirements, serve primarily to establish the formal financial landscape by determining the number, types, and sizes of institutions operating in the market. While many requirements are ostensibly for the protection of those financing new institutions (investors, commercial creditors, and depositors), they often function primarily to ensure that the regulatory authorities are able to prudently monitor and regulate the financial sector. Most entry requirements, such as review of the institution's financial and management structure, are generally neutral with regard to the institution's target clientele. However, minimum capital requirements, as opposed to *capital adequacy ratio requirements,* can be an im-

23. This section draws substantially from Tor Jansson, *Financial Regulation and its Significance for Microfinance in Latin America and the Caribbean* (Washington, D.C.: Inter-American Development Bank, December 1997).

pediment in the transformation of an NGO microfinance institution into a bank or finance company, or for a microfinance program to be spun off as a subsidiary or independent organization from the sponsoring public or private bank.[24]

In many Latin American countries, successful microfinance programs that began as NGOs transformed themselves into formal financial institutions so that they could better mobilize debt and equity from the general public to finance their expansion.[25] In most cases NGOs first converted to financial companies, which have lower minimum capital requirements than banks, so they could gain access to commercial equity and debt financing and develop a branch network. As the programs grew, the finance companies applied for banking licenses so they could mobilize savings and expand the financial services offered to clients.

Brazil's minimum capital requirements (Table 12), while not the highest in Latin America, are nonetheless relatively high, particularly for an NGO considering transformation into a bank. Utilizing the weighted average outstanding loan balance of US$286 for the four Brazilian programs in Table 11, suggests that full leverage would require about 225,000 clients for a bank, and 90,000 clients for a finance company—portfolios many times that of the largest microfinance programs currently operating in Brazil. Adjusting this figure for a lower level of leverage of only 1:6, consistent with microfinance institutions in their earlier, high growth stages, still suggests portfolios of about 135,000 clients for a bank and 54,000 clients for a finance company.

Minimum capital requirements can pose a barrier not only to becoming a formal financial institution, but also to establishing new branches. Brazil's Central Bank requires a 1 percent increase in an institution's minimum capital of for each branch established after the "pioneer" branch. In the states of Rio de Janeiro and São Paulo, the capital requirement increases 2 percent for each additional branch. This represents a potentially important impediment to institutional expansion that would help address regional imbalances in access to microfinance services.

Bolivia and Peru have chosen to support the entry of regulated, microfinance-focused institutions through creation of a distinct type of financial entity. These specialized institutions have lower minimum capital requirements (less than US$1 million), but with similar capital adequacy ratios, limitations on maximum loan size (3 to 5 percent of net capital), and additional operating restrictions. Both cases allow savings deposits but not demand deposits. The above approach is consistent with "tiered banking" in which regulations are adapted to the requirements of the microfinance industry. In a tiered-banking approach, the Central Bank defines intermediate institutional forms

Table 12. Minimum Capital Requirements and Required Size of Loan Portfolio

			Minimum number of clients [b]	
Institution type	*Minimum capital requirement* [a]	*Capital adequacy ratio*	*Avg. loan of US$500*	*Avg. loan of US$1,000*
Bank	US$9.2 million	1:10	128,800	64,400
Finance Company	US$3.7 million	1:10	51,800	25,900

a. Central Bank Resolution No. 2607, dated May 27, 1999.
b. Assumes that 70 percent of institution's assets are in its loan portfolio.
Source: Based on Jansson, 1997. Updated with revised figures from Central Bank of Brazil.

24. Richard Rosenberg of CGAP argues that minimum capital requirements rarely present a real impediment for profitably managed microfinance institutions given the large amount of donor capital looking for investment opportunities in good microfinance programs.
25. Carlos Cuevas, "Enabling Environment and Microfinance Institutions: Lessons from Latin America," *Journal of International Development* 8, no. 2 (March-April 1996).

that generally have lower minimum capital requirements, limitations on services that can be offered (in particular savings services), and more stringent prudential guidelines.[26]

The Central Bank of Brazil has indicated that it considers the banking sector in Brazil to be "saturated" and has imposed restrictions on entry of new institutions from abroad. Nonetheless, Central Bank officials have indicated that they have no objection to considering endorsement of new institutional structures to serve markets that currently are not serviced by the banking sector. However, the Central Bank would like these structures to emerge from the particular needs of the Brazilian market rather than trying to anticipate them through laws or regulations. Undoubtedly, the Central Bank's capacity to carry out off-site monitoring and on-site inspections will be an important factor in determining its willingness to authorize new entrants.

Prudential Supervision

Although Brazil does not yet have any regulated financial institutions dedicated to microfinance lending, the rapid growth of CrediAmigo and FENAPE, and their interest in deposit mobilization, suggest that the Central Bank may soon be requested to develop supervisory guidelines for microfinance portfolios. Microfinance loan portfolios are generally considered less "stable" than conventional bank portfolios because their delinquency rates are more volatile and consequently there is greater threat to equity due to the high operational cost structure of microfinance institutions (typically 30 to 50 percent of assets).[27] In addition, microfinance lending technology may require regulatory authorities to develop specialized techniques for off-site and on-site supervision.[28]

Loan-Loss Provisioning Requirements

Standard loan-loss provisioning requirements generally do not reflect the value at risk in a microfinance loan portfolio. Given their rapid turnover and more frequent repayment periods, standard past-due provisioning requirements often exceed the terms of microfinance loans. Brazil's Central Bank regulations require full provisioning for any loan with a payment more than 180 days overdue. Given that most microloans are for between 90 and 180 days, microfinance lending requires a more aggressive loan-loss provisioning policy related both to the time overdue as well as the number of installments missed. However, any new classification system should take into account the variability in the terms and conditions of the loans as well as the potential implications for audits of loan classification of institutions with both micro and standard commercial portfolios.[29]

Capital Adequacy Requirements

Standard capital adequacy requirements may also be inappropriate for microfinance institutions, particularly during periods of rapid growth. Assuming that an institution has been able to meet the minimum capital requirements to become a regulated financial intermediary, the rapid growth in assets typical in microfinance is likely to quickly undermine the cushion of safety against busi-

26. For application of the tiered approach to regulation of microfinance institutions see Hennie van Breuning, Joselito Gallardo, and Bikki Randhawa, "A Framework for Regulating Microfinance Institutions," World Bank Policy Research Working Paper Number 2061 (Washington, D.C.: World Bank, February 1999).
27. Robert C. Vogel, "Other People's Money: Regulatory Issues Facing Microenterprise Finance Programs," (Miami: IMCC, 1997).
28. Robert Peck Christen, "Issues in the Regulation and Supervision of Microfinance," (paper presented at ACCION International conference, Washington, D.C., November 1995).
29. Shari Berenbach and Craig Churchill, "Regulation and Supervision of Microfinance Institutions," Occasional Papers No. 1 and No. 2. (Washington, D.C.: Microfinance Network, 1997).

ness risk. As discussed above, the potential volatility of microfinance loan portfolios suggests the need for higher capital adequacy requirements—generally in the range of 15 to 20 percent of risk adjusted assets.[30]

Nontraditional Collateral

The use of nontraditional guarantee mechanisms, and particularly of solidarity group guarantees, poses a special challenge for regulators. Because minimum capital, provisioning, and capital adequacy requirements are all based on classification of asset risk, the treatment of nontraditional guarantees by Central Bank authorities can have an important impact on the perceived and actual performance of a microfinance institution. Although many institutions use the joint-liability arrangement to reduce transaction costs and achieve high repayment rates, most central bank authorities—including Brazil's—regard loans backed by solidarity groups as equivalent to personal loans and therefore essentially unsecured. The actual classification of these and other nontraditional guarantees should be based on their historic performance,[31] much like the approach used for credit cards and other standardized lines of credit that are granted on the basis of cash-flow analysis.

Framework for Secured Transactions

Like most countries rooted in the civil law tradition, Brazil's framework for the *creation, perfection,* and *enforcement* of security interests is a major impediment to the use of moveable property as collateral.[32] Difficulties in registration, and particularly in repossession, significantly reduce the willingness of formal lenders to provide credit secured by property that could disappear or substantially depreciate during long legal proceedings. Like the usery law, the legal provisions that prevent nonjudicial repossession are rarely enforced. However they do create uncertainty for both borrowers and lenders, resulting in higher costs and a lower volume of credit transactions secured by collateral other than real estate. These transactions are appropriately classified by the Central Bank as unsecured loans for purposes of provisioning when such loans become overdue.

Limitations in the framework for secured transactions can in effect limit the types of lending services provided to microenterprises and/or significantly increase their cost. Although classical microfinance technology, by focusing on cash flow–based lending and solidarity groups, offers an effective means to get around problems associated with the use of physical collateral, most microfinance programs eventually expand beyond working capital loans and offer investment loans for the purchase of equipment. Since these loans represent significantly greater exposure in the case of default, group lending is generally not a viable means of guaranteeing repayment. Therefore most programs attempt to guarantee the loan either with the equipment purchased or with other household property such as appliances that, in physical terms, are easy to repossess. In addition, use of stocks and inventory as collateral can also be increased, thereby lowering the cost of credit to suppliers who in turn are often the primary providers of credit to small businesses and farmers.

30. Robert Peck Christen, "Banking Services for the Poor: Managing for Financial Success" (Washington, D.C.: ACCION International, February 1997).
31. Rock and Otero, *From Margin to Mainstream.*
32. World Bank, "Argentina: How the Framework for Secured Transactions Limits Access to Credit in Agriculture" (Washington, D.C.: World Bank, April 1996).

Several civil law jurisdictions, including the province of Quebec in Canada and New Orleans in the United States, have effectively incorporated key elements of commercial law from common law jurisdictions—in particular, Article 9 of the Commercial Code of the United States. The effectiveness of any legal reform hinges on the introduction of *harmless*, or nonjudicial repossession and sale by which the lender is able to repossess and sell the property in the first instance and the borrower is obligated to demonstrate that the repossession was unlawful. Introduction of harmless repossession requires the simultaneous introduction of consumer protection legislation that permits claims of damages above and beyond the value of the collateral in cases of unlawful repossession.

Loan Documentation Requirements

As indicated above, microentrepreneurs consider documentation requirements for loans to be a major impediment to accessing bank credit. Few microenterprises have updated accounts or even pay taxes on a regular basis. Brazilian regulations provide banks with substantial latitude in the definition of documentation requirements, particularly for consumer loans. However, due to their lack of familiarity with the microenterprise sector many banks impose onerous loan documentation requirements. Credit-scoring models, based on the lending experience of microfinance institutions, can reduce this reliance on documentation while providing more accurate information regarding the probability of repayment.

Operational Restrictions

Regulations that restrict operations of financial institutions are often holdovers from a time when either economic activity was largely restricted to a certain period of the week for religious reasons, or manual bank clearing required that banks close in the afternoon. Many of these restrictions impede the ability of institutions to serve clients in a convenient manner, yet are no longer necessary given current technology. Brazilian labor laws restrict the operating hours of banks to five days a week and no more than five hours per day. While these restrictions do not apply to NGO lenders, they could restrict the ability of commercial banks to attend to microenterprise clients on important market days, many of which fall on weekends and holidays. Care also will have to be taken not to automatically apply these or other restrictions to client outreach as new institutional forms are defined for emerging microfinance institutions.

Deposits and Savings

Regulation of deposits and savings mobilization, particularly as pertains to restrictions on the application of funds, will have to be revised if this is to become an attractive source of funding for qualifying microfinance institutions. Brazilian Central Bank regulations require that a large proportion of demand deposits and savings deposits be used in rural and housing credit programs (Table 13). When combined with the reserves that must be deposited with the Central Bank to guarantee the system's security, this means that only 20 percent of demand deposits and only 25 percent of savings (45 percent in case of national public banks) would be available for funding microfinance activities.

The rural and housing credit programs financed under these restrictions impose limits on the interest rates charged, amounts lent, and other terms to the final borrowers. In the case of demand deposit–financed rural credit, 60 percent of the funds must be lent through programs in which loan terms are based on the type of crop as determined by national agricultural priorities, rather than on the basis of credit risk criteria. The remaining 40 percent must be lent through programs

Table 13. Requirements for Application of Deposits and Savings

Deposits/savings instrument	*Reserve requirement*	*Additional requirement*
Demand deposits	55% without remuneration	25% for rural credit, of which: • 40% with loan ceiling of R$40,000 • 60% for specific crop financing
Time deposits	None	None
Investment funds	None	None
Contractual savings		
Banks authorized for mortgage lending	15% with remuneration	60% for mortgage credit, of which: • 80% for single family homes • 10% business real estate • 10% free of restrictions
Public banks not eligible for mortgage lending [a]	15% with remuneration	40% for rural credit programs

a. Applies to Banco do Brasil, Banco do Nordeste, and Banco Amazônias.
Source: Central Bank of Brazil.

aimed at small farmers, with a loan ceiling of R$40,000. The majority of these lines of credit are operated by Banco do Brasil, which due to its near monopsony power and the relatively low return on the loans, provides a low rate of interest to the banks that provide the mandated funds. In the case of savings-financed housing loan programs, 80 percent of the funding (48 percent of the deposits) goes to single family homes, for which the interest rate is limited to 12 percent per year above the referential rate (TR) for loans up to R$180,000. In contrast, the market rate for other types of loans is 15 percent above the referential rate.

This policy creates a number of distortions, not only in the application of Brazil's private capital, but also in the incentives for financial institutions, and eventually their customers, to mobilize deposits. As indicated above, savings services are important to microentrepreneurs and their families and can be an important source of funds for expansion of the microfinance industry (Box 2). Thus, the directed credit programs supported by current policies should be evaluated in terms of their distributional as well as economic benefits in the housing and rural sectors, and in terms of the cost of lower returns to the many low-income savers (and potential savers) in Brazil.

Proposals to include microfinance within the eligible applications for mandated rural credit funds are unlikely to result in substantial expansion of microfinance at this stage of the industry's development due to the limited number of microfinance institutions that would qualify to use the funds without additional government guarantees. In any case, the high interest rates charged by the leading Brazilian microfinance institutions suggest that there is no need to subsidize their funding since this would simply further distort credit allocation and could lead to development of supply-driven microlending capacity that would undermine the financial and operational discipline required for truly sustainable development of the industry.

Restrictions on Public Banks

Brazil's public banks, while enjoying several advantages relative to the private sector, also are subject to limitations that could impede their entry and growth in microfinance. Public banks receive both direct subsidies from the government and indirect subsidies such as special dispensations from Central Bank requirements for provisioning and financial reporting that are meant to compensate for the higher risk and operating costs associated with their public service missions. However, in order to limit the potential for public banks to crowd out the private sector, the government has placed limits on their operations. For example, Banco do Nordeste is not permit-

Box 2. The Importance of Savings in Successful Commercial Microfinance

Bank Rikyat Indonesia (BRI), a state-owned bank, ran directed, subsidized credit programs for rice farmers until 1983. The Unit Desa (BRI-UD), established in 1984 as a separate profit center from BRI, consists of a nationwide network of small village banks. The founding objectives of the BRI-UD were to (a) replace directed agricultural credit with broad-based credit to the rural population involved in any type of economic activity, (b) replace subsidized credit with positive onlending rates at spreads sufficient to cover all financial intermediation costs, and (c) provide a full range of financial services (savings as well as credit) to clients. All of these objectives were achieved only a few years after inception of the BRI-UD, and its savings mobilization has been particularly successful. As of December 31, 1995, the BRI-UD had over 2.3 million loans outstanding, which represented an outstanding balance of almost US$1.2 billion, while deposit accounts numbered 14.5 million with a balance of US$2.6 billion, or 180 percent of the outstanding loan portfolio.

Source: "Rural Finance: Issues, Design, and Best Practices" by Jacob Yaron, McDonald Benjamin, and Gerda L. Pipreck. World Bank, 1997.

ted, under its statutes, to engage in mortgage lending, thus creating additional disincentives for savings mobilization. Public banks are also generally prohibited from engaging in consumption lending—a provision which is difficult if not impossible to enforce with microcredit.

These provisions would not be worrisome if private banks could be expected to take the risk of developing commercial microfinance services within the Brazilian lending environment. However, international experience has demonstrated that public banks—such as the *Bank Rikyat Indonesia*, the *Bank of Agriculture and Agricultural Cooperatives* in Thailand, and *Banco del Estado* in Chile—can be important "pioneers" in the development of "massified" microfinance services.[33] Several governments are looking to the development of profitable microfinance services in public financial institutions to increase the likelihood of maintenance of financial service infrastructure in poorer communities following privatization.

Credit Reporting

Brazil is fortunate to have a rapidly developing credit reporting industry. *SERASA, Serviço de Proteção do Crédito* (SPC), and *Equifax* are examples of services that are widely used by businesses to verify customer credit standings. These and similar services draw on information from a variety of private and public sources, such as the Central Bank's registry of checks presented against insufficient funds, and overdue utility and tax payments, to provide up-to-date information on any outstanding delinquent payments owed by a potential client. The widespread use of these services by the banking and retail sectors has made them an effective deterrent to delinquency because most Brazilians are very concerned with staying out of the reporting systems.

In addition to checking the current status of clients, these services increasingly are providing centralized information on the credit history of specific individuals and firms. They document on-

33. Jacob Yaron, "Successful Rural Finance Institutions," World Bank Discussion Paper No. 150 (Washington, D.C.: World Bank, 1992).

time repayment records and develop credit-scoring models that provide an estimated likelihood of default. Credit histories and scoring models can help both lenders and borrowers reduce the evaluation costs and uncertainties involved in character-based or cash flow–based lending. It also provides additional incentives for prompt repayment by microfinance clients because the positive credit history can be taken with them and applied to other financing and character-verification needs.

However, several legal impediments related to consumer protection and privacy laws have created uncertainty about the right to collect and utilize this information. Laws that require credit reporting services to request permission to release such data make information sharing overly cumbersome. In addition, these broad protections do not make up for the absence of specific requirements to give consumers access to their credit history and rating, and to reveal who has requested their credit information.[34]

NEW POLICY INITIATIVES IN SUPPORT OF MICROFINANCE

Commensurate with the recent growth of its microfinance industry, Brazil has begun to address legal and regulatory issues that are impeding industry development. In 1997 the Council of Community Solidarity, which is attached to the Office of the President of Brazil, initiated a review of laws and regulations that might impede development of microfinance in Brazil. A working group was established with participation from the Central Bank to review mechanisms to (a) facilitate the capture of external resources by NGOs for microfinance, (b) permit microfinance NGOs to operate outside the restrictions of the usery law that applied to all financial entities not regulated by the Central Bank, and (c) define an alternative type of bank branch that would be limited in its operations but not subject to minimum capital requirements.

In March 1999, Law No. 9.790 clearly defined the rights and responsibilities of "Civil Society Organizations," including their right to mobilize external funds for activities that include development of microfinance. In July 1999, Central Bank Resolution No. 002627 defined the rights and responsibilities of "microenterprise credit societies" (Box 3). In February 2000, Central Bank Circular No. 002898 defined accounting standards for microenterprise credit societies based on those already in place for finance companies. Also, in July 1999, the Presidency issued provisional measure No. 1.914-4, which redefined Brazil's usery law to specifically exclude qualified microenterprise credit societies and civil society organizations from its provisions and permit the National Monetary Council to identify other institutions to which the usery restrictions would not apply.

The working group is also reviewing the establishment of trust fund–type arrangements for microfinance programs within regulated banks. The trust funds, similar to the microenterprise credit societies, are intended to facilitate access to concessional funding by providing a transparent mechanism by which banks can segregate the accounting and equity of their microfinance activities, which would facilitate monitoring by donors. It is still being determined whether these trust funds will provide the basis for special provisions regarding minimum capital requirements for branches, or if the branches of microfinance programs can be treated as "service posts" as in the case of microfinance credit societies. The ability of these branches or posts to mobilize savings, and their treatment relative to the parent bank, are also under discussion.

34. Margaret Miller, World Bank, personal communication.

Box 3. Characteristics of Microenterprise Credit Societies

Central Bank Resolution No. 002627 established a new type of institution, the "microenterprise credit society," to provide NGOs with a more formal means of organizing themselves within the broad oversight of the Central Bank. The primary benefit to NGOs is the ability to mobilize grant and loan funds from Brazilian and international donors. Central Bank requirements and oversight are minimal, and are intended to improve transparency and avoid the worst potential abuses. Private bank and nonbank financial intermediaries are eligible to establish microenterprise credit societies, but public banks are not. Under the resolution, microenterprise credit societies must:

- Focus exclusively on microfinance
- Have minimum capital of R$100,000 (US$52,630)
- Capture domestic and international funds exclusively from private and public agencies in the form of donations and loans
- Establish "service posts" (rather than branches), which can be fixed or mobile, permanent or temporary, and are subject to Central Bank approval
- Consolidate the financial results of each service post into the headquarters' daily accounting.

Microenterprise credit societies are prohibited from:

- Calling themselves "banks"
- Public ownership
- Lending more than R$10,000 (US$5,263) to a single client
- Transforming themselves into a formal financial institution
- Capturing resources from the wider public (deposits, savings, or personal loans)
- Taking complete or partial ownership of another business
- Making or receiving interbank deposits
- Providing consumer loans

Should Central Bank Regulation and Supervision Be Expanded for Microfinance?

Policy initiatives in Brazil to date reflect an expectation of continued NGO-focused and donor-dependent provision of microfinance services. This is consistent with the industry's relatively recent development and the important role of NGOs in establishing the viability of sustainable microfinance in Brazil. The interest of the FENAPE network in obtaining funding through deposits and savings, and the expansion of CrediAmigo beyond the existing branch network of Banco do Nordeste, suggest that the Central Bank may be forced to address issues related to regulated commercial institutions in the near future.

In many countries, government and donors are pursuing a "proactive" approach to microfinance regulation and supervision in the belief that this will accelerate development of a sustainable microfinance industry by encouraging better performance of currently unregulated institutions and increase confidence among potential investors and lenders. However, the limited experience to date does not substantiate the hypothesis that reform of the financial sector's regulatory and supervisory framework is either a necessary condition or an incentive for development of a sustainable microfi-

nance industry. The cost of establishing a special regulatory framework and developing sufficient supervisory capacity can be extremely high relative to the very few institutions that are able to establish real profitability and qualify as regulated, deposit-taking institutions.

This experience supports the position of the Central Bank of Brazil, which has indicated that it is open to new proposals but does not want to try to anticipate the regulatory requirements of the emerging microfinance industry based on external experience. Instead, the Central Bank has indicated that it will draw on both Brazilian and international experience to develop a framework that responds to the emerging needs of the microfinance industry.

Alternatives to Central Bank Regulation and Supervision[35]

There are several alternatives to establishing new Central Bank regulatory and supervision requirements, including:

- Exceptions under the existing the regulatory framework
- Alliance with existing, regulated institutions
- Nonintermediated savings
- Self-supervision
- Delegated supervision
- Rating agencies
- Bank guarantees

Exceptions Under Existing Regulatory Framework

Since microfinance is a relatively new activity in Brazil, with few NGOs likely to be willing or able to seek formalization as deposit-taking institutions, it may be more practical to permit exceptions to existing regulations until additional experience is gained to develop a more generally applicable set of regulations based on experience with actual portfolio behavior. These exceptions could apply, for example, to minimum capital requirements, provisioning of "unsecured" microfinance loans, or restrictions on the application of deposits (though not reserve requirements).

Alliances with Existing Institutions

Several NGOs have already engaged in or are considering alliances with existing, licensed banks or financial companies in Brazil. For example, VivaCredi in Rio de Janeiro has been working in cooperation with a large private bank, UniBanco. Under this arrangement, the loan contract is formally signed between the client and UniBanco and disbursed through local branches of the Caixa Econômica, with VivaCredi carrying out the client screening, orientation, loan approval, and supervision responsibilities. VivaCredi also has provided assistance to the financial company subsidiary of UniBanco to develop a microfinance program oriented toward consumer lending.

Alliances with regulated financial intermediaries can range from the NGO operating as an agent of the bank for capturing deposits and making microloans on a fee basis, to the NGO receiving a guarantee from the bank that satisfies supervisory authorities. The relationship can begin at either end of the spectrum and evolve in either direction, depending on the status and interests of the parties involved.

35. The following draws substantially from Robert Peck Christen and Richard Rosenberg, "The Rush to Regulate: Legal Frameworks for Microfinance" (working draft dated October 29, 1999, CGAP Secretariat).

However, while several public and private commercial banks have expressed interest in working with NGOs to reduce their entry costs and management requirements for microfinance activities, most NGOs have expressed reluctance to formalize such partnerships beyond the use of banks for simple payments services. The factors that NGOs in Brazil cite for this reluctance include uncertainty regarding the long-term commitment of banks to microfinance, culture clashes between NGOs and banks and in particular concerns regarding the imposition of heavy bureaucracy on the NGOs' operations, and loss of NGO identity and independence. Nonetheless, to the extent that commercial banks begin to expand into the microfinance market, NGOs may wish to pursue partnerships to avoid loss of personnel and eventually market share to their better financed competitors.

Nonintermediated Savings

NGOs and subsidiaries of banks are appropriately concerned about the additional managerial responsibilities associated with mobilization of savings. These concerns, combined with the complicated restrictions in Brazil on the application of savings, pose a substantial impediment to provision of savings services through microfinance intermediaries. In order to gradually introduce these institutions to the management of savings, institutions could be permitted to mobilize savings subject to their being redeposited in investments such as federal government bond funds or certificates of deposit. In addition to their low risk, these applications do not carry reserve requirements. Special regulations may be required to provide qualifications and a minimal supervisory framework for institutions that provide such services to their clients.

Self-Supervision

Experience with self-supervision of financial intermediaries has generally been disappointing. Federations of microfinance intermediaries are best focused on establishment of performance standards, setting consistent reporting formats, delivering training and technical assistance to member institutions, and potentially providing centralized liquidity management. This is similar to the role currently carried out by FENAPE for the individual CEAPEs, or reporting guidelines and portfolio quality requirements imposed by BNDES on microfinance institutions participating in its apex program. Expanding the responsibility of microfinance federations to include prudent regulation and supervision of individual intermediaries has generally not succeeded in either protecting depositors or ensuring the financial health of the overall network of institutions.

Limitations with self-regulation are linked to governance issues.[36] Experience with credit unions demonstrates that establishment, monitoring, and enforcement of prudential norms appears effective until problems arise and the authority of the "peer group" is challenged by competing interests within the network.[37] This can be particularly problematic for NGOs where, unlike credit unions, there are no owners, and directors often have limited financial or business knowledge and have no personal assets or liability at stake.[38]

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36. See Anita Campion and Cheryl Frankiewiez, "Guidelines for Effective Governance of Microfinance Institutions," (Washington, D.C.: Microfinance Network, 1999).
37. See Rodrigo A. Chaves and Claudio Gonzalez-Vega, "Principles of Regulation and Prudential Supervision: Should They Be Different for Microenterprise Finance Organizations?" Economics and Sociology Occasional Paper No. 1979 (Colombus, Ohio State University, September 1992).
38. VivaCredi, whose board of directors includes the president of UniBanco, is an important exception to the generalization about lack of business knowledge. However, even in this case, the board views the program as a charitable endeavor with limited focus on its potential as a profitable financial institution.

Similar concerns can be expressed regarding publicly owned banks and even private banks where the microfinance program is unlikely to represent an important share of the bank's total assets. As a result, unless they are motivated by intangible benefits such as personal interest or public relations, senior management and directors are unlikely to invest time and effort in either learning about the peculiarities of microfinance nor in closely examining management performance in the operation of the program. Of course in this case it is the financial condition of the overall bank, rather than the microfinance program, that determines the risk to savers and investors.

Donors are even less likely to provide effective supervision. Generally, the contribution of donors is to establish performance standards for recipient institutions, as is done by BNDES. However, donors generally are not qualified and never have sufficient field presence to effectively monitor and evaluate the institutions they finance. On the other hand, donors can provide incentives for institutions to achieve performance targets.[39]

Delegated Supervision

An intermediate step between self-supervision and direct supervision by the Central Bank is for the Central Bank to delegate monitoring and inspection activities to a third party while retaining supervisory authority. For example, the Central Bank could contract these activities to a commercial bank or rating organization that has the existing installed capacity to carry out the specialized supervision required at a relatively low incremental cost. If such a strategy is be pursued it is important to define *a priori,* as part of the performance contract, the criteria for evaluating and monitoring the capacity of the third party to carry out its mandate, as well as the triggers for direct intervention by the Central Bank in case of collapse or fraud. New Zealand has been a pioneer in the use of contracted, third party regulation for a wide variety of regulatory and supervisory responsibilities, including the financial sector.

Rating Agencies

Rating agencies offer a variation on the self-regulation and delegated supervision approaches whereby independent agencies are contracted by the microfinance intermediaries or the Central Bank to provide public certification of the rated institutions. Rating is focused on objective, transparent criteria such as the CAMEL assessments that ACCION International has applied to its affiliates.[40] International experience can be used to complement limited domestic experience for development of performance standards to compare different types and scales of institutions.[41]

39. See Consultative Group to Assist the Poorest (CGAP), "The Anatomy of a Microfinance Deal: The New Approach to Investing in Microfinance Institutions," Focus Note No. 9 (Washington, D.C.: CGAP, August 1997).
40. CAMEL stands for Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity Management. CAMEL was developed by the Office of the Controller of the Currency of the United States Government for banking supervision. Ratios for C, A, E and L (M is generally more qualitative) can be developed for each segment of the financial sector. This approach was adapted to microfinance institutions by ACCION International as a tool for evaluating the institutions in its network.
41. For an example of comparative analysis of microfinance institutions around the world and associated peer group benchmarks, see *The Microbanking Bulletin* published by Calmeadow (www.calmeadow.com). Peer groups are organized according to geographic location, size, and target group.

SUMMARY AND CONCLUSIONS

Brazil is at an early stage in the development of its microfinance industry, but all indicators suggest that the industry can grow quickly to become a regional and world leader within the next 10 years. Macroeconomic stability has proven resilient in the face of the recent international financial crisis, and devaluation has not undermined the country's low and stable inflation rate. Microenterprises represent a large proportion of the business establishments in Brazil and an important share of employment, particularly in the poorer regions of the country such as the Northeast. The existing survey information for microenterprises in Brazil indicates that they are primarily involved in commerce and services and have cash flow patterns consistent with those required to support short-term loans with frequent repayment periods.

Despite its size, banks and other formal financial intermediaries have not pursued this potential market. This is less a reflection on microfinance than on the status of the financial sector as a whole. Financial intermediation in the private sector in Brazil is low. This is due not only to high government borrowing requirements, but also to high intermediation costs that are a disincentive to both borrowers and savers. Medium- and long-term finance is provided almost exclusively through government-owned banks through specialized lines of credit.

However, from the perspective of low-income clients, ease of access appears to be of greater importance than the price of financial services. Middle- and upper-income clients appear to be more sensitive than small-scale borrowers and savers to the effect of imperfections in Brazil's financial markets on interest rates. For example, the survey of Northeast microenterprises indicated that while few have taken a formal bank loan, when they borrow they typically pay *monthly* interest rates of 15 to 20 percent to suppliers and moneylenders. The survey also indicated that these microentrepreneurs are more likely to use savings services in banks. This is consistent with national data that shows Brazil is a country of very small-scale savers, with more than three-fourths of all savings accounts being under R$500 (US$280).

Over the past several decades the Brazilian government has tried, with limited success, to increase access to financial services through the extensive branch networks of publicly supported banks and numerous subsidized credit lines targeted to the poor. The very rough proxy of population per bank branch reveals important disparities between regions. From the perspective of private bankers, this disparity is logical given the lower savings rates and GDP per bank branch in the poorer regions. While public banks have partially addressed imbalances in the provision of savings services, public expenditures to improve access to lending services through subsidized credit appears to have been less successful. Survey results from the Northeast indicate that less than 2 percent of microenterprises have accessed bank credit, primarily due to their inability to comply with documentation and guarantee requirements.

Given the large number of microenterprises and the apparently price-inelastic demand for financial services, it is not surprising that several well-run microfinance programs have emerged in the past few years. The FENAPE network, an NGO program, is the oldest and geographically most extensive program. However, Banco do Nordeste's CrediAmigo program, focused in the Northeast Region, has grown rapidly in under two years to become the largest program in Brazil in terms of active clients and outstanding portfolio. In addition to these two programs, PortoSol and VivaCredi are NGO programs that represent distinct models of public and private partnership with civil society organizations. While these programs are quite diverse in their institutional structures and outreach, they distinguish themselves from most other microfinance initiatives in Brazil by their successful focus on low arrears, cost recovery, and efficiency, and they are demonstrating the potential to provide unsubsidized microfinance services on a large scale in the Brazilian market environment.

The government has recognized the potentially important role of microfinance in providing more effective financial services to the poor without requiring the large public subsidies associated with credit lines and maintenance of public bank infrastructure. Government and donor support has focused on supporting evolution of the above programs into sustainable institutions as well as providing funding for new initiatives. A review of the policy framework for microfinance indicates that the government has taken steps to remove restrictions on NGOs that impeded their entry and development in the market. The review identified several additional issues that may become relevant as private and public banks seek profitable mechanisms to provide microfinance services on a wide scale and NGOs seek to convert themselves into regulated institutions.

This report supports the stance taken by the Central Bank of Brazil to not attempt to "regulate microfinance into existence," but rather to respond to the emerging needs of the industry. "Proactive" regulation implies high incremental supervision costs and demands on Central Bank staff resources that, if not met, result in a false image of prudential oversight. This is particularly relevant given the small number of programs—essentially just CrediAmigo and the FENAPE network—that are moving to a scale that may justify institutional innovations to permit the capture of savings and other commercial sources of funding. Several alternatives to high-cost formal regulation and supervision are presented and discussed in the context of Brazil's experience to date.

Development of a profitable microfinance business can provide the basis for sustaining financial services in underserved communities at low or zero levels of subsidy. Given their focus on low-income clients and their need to develop profitable lines of business that do not compete with private banks, public institutions are likely to play an important role in carrying out the pioneering work in commercial microfinance, at least until private intermediaries enter this market segment and assume these and other functions of the public banks. This report suggests that the Central Bank take into account the potentially important role of the public banks in Brazil, and ensure that they are afforded the opportunity to develop microfinance programs on a level playing field with private banks, cooperatives, NGOs, and other potential entrants.

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