
Microfinance

Lessons Learned in Latin America

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Introduction

In the last two decades, the development of the microfinance industry in Latin America has made considerable progress. In contrast to the promotion of rural credit programs, which absorbed large sums of money over several decades, support for microfinance institutions (MFIs) has increasingly relied on the design of viable financial institutions.

Credit programs for small productive units – initially farmers and later urban entrepreneurs -- have received large sums of foreign aid to promote their growth and facilitate their access to the formal financial system. The visible results seem to indicate that microfinance institutions founded during the last decade have come closer to reaching their objectives than the rural credit institutions created in the 1950s, 1960s and 1970s.

This document is based on the hypothesis that the mistakes of the past contain many valuable lessons. These mistakes have revealed which policies and concepts are coherent and consistent with the goal of benefiting thousands of clients -- excluded from the formal financial system – and also strengthen the institutions designated to permanently attend to this sector.

Because of low communication costs and the involvement of many interested actors (governments, NGOs, multilateral organisms, banks, consultants, universities, etc.), it has been possible to widely publicize best practices, as well as bad practices and defective interventions. This makes it possible for many MFIs to capitalize on the mistakes of the past and introduce sustainable practices that support the target market.

Despite this progress in the industry, many challenges remain. The final section of this report lists these challenges.

Historical background

After WWII, and in the 1950s, government, multilateral, and international support for credit programs for marginalized sectors became very important.

At first, credit was channeled principally to the rural sector, since agriculture made up the largest share of total production in developing countries and involved a high percentage of the population. At that time it was thought that low-cost credit was the necessary instrument to free farmers from their dependency on informal moneylenders.

Later, as agriculture become less important relative to GNP¹ and economies became predominantly urban, the service, commercial and industrial sectors of the economy increasingly used more labor and inputs. Emphasis is now placed on supporting the creation and consolidation of credit programs in urban zones rather than rural areas.

Financial intermediaries specialized in rural credit are losing interest in the agricultural sector to the degree that this sector's participation in exports, labor and the Gross Domestic Product decreases.

In addition to this phenomenon of agricultural displacement, rural immigration to cities is creating a surplus of labor. If this surplus cannot be absorbed by the formal sector, it becomes unemployment and under-employment. The only way for the unemployed to survive is through informal economic activity such as the operation of a microenterprise or immigration to other countries.

Déjà Vu or Lessons Learned

The small number of permanent and financially viable intermediaries is one of the errors of the past. Many of these programs have been criticized for not reaching out to a larger number of clients and for their credit technologies, which entailed high transaction costs for the borrower. These programs lacked strategies and instruments to attract deposits and savings mobilization. They skewed income distribution even further, particularly when credit was subsidized.

The establishment of microfinance institutions that operate principally in urban regions gained impetus during the 1980s and 1990s. There was great concern that some of the errors of the past that destroyed many rural credit programs would be repeated. Some specialists warned of the possibility that the new microfinance industry would confront the same problems as the rural credit programs (Adams and Von Pischke 1992, Gonzalez-Vega, 1990).

These fears were based on the following factors: both programs make the same assumptions regarding the behavior of small farmers and small businessmen; both have similar policies; the allocation of credit does not take into account the risk of the borrower's activities nor its demand for financial services; the justification for these programs does not come from a genuine effort to adapt services to the client's needs, but rather to channel credit to "beneficiaries with needs" or target groups.

However, the experience with rural credit in the 1950s, 1960s and 1970s not only involved high costs, but also many lessons learned and consensus on types of

¹ As the economies grow, the agricultural output increases in absolute terms, but given the improvements in technology, the sector utilizes less inputs. These inputs that are freed up plus the reinvestments generated by the agricultural surpluses facilitate growth in other sectors of the economy.

interventions, the structure of financial institutions and the definition of financial policy. Microfinance institutions were able to use all of these lessons, and so began their experience with the great advantage of accumulated knowledge.

Those that do not know history are condemned to repeat it. The major actors in development finance -- governments, multilateral institutions, NGOs, universities and consulting firms -- do know this history. They have incorporated many of the past lessons into the founding principles of the microfinance industry in Latin America today.

The large quantity of funds (Yaron,1998)² -- often subsidized and with the sovereign guarantees³ of the receiving countries -- were channeled to few rural credit institutions. This strategy contrasted with the multiple types of operations,⁴ many of them precursors, directed towards microfinance institutions: i.e., revolving credit lines, long-term technical cooperation, capital and quasi-capital, and specialized investment funds in these types of institutions distributed among a large number of MFIs.

The multiplicity of operations facilitated the adoption of a wide diversity of approaches, methodologies and work plans to carry out promotional programs for microfinance within an atmosphere of decentralization. In these circumstances, the new approach of financial services for small businessmen is very different from the rural credit programs which were rather centralized. Projects which generated financial gains and gave wide coverage were rapidly reproduced, ensuring that the most successful practices were quickly publicized.

In addition to financial operations, the microfinance industry in Latin America has grown in an environment of continual discussion, debate and understanding, and many documents and publications have been produced.

Many of the technical operations that donors and international organisms designed to support the microfinance industry have been directed towards disseminating information, training MFIs, supporting governments in the design of appropriate regulatory frameworks, transferring successful financial technologies and delineating standards through the publicizing of best practices and cases, both success stories and failures.

This documentation and information has permitted a healthy debate and exchange of ideas that rapidly became publicized on the Internet. With the advent of globalization, the actors interested in this new industry are well connected and informed. The public quickly hears of success stories and failures. The exception is if the MFIs close down and do not publicize their situation making them very unattractive to financiers. It is no

² By 1992, the World Bank channeled US\$ 16.5 billion in agricultural credit.

³ In 1982 the Inter-American Development Bank approved the Small Project Program (OP-706), the first transaction targeted to microenterprises approved by a multilateral bank without the sovereign guarantee.

⁴ The Inter-American Development Bank alone financed 464 projects between 1982 and 1998. By the end of 2000, the Multilateral Investment Fund had approved 72 projects targeted to support microenterprises.

longer possible to hide anachronistic practices or to continue with obsolete finance technologies without being penalized and condemned and institutionally ostracized.

The lessons of half a century of interventions directed to support rural credit programs have been learned and incorporated. This makes it possible to affirm that the many Latin American microfinance institutions have already had positive results at the dawn of the 21st century.

It can be effectively said that both finance and information technologies provide great opportunities as well as important challenges to microfinance in Latin America, as it is an industry that is still maturing.

The past problems confronted by rural credit programs will be discussed in the following section. This section will explain how these challenges were met and resolved by the microfinance industry.

Lessons Learned: We Have Not Been Throwing Crumbs into the Sea

What matters is the total cost of debt, not just the interest rate. Today the interest rate is seen as just another component of the total cost of debt. Instead of finding ways to control or subsidize the interest rate, the most successful effort to reduce the total cost of debt has focused on reducing transaction costs, finding efficient methodologies to extend and recover credit rapidly to the small economic units and on the promotion of competition to avoid monopolies.

In Latin America there is an ongoing and significant debate over the negative effects of subsidized interest rates on the viability of financial intermediaries, on income distribution, on outreach -- number of clients served -- and in general on the development of finance markets. Although this discussion continues, it has already had implications for policy in the design of new financial intermediaries that specialize in the supply of financial services to sectors that have been excluded by the traditional banking sector.

This is not a trivial problem. It is generally recognized that costs to the borrower cannot be reduced simply by attacking the symptoms with superficial measures, such as controlling the interest rate. Solutions must go deeper and take measures to reduce the margins of financial intermediation, which can be done with greater efficiency through the promotion of competition, and of course, protecting depositors.

Credit is not everything. Before it was thought that credit was an input and that as such, the more credit channeled to productive units, the better. From a practical point of view, it was easier to offer credit than other inputs, such as raw materials, qualified labor, capital, land, etc. In order to channel this input, large development banks were established to "push" credit down. This plan failed and many of the institutions created with this goal in mind have already disappeared.

The Latin American experience shows us that this view of credit does not necessarily work. The impact of credit programs on the viability of institutions cannot be ignored, and it cannot be ignored that credit is not an input of production nor a panacea. Credit is a fragile financial instrument that offers purchasing power to take advantage of opportunities that already exist (Gonzalez-Vega, 1997). The majority of Latin American MFIs have understood this and the most successful have a mission that goes beyond simply extending credit. Their reason for existing lies in the development of an approach to satisfy clients by offering products and services that they truly demand.

The growth of economic units, as with countries, is not linked to the level of contracted debt. Growth is linked to capital accumulation, higher productivity levels, technological development and the aggregated value that products or services generate for the client.

The other half has not been forgotten. Besides a few notable exceptions,⁵ Latin American microfinance institutions have developed the management of their assets -- credit portfolios -- more than their liabilities and mobilization of deposits (Prado, 1999). But it is also true that many microcredit programs have evolved and matured in their intermediary role, offering credit services and making it easier to deposit and transfer funds.

Perhaps for both the weaknesses in attracting deposits is due to historical factors, both for cooperatives and the NGOs that became financial intermediaries.

Without supervision, NGOs are not allowed to take deposits from the public. When they become regulated financial intermediaries, they inherit methodologies for disbursing and collecting credit, but they lack relevant experience in the management of liabilities.

According to one hypothesis, savings and credit cooperatives in Latin America were established with the goal of channeling foreign aid to their members (Christen, 2000). Savings and credit cooperatives in industrialized countries, on the other hand, grew from a community support base with a clear mission to provide financial services to those excluded from the traditional banking system.

Those who argue that small rural Latin American producers cannot save have been proven wrong empirically (Wenner y Proenza, 1999), (Quirós, 1991). They can save although often they are forced to do so in non-financial assets because they have no access to banking institutions.

The MFIs that have operated within a regulatory framework under a supervisory

⁵ Among these exceptions, Banco Caja Social in Colombia and the Cajas Municipales in Peru are worth mentioning.

authority have grown rapidly, possibly because they have access to public deposits and other sources of funds. Although there is no statistical information to verify this empirically, programs such as the Fondos Financieros Privados in Bolivia and the Cajas Municipales in Peru seem to confirm this observation.

Robert Vogel (1987) drew attention to the problem of ignoring the mobilization of savings in rural finance, which has made an impact on the microfinance industry. Those institutions with a permanent horizon in the marketplace and that strive to cater to the client and remain independent are the ones that try to structure their liabilities in a diversified form, with a foundation in local deposits and savings accounts. They also control interest rate risks and do not take on exchange risks.

There are viable institutions. The ingredients necessary to create a favorable environment for MFIs are: a large microenterprise sector, an appropriate regulatory framework and a stable economy. Several Latin American countries comply with these prerequisites and as a result, it is no surprise that viable MFIs are found there.

According to the Micro-Bank Bulletin of September, 2000, a publication with data covering 114 MFIs in Latin America, Asia, Africa and Eastern Europe fifty seven percent of microbanks (of a total of 65) have reached financial self-sufficiency. Financial self-sufficiency is defined as the ratio of adjusted operative earnings to adjusted operative expenditures. The adjustments are made to neutralize the impact of inflation, subsidies, as well as reserves and provision expenses. Of the total number of institutions studied, 53 are located in Latin America, and of these, 77 percent are financially self-sufficient. The aggregate loan portfolio of these Latin American MFIs is over US\$432 million loaned to 645,150 borrowers.

Governance is important. The most important contribution an investor makes to a microfinance institution cannot be measured in terms of the amount of the disbursement, but in terms of the definition and approval of policies. This contribution is made by continually clarifying the strategic orientation and mission of the firm and above all by monitoring management performance. In the past, the involvement of shareholders or investors was considered done when the disbursement was made. Today, investors recognize that follow-up and supervision of investments may be even more relevant and important than approval and disbursement.

The board of directors of these institutions needs to send a clear message to management that capital has a cost and that if the firm cannot create value for its shareholders equal to or greater than this cost, the institution is useless. If a board of directors does not defend the property rights of shareholders on the pretext that external social benefits outweigh capital losses, it is neither fulfilling its responsibility nor creating a viable institution.

A regulatory framework is not sufficient. An environment is needed in which clear rules

exist for regulation and control, as well as supervisory capacity and the existence of minimal operating prerequisites, but not enough on their own to assure the proper functioning of the microfinance industry.

The existence of an appropriate regulatory framework as well as good supervision does not guarantee proper behavior. This behavior should mean that the level of risk assumed by MFIs does not put depositors or the society at a disadvantage with respect to shareholders. A warning has been brought to the attention of premature regulations aimed at institutions that do not reach an adequate maturity level (Christen and Rosenberg, 2000).

No matter how much control exists over regarding capital adequacy, quality of assets, management, handling of liquidity are put in place, prudent supervision is still not a substitute for a series of policies, organizational agreements, business plans, internal controls and the administrative capacity of an efficient intermediary.

The incredible diversity in institutional design of the MFIs (many of which are NGOs, cooperatives, finance institutions, banks, etc.) makes it difficult to standardize regulation (Chaves y González-Vega, 1992). Each country varies in terms of the industry's evolution, which also impedes adoption of homogeneous regulatory frameworks. Thus it is important to monitor the rhythm of regulation and maturity of the market (Loría, 2000).

With regards to the supervision of small financial intermediaries, the principal challenge is one of organization. How can one assure that supervisors treat small intermediaries in the same way as the large banks that manage a greater quantity of financial assets and that can compromise or weaken the economy's payment system?

The institution, not the instrument. Effective support for MFIs goes further than simply channeling funds. What matters is not the instrument through which the funds are transferred -- whether it is a loan or an equity investment, in all cases it is necessary to have continual follow-up, formulation of policies, elaboration of plans, and the monitoring of performance, recruitment and investment of human capital in institutions. These are all elements of a successful business.

The development of a viable and permanent institution is more intensive in the use of human capital than monetary capital. This means that in terms of finance for development, success should not be measured based on the flows of money into the sector, but rather on the establishment of financial institutions that have the capacity to design products and services valuable to the client.

An Unfinished Agenda

The number and quality of many institutions that specialize in microfinance has increased greatly in the past decade. In Latin America this phenomenon is very significant since commercial banks only serve a fraction of the population, and in some countries a large percentage of the economically active population is without financing sources and cannot take advantage of productive opportunities.

The technologies used, management capacity, outreach and financial results are satisfactory in many cases, and contrast with the poor performance of rural financial institutions in the past. However, the micro-finance industry is still immature.

Anecdotal evidence suggests that micro-finance institutions are capable of generating similar or even better results than traditional commercial banks. If this is true, why is the flow of private investment towards this sector not greater? Why is the level of investment in the microfinance sector still below the socially optimal level?

Obstacles to private investment. During the Second Inter-American Forum of Microenterprises, held in Buenos Aires, Argentina in June, 1999, a group of investors mentioned the following obstacles to private investment:⁶

Ignorance about adequate banking technologies, the lack of knowledge about industry standards and how the informal economy works, and the absence of reliable financial information all cause potential investors to continue to keep their distance.

Traditional bankers also have more attractive investment options in well-known sectors that are closer to their own operations. Also, the culture of traditional commercial banking and microfinance institutions differs substantially, making it even more difficult for the two sectors to mix.

The politicizing of terms like "microenterprise and microcredit" and the inappropriate use of these words as a panacea to solve serious social problems (unemployment, poverty, migration, etc.) may scare off private investors who fear that bureaucrats will determine how and under what conditions funds will be channeled and assigned in the market.

The legal environment is another obstacle for private investment. Microfinance institutions should assume an active approach to help mold appropriate frameworks, in other words, become part of the solution to the problem. For example, agile, efficient and low-cost legal mechanisms are needed to recover credit, as well as functional land surveys and property registries. A solid microfinance system needs a legal framework that can guarantee contract compliance.

⁶ This section is based on a summary prepared by the author who was the moderator of a panel in which current or former investors in microfinancial institutions shared their views. The participants were: Juan Uslar, Bangente-Venezuela; Carlos Johnson, Fie-Bolivia; Beltrán Macchi, Visión de Finanzas-Paraguay; Carlos Gasser, Fassil – Bolivia and Enrique Ferraro from Gateway Accion International.

As far as prudential regulation, it is necessary to offer a framework with clear, precise and long-lasting norms. A functional regulatory environment is a necessary condition for the acceleration of development of the financial and economic systems of Latin America. Optimal regulation should not create entry barriers and should not be continually changing, although it must adjust to environmental changes. It should be transparent, and while it is important that it not discriminate between different types of institutions, differences should still be recognized.

One of the obstacles frequently mentioned has to do with the presence of subsidies which can result in unfair competition for formal private microfinance intermediaries despite good intentions. Subsidies, just like taxes, create price distortions that divert private costs from the social costs and so investment does not flow towards the most profitable economic sectors.

But there are not just obstacles and problems. There are also opportunities that come from the foreign banking sector's strong competition within traditional financial sectors. This is an incentive for local finance institutions to find new niches where there are competitive advantages, such as those based on the intensive use of information and the accessibility of the microenterprise client.

Immunize the sector from negative political interventions. The importance and need for a solid microfinance industry means it is inevitable that politics will be used as a way to influence institutions that could have an impact on the well-being of thousands of clients. However, these political interventions should be well oriented, and should not contradict the technical criteria on which finance intermediaries base their policies, risk analysis and distribution of resources.

The presence of governments and international organisms should be creative, and they should act as facilitators for technological transfer, dissemination of information and best practices, making prudential regulation possible, the establishment of credit bureaus and promoting research to better understand the nature of the informal sector.

Macroeconomics is important. It does not matter how much an intermediary understands and knows about how to manage risks such as credit risk, liquidity risk, exchange risk, interest rate risks, and risk of fraud. Macroeconomic instability, and systemic crises in the financial system that create inflation, devaluation and fiscal imbalances are the greatest obstacles that an institution in the finance sector confronts and are also the principal determinants of investment profitability in the sector.

The greatest contribution that a government can make to the microfinance industry in particular, and to the finance sector in general is to assure a macroeconomic equilibrium in which depositors, borrowers and shareholders can simplify economic planning and make

long-term decisions. In such an environment, allocation of resources by financial intermediaries is less complex.

Connection with commercial banks. Generally, few traditional commercial banks have shown any interest in offering financial services to micro and small enterprises on a large-scale basis. The main reasons are the difference in methodologies, as well as attitudes and risk appetite. This gulf between the two sectors has made it impossible to take advantage of the benefits of utilizing the banking infrastructure, sources of financing and a commercial orientation.

In some countries the microfinance industry has advanced more than in others. In those with greater competition, there has been a decrease in the interest rate on assets, and consequently, a reduction in the profitability of these intermediaries. This competition is healthy since it gives the client more alternatives at a lower cost, but it can also hurt the client if weakened institutions look for strategic diversification alternatives in sectors other than the microenterprise sector.

In systems where the proliferation and number of MFIs is too high, it is more difficult to create economies of scale. The system would gain in terms of efficiency with the merger, banking acquisition or alliances between MFIs and banks. This is an area of possible transactions in the near future, and could be an indicator of the industry's evolution.

Conclusions

In general, it is clear that the microfinance industry has progressed in Latin America, particularly during the past decade. Every day, there are more financially viable institutions or institutions in the process of becoming financially viable. The results in terms of attention to the client are satisfactory (outreach, access, quality of services, etc.), and show how the industry has evolved.

Contemporary microfinance institutions show promising results, in contrast to the rural credit programs promoted after WWII. These failed in large part because of the inability to make services fit the client's needs and because there were no policies to create and strengthen viable and permanent institutions.

The central thesis of this document is that the relative success of microfinance with respect to rural credit programs is due to the development approach that was adopted. It has been a decentralized approach, with many individual interventions including hundreds of participants with diverse visions and strategies, in an environment where ideas were discussed and the lessons and errors of the past were always kept in mind.

The industry has evolved, but important challenges remain. Some of these challenges include attracting private capital, protection mechanisms for systemic risk in the financial

sectors, consolidation mechanisms to build economies of size and improved technology to achieve greater efficiency. The search for solutions to these challenges requires the continual joint actions of governments, international agencies, private investors, political authorities, centers of learning and consulting firms.

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