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# The Value of Proximity Finance: How the Traditional Banking System Can Contribute to Microfinance

This article presents findings that are part of a larger research program on financial inclusion that the authors have engaged in over the last seven years. Two of the authors have been engaged in research on the Brazilian banking sector for the last 15 years, tracking the evolution of microfinance projects and the progressive integration of microfinance operations in the portfolio of public and commercial banks.

The focus of the research is the role ICT plays in improving financial inclusion, particularly targeting microfinance projects. The research that deals primarily with financial proximity was based on 23 in-depth interviews of 90 minutes each with executives responsible for the CB networks and for microcredit operations in seven selected banks, with network integrators responsible for providing technological infrastructure, and with MFI loan officers and managers. All interviews were recorded with the consent of the interviewees and transcribed for analysis.

Based on our research on how to bridge the financial inclusion gap and reduce poverty, we argue for the value of proximity finance, a strategy by which traditional banks partner with microfinance institutions, drawing benefit from the rich knowledge and skills that "local proximity" provides and thereby creating room for the diversification of microfinance services in ways that maximize their outreach and, we hope, their social impact.

According to the World Bank, only 50 percent of adults worldwide report having an individual or joint account at a formal financial institution.[1] When that percentage

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is broken down by income, most who are excluded from financial markets live in poor countries. While account penetration is nearly universal in high-income economies, where 89 percent of adults report having an account at a formal financial institution, the corresponding proportion is only 41 percent in developing economies. This means that more than 2.5 billion adults around the world do not have a formal account, 2.2 billion of whom live in poor countries.

Financial inclusion is not the same as financial expansion. To render a more equitable service to society, the financial system has to move toward the former. The gap between the current supply and potential demand for financial services is striking, particularly when considering the tremendous global expansion of financial assets over the last few decades.[2] The recent backlash against the financial sector in the wake of the subprime crisis—the Occupy Movement, for instance—suggests that the mainstream financial system must take a more active role in terms of ethical behavior and social inclusion. This responsibility is intensified by the scale of the challenge, since alternative arrangements such as nongovernmental organizations (NGOs) and communitarian banks will not fill the need to reach out to more than two billion people.

Innovations related to information and communications technology (ICT) are also important drivers of new microfinance business models. The microfinance ecosystem has been expanded to include mobile operators, social networks, and peer-to-peer platforms, thus there is a growing field of research under the umbrella of a recently coined term: inclusive finance. The term is not merely a rhetorical recourse, as it captures the idea that new technologies and business models have blurred the boundaries that delimited traditional banking and points out that an inclusive financial system should include many other actors. However, the challenge of reconciling development and profits within this so-called inclusive financial system is even harder, given that new actors and business models add complexity to the task of serving the poor. Above all, to build up a truly inclusive financial system, clear ethical principles must be taken into account.

## The Boom and Bane of Microfinance

One of the leading strategies in responding to the challenge of leveraging inclusion is to promote microfinance, which has long been at the center of efforts to alleviate poverty and of development. It encompasses a range of financial instruments, including credit, savings, insurance, and mortgages. The rise of microfinance and its integration into the financial sector must be understood in the context of the evolution of development finance. Until the mid-1970s, the focus of development finance was the large-scale delivery of capital to government banks in developing countries, often with favorable terms and interest, which in turn were in charge of transferring the funds to large private firms.[3] The assumption was that encouraging "growth poles" would create a virtuous cycle of sustainable growth. Specific measures related to small and microenterprises were not considered part of this cycle, since the latter would benefit from externalities or spillover effects from large companies. The general result of this strategy was reason-



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ably acceptable in terms of growth, but definitely a failure in terms of reducing poverty and inequality.

There was an evident need for a new strategy that would include distribution channels that enabled capital transfers directly to the poor and to small and microenterprises. The main idea was to create and/or support existing nonprofit institutions that could be used as vehicles for distributing funds.[4] The Grameen Bank, founded by Muhammad Yunus in 1976, was one of these institutions. Yunus is a charismatic leader who challenged the conventional wisdom of the 1970s by adopting innovations in extending credit to the poor, such as group lending, use of credit agents, and attending to women's financial needs.[5] Other microfinance institutions (MFIs) were created worldwide, many of them inspired by Grameen, which along with Yunus became "the face of microcredit."[6]

One question that soon emerged related to the possibility of replicating Grameen, which at the time seemed more the exception than the rule, in that it depended primarily on donations to cover costs. Therefore, the bulk of the support went to institutions that were more business oriented in order to disseminate models that had greater potential to scale up. Starting in the early 1990s, most support from multilateral agencies, such as the Interamerican Development Bank, was directed to MFIs with operating costs less than 20 percent of the loan portfolio.[7]

This line of action created a new paradigm for the microfinance sector, as greater efficiency and return became a precondition for being financed. In practical terms, this new reality called for greater scale and relatively higher interest rates. Therefore, in order to serve the poor on a profitable and thus sustainable basis, MFIs were supposed to adopt a commercial view to business, giving birth to what became known as the commercialization approach.[8]

A later extension of the commercialization approach was the idea that selected MFIs should "upgrade" to become formal financial institutions. The main advantage was the possibility that some MFIs would resort to taking deposits and market funding to serve a larger number of clients. Furthermore, operating under a formal bank license would supply of a variety of products that would meet the diverse needs of the poorest segments more effectively. The shift toward building up formal bank institutions was emblematic of the idea of mainstreaming microfinance, which was ethically justified by the possibility of exponentially expanding outreach.[9]

This commercialization process, and later the upgrading movement, was followed by intense criticism that reached a peak after the initial public offering (IPO) of Compartamos in 2007. Briefly, Compartamos is an NGO established in 1990 that moved its operations to a regulated for-profit finance company in 2000. In 2006 the company was authorized to operate as a full-service bank. Having shown an impressive performance of annual returns on investment of 100 percent compounded for eight years running, and considering the bullish 2007 market, the IPO was a huge success among the major traditional market players, whose demand for shares guaranteed a 13-fold oversubscription.[10] The run of investors to Compartamos shares may have been based on



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expectations that the institution would struggle to maintain its unusual rate of return, which in turn was linked to the 86 percent per annum interest rates charged around the time of the IPO.

Another occurrence that put pressure on MFIs was a wave of suicides in the Indian state of Andhra Pradesh in 2010. Local politicians held microlenders responsible for the suicides of 57 people, who allegedly were hounded by the lenders' coercive recovery practices and the restrictions state government imposed that came close to capping interest rates.[11] Ironically, the tragedy occurred just when a significant expansion of microfinance in India was expected. Similar clashes between local authorities and MFIs occurred across Latin America.[12] In sum, although integrating microfinance into the financial system is appealing and undoubtedly necessary, in practice it remains a difficult task.

**Moving toward Proper Product Design and Delivery**

The episodes described were part of the first period of integrating microfinance into the financial system. As noted, the main challenge during this period was to reconcile social mission and commercial practices in microcredit models. One potential solution to the challenge was governance; for example, voting rights had to be controlled by socially committed investors to ensure that appropriate principles were followed.[13]

We argue that a second period of integrating microfinance into the traditional system is currently underway. Microcredit is no longer the only focus; another serious issue that must be addressed is the lack of knowledge of the behavior, preferences, and aspirations of low-income clients.[14] The challenge facing the traditional financial system when developing strategies to reach the poor and underserved is similar to that faced by multinational companies when entering emerging markets. Banks frequently resort to shelf products when confronting the need to extend financial services to low-income populations; that is, they use existing products that suit the needs of more affluent clients but often are unsuited to the daily lives of the poor.

Selling products and services to low-income consumers is not an easy task, particularly in terms of product design and delivery. Product design is a challenge because the target markets are the poorest urban and rural segments, whose preferences and buying behavior are different from those of traditional clients, who are mainly prosperous urban consumers. Affordability should be the focus of a proper design process, as low-income consumers want a product that offers the key benefits of a standard product while also meeting their budget constraints. The guiding principle in designing products to reach this new group of consumers should be "delivering more value at less cost."[15]

However, even the best-designed product will be of little use if not adequately distributed. This is an obvious challenge when trying to reach consumers located on the outskirts of urban regions or in rural areas. Another obstacle to distribution relates to mobility and security. This is primarily true in urban areas, where mobility issues are a consequence of the lack of urban planning and public transportation solutions to handle significant rapid growth. Security is a complex issue usually present in poor urban areas.



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The current challenge could be summarized as how to design and build a reliable infrastructure for delivering financial services and products that meet the needs of the poor. We argue that combining traditional banks' capabilities with local information and infrastructure through partnerships with local actors is an important part of the answer.

## The Value of Partnering with Local Actors

Poor people who struggle to survive must frequently juggle complex financial schemes and transactions. Although ignored by banks, there are sophisticated tools, mostly informal, that can be used to manage finance. The relevant local knowledge needed to design and deliver appropriate products for lower-income clients is available, but it has not been explored sufficiently by the traditional financial system. It can be understood readily by observing and interacting with local actors, such as government institutions, NGOs, and above all local associations and collectives. To capture and use relevant local knowledge, banks must learn to build successful partnerships with local actors. Partnering could be a winning strategy for all involved, as it can reduce distribution costs and use local actors' basic infrastructure to deliver financial products more readily. Moreover, by partnering with local actors, commercial banks could come to understand the local problems that affect the logistics of distribution and develop viable solutions. Local actors in turn could take advantage of the banks' capabilities and technology to leverage local development solutions.

## How to Create Proximity Finance Business Models: The Case of the Brazilian Correspondent Banking Network

Examples of proximity finance include commercial banks using local information to originate business, to analyze, monitor, and collect information, or even to lower the cost of distribution channels based on local infrastructure. For example, partnerships between banks and local actors can use ICT to reduce transaction costs, which are a main obstacle to expanding microfinance, and thus contribute to partnerships that enhance proximity finance business models.[16]

The recent evolution of microfinance in Brazil deserves a closer look in terms of the new arrangements being established at the core of the traditional financial system. An exemplary illustration is the partnership between commercial banks and local actors through correspondent banks also known as CBs. A CB involves points of service (POS) installed by banks in partnership with local non-bank businesses, such as supermarkets, pharmacies, post offices, and other retail establishments throughout Brazil, many of them in underserved, low-income areas. CBs are legally authorized to offer a range of financial services that include the four basic financial services: credit, savings, means of payment, and insurance.

In Brazil, a network of hundreds of thousands of CBs, more than six times the number of regular branches, has enabled the formal financial sector to expand its operations and extend its services over great distances, which favors low-income populations. The potential of this model hinges on using existing ICT infrastructure. The



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CB network's coverage across Brazil is impressive. In 2000, approximately one-third of Brazilian municipalities (1,600 out of 5,560) were without banking services. Due to the rapid expansion of the CB network, no Brazilian city has been without access to banking services since 2003.[17] CB outreach serves a relatively vulnerable segment of the population, such as those in rural areas, in poor areas of big cities, women, and informal workers.[18]

One important aspect of CBs is that the ICT they are based on—traditional POS terminals or PCs connected to the banks' transaction processing systems through existing transmission technologies—does not represent an innovation per se. The innovative element actually lies in the new arrangements and business partnerships throughout Brazil between banks and a vast number of actors known as CB agents, such as small local retailers. Being based on consolidated technologies helps reduce maintenance costs and training, and guarantees reliability in places with less infrastructure and fewer technical skills. To connect the thousands of CB entities spread around the country, the network relies on a variety of communications infrastructure already in place, such as mobile, Internet, satellites, and others, which are managed by network integrators or existing banking infrastructure. CBs and their networks can be characterized as a social innovation that has led to the use of existing and consolidated banking technologies in ways that favor the poor.

The CB network has created a way for clients, especially poor ones, to do their banking, which previously has been very difficult. There are several reasons for this: CB outlets are closer to these people than bank branches, especially poor women; they reduce the cost of travelling to banks to pay their bills or receive government benefits; and they reduce the time spent waiting to conduct such transactions and offer more flexible business hours.

Two key factors explain the success of CBs in Brazil: technology and the regulatory environment.[19] Technology facilitated real-time communication between the agents and the banks, allowed electronic identity verification of customers, and supported a widespread network infrastructure created during the high inflation period, when banks invested in technical solutions to process transactions more quickly. The regulatory environment was driven by the Central Bank's role in supporting federal social policies and developing ways to democratize access to credit and build partnerships to promote financial inclusion among the Brazilian population. The CB infrastructure evolved further through a diverse network of partners that operated together under business agreements based on a branchless banking concept.[20]

The CB network exemplifies a proximity model of microfinance. As MFIs partnered with commercial banks, they played a major role, both directly as CB agents and indirectly by providing information relevant to expanding products and services in communities located in poorer areas. This model has been adopted by traditional banks in Brazil, including government banks that played a role in implementing governmental policies, although they operated as regular commercial banks.[21] Recognizing their social role and their relative lack of knowledge about how to address the needs of the poor, these banks found it more effective to create partnerships with local



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| As of 12/31/14 | Banco do Brasil | Caixa |
|---|---|---|
| Total Assets | US$ 560 billion | US$ 407 billion |
| Loan Portfolio | US$ 305 billion | US$ 230billion |
| Customers | 61.7 million | 77.27 million |

*Sources:* www.bb.com.br and www.caixa.gov.br

**Table 1.** Some numbers on Banco Palmas' partners

MFIs. The potential advantages of this partnership model are not limited to government banks and may be useful for the traditional financial system as a whole. In fact, the worldwide image of a bank tends to be an institution for "money owners" whose branches are far from communities in the city outskirts and rural areas. Since the CB network was implemented on a large scale in Brazil, it has already expanded to many other countries, including Mexico, Colombia, and India.

These partnerships employ the credit expertise and methodologies already used by the partnering MFIs, adding funding as well as technological and operational support from big retail banks through their CB network. Supplying and using this kind of indigenous information strategically decreases transaction costs and helps to overcome the design and distribution limitations previously mentioned. An example of the reach of microfinance operations following the CB partnership model is the collaboration between Banco Palmas, a well-known Brazilian MFI, and two government banks, initially with Banco do Brasil—the country's first state-owned bank—and more recently with Caixa, the second largest state-owned bank and the institution designated to make social security payments.

**Banco Palmas and Banco do Brasil/Caixa Partnerships**

Founded in 1998, Banco Palmas is a community development bank whose general mission and goals are local development on the outskirts of Fortaleza, a village in the northeastern state of Ceará that is home to about 32,000. The bank was founded in an attempt to counter high poverty levels in the poor neighborhood of Conjunto Palmeira by fostering activities to create jobs and generate income for local inhabitants. Its grounding principle is to create a solidarity economy that employs innovative financial mechanisms, such as offering microcredit at low interest rates. Joaquim de Mello is one of the main figures responsible for the creation of Banco Palmas. He is a former seminarian who left the Catholic Church to become an active communitarian leader. He was part of the group that decided to create a grassroots association in the Conjunto Palmeira neighborhood in 1984 to help its occupants overcome extreme poverty and the concomitant lack of basic infrastructure.



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While Conjunto Palmeira did improve living conditions throughout more than a decade of militancy, de Mello and other community members perceived that one major obstacle to development was the absence of commercial activities within the boundaries of the neighborhood, which forced most residents to travel some distance to buy basic consumer goods. This led to the launch of Banco Palmas in 1998. The MFI was formally organized as a communitarian bank that provided credit to residents and maintained a social currency called the Palma, which was only accepted locally.

Banco Palmas used this social currency to redirect capital toward local production and consumption and, ultimately, local socioeconomic development.[22] By getting local retailers to accept the Palma in commercial transactions at an exchange rate equal to Brazil's national currency (1 Palma = 1 Real), Banco Palmas was able to keep the capital owned by local residents within the neighborhood. As of December 2013, 260 local retailers were accepting Palmas.

The Palmas methodology has two other core components: it provides producer-oriented microcredit for new entrepreneurs in Reals, and consumer-oriented microcredit for residents in Palmas; and it created a production-consumption map of the territory that guides the opening of new businesses. Due to the originality of the Banco Palmas model, it is now considered iconic in the field of solidarity economy in Brazil.[23] Since 2003, its methodology of creating community banks has gained increased recognition and support from governments and public entities across Brazil, and in other countries.[24]

In 2003, in an effort to further capitalize both public and private resources and to facilitate information-sharing and capacity-building with other emerging community banks throughout Brazil, Banco Palmas created an umbrella institution, the Palmas Institute.[25] The institute's main goal was to provide nascent community banks with technical and legal support based on its methodology, and to disseminate the principles of a solidarity economy. In 2005, the government's National Department for Solidarity Economy designated the Palmas Institute as the major entity to facilitate and support the implementation of community banks in other poor municipalities. By guaranteeing substantial funding to the sector, the government helped to consolidate a Brazilian network of community banks.[26]

The first replication of the Banco Palmas model occurred in September 2004, with the implementation of Banco Par, a community bank in the city of Paracuru, 70 kilometers from Fortaleza. The Paracuru government encouraged the adoption of the bank model by diverting funds from the Secretary of City Social Development and the sagging infrastructure of the Reference Center for Social Assistance to install the community bank.[27]

In 2005 and 2006, Banco Palmas consolidated the community bank concept through two major partnerships, thereby expanding to other locations with the National Secretary for Solidarity Economy (SENAES). SENAES partnered with Banco Palmas in 2005 to extend the community bank methodology to other districts and municipalities. This agreement was renewed in 2006, and by the end of that year, 13 new CDBs had been created—a striking result in such a short time.



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Another strategic partnership was formed in 2006, when the Palmas Institute partnered with the Banco do Brasil to act as intermediary between the bank and each newly created community bank across Brazil.[28] Each of these banks was formally engaged by Banco do Brasil as a CB agent, which allowed an expansion and diversification of the products available to clients. Moreover, the partnership guaranteed each community bank a regular source of funds by charging fees.[29] The services offered included savings account transactions, payment services, social security benefit withdrawals, life insurance, and loan requests.

The partnership between the Palmas Institute and Banco do Brasil consolidated the CB model into Banco Palmas and also provided an enhanced ICT infrastructure that could be used to improve microcredit operations. In short, Banco Palmas now offered typical bank branch services to bankless communities, including opening and managing bank accounts and collecting bill payments.

Another important outcome of the community bank model was a rise in the importance of using ICT banking tools to improve management of the financial services offered.[30] As the CB has become increasingly important to Banco Palmas, it has been incorporated into the community bank model. The network of community banks has developed in both the number of institutions and the consolidation of its model, which has incorporated CB as one of its strategic pillars. More than 100 community banks from 19 Brazilian states joined the third meeting of the network of community banks held on the 15th anniversary of Banco Palmas.[31]

Although they differ in many ways, all these community banks are based on the basic Banco Palmas pillars—credit methodology, social currency, and CB—and the anniversary meeting demonstrated the replication power of the Banco Palmas model. Spread across several Brazilian states and growing in importance in defining the direction of their communities' development, community banks have also helped to consolidate partnerships between traditional banks and MFIs through CBs, which provide financial inclusion using typical products of the microfinance environment.

The Palmas Institute has been appointed the administrator of the Brazilian network of community banks, due to its partnership with the Banco do Brasil and the mandate from the National Department for Solidarity Economy. Under this agreement, the institute aims to provide more efficient technological banking infrastructure to the network of community banks that have been taken on as CBs. Once an individual community bank becomes a CB, it is automatically linked to Banco do Brasil's banking system and thus is able to offer a menu of services.

Nevertheless, it's not uncommon to hear community banks complain about the partner banks, particularly about the low remuneration they receive for services rendered or the lack of logistical and technological support. This reflects the persistent imbalance in the business relationship, wherein the local agent has little leeway in complying with the uniform rules set out by the big banks, despite the differences of each locality.

In 2011, Caixa replaced Banco do Brasil as Banco Palmas' main financial collaborator. In addition to acting as Caixa's CB partner and having access to microcredit



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funding, Banco Palmas is authorized to pay social security and cash transfer benefits, such as the Bolsa Familia Program, which is advantageous to the bank as it means it will collect more fees.[32] In 2012, community banks, now Caixa's CB partners, processed 436,190 transactions amounting to about R$ 65 million; Bolsa Familia payments accounted for 7.7 percent, or R$ 5 million. In the same period, 1,549 accounts were opened via this service.[33] Considering a US$ 0.30 fee per transaction, the direct revenues would amount approximately to US$ 131,000. However, the primary motivation for CBs as a whole and for Banco Palmas specifically is the increasing foot traffic, since more people from the community are attracted to the bank's facilities, leveraging the supply of other services.[34]

**Final Comments**

We argue that local actors have access to information, formal and informal, that may add value to business decisions, particularly within the financial system. Local actors also have a certain level of general knowledge about the activities of local entrepreneurs and residents, and this position enables them to map social relationships that can be used to leverage credit and production.

The current level of financial exclusion among the poor is evidence that the traditional financial system's models were created to meet the needs of the most affluent, particularly in terms of product design and delivery. We argue that the traditional financial system could reach a whole new world of clients by partnering with local actors. By incorporating this sort of partnership into its strategy, the system could create shareholder value while contributing to development. Banco Palmas' business arrangement as a CB partner of traditional retail banks is a concrete example of this sort of partnership. The CB network based on the Palmas model currently numbers 103 members that span all five Brazilian regions—an expansion that would not have been feasible without this partnership.

Under the partnership, the Palmas Institute bases its actions with its network on three primary goals: to identify and capitalize funding sources for providing microcredit; to establish more efficient banking technological infrastructure within the network, building on the CB network; and to use public lines of credit to promote local social projects via the community bank methodology. By opting to enter the network, CBs are automatically linked to the bank's system and thus eligible to access microcredit funding.

The CBs' resources and technology are vital to both the design and delivery of products that serve the poor and excluded, a profile that differs from that most banks are generally familiar with. At the same time, given the scale of the unserved population, the success community banks have had in dealing with poverty and promoting development is conditioned on partnerships that involve the traditional financial system. For the latter, promoting financial inclusion with the help of local actors' savoir faire offers an opportunity to expand the scope of business beyond their current customers, including the chance to roll out the Brazilian model in other countries. The



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logic of partnership embedded in the CB network is a concrete example of a caring market solution to poverty.

The most important outcomes of the partnership model are as follows:

- Greater equilibrium between development and profits, since the partnerships involve local actors that are development oriented. Binding commitments therefore may be established a priori, such as a balance between consumer- and producer-oriented microcredit.
- For the partner banks, incorporating consolidated microcredit methodologies mastered by the MFIs represents valuable knowledge they are now developing.
- The MFIs are using a robust technological infrastructure with the CB network, which is starting to be combined with microcredit initiatives.
- It provides the opportunity to increase the scale of an arrangement that is working well on a relatively small scale.

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