Corposol/Finansol:

Lessons for Commercialization

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Corposol/Finansol Case Study: Lessons For Commercialization

by

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Based on an original paper by Jean Steege

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CHAPTER ONE
INTRODUCTION

Corposol began operations in Colombia in 1988 as a nongovernmental organization (NGO) whose mission was to provide microfinance services to poor small business owners.

Through its 1993 acquisition of Finansol – a regulated, commercial finance company (CFC) – Corposol became the second microfinance institution (MFI) in Latin America to enter the commercial arena.[1] In its heyday, Corposol was internationally celebrated for its rapid growth and success in meeting the needs of a vast number of Colombian microentrepreneurs in need of credit. But in 1996, Corposol collapsed under the weight of its rapid growth, flawed institutional relationship with Finansol, and inadequate governance structure.

This chapter details the accomplishments of Corposol's first seven years, the events leading to Corposol's fall, and Finansol's ensuing recapitalization. Moreover, this chapter analyzes the strengths and shortcomings of both organizations and suggests lessons for other NGOs that have transformed, or are planning to transform into commercial institutions.

[1] BancoSol in Bolivia was the first MFI in Latin America to be commercialized when it became a bank in 1992.

CHAPTER TWO
BACKGROUND

On August 22, 1988, a group of Colombian business leaders led by Alvaro Arango and Oscar Giraldo founded the NGO Actuar Bogotá, which at a later stage of its evolution would be called Corposol.[2] The mission of the organization was to provide business credit and training to Bogotá's microentrepreneurs – poor business owners running small, often unlicensed businesses such as fruit stands, shoe repair shops and small restaurants. At the time of Corposol's formation, this informal sector accounted for 40 percent of employment in Colombia, with approximately 1.2 million microenterprises employing 3.3 million people.[3]

Both Oscar Giraldo, Corposol's president and Alvaro Arango, the president of Corposol's board of directors, had business backgrounds and were personally committed to helping communities in need. Charismatic and ambitious, their personalities had an enormous influence on the growth of the organization in its early days. However, their personal and professional desire for success led them to pursue a strategy that was overly focused on growth, without sufficient priority on portfolio quality.

From 1988 until 1995, Corposol grew rapidly under the management's mandate for growth (Figures 1 and 2). But by 1991, the organization was growing too quickly under unsustainable performance objectives, a poorly researched product diversification plan, and a lending methodology inconsistent with the needs of the market.

In 1993, to facilitate its expansion, Corposol acquired a regulated, for-profit finance company named Finansol. For several years, the institutions appeared to work well together – Finansol issued microloans while Corposol provided client training.

By 1995, the loan portfolio and operations were beginning to exhibit significant weakness. The division of responsibilities between Corposol and Finansol were so clouded that there were few distinct lines of accountability between the two organizations. Clients were taking on more debt than they could pay back and lending practices were degenerating. By September 1996, those weaknesses devolved into a full-blown crisis, revealing the mounting financial and operational troubles of the organizations.

In 1996, Finansol established a new management regime. Together with the Colombian Superintendency and international stakeholders, management recapitalized Finansol's portfolio, allowing the institution to continue lending to this day. Corposol's fate was not as bright: In September 1996, the Colombian Superintendency of Companies (*Superintendencia de Sociedades*) ordered the official liquidation of Corposol. Since 1996, Finansol (renamed FINAMÉRICA in 1997) has rebuilt its business slowly and carefully.

[2] For the purposes of this chapter, we will refer to the nonprofit organization as Corposol with the understanding that from its inception until 1993, the name of the organization was Actuar Bogotá.
[3] Estudio de Factibilidad, Compañia de Financiamiento Comercial CFC-Actuar, May 1993.

At year-end 2000, Finansol had 16,000 clients and an outstanding portfolio of US$16.8 million, a 72 percent increase in active clients and a 13 percent increase in outstanding portfolio from 1999.

Figure 1: Active Clients C **Corposol/Finansol/Finámerica**

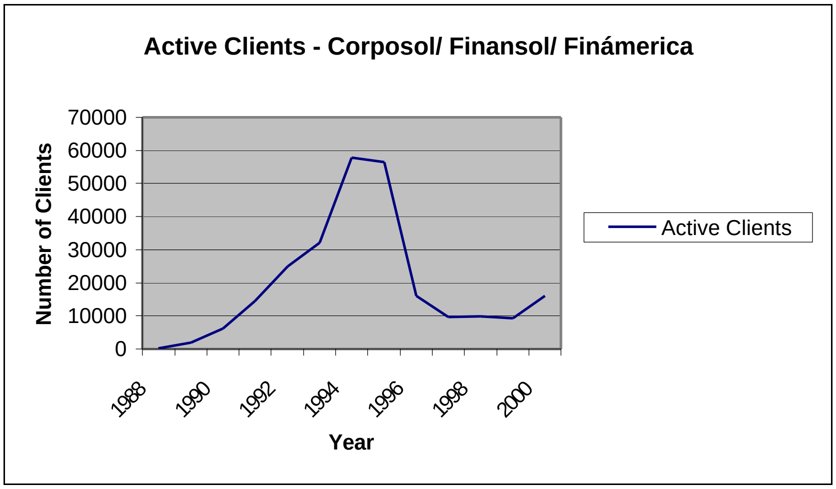
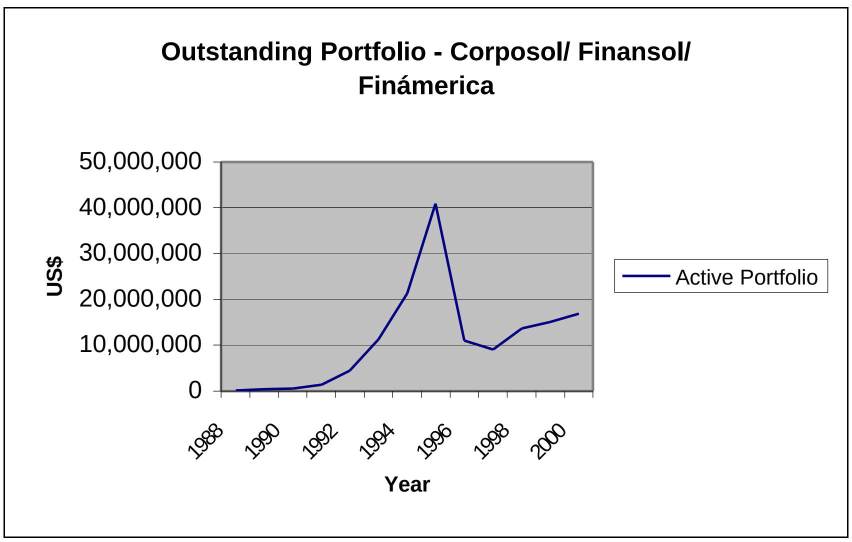


Figure 2: Outstanding Portfolio C **Corposol/Finansol/Finámerica**



Despite the impressive numbers in terms of numbers of clients and portfolio size, neither Finansol nor Corposol have ever achieved profitability.

The history of Corposol/Finansol can be categorized in six distinct periods:

1. Controlled Growth (1988-1991)
2. Signs of Trouble (1991-1992)
3. Product Over-diversification (1992-1994)
4. The Unraveling (1995-1996)
5. The Turnaround (1996-1997)
6. The Rebuilding (1997-2001)

1988 – 1991: Controlled Growth

From 1988 until 1991 Corposol experienced rapid yet controlled growth, with a focused and consistent lending methodology. During that time, Corposol was flourishing, boasting an outstanding portfolio of US$1.4 million and over 14,000 active clients after just over two years of operations.

Operational Consistency

Corposol's original lending methodology was to provide loans to "solidarity groups" – networks of four microentrepreneurs who were mutually responsible for the loan repayment of each member of the group. To induce growth and maintain controlled lending practices, loan officers were assigned specific geographical zones. They were not permitted to lend in a new zone until their existing territory was sufficiently served. Additionally, expansion into different zones would be considered only if a minimum of 20 solidarity groups were established. Until 1990, the system seemed to work well. Loan officers were able to reach their performance objectives, which were based on the number of new clients and the number of renewed loans each loan officers made. Unfortunately, even at this early stage, the system gave insufficient weight to loan repayment, prioritizing lending volume often at the cost of portfolio quality.

Funding Sources

Corposol's founders planned to create an initial financial base through donations, but the portfolio grew faster than donations could support. To maintain its growth trajectory, management pursued a larger, more reliable funding source – commercial bank loans personally guaranteed by Corposol's board members. But these guarantees, which totaled less than US$55,000, were not sufficient to support the organization's rapid growth, temporarily halting expansion.

In 1990, to overcome this financing constraint, Corposol turned to FUNDES, a Swiss business family foundation operating in Colombia, and ACCION International, a U.S.-based private nonprofit specializing in microfinance. ACCION and FUNDES co-guaranteed letters of credit to Colombian banks, greatly increasing the amount of funding available to the institution. As banks grew more familiar with Corposol as well as the successful repayment rates of their microentrepreneur clients, they became comfortable directly lending to Corposol. Eventually banks began accepting promissory notes signed by microentrepreneurs as collateral. At the same time, Corposol's portfolio received a clean audit from an international accounting firm. By all accounts, the growth trajectory of Corposol was sustainable, supported by ample funding.

1991 – 1992: SIGNS OF TROUBLE

Beginning in 1991, Corposol's lending methodology and performance objectives became increasingly unrealistic. In response to donor wishes and management's desire for expansion, there was a notable shift away from simply "growth" toward a demand for "growth at all costs."

Operational Inconsistencies

Although the zone system worked well at the beginning, it began to falter after 1991. Management began demanding higher productivity from loan officers, despite feedback that zones were becoming saturated and consumer demand was waning. When loan officers requested to expand into new territories, management often refused, leading loan officers to deviate from the original, effective lending methodology. They began to arbitrarily lend in unapproved geographical areas, and worse, issued loans for the sake of meeting requirements, without confidence that the client needed additional funds or had the ability to repay.

Furthermore, Corposol's management assigned performance objectives that were difficult for loan officers to attain. By 1992, it was nearly impossible for loan officers to reach these objectives and still practice standard lending procedures. With a strict incentive system based on lending volume rather than the borrowers' ability to repay, increasingly risky loans were disbursed. Loan officers who didn't meet the objectives incurred harsh penalties, from public reprimands to dismissal. As the rate of hiring new loan officers was increasing, less emphasis was put on training, further contributing to the relaxation of the earlier, more proven lending methodology.

Funding Problems

In 1992, Corposol hit a major funding wall. With a capital to loan ratio of 1:16, the organization was overleveraged and could not obtain additional credit from banks. ACCION International and FUNDES had reached the limits of their approved risk exposure, and neither institution could provide additional letters of credit to Corposol. At this time, both ACCION and FUNDES were concerned with the rapid rate of growth and the ability of the institution, as an NGO, to manage this growth. But awkward dynamics within the Corposol board – where Arango and Giraldo were increasingly monopolistic of the decision-making process – precluded both shareholders from following their instincts and demanding more controlled growth.

1992 – 1994: PRODUCT OVER-DIVERSIFICATION

From October 1992 to December 1994, Corposol's structure significantly changed. Its management introduced two new subsidiaries, Finansol and Mercasol. Finansol, the commercial finance company, offered four distinct credit products – construction loans (under the brand name Construsol), agricultural loans (under the brand name Agrosol), individual loans and solidarity group loans (see Figure Three and Table One). Although the establishment of these programs, collectively called Gruposol, was consistent with the overall mission of Corposol – to provide the poor with tools to increase their income-generating capacity and quality of life – they were initiated with insufficient market research.

Figure 3: Gruposol

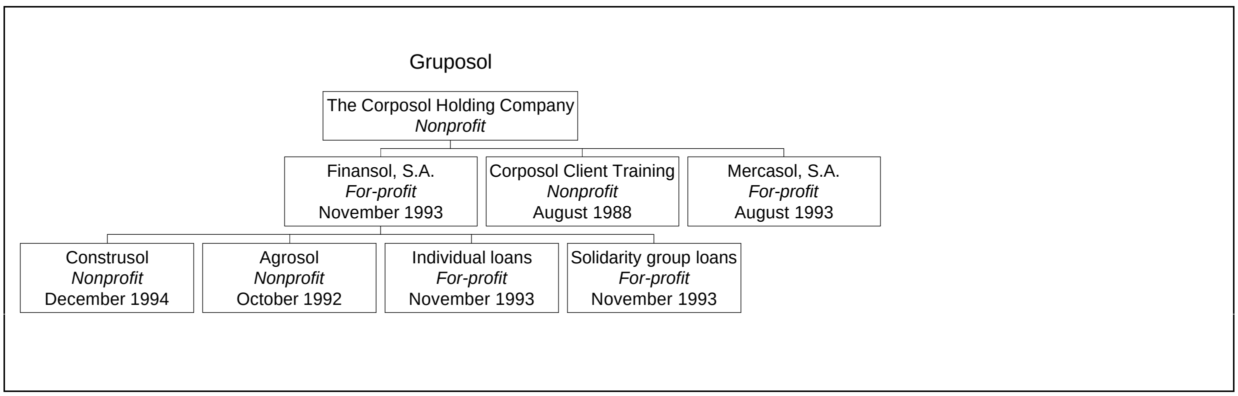


Table 1: Gruposol

Under the leadership of Oscar Giraldo, Corposol grew rapidly and diversified its products. With the overall objective to deliver a range of services, the following arms of Gruposol were established between 1988 and 1994.

Name	Year Established	Non/For-Profit	Mission
Corposol	1988	Nonprofit	Corposol holding company provided strategic leadership, administrative support, public relations and general coordination for the entire group. Corposol was the majority shareholder in Mercasol and Finansol, and served as a fundraiser for the nonprofit arms.
Finansol	1993	For-profit	Finansol was a private CFC supervised by the Superintendency of Banks, and served as the financial intermediary of the group. It issued loans for each part of Gruposol that had credit operations. It primarily funded its operations by issuing certificates of deposit (CDs) to the Colombian government and local commercial banks. As the only regulated entity, Finansol was accountable for the quality of Gruposol's aggregate portfolio.
Mercasol	1991	For-profit	Mercasol was a commercial retailer, selling inventory to microentrepreneurs by offering them lines of credit. Mercasol purchased in bulk from suppliers and passed the savings on to clients, while allowing them to purchase in small quantities. This service was available to clients with businesses that used or resold food and other consumer goods (such as stores and restaurants).
Construsol	1994	Line of Credit through Finansol	Construsol was a credit product offered through Finansol. Construsol provided loans to clients making physical improvements to their homes or businesses. Based on the belief that many clients were already pursuing such improvements inefficiently because of minimal or sporadic income, Construsol provided, for a fee, the technical assistance of architects, engineers and lawyers to help clients plan and execute construction projects. Clients could take out a Construsol loan to fund their improvement projects in addition to their other existing loans for working capital or fixed assets. Corpsol created Construsol with the intention that it would become financially self-sustainable and be spun off as its own private institution.
Agrosol	1992	Line of Credit through Finansol	Agrosol was a line of credit issued through Finansol. Agrosol provided loans, training and technical assistance to rural clients.
Corposol Client Training	1988	Nonprofit	Corposol client training reflected management's belief that clients were more likely to increase their income and quality of life if taught to better manage their businesses, improve the nature, quality or diversification of their production or sales, and better utilize their income. Any credit client was automatically charged a training fee that was tied to the disbursement of their loans. Although clients were not obligated to attend training courses (or could opt to send family members or employees), they were still charged the fee. Although this component of the holding company was defined as nonprofit, it did generate significant income for Corposol.

By the end of 1994, Gruposol reported that it was collectively serving 58,000 clients, a 190 percent increase since they began to diversify their services, just two years before.[4] This produced a 1994 outstanding loan portfolio of US$21.5 million, nearly double its value from the previous year. To continue to fuel this growth, the management of Corposol needed to access more stable sources of funding than was possible as an NGO. In 1993, the opportunity to acquire a commercial finance company and access that funding presented itself.

The Acquisition of Finansol

Corposol's management and board realized that they needed to become a regulated finance institution to reach enough microentrepreneurs to affect substantial positive change among Colombia's microentrepreneurs. After years of feasibility studies and assessments of alternative options, Finansol was launched on November 2, 1993 as Corposol's for-profit commercial finance corporation (CFC). Finansol was charged with managing all credit operations for Gruposol.

Before the opportunity to transform into a CFC presented itself, the management and board of Corposol planned to create a fully-regulated bank. At the beginning of 1993, a feasibility study concluded that the creation of a bank would solve their recurring capital shortage problem, ensuring fund availability for its clients in the long-term. As a bank, Corposol could:

- Capture funds directly from the public (including savings deposits), thus proving that microentrepreneurs have the capacity to save
- Maintain a capital to loan ratio of 1:10
- Eliminate commercial banks as intermediaries, thereby reducing the cost of loans to its clients

However, becoming a bank required a minimum capitalization of US$13.7 million, which neither Corposol nor its international supporters could afford.

Later in 1993, a change in the Superintendency's banking law made an alternative option available to Corposol. Previously, companies held one license for both leasing and financial services, even if a company only offered one of the two services. The new regulation separated the license into two distinct parts. This rendered the license to make loans redundant for Financiera Fenix, a local leasing company. Corposol, along with several external partners, purchased the finance license on September 30, 1993 for US$250,000. The acquisition involved only the license to operate, with no transfer of the portfolio, employees or even the company's name. By purchasing an existing license, Finansol could begin operations in two months, while it would have taken over a year to apply for government

[4] As the 1994 loan portfolio was examined in later years, it was discovered that many of the same clients were receiving loans from several product lines within Gruposol. In fact, some of the performance indicators reported at the time were inflated by as much as 30 percent.

authorization had they created a new commercial finance company. Capitalized at US$3 million, the new CFC was named Finansol.

Corposol was the majority shareholder of Finansol with 71 percent of the shares. Minority shareholders included private individuals, and international microfinance specialists ACCION International, Calmeadow and FUNDES.

The Finansol acquisition represented an excellent opportunity from the standpoint of Colombia's Superintendency of Banks. Corposol had a strong board of directors, comprised of prominent members of the Colombian banking, business and law community and the financial and governance support of several international shareholders. Furthermore its leaders, Arango and Giraldo, were well-known businessmen with strong backgrounds in both business and social development.

Finansol handled all of Gruposol's lending activities. Finansol inherited 32,000 clients, a high-quality portfolio and a successful track record from Corposol and Agrosol. As a CFC, Finansol could obtain funds through certificates of deposit or bond issuance, but was prohibited by law to offer savings and checking accounts.

Corposol remained an NGO, offering training to clients and administrative support to Finansol. Notably, the loan officers remained the employees of Corposol. This put Finansol in the awkward position of being legally responsible for portfolio quality, but having no management authority over the loan officers who controlled the disbursement of loans.

Finansol established its own board of directors and management team. However, despite the autonomous structure, Giraldo, as the president of Corposol, closely monitored Finansol's management. Additionally, the board of directors of Finansol was made up of some independent members, but more than half of the seats belonged to Corposol board members. Furthermore, the president of the board of Corposol, Alvaro Arango, was also the president of the Finansol board.

Although formally Finansol and Corposol were separate entities, Corposol used its majority ownership of Finansol and its overwhelming management and governance role to support projects that contributed to growth (Corposol's goal), with less focus on the financial integrity of the organizations (Finansol's responsibility). These divergent goals and mismatched responsibilities eventually impaired the successful marriage of the two organizations.

1995 – 1996: THE UNRAVELING

Through early 1995, Gruposol continued to grow and seemed to be running smoothly, reporting over 56,000 active clients whose loans generated an outstanding portfolio of US$41 million. The success of Finansol was widely considered proof that the commercial approach to microfinance worked. Although these numbers appear to be robust, the structure behind them proved to be shaky.

In May 1995, after eight months of delays by Corposol's management, ACCION International performed a diagnostic assessment (CAMEL)[5] that pinpointed a deterioration of operations between 1992 and 1994. It also brought to light several other problems, including:

- Ambiguity caused by dividing management of the credit function between Corposol and Finansol
- Ineffective information flow within the organization, which negatively influenced the efficacy of management and decision-making
- A high rate of employee turnover, a costly symptom of broader organizational problems
- Deterioration in asset quality, efficiency[6] and profitability, with a 24 percent decrease in net income from 1992 to 1993
- Inconsistent statistics, which set off alarms concerning the accuracy of Corposol's reporting practices

By mid-1995, it became clear that Finansol had performed extensive loan refinancing and had even sold part of its poor-quality portfolio to Corposol to disguise its poor portfolio quality and defer the required provisions and write-offs of its many bad loans. Despite their governance role, ACCION International and other Finansol shareholders did not address their concerns because of their strained relationship with the management of Corposol, an error of judgment as their concerns ultimately proved to have merit.

During the initial stages of the crisis, Arango and Giraldo purchased Urban Solutions, a low-income housing developer. The purchase was poorly timed, given Gruposol's already-troubled portfolio, and led to further distrust by the board in management's ability to make wise business decisions in the face of a financial emergency.

Gruposol's operational difficulties and poor profitability continued. By May 1996, Finansol's continued losses had eroded its equity to less than half of what it had been at the start of that fiscal year, rendering the organization insolvent. By then, Corposol was unable to meet payroll, much less repay its creditors. Together with Finansol's board, the Colombian Superintendency of Banks agreed to a restructuring plan accompanied by a recapitalization. Aware of the gravity of Corposol's financial situation, the Superintendency declared a moratorium on the issuance of new loans.

The restructuring plan was logical from a regulatory standpoint, but had two unintended negative effects. First, certain "good clients" began to go into arrears when they learned that their loans might not be renewed because of the Superintendency's ruling. Second, Finansol found itself experiencing losses since the overall loan portfolio was shrinking and its fixed costs were now covered only by the interest on existing loans versus interest received on new loans.

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[5] ACCION International conducts CAMEL evaluations (based on a similarly-named assessment tool developed by US bank regulators) to assess the financial and managerial soundness of its microfinance affiliates in Latin America.

[6] Asset quality was measured by delinquent portfolio as a percentage of outstanding portfolio and as a percentage of equity. Efficiency was measured in terms of both operational costs and physical productivity of loan officers.

Luis Fernando Tobón, a respected banking professional, became Finansol's third president in October 1995. He implemented a series of corrective measures, including the termination of the development of new credit products as well as a reinstatement of the ACCION lending model[7] (from which the institution had deviated during its drive for growth). He completely separated the operations of Finansol from Corposol, and formulated a plan to streamline financial management. He put in place plans to improve management information systems, day-to-day operations and human resources. Additionally, Tobón made the collection of doubtful loans a priority for Finansol. Despite these corrective measures, Corposol's situation was becoming increasingly desperate.

1996 – 1997: The Turn-around

Luis Tobón resigned in March 1996 to take another position within the Colombian banking sector. His replacement, María Eugenia Iglesias became Finansol's fourth president. A 20-year Citibank veteran and former consultant to Corposol, Iglesias was the perfect candidate to turn Finansol around. As a friend and former colleague of Tobón, she was well aware that the institution teetered on the brink of disaster when she took over. She performed the difficult and crucial task of removing all 260 loan officers from the Corposol payroll and incorporating them into the structure of Finansol.

ACCION then spearheaded a commercial private equity placement as the solution to the capital adequacy needs of the institution. This entailed engineering the involvement of a major global financial player, Citibank Colombia. The issuance of equity failed, due mainly to the deterioration of the Colombian financial markets and the damaged reputation of Finansol. In July 1996, another Finansol recapitalization effort began.

Led by ACCION and Citibank, the shareholders raised a total of US$3.5 million by August 1996 and another US$2.6 million by the end of that year. ACCION and ProFund negotiated the terms and conditions of the major shareholding position accepted by the Instituto de Fomento Industrial (IFI, a government development bank). IFI accepted the role of major shareholder to avoid provisioning Finansol's debt as a creditor. As a second-level funder, IFI could convert Finansol's debt into equity and have the chance to recoup its losses.

The new shareholders included ProFund and IFI as major partners. Calmeadow, Citibank-Colombia, ACCION International, the Fondo Nacional de Garantías (Colombia's National Guarantee Fund) and the Fundación Social (one of Colombia's leading non-profit foundations) participated as well. Support also came from the microfinance sector itself, with participation from ACCION's Latin American Network and other Colombian microcredit institutions.

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[7] The ACCION lending methodology aims to meet the needs of the poor while paying for itself. Loans are provided on a commercial basis and are for short periods, as few as two months. Loans start small – as low as $100 – to build confidence and a repayment record. Clients become eligible for larger loans as earlier loans are repaid (step lending). Clients with no collateral borrow in "solidarity groups" of 3-5 people, in which each member cross-guarantees the others' loans.

In September 1996, the Colombian Superintendency of Companies ordered the complete separation of Corposol and Finansol. Corposol ceded its shares in Finansol to creditor banks whose loans to Corposol had been collateralized by those shares. Buckling under outstanding loans from 17 financial institutions and debts equaling US$15 million, Corposol was unable to restructure its debt with any of its creditors. Corposol – along with Agrosol, Construsol and Mercasol – was completely dissolved in September 1996. Finansol remained as the only surviving entity within Gruposol, continuing to offer individual and group loans.

From July 1996 to July 1997, with higher expenses due to increased provisioning for loan losses coupled with the reduction of the loan portfolio, Finansol's net income fell rapidly. A second tranche to the initial recapitalization equaling US$3 million was launched in July 1997, bringing the total the recapitalization effort to US$9.1 million. In 1997, to break its association with its tumultuous past, Finansol was re-named FINAMERICA and hired a new president, José Manuel Montaño.

Table 2: Ownership Structure in FINAMERICA, 1997

Shareholder	1997	2001
IFI	44.95%	45.78%
ProFund	26.58%	25.77%
Acciones y Aportes Ltda.	4.34%	3.25%
Incame (Instit. de Cap. Microemp.)	4.29%	N/A
Citibank (Repfin Ltda.)	4.28%	3.20%
Fundación Social	4.18%	3.13%
Fondo Nacional de Garantías	2.94%	2.20%
Stichting Triodos Doen	2.28%	2.27%
ACCION International	1.74%	1.97%
FUNDES	1.73%	5.80%
Inversiones Ramoresa	N/A	0.32%
Calmeadow	N/A	0.32%
ACCION Gateway Fund L.L.C.	N/A	4.69%
Other	2.69%	1.30%

1997 – 2001: THE REBUILDING

From June 1997 until August 2001, Jose Manuel Montaño was the president of FINAMERICA. Under Montaño's leadership, FINAMERICA portfolio improved steadily and the institution regained stability, although it has not yet returned to the level of success characteristic of its early days. In 2001, Germán Contreras, formerly an executive at IFI, Finansol's largest shareholder, succeeded José Manuel Montaño. In response to the institution's new-found stability, Contreras plans to consolidate the institution and to ensure that all segments of the microenterprise market are being served, as the institution had focused on slightly larger microbusinesses in the years immediately following the crisis in an effort to regain financial stability.

With net losses in 1999 and 2000 totaling US$491,000 and US$198,000 respectively, FINAMERICA has not yet reached profitability. However, it has been operationally self-sufficient for several years and all numbers indicate that the institution will be profitable in 2001.

CHAPTER THREE
WHY DID IT FAIL?

The transformation from an NGO to a regulated finance company allowed Corposol to increase its access to funding sources; it was an effective way to realize its goal of reaching more poor Colombian microentrepreneurs. So why did this seemingly successful example of a commercialized microfinance institution fail? Its failure can be broadly attributed to problems within the institutional relationship between Corposol and Finansol as well as a flawed governance structure.

THE INSTITUTIONAL RELATIONSHIP BETWEEN CORPOSOL AND FINANSOL

Much of the institutional dysfunction between Corposol and Finansol can be attributed to ambiguity of authority and of responsibility within the credit process.

Mismatched Responsibilities

Within Corposol and Finansol, staff responsibilities were inconsistent with ultimate accountability. Loan officers, as the primary liaisons between the clients and Corposol's many services, remained part of Corposol's staff until 1996. Their responsibilities went beyond evaluation of clients' creditworthiness and repayment capacity. They also advised clients on training options, and reviewed with them possibilities for additional credit lines offered by Construsol or Mercasol. Because all of Corposol's income was generated through mandatory training fees, there was an inherent conflict of interest: Priority was placed on the one-time training fee that clients brought in, not the long-term relationship, or even the probability that clients would repay their loans.

Finansol, as the regulated institution within Corposol, was ultimately responsible for the quality of the portfolio, yet had little or no control over the loan officers who were in the position to follow up on client repayment. Finansol's role was limited to the financing, including tapping the financial markets to fund Gruposol's operations, loan disbursement and reporting to the Superintendency.

Essentially, Finansol acted as a checkbook for Corposol with no control over who received the checks. This division of the credit process – questioned even by the Superintendency – caused problems between the staff of Finansol and Corposol, with the disadvantage generally falling on Finansol. When loan officers were finally incorporated into Finansol's organizational structure in 1996, it was far too late to ameliorate the problems caused by the weak institutional relationship.

Cultural Differences

Differences between the nonprofit culture of Corposol and the banking culture of Finansol caused tension between the employees of the two organizations. Finansol’s survival was dependent on solid financial performance and a high-quality portfolio. These concerns were not as important to Corposol as an NGO.

Informal vs. Formal Cultures

In an industry that traditionally represents a hybrid of financial and social mentalities, Corposol staff felt that Finansol bankers did not understand the idiosyncrasies of the microentrepreneurs or Corposol’s methodology. They also felt that Finansol staff was excessively bureaucratic and their higher budget and salary expectations were not in keeping with the overall mission of helping the poor.

The attitude of informality that had driven Corposol's operations throughout its history conflicted with Finansol’s need to be accountable to its shareholders and the Superintendency. By the time Finansol was established, the “growth at all costs” mentality and consequent methodological shortcuts were firmly entrenched in the lending operation, as was the practice of refinancing to sweep bad loans under the rug.

Additionally, an unwritten code of flexibility permeated clients' repayment culture, further damaging portfolio quality. Clients were accustomed to Corposol overlooking late payments, as long as they eventually paid. By August 1995, there was a significant deterioration in Finansol’s credit portfolio because Corposol consistently failed to collect in a timely manner. The stricter collection culture of Finansol confused clients and fostered a negative perception when they began incurring penalties and interest on payments in arrears. As a result, some clients resisted repaying their loans at all.

For Corposol, the price of these sloppy lending procedures had been inconsequential. However, once Finansol was required to make provisions for portfolio at risk (in accordance with the Superintendency regulations), the burden was overwhelming for the new financial institution struggling to break even.

Differences in Lending Methodology

As Corposol and Finansol continued to grow, a distortion of the lending methodology emerged. Under pressure from Corposol to bolster the number of clients (so they could receive the mandatory training fee), the loan officers allowed larger loans for longer terms, without following traditional, more stringent lending criteria.

Due to rapid growth and product diversification goals, by 1995 Gruposol programs often made parallel loans to the same client without proper lending analysis. Furthermore, Corposol’s management allowed loans to be refinanced to circumvent the provisioning requirements, solving a short-term problem, but creating the conditions for the future crisis.

As it turned out, there were other serious problems that would contribute to the Corposol and Finansol crisis. Finansol was in the practice of financing long-term assets with short-term capital, paid little attention to the systemization of financial data, and was vulnerable to fraud due to a lack of checks and balances. For example, as early as 1992, loan officers were fired because they had made loans to “ghost groups” that did not exist. At that time, such indiscretions were still the exception. By 1995, fraud was increasingly prevalent. In a diagnostic undertaken by Tobón in 1995, he discovered ghost groups and self-lending (funds disbursed to loan officers themselves) totaling US$200,000 in several branches.

Ability to Hide Problems

By working through a non-regulated entity, Finansol was able to avoid government regulations when they were inconsistent with the institution’s strategy or needs. For example, when the Superintendency imposed blanket limitations on the lending growth of financial institutions in 1994, Finansol issued loans through Corposol, thus avoiding interruption or limitation of client service. This opportunistic swapping of loan portfolios was one of the most detrimental practices undertaken by the two institutions.

The Corposol crutch made it possible to mask the true performance of Finansol. When Finansol’s portfolio began to deteriorate, the worst loans were restructured and sold to Corposol, whose portfolio was not subject to provisioning requirements or review by the Superintendency.

Such maneuvers were, at best, temporary fixes and allowed Finansol to hide behind an NGO to avoid Superintendency scrutiny. This tactic exempted Finansol from developing operational standards with the required rigor of a regulated entity. At the same time, Finansol did not have to bear its own full operational cost (as loan officers were supported by Corposol until 1996), helping to camouflage its true financial condition.

FLAWED GOVERNANCE STRUCTURE

The Management

In addition to mismatched responsibilities on an operational level, Finansol’s management lacked autonomy because Corposol had ultimate oversight and management control over the CFC. Strategic decisions – such as rapidly diversifying lending products with little market research to back it up – were imposed upon Finansol by Corposol’s management.

Corposol’s strategic direction, operational details and organizational culture were influenced by the strong ambition and personalities of its president, Oscar Giraldo and the president of its board of directors, Alvaro Arango. Their emphasis on the growth of the organization propelled it to the levels it achieved in 1995, but their insatiable appetite for that growth led them to pursue ill-advised strategies.

For the first two years of Finansol's existence, its management had little autonomy and acted as a pawn of Corposol. Finally in late 1995, management's directives were challenged with the arrival of Tobón, an independent thinker with knowledge of the market.

Finansol's Presidents

November 1993 – March 1995: Mario Rodriguez Escallon
March 1995 – August 1995: José Antonio Jaime
October 1995 – March 1996: Luis Fernando Tobón
March 1996 – August 1997: María Eugenia Iglesias
August 1997 – August 2001: José Manuel Montaño
August 2001 – Germán Contreras

Finansol's first president, Mario Rodriguez Escallon had a background in banking. He was fired in March 1995 after having trouble adjusting his traditional banking practices to the more informal practices of Corposol. In response, Corposol replaced Finansol's initial management team with people directly from its own ranks.

The second president, José Antonio Jaime had worked in senior management at Corposol since its inception in 1988. After only five months in the position of president of Finansol, Jaime resigned. He left a troubled portfolio, which had been refinanced before his departure, giving the impression that the weakened portfolio was in better shape than it actually was.

Luis Fernando Tobón, a former Citibank executive, replaced Jaime. Tobón had been on the team that conducted the original feasibility studies to acquire a commercial finance company (CFC). He played a key role in the restructuring of the institutions at the beginning stages of the crisis. Six months later, in March 1996, Tobón resigned to take the position of president at Banco Superior, a leading Colombian bank.

In March 1996, María Eugenia Iglesias became the fourth president of Finansol. She accepted the position fully informed about the precarious state of the portfolio. She accepted the position because she knew Tobón well, the social aspect interested her, and she had also participated in the feasibility study to acquire the CFC. Iglesias resigned in August 1997 after overseeing the successful recapitalization to make way for the organization's next phase.

José Manuel Montaño became the fifth president of Finansol in 1997. He had held distinguished positions in the most important financial institutions in Colombia for 20 years, followed by nearly two years at FUNDES before accepting the position at FINAMERICA. Montaño turned around the institution's field operations, and implemented a strict system of checks and balances between the board and management, enabling FINAMERICA to recover from the crisis.

Germán Contreras succeeded Montaño as president of FINAMERICA in August 2001. Contreras had been on the FINAMERICA board of directors since 1996 and was an executive at IFI for a decade before becoming the sixth president of FINAMERICA. With over 30 years of experience in Colombia's financial sector and a sound understanding of the institution itself, Contreras plans to bring the institution to profitability for the first time in 2001.

The Board of Directors

The inability of Finansol's board of directors to prevent the Corposol crisis was due to the weak structural relationship between the Corposol and Finansol boards. Finansol's statutes mandated that majority control of its board must always remain with Corposol, the primary shareholder. This governance structure was fundamentally flawed as it placed the decision-making power of a for-profit institution in the hands of an NGO. Their differing missions and responsibilities were inherently at odds.

With five Finansol board seats occupied by close friends and staff of Corposol, the Finansol board played only a nominal role in governance of its own institution. Furthermore, with no rotation of the presidency of Finansol's board – Alvaro Arango always held the position – there was a lack of new opinions to challenge the status quo. Given his daily meetings with Giraldo and his dual position as president of Corposol's board, Arango was unable to truly consider Finansol's best interests at all times. Especially in key events leading to the Corposol crisis, Finansol board members did not exercise their power to override the decisions of management as they should have. When the Finansol board finally took action and demanded that the recovery of doubtful loans become a priority in October 1995, it was too late to save Corposol.

WAS THE BAILOUT WORTH IT?

The Finansol board realized that the failure of the CFC would hurt its clients in particular and the microfinance sector in general. But was spending US$9.1 million and countless person-hours worth the salvation of the apparently capsizing institution?

After four years of the 'new' FINAMERICA, the organization has not yet been profitable, due largely to the losses the institution absorbed from the crisis and a small margin due to interest rate caps in an environment of deep recession. Still, FINAMERICA's year-end 2000 loan portfolio was only at 1994 levels. Critics maintain that the cost of salvaging the institution was substantially higher than starting a new institution from scratch. Additionally, Finansol's public image underwent irreparable damage, as evidenced by a donor community is still reluctant to support FINAMERICA to this day.

It must also be noted, however, that the crisis came at a critical time in the burgeoning microfinance industry. A failure of Finansol – which represented only the second regulated MFI in Latin America – may have convinced others that the commercial approach to microfinance was ineffective. ACCION International and other shareholders were committed to rebuilding Finansol because they believed that the implicit cost of its failure would be much greater than the rescue costs.

Furthermore, despite the declining portfolio quality, 40,000 small business owners depended on Finansol's financial services to maintain their businesses. Taking away their source of funding would have been detrimental to the individual businesses, as there were few alternative microlenders at the time that could have replaced Finansol.

LESSONS FOR OTHER COMMERCIAL MICROFINANCE INSTITUTIONS

In hindsight, a clear set of factors contributed to Corposol's downfall. Yet during the critical years when steps might have been taken to identify and halt the institutional and operational problems, necessary improvements were not made. The following summary suggests lessons that can be learned from Corposol's experience so other commercial MFIs can avoid the same mistakes.

Lesson One: Increase the Autonomy of the Regulated Institution

The relationship between Corposol and Finansol was structurally flawed. Corposol, the NGO, retained the credit officers and maintained control over disbursement decisions while Finansol, the financial institution, served only as a booking and financing agent. Additionally, Corposol management controlled Finansol's board. These factors left Finansol without the ability to control loan placement or the ability to make independent organizational decisions.

The Corposol/Finansol experience suggests that NGOs should be responsible for training and administration only. Regulated institutions should have control over the lending and collection processes, as they are ultimately responsible to the Superintendency and their shareholders for the quality of the portfolio. If each entity is operationally independent, there will be greater objectivity in decision-making.

Lesson Two: Apply Consistent Performance Objectives

Management imposed performance objectives upon loan officers and other staff of Corposol and Finansol, without consistent grounding in past performance as a measure of feasibility. Loan officers became resentful as performance objectives became increasingly unrealistic.

To avoid uncertainty and ambiguity among staff, MFIs should define and apply consistent, attainable and transparent performance evaluation criteria. By clearly linking positive performance to rewards and employing analysis of poor performance as input for feedback and subsequent follow-up, employees will take ownership of their own performances.

Managers should pursue a system of hiring, firing and promoting based on clearly defined, predictable and objective parameters to ensure staff motivation and accountability while fostering an environment of security.

Lesson Three: Manage Growth

Corposol's mandate for growth was effective when the organization was small. Yet as the institution grew, structures were not put in place to accommodate growth, causing gaps in information flow, inhibiting good decision-making, and limiting the effectiveness of middle management. For example, training new loan officers had been a priority in the first several years of Corposol's existence, but the practice became increasingly rare as the rate of hiring new staff increased.

To determine their optimum size, organizations should analyze the relative costs and benefits associated with the size of their operations. Furthermore, pursuing an a growth rate consistent with demand and institutional capabilities will allow MFIs to mitigate risks related to the speed of growth.[8] MFIs should not only be vigilant of the number of loan officers required to serve the client base, but also the number of new loan officers the existing supervisory capacity can handle.

Lesson Four: Design Channels for Board Intervention

Finansol's board did not act quickly when it had misgivings about Corposol's risky lending activities and management decisions. Furthermore, the high representation of Corposol's board on the Finansol board created a governing body that did not always consider the best interests of the regulated institution. ACCION and other board members have reflected on their role in the crisis and their inability to recognize the seriousness of the situation or remedy the institutional problems before they led to a crisis. The lessons learned from Corposol's experience remain uppermost in the minds of those exercising governance functions.

To ensure the proper functioning of governance, the board of directors of the regulated institution must be able to question managerial decisions. All representatives should have equal say and feel empowered to voice their concerns and to make suggestions. As part of their governance duties, board members are obliged to exercise independent judgment and participate actively in strategic decisions (see Governance chapter 10).

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[8] Craig Churchill, *Managing Growth: The Organizational Architecture of Microfinance Institutions*, June 1997.

Lesson Five: Effectively Manage Product Diversification

Without soliciting the opinions of their clients or loan officers, Corposol began offering new financial products with little evidence of sufficient demand. Furthermore, Corposol expanded products and services without the appropriate supply channels or business plans to deliver the services. Product diversification appeared to offer new avenues for growth while meeting a broad range of client needs. Yet the structure and policies that governed the new products encouraged loan officers to give multiple loans to the same clients, augmenting the risk of over-indebtedness, and contributing to portfolio instability.

Before developing initiatives to meet institutional objectives, organizations should analyze markets to ensure sufficient client demand exists, while keeping the client's best interests (i.e. repayment and debt capacity) in mind. Time should be dedicated to develop, pilot, monitor and adjust new initiatives. Management should support each functional area to prepare for new responsibilities associated with new products.

Lesson Six: Increase Communication between the Regulated Institution and the NGO

With its own corporate culture, employees of the nonprofit Corposol had different ideas about microlending than the for-profit Finansol. Corposol viewed the organization's purpose as primarily social, while Finansol had a much greater focus on the financial aspect of microfinance. These divergent mentalities often cultivated resentment between the two institutions. Furthermore, Finansol employees were accustomed to receiving higher salaries than their nonprofit counterparts, further fueling inter-institutional conflict.

Some element of conflict is inevitable when an organization is created or reshaped from two different organizational cultures. However, communication and training can minimize the negative impacts and create an atmosphere of mutual learning. MFIs should identify sources of variation in institutional culture. By seeking to understand and reconcile differences, organizations can glean the best ideas from each. Organizations must recognize that any paradigm shift in strategy, operations or personnel can affect institutional culture. However, by anticipating the impact and developing a strategy to incorporate the change, there will be minimal shock to existing systems. Above all, organizations should communicate frequently with all levels of staff.

Lesson Seven: Commit to Transparency

Corposol and Finansol unethically swapped the loan portfolio to avoid detection of poorly performing Finansol loans by the Superintendency of Banks. At its most extreme, Finansol would sell its bad loans to Corposol the day before the end of the month (when reporting was done) and buy them back a few days later.

By committing to transparent financial management, MFIs can ensure ongoing quality control and long-term sustainability, reducing the temptation to engage in fraudulent and unethical practices.

Lesson Eight: Avoid Centralized Control

Strong charismatic leadership set the tone for Corposol in its early days. As it grew, however, upper management exercised their power absolutely, without soliciting advice from other management or staff.

Because a weak or subservient staff will undermine the goals of the institution in the long-term, organizations should develop a strong middle management and empower them to make real decisions. Although parameters should be established to guide operations, some degree of staff autonomy should be encouraged.

Lesson Nine: Focus on the Mission, Not Public Expectations

Corposol's positive public image initially helped inspire employees and attract new clients, while building the credibility necessary to access funding. But as Corposol's image grew rosier than its actual performance, protection of that image eventually led to misrepresentation of statistics and refinancing to hide portfolio deterioration. This pattern was destructive as it valued image above substance, which subsequently affected personnel behavior.

Exerting excessive pressure on field operations to succeed at all costs may result in compromised lending standards. Organizations should celebrate success, but be realistic about the scale of future expectations.

Summary

As NGOs enter the commercial arena, it is imperative to understand the pitfalls of creating a separate regulated institution. Although becoming a regulated financial institution often accomplishes the funding and operational objectives of an organization, the resulting institutional dynamics can lead to weakened portfolio, overindebted clients, an unproductive staff and disillusioned stakeholders. Recognizing the remaining NGO and the new commercial institution as separate entities will reduce some of the problems. It is important to define the roles of each organization distinctly from each other, and in concert with their ultimate responsibilities. Furthermore, an active and vocal board will protect against power concentrated into the hands of one or two executives.

Entry into the commercial arena is a wise decision for many microfinance institutions that want to expand their reach, provide better services to their clients and access commercial financing. As institutions continue to pursue these lofty goals, lessons from Corposol/Finansol provide an example to shareholders and MFI management whose social goals can be distracted by the lure of rapid growth.