Microfinance in Nicaragua

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LIST OF ABREVIATIONS

ACODEP	Asociación de Consultores para el Desarrollo de la Pequeña, Mediana y Microempresa, Nicaragua
ACP	Análisis del Componente Principal
ADRI	Asociación para el Desarrollo Rural Integrado
ASODERI	Asociación para el Desarrollo de Rivas, Nicaragua
ASOMIF	Asociación Nicaragüense de Instituciones de Microfinanzas, Nicaragua
BANADES	Banco Nacional de Desarrollo, Nicaragua, Guatemala
BANADESA	Banco Nacional de Desarrollo Agrícola, Honduras
BANCENTRO	Banco de Crédito Centroamericano
BANCOSOL	Banco Solidario, Bolivia
BANIC	Banco de Crédito Nicaragüense
BCN	Banco Central de Nicaragua
BCR	Banco Central de Reserva
CAC	Cooperativas de Ahorro y Crédito
CARUNA	Caja Rural Nacional
CDR-ULA	Centro de Estudios para el Desarrollo Rural de la Universidad Libre de Amsterdam
CEPRODEL	Centro de Promoción del Desarrollo Local
CGAP	The Consultative Group to Assist the Poor
CMCA	Consejo Monetario Centroamericano
CONFIA	Corporación Financiera Nicaragüense
COSUDE	Agencia Suiza para el Desarrollo y la Cooperación
EMNV	Encuesta de Medición de Nivel de Vida
FAMA	Fundación para el Apoyo a la Microempresa, Nicaragua
FAO	Food and Agriculture Organization of the United Nations
FCR	Fondo de Crédito Rural
FDL	Fondo de Desarrollo Local
FIDEG	Fundación Internacional Para el Desafío Económico
FINDE	Financiera Nicaraguënse de Desarrollo S.A.
FINDESA	Financiera Nicaraguënse de Desarrollo Sociedad Anónima

FINSOL	Financiera Solidaria, Honduras
FNI	Financiera Nicaragüense de Inversiones
FODEM	Fondo para el Desarrollo de la Mujer
FONDECA	Fondo de Desarrollo Campesino
FONDECO	Fondo de Desarrollo Comunal Bolivia
FSD	Financial Systems Development
FUDESI	Fundación para el Desarrollo Social Integral de Nicaragua
FUNDEPYME	Fundación de Pequeña y Mediana Empresa
GTZ	Cooperación Técnica Alemana
IDR	Instituto de Desarrollo Rural
IFAD	International Fund for Agricultural Development
IFPRI	Instituto Internacional de Investigación de Políticas Alimentarias
ILO	International Labour Organization
INEC	Instituto Nacional de Estadística y Censos
INPYME	Instituto Nicaragüense de Apoyo a la Pequeña y Mediana Empresa
MFI	Microfinance Institution
NITLAPAN	Instituto de Investigación y Desarrollo
OEF	Asociación para la Organización y Educación Empresarial Femenina de El Salvador
PAMIC	Programa Nacional de Apoyo a la Microempresa
PRODEL	Programa de Desarrollo Local
PROMICRO	Programa de Microempresa
PROMIFIN	Programa de Fomento de Servicios Financieros de Nicaragua
PROSESUR	Proyecto de la Región Seca del Pacífico Sur
SEWA	The Self-Employed Women's Organization
SUC	Sistema Único de Calificación
UCA	Universidad Centroamericana
UNDP	United Nations Development Programme
USAID	US Agency for International Development
WCCN	Wisconsin Coordinating Council on Nicaragua
WWB	Womens World Banking
WWF	World Wide Fund for Nature-India (WWF-India)

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PROLOGUE: DEVELOPMENT BETWEEN PROMOTION AND RELEGATION

Pitou van Dijck, Hans Nusselder and Arie Sanders

Microfinance has only a short history in Nicaragua. When the government changed color in 1991, the first experiences of financing small producers by use of non-conventional methods still had to be established. Twelve years later, in 2003, the country can boast a plethora of experiences, as well as an important record of institutional practices which have significantly contributed to the financial market and its deepening over the years. But the record is also a mixed one of successes and failures. Some of the experiences deserve to be highlighted because of their being plainly positive, others because of the hard lessons taught that should never be repeated. The authors of this book coincide in the view that the balance of microfinance in the case of Nicaragua, over just more than the last decade, is generally positive, also to the 46 per cent of the population which live in poverty. Even so, the challenges to overcome the obstacles ahead are immense too.

If the country is to be counted in the category of the more advanced in the domain of microfinance, this is due to both enabling as well as adverse factors in its environment. After the 1980s, a decade in itself marked by developmental state banking, the country maintained a tradition of financial intermediation through sizeable, formal institutions well into the 1990s. After the dismantlement of the national development bank BANADES, which started in 1996, and the string

of difficulties haunting institutions purported to serve the rural sector, followed by other banking crises between 1999 and 2001, all what was left were doubts whether or not formal banks were able to genuinely perform as financial intermediaries in a developing economy. On the other hand, doubts also emerged as to whether non-regulated intermediaries were capable of recasting a role, unfulfilled by a formal sector, for which the latter was supposed to be more specialized and better equipped.

This sort of optical illusions do not only prevail at the supply side of Nicaragua´s financial sector. Various studies (Sanchez 2000, see also Chapter 2) have expressed a rather qualified view on the supposedly vast demand for credit among the productive sectors of the economy. Researchers have put such demand into doubt, not only in the light of available statistical evidence, but also when considering the macroeconomic structure and, in particular, the external sector. The deficit on the current account of the balance of payments, although decreasing from 49 per cent of GNP in 1999 to 35 per cent in 2002 (Annual Reports BCN 2001 and 2002), remains one of the country's major weaknesses. In 2002, the deficit amounted to approximately 890 million US dollars, which was in part made up for by official development assistance and loans (450 million US dollars) and transfers to non-governmental organizations (NGOs) (120 million US dollars). Together with debt forgiveness and migrant remittances, the sector of technical cooperation has been a crucial factor in the chronic deficit of the external sector.

One might question what would happen in economic terms if the country were no longer able to attract similar volumes of foreign aid (De Franco, 2000). In such conditions, one would expect an adjustment in the exchange rate to the point where the domestic terms of trade and corresponding factor prices would adequately reflect a new equilibrium. A steady depreciation of the national currency would foster the competitiveness of the productive system. This benefit would spill over to demand for credit among large and small producers alike.

However, in reality the weak demand for credit is, at least partially, to be attributed to the absence of an adjustment mechanism which would bring an end to the deficit of the external sector. It would come to no surprise to observe a reduced credit demand, when considering that Nicaraguan producers, disadvantaged by a hard currency, remain relatively uncompetitive with regard to their peer producers overseas. Therefore, credit demand may be expected to remain sluggish as long as the deficit on the current account will continue to be compensated

by both remittances and resources flowing in from sources of external cooperation. In that sense, the national economy suffers from a phenomenon similar to the Dutch disease. Today, technical cooperation seems among other factors to have a comparable effect in the Nicaraguan economy.

Another effect of a monetary inflow from abroad, which does not exert a direct influence in the real sector of the economy, is its potential to increase inflationary pressure. As will be shown in Chapter 2, Nicaragua is no exception in this respect, nor is the policy of monetary authorities to restrain this pressure optimal. The guidelines of the central bank of Nicaragua remain strict, with a minimum reserve requirement close to 19 per cent of liquid resources, obviously aimed at keeping control of the amount of money in circulation. As if this were not enough to keep the costs of capital high, another factor has been the deficit of the non-financial public sector. This stems from the financial needs of the central government to finance its fiscal deficit over the last years. The fiscal deficit rose to almost 19 per cent of GNP in 2001, to drop again to 8 per cent in 2002 as a result of pressure from multilateral financial institutions. The credit demand of the public sector has pushed up the costs of capital, to the extent that private sector demand has effectively been crowded out.

In short, the first decade of microfinance in Nicaragua has been marked by rather unfavourable macro-economic conditions. This resulted from an overvalued currency, strict anti-inflationary policies by monetary authorities, as well as the crowding out of the private sector by the public sector.

Beside these adversities, the position of the government towards the microfinance sector has not always been benign nor stable. In general terms, the position has evolved according to three successive stages. The first stage was between 1991 and 1996, at the time that substantial programmes were in operation aimed at direct financing of producers. This tendency was reverted during the execution of the national programme of support to microenterprises (PAMIC). This programme channelled credit resources to producers through specialized institutions, initially commercial banks but later on more than a dozen NGOs, informally belonging to the so-called PAMIC-network[1]. This network served as a nursery not only for the creation of professional capabilities, but also for passing a first experience in what is now known as a sectorwide approach. An environment was forged with a view to create a level playing field, with equal conditions in which all intermediary participants could freely compete. Although a broad seg-

ment of government opposed NGOs remained outside this network, PAMIC stood at the basis of a nationwide surge of microfinance later in the decade.

The relations between the state and intermediaries in the sector cooled down at the end of 1996, due to various factors. The main donor country of PAMIC (The Netherlands) changed its priorities, steering away from promoting NGOs as financial intermediaries towards rather non-financial services. Its pioneering role was taken over by other sources of cooperation, such as UNDP, the Scandinavian countries and Switzerland. The latter was the first to launch a programme for microfinance sector development in the country (COSUDE-PROMIFIN). However, more important than the range of stop-go policies in the donor community was the change in overall orientation of the Nicaraguan government. On the one hand the supply of microcredit, backed by external sources, expanded vastly in terms of funds and institutions involved. On the other hand, the complementary relationship with the NGO sector deteriorated. The distance between unregulated intermediaries and the government sector increased in the period between 1999 and 2001, marked by a string of financial bankruptcies which put supervisory authorities on high alert to NGO activities. Asset management by NGOs became further constrained when Law 374 was introduced which put an interest rate cap on private loans by non-bank entities.

In retrospect, the period between 1997 and 2001 is to be seen as one of containment of the sector by the government institutions. Part of this is to be attributed to the preferential treatment the microfinance institutions (MFIs) had been receiving from external cooperation agencies. As a matter of fact, the MFIs were clearly filling the gap left behind after the closing down of the state development bank BANADES, without the provision of alternatives for first tier financing. A more permissive attitude by the government with respect to microfinance emerged only in 2002, although the signs of it as yet are, to some extent, ambiguous. There is a preparedness for dialogue with the sector, in this case ASOMIF, but the present administration is also reluctant to grant it a preponderant role by legislative means.

By and large, the microfinance sector in Nicaragua is fundamentally different from those in other Latinamerican countries in more than one respect. For instance, it differs from the sector in Guatemala where financial cooperatives control about 60 per cent of the microfinancial market, in terms of borrowing clients and the size of aggregate portfolio. By its structure of affiliation, these cooperatives are regulated

and supervised, contrary to the situation in Nicaragua. The situation is also different from Ecuador, where the regulated segment (1 bank and 27 cooperatives) represent an estimated 80 per cent of the entire market for microfinance in the country. By contrast, Nicaragua has two regulated financial institutions (CONFIA and FINDESA), among 276 unregulated intermediaries. The former two embody approximately 16 per cent of the aggregate microcredit portfolio. The surge of microfinance in the country has been a trend that was neither foreseen nor structured from its beginning.

It is estimated that more than 310,000 borrowers make use of microfinance services, which may amount to over 200,000 natural persons taking out microloans. Assuming that the latter represent on an average families with five family members, microfinance could by now have reached the homes of 20 per cent of the total population. By contrast, it is most unlikely that the formal financial sector, made up mostly by half a dozen private banks, would be able to cover a population segment as vast as microfinance does, even though its degree of solvency and of liquidity are constantly screened. It must be the clientele and their respective latitude of economic options that make up the difference between the segments.

With the government in the process of redefining its policies, the development agencies face their own challenge in defining a new approach. Many of them, at least in their headquarters, are sponsoring the multilateral project of the Consultative Group to assist the Poorest (CGAP). However, representatives of the very same agencies in the field do not always follow up the recommendations of CGAP (Donor Brief 9, December, 2002). Few of them promote access to microfinance beyond the standard microloans offered by intermediaries. Many of them are interested in supporting one or various intermediaries, but the provision of microfinance services on a permanent basis and on a massive scale is rarely a priority. Only a few agencies recognize that the social return of microfinance only will increase when intermediaries are sustainable in the longer run. Many expect that microfinance providers serve a population in extreme poverty, but in reality this objective is not or hardly to be achieved (Chapter 5). This is just to illustrate how donor rhetoric is meeting obstacles in practice.

In the debate on the state of microfinance in Nicaragua, the actors of the sector are the ones who will have to be abreast of the outcome of their practices. The task of actively targeting financial services, after having analysed the mechanisms of client selection and embeddedness (Chapter 3), seems a priority. The dilemmas of gender strategy, in par-

ticular that of forging a strategy for expanding the scale of operations while deepening a view of empowerment, may not escape the attention of intermediaries who claim to have a mandate in this respect (Chapter 4). When it comes to reforming the legal framework of microfinance, a vision is needed on the future of the 278 intermediaries, at least on most of them at the sector level (Chapter 6). It is hard to shape a heterogeneous and fragmented sector, especially when policies are at stake which pretend to serve a public good. Therefore, it is important to carry on the debate in the heart of the microfinance sector, with externally formulated arguments, from which initiatives will surge for better practices in the future.

Notes

[1] In all, 14 NGOs were informally affiliated with this network, six of which are presently member of the Asociación Nicaragüense de Institiuciones de Microfinanzas (ASOMIF): ASODERI, CEPRODEL, FUNDACIÓN Nieborowsky, Léon 2000, FUDESI and ACODEP.

[2] In this respect reference is made to the present Financiera Nacional de Inversiones (FNI), created already in 1993, the Fondo de Crédito Rural (FCR), the Fondos de Desarrollo Campesino (FONDECA) of IDR with resources from IFAD, and INPYME as from 1997 as a follow-up of PAMIC, with additional funding from Norway and Spain.

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THE MICROFINANCE MARKET

Arie Sanders and Hans Nusselder

1. Introduction

At the beginning of 1990, the government of Nicaragua initiated a process for the structural adjustment of the economy, thereby responding to the crisis through which the country had passed during the previous decade. One of the reforms contained in this programme was the liberalization of the financial sector, including the circulation of the national currency and the removal of interest rate controls. From then on, the structural reforms have been accompanied by a fiscal and monetary policy addressed to achieve macroeconomic stability. The financial reform introduced significant changes in the structure of the sector. An important step was the creation, in 1991, of the superintendency of banks and other financial institutions, with the aim of supervising, overseeing and controlling the performance of the national financial system. Additionally, the operation of private banks was authorized to help with the increasing demand for financial resources. However, the reforms implemented did not broaden the banking system (Sanchez, 2000). As compared to the other Central American countries, Nicaragua has the most limited financial market, both in terms of volume as well as the number of licensed banks.

The financial reforms reduced the role of the government as financial intermediary in the market. One of the results of this policy was the

closure of the National Development Bank (BANADES), which had been historically one of the most important suppliers of credit in the country. Its closure left many households without access to credit. The vacuum left by the public sector was partially filled by private initiatives from the credit union sector and non-governmental organizations (NGOs).

This chapter deals with the performance of microfinance institutions (MFIs) in Nicaragua and identifies the factors that influence their expansion in the country. Nicaragua is an interesting example of development due to the predominant role of international development agencies. By and large, they encouraged the creation of a large number of institutions with the objective of enlarging credit opportunities for underprivileged households. However, the initiative itself lacked a comprehensive vision to promote the proper development of this sector as well as the consolidation of its entities. The result was a permanent dependence upon new funds to pursue operations.

This article is composed of six sections. Section 2 describes the background of the financial sector in Nicaragua. Section 3 deals with the potential demand for services. Section 4 evaluates the state of the microfinance sector in Nicaragua, taking into account the participants, the outreach and the sustainability of the services offered. Section 5 addresses the initiatives assumed by different participants in the area of financial regulation. Finally, Section 6 presents the opportunities, limitations and recommendations for the development of this sector.

2. Financial depth

The financial depth is one of the key indicators to analyse the growth of the financial sector in relation to other sectors. When the economy undergoes a modernization process, the financial sector usually grows both in absolute and in relative terms, as it must provide the funds necessary to finance the demands of the productive sector. The most common way of measuring the financial depth of the sector is by dividing the M2 (the sum of currency in circulation, fixed term and demand deposits, as well as other saving accounts) by the gross domestic product (GDP).

During the last five years, and helped by an economic recovery in the second half of the 1990s, Nicaragua registered certain stability in its financial depth. Its depth index is the highest in Central America, with an average of 65 per cent. This stems mostly from the considerable participation of the public sector in domestic credit (Table 1).

Table 1. Indicators of the monetary sector.

	M2 / GDP		Public credit / Internal credit	
	1997-2001	2002	1997 -2001	2002
Nicaragua	59.6	64.8	67.0	69.1
Regional average	40.0	41.2	14.1	9.7

Source: CMCA, 2002

The loans granted by banks to the private sector are frequently used as an indirect indicator of the degree of efficiency of the banking system. Credit to the private sector tends to be considered more beneficial for the growth of the economy than loans to the public sector. In 2001, the participation of the public sector in the net internal credit was 69 per cent, which reflects a rather unbalanced pattern for maintaining growth in the long term.

Real interest rates in Nicaragua have remained relatively stable during the last few years (Table 2). Borrowing rates have ranged between 9 and 10 per cent, a demonstration that negative interest rates in deposits do not apply any longer. As far as the effective lending rates, they have been the highest in the region. Some of the reasons for this are the restrictive monetary policies and the high rate of the minimum reserve requirements (which the banks are obliged to keep in central bank accounts with below market interest rates). The reserve requirement force banks to charge higher rates on remaining resources channelled to private borrowers.

During the 1990s, the reforms introduced to the financial sector in Nicaragua were one of the most important objectives of the structural adjustment programmes. The liberalization of interest rates and the reduction of reserves were accompanied by the modernization of the regulation and legislation of the banking sector. An important element has been the creation of a more autonomous central bank, equipped with more technical expertise and increasingly immune to external political influences (Camacho et al., 1999).

Regarding its banking system by the end of 2002, Nicaragua had a total of six private banks and their total assets amounted to 1,929 million US dollars (Table 3). This sector has always remained small, with few possibilities of reaching economies of scale that would allow the banks to become more efficient. The restructuring process was

Table 2. Effective interest rates.

	Effective lending rates		*Effective borrowing rates*		*Interest spread*	
	1997-2001	2002	1997-2001	2002	1997-2001	2002
Nicaragua	23.4	25.5	9.3	9.4	14.1	16.1
Regional average	14.8	14.6	6.0	5.4	8.8	9.2

Source: Based on data from CMCA, 2002.

Table 3. Indicators of the banking sector, December 2002.

	Nicaragua	*Regional average*
Banks	6	107
Assets (million US$)	1,929	30,133
Asset annual growth (%)	8.6	8.9
Assets / GDP (%)	76.3	50.5
Delinquency (%)	3.7	7.3
Spread (%)	11.3	9.4
Efficiency (%)	4.2	4.8

Source: CMCA, 2002.

introduced as a result of the bankruptcy of four banks between 1999 and 2001, with heavy losses to central bank reserves

3. The demand

The total population of Nicaragua stood in 1998 at 4.8 million persons and the population density was established at 35 inhabitants per km^2. Less than half of the population resides in rural areas and one out of every four resides in the Managua metropolitan area. Slightly more than one third of the population lives below poverty level and 10 per cent live under conditions of extreme poverty.

In 1998, through the Living Standards Measurement Survey (LSMS), the World Bank analysed the demand for credit, based on household units (INEC, 2000). According to the results of the survey, 17 per cent of households avail themselves of some type of credit (three times the percentage recorded in 1993). Two thirds of these receive loans through formal and semiformal financial entities. Nearly half of

the borrowers use loans for consumption. As a rule, households only maintain one loan at a time.

Sanchez (2000) estimated that 40 per cent of the households are in the need of credit. Demand is directly related to the household income level, its numerical size, the educational level of its members and the geographical zone. Demand for credit is concentrated among poor households (42 per cent) and very poor households (44 per cent). On the Atlantic coast the demand is lower (21 per cent), which might be attributed to a lack of attractive investment opportunities.

A linear regression model served to determine the factors that influence the household demand for credit. According to this model, households with liquidity problems and few financing options search for loans. Additionally, the demand is more focused on securing liquid funds to cover daily expenses (consumption) than on making productive investments.

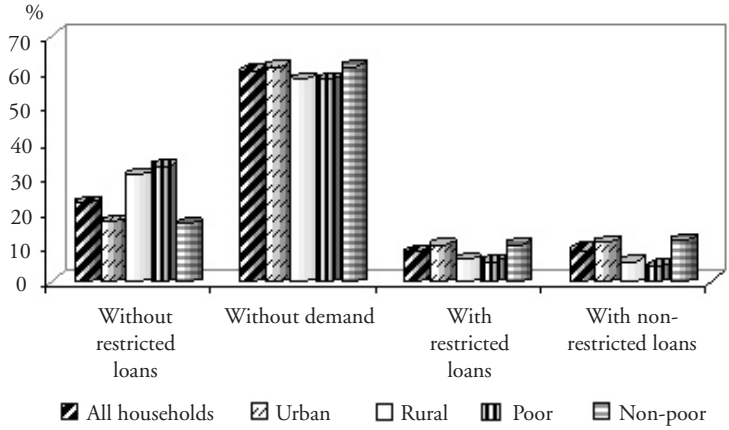
Some of the factors that influence demand of households are related to the conditions to obtain credit. The requirement of mortgage collateral - especially when the value of the property is higher than the amount borrowed - turns the risk for a borrower, who may face repayment problems, too high. Many households do not want to assume such a risk. The problem gets worse in cases with low rates of return on investment. As a matter of fact, the costs of credit amount on an average to 1.3 per cent per month, which can only but reduce the probability of households requesting a loan.

Obtaining a loan does not automatically satisfy the full demand of a household. In turn, the fact that a household cannot obtain a loan, does not necessarily translate into not having access to credit. In total, there are four different situations related to access of credit:

(a) households with restrictions that do not obtain a loan;
(b) households that do not request a loan;
(c) households that receive a loan but do not receive the amount desired (restricted borrowers); and
(d) borrowers who receive the amount desired (borrowers not restricted).

Figure 1 contains the results of the household survey according to the four situations mentioned above. In Nicaragua, credit is highly restricted. Only 9 per cent of households were able to obtain a loan for the desired amount under the conditions established. Furthermore, 23 per cent of households face severe credit restrictions. It is worth noting that rural and poor households have the highest demand for credit but face most restrictions.

Figure 1. Restriction in access to loans



4. Supply of financial services

The participants

MFIs in Nicaragua can be classified in three groups: regulated institutions such as banks and financial corporations; credit unions; and other unregulated institutions, which mainly include NGOs and some private companies. According to an inventory carried out by the project COSUDE-PROMIFIN, there are about 300 active MFIs in the country and most of them are credit unions in the cooperative sector. Table 4 provides an overview of the actors involved and their respective size of operations.

The two most important regulated institutions that provide microfinance services are FINDESA and CONFIA. The institutions share a similar history, as they were previously NGOs that offered microcredit to the sector of micro-enterprises. Through intensive programmes of technical assistance sponsored by international agencies, both institutions were able to become financial institutions regulated by the superintendency. FINDESA and CONFIA are the largest MFIs and their portfolios combined amount to approximately 21 million US dollars.

Credit unions are relatively old entities, but it was not until the 1990s that they were considered as microfinance service suppliers. According to the information received, there is a total of 180 credit unions and they manage an aggregate portfolio of 28 million US dollars, while serving about 60,000 clients. The average portfolio of credit unions is

Table 4: Characteristics of participants, as of 31 March, 2002.

Sector	*Number*	*Total portfolio (thousands of US$)*	*Number of clients*	*Average amount (US$)*	*Average portfolio (thousands of US$)*
Financial corporation	2	20,739	19,969	1,039	10,369
Cooperatives	180	28,158	59,707	472	156
NGOs	93	75,139	227,834	330	808
Corporations	3	2,517	3,733	674	839
Total	*278*	*126,553*	*311,243*	*407*	*455*

Source: Blijdenstein, Nusselder y Rosales, 2002.

rather modest, amounting to approximately 156,000 US dollars. This average would have even been lower, if it did not include the Caja Rural Nacional (CARUNA), whose portfolio amounts to 3.5 million US dollars while serving over seven thousand clients. The cooperative sector is, in legal terms, being supervised by the Ministry of Industry and Labour. Moreover, they are allowed to capture savings from their members.

NGOs are in their category the most important providers of microfinance, both in outstanding credit volume (more than 75 million US dollars) as in number of served clients (almost 230,000). As of December 2001, NGOs were channelling approximately 60 per cent of the total amount of microcredit in the country, thereby serving 73 per cent of the clients. The NGOs constitute a very heterogeneous group as far as objectives, target groups, size of the portfolios, geographic scope, number of clients and size of the staff. Some organizations work locally with groups of about 30 people and manage portfolios below 10,000 US dollars. There are also specialized microfinance institutions with portfolios that range 5 million US dollars distributed among 5,000 clients.

Outreach

A recent study revealed that the resources of the three sectors of MFIs - finance societies, credit unions and NGOs - added up to 127 million US dollars by the end of 2001, and were distributed among 311,000 clients (Blijdenstein et al, 2002). This volume represents 18 per cent of the total portfolio of the private banking sector, which amounted to 696

million US dollars at the end of 2001. MFIs have a total of 455 offices, while private banks register a total of 171 offices between headquarters and branches. Such data reflect that the microfinance sector, in spite of operating at a lower scale than private banks, has in comparison a wider physical coverage, while serving social strata whose transaction costs to obtain credit from MFIs are substantially lower.

Regarding the gender distribution of the MFI portfolios, the participation of women is rather high: more than 57 per cent of borrowers are women. There is no conclusive evidence regarding participation of women in the composition of portfolios. However, on an average, the amounts granted to women are lower than those granted to men. It has been estimated that women receive about 40 per cent of the total portfolio, which would imply that among borrowers the average loan of a man is twice the amount lent to a woman.

In the analysis of the distribution by geographic area, there is a concentration of microfinance services in the districts of Managua and Matagalpa (Central Region). One out of every four offices of MFIs is located in these districts. Moreover, out of every dollar lent out, 65 cents are channelled to the Central Region (Table 5).

The concentration of credit supply in some districts has, to some extent, led to market saturation. In one way, the advantage is that growing competition drives MFIs to develop novel financial products, aiming at adjusting their service to existing demand. However, this may increase the risk of clients getting over-indebted, which in turn may drive up the delinquency in loan portfolios. In Matagalpa, the case exists of an association of debtors, which is indeed a sign of high indebtedness, in particular after the sudden fall in coffee prices in 2000.

Regarding the distribution of credit resources by economic activity, the data obtained from members of ASOMIF, which represent 41 per cent of the national supply, indicate that 38 per cent of the portfolios is lent to the trade sector, followed by agriculture (36 per cent). The high participation of agricultural activities in the portfolios of members of ASOMIF, not only reflects the importance of the agro-sector in the country, but also the fact that MFIs serve a group of clients with relatively few financial resources.

Sustainability

Most of the Nicaraguan MFIs were established in an era when sustainability and operational efficiency were not having the same priority as at the turn of the century. Until the mid-1990s, the main objective of an MFI was to merely serve the largest possible number of small entre-

preneurs who faced difficulties in getting access to financial resources from the formal sector. The costs of rendering financial services were rarely a matter of concern, even though the intermediaries had sufficient latitude to charge the costs of credit to their clients, who had no alternative financing sources. Increased competition between MFIs and a more demanding stance of donor agencies have now turned sustainability and efficiency into vitally important issues. The degree of efficiency of MFIs is usually reflected by their level of administrative costs in relation to portfolio size.

According to Micro Rate, in June 1999 the most important microfinance entities in Latin America registered an administrative efficiency of 15 to 20 per cent (Farington, 2001). In the case of Nicaragua, Von Stauffenberg et al. (1998) found that MFIs spend 50 cents on administrative costs out of every cordoba disbursed for loans. Ultimately, he considered these institutions as highly inefficient.

In 2003, CDR-ULA carried out a new study on the state of microfinance institutions (Nusselder and Sanders, 2002). A comparative study on financial performance was carried out using a sample of seven successful MFIs. They were compared to the best performing MFIs in the Latin American region using the list of reference prepared by Micro Banking[1]. The most important findings of the study were the following:

(a) The MFIs in the study are close to a level of operational and financial self-sufficiency and their results are better than those of the reference group. Some of the factors that explain the difference between both groups relate to the modest level of operating costs as a proportion of portfolio revenues. The advantage of the group under study has also to do with relatively low capital costs for external resources, as well as a lower loan loss provision (i.e. lower delinquency rates) and low administrative costs.

(b) The administrative efficiency of the seven MFIs in the study is significantly higher than that of the reference MFIs chosen in Latin America. Within the group of Nicaraguan MFIs, there is no direct relationship between the size of the portfolio and the MFI's efficiency. Other factors which may explain higher efficiency in Nicaragua could be relatively low salaries of technical staff and more competition in the microfinance sector, which forces MFIs to exert strict control on operating costs.

(c) The productivity at team level in the Latin American MFIs in the reference group was higher than that of the MFIs studied in Nicaragua. However, when assessing only technical staff (i.e. credit officers) and the number of loans disbursed per officer, the productivity of the MFIs under study was higher. On an average, the MFIs in the study have

more administrative staff than credit officers, when compared with MFIs in the reference group. This is possibly explained by the fact that organizations in Nicaragua still have rudimentary information systems.

(d) Important differences were found in the structure of capital and equity among the group of MFIs under study. Some MFIs have received most of their funds through the market (capturing savings and requesting loans from national and international markets), while others have received financial resources under soft conditions. As of 31 December, 2001, the MFIs under study had received an average 60 per cent of their gross portfolios through loans obtained in accordance with market conditions, more than the MFIs in the reference group. This may help to explain why the equity of MFIs under study amounted to 25 per cent of the assets. In the reference group, equity represented 35 per cent of assets.

From an international perspective, the question is whether programmes are efficient and whether or not they are related to concepts of sustainability and viability. These questions mainly assess the dependence of programmes upon public and/or private subsidies. The definitions established by Otero and Rhyne (1994) to identify the different levels of development of MFIs indicate the following:

Level 1. Highly subsidized. Programmes that generate portfolio revenues which are insufficient to cover their costs. In fact, more than half of the revenues stem from sources of technical cooperation. At this level, organizations need access to funds under bland financial conditions. They face a high risk of loss due to costs disequilibria and a permanent dependence upon the donor community.

Level 2. Programmes with lower subsidies. The income produced by the credit fund covers financial costs and part of operating costs. The external financing required at this level must include special conditions to cover operating costs and inflation, which takes effect through direct subsidies or soft loans.

Level 3. Programmes with operating self-sufficiency. The income covers financial and operating costs, but there are limitations to protect the fund from inflation or to pay loans under commercial conditions. The external subsidy is limited to relatively soft interest rates as part of the conditions of the loan.

Level 4. Programmes with financial self-sufficiency. All costs are covered by the income generated by the fund. The organization is capable of obtaining resources from the financial market under commercial conditions.

Cuadro 5. Distriburion of microfinance portfolios by typology, MFI and region, as of 31 December, 2001. Portfolios in millions of US dollar.

	Credit union		*Financieras*		NGO		*Corporations*		*Total*	
Region	*Portfolio*	*Branches*	*Portfolio*	*Branches*	*Portfolio*	*Branches*	*Portfolio*	*Branches*	*Portfolio*	*Branches*
Managua	2,355	21	8,281	2	15,972	41	1,516	2	28,124	66
Pacifico	6,960	70	6,883	10	22,970	69	207	2	37,018	151
Central	15,528	104	5,575	7	31,475	98	795	1	53,371	210
Atlántica	2,527	16	0	0	3,393	12	0	0	5,920	28
Total	*27,370*	*211*	*20,739*	*19*	*73,810*	*220*	*2,518*	*5*	*124,433*	*455*

Source: PROMIFIN-COSUDE, 2002.

Out of the seven Nicaraguan MFIs in the study of CDR-ULA, three have proved to be at level 4, three at level 3 and one at level 2. The average result is considered as positive, demonstrating that the sample obtained from the microfinance sector in Nicaragua does not warrant a generally negative judgment (any more) on the sector as a whole.

On the other hand, the experience emerging from numerous evaluations in other MFIs is that many are far away from reaching operating self-sufficiency. In particular, the sustainability is in doubt of credit funds managed by organizations with social agendas. Out of 80 specialized MFIs in Nicaragua, it is estimated that only eight of them generate sufficient revenues to be sustainable.

According to the World Bank (2002), the microfinance sector is still extremely weak and inefficient. These results do not mean that the microfinance activity is not economically attractive, but it does indicate that success requires a business culture and a tailor-made methodology that only a few MFIs have been able to develop (Nusselder and Sanders, 2002).

5. Limitations and opportunities for development

The experience of microfinance in Nicaragua during its growth process provides important lessons to the rest of Latin America as far as maturation processes are concerned. The ample presence of cooperating agencies and the general interest triggered during the 1990s has produced a vast supply of credit resources available through MFIs. This represents a valuable substitute for the state banks that disappeared during the 1990s, and to the modest attention paid by private banks to clients from lower social strata. Approximately 20 per cent or more of the national population can be directly or indirectly considered as MFI service users.

On the other hand, the extensive supply of microcredit is directly related to the availability of resources from donor agencies and the government. External observers to the donating community in Nicaragua issued a clear criticism in this respect: the strategy of remaining relatively passive *vis-à-vis* an unbalanced evolution of the sector may become costly if no effort is made to coordinate, both in the donor community and with the very actors in the sector, the promotion of an enabling environment. The fact that Nicaragua remains far from having developed a true microfinance industry has to do with the diversity of donor intervention strategies. Some of them aim at supporting almost directly the position of credit end users, whereas others foster

the development of either a particular intermediary or several entities along the sector. By and large, the massive injection of credit resources was not accompanied by a nationwide set of rules regarding financial accountability and institutional checks and balances. The difficulties in the transfer of credit funds show in some way the arbitrariness in which at present financial support lines are being managed.

Until today, MFIs have been restricted in their strategies to expand their products and services. With the exception of credit unions, these have been confined to the disbursement of loans. Financial policies of MFIs are legally circumscribed and their interest rates are legally restricted within a maximum average derived from the banking sector. The system of using collateral has been applied in rather improvised modalities, without introducing reforms as was done, for instance, in Bolivia. Although their financial performance is adequate when compared to a reference peer group, this is a result more in spite of than attributable to its national environment. Until now, MFIs have not been able to fulfil the role of a genuine intermediary, as both their legal status as well as their small size proved to be major obstacles.

In relation to the above, the biggest structural problem of the sector is the lack of regulation and supervision. Unregulated MFIs remain outside the structure of regular supervision on a routine basis. The lack of a legal structure to carry out financial intermediation cannot but have a negative bearing on their performance and sustainability in the long run. NGOs cannot offer saving services and depend upon funds from international cooperation. Moreover, through regulation it is possible to maintain the competitiveness in the financial sector, in the sense that a sufficient number of intermediaries would have to ensure the smooth allocation of goods and services to the real sector of the economy, while freely and fairly competing for new clients (Fiebig, 2001).

Creation of the political environment

The financial reforms carried through during the 1990s have contributed to an improved financial climate of the country. Nevertheless, a favourable policy for the development of microfinance has yet to be developed. An example of current restraints are the interest rate cap for loans and the legal limitations to the establishment of loan collateral.

In the short term, it appears desirable for the government of Nicaragua to define a policy appropriate for microfinance, in close coordination with international cooperation agencies that are willing to finance new initiatives. A crucial first step would be to recognize that international donor financing of most activities in microfinance

have, so far, remained isolated and that time is due to a more integrated approach for the future development of the sector. The lack of coordination, in spite of good intentions to solve problems of individual and relatively small MFIs, is driving up the total costs for the provision of the services, and indeed hampering the emergence of a competitive market for microfinance.

Strengthening the financial infrastructure

The trend in Nicaragua was, during the 1990s, to focus on the creation of MFIs and microfinance programmes without considering the establishment of an infrastructure to support, strengthen and guarantee the sustainability of MFIs and microfinance programmes.

The greatest challenge faced by the sector is the creation of an appropriate regulation and supervision framework that should not affect the use of novel methodologies applied by MFIs, while providing financial services to low-income population strata.

Another important issue is the development of systems to collect and disseminate relevant borrower information. The exchange of information between MFIs is too limited to have a real bearing on their internal procedures for client. There is a role to play by technical cooperation agencies. It would be expedient to analyse the prospects and limitations of an independent credit bureau. In the same context, it would be worthwhile promoting a culture that allows for sharing client information among MFIs.

In an environment such as in the case of Nicaragua, with a large number of MFIs (almost 300), the supervision proposed could become a very complex task and difficult to exert. The actions taken to this effect should give an impulse to strategic alliances between MFIs with the goal of achieving a strengthening and, where possible, integration of several intermediaries into a new venture. In countries with a record in the domain of MFI regulation, the trend has been indeed the merger of parallel entities.

Institutional development

The present approach followed by many international agencies in Nicaragua has led to a variety of isolated initiatives and subsidies for operations that in many instances have proved to be unsustainable. The approach of some cooperation agencies to target a specific population segment has equally produced limited client outreach in the country. The emergence of a large number of independent MFIs affects the viability of the sector as a whole, as the existing MFIs are unable to

develop economies of scale. For this reason it is important to start the debate on the future of the sector and the role of MFIs, while fully taking into account the costs of supporting many small institutions whose future is in doubt.

Past experience reveals that strong institutions are managed by well-trained senior staff. Upon evaluation of the existing capacity of MFIs, there would be a case to make for offering specially designed training programmes, as part of their institutional development. The initiative of PROMIFIN to develop a recognized advanced training programme in microfinance is an important step towards a lasting set of instruments that may strengthen the coming to maturity of MFIs in the long run.

There is a need to move the microfinance frontier towards the rural sector, where microfinance outreach so far has been rather limited. By this token, there is room for initiatives that would allow financial products to be developed along the lines of higher efficiency and greater depth.

6. Final observations

When compared with the first half of the 1990s, the sector of microfinance institutions has substantially moved forward. They serve a higher number of clients with still, to some extent, a pent-up credit demand in the rural sector. A comparative study carried out in 2002, showed that their performance was superior to that of a group of microfinance entities in other Latin American countries, against benchmark criteria of profitability, efficiency and productivity per credit officer. Moreover, their level of external financing was higher than in the reference group, thereby reflecting a respectable standing in the international market of development finance.

The above might warrant the conclusion that the microfinance sector has bright prospects ahead for replacing a banking sector which - as a result of recent restructuring process - is no longer able to lend to low-income households. However, three factors jeopardize the future of microfinance. First, most MFIs depend strongly on external cooperation sources and do not have the possibility of capturing savings from their own clients. Microfinance in Nicaragua has not become mainstreamed into the formal financial sector, following the case of, for example, of some Andean countries.

Second, the relative abundance of external funds has helped to pave the way for fragmentation of the sector. There are now approximately 300 intermediaries, and most of them mainly dedicated only to mi-

crofinance. The necessary stages of consolidation and rationalization of the sector cannot be achieved, as long as that many MFIs continue individually obtaining funds from a wide array of sponsoring agencies. For the same reason, there is no trend towards economies of scale, which would imply a wave of mergers, acquisitions and an exit of some institutions, as has been the case in the banking sector.

The two problems mentioned above will possibly only be addressed when the right conditions are in place to transform the microfinance sector into a real 'industry' within the regulated sector and in accordance with market rules. For such transformation process to unfold, mechanisms are required for change of information, coordination and regulation of the sector with the full backing and participation of the government, the MFIs themselves, and also the agencies for technical cooperation. The mechanisms should provide for the formulation of sector policies geared to the viability and competitiveness of the sector as a whole, and gradually abandon the policy of supporting of a particular entity, 'cherished' as it may be by one or several donor agencies. To enforce a policy that in the long run favours the poorest strata of the Nicaraguan society, the present challenge is to achieve a system of efficient financial intermediation, with its benefits materialized through economies of a larger scale.

Note

[1] The MFIs included in the study were: AVANCE, CARUNA, FUNDEPYME, FDL, FINDE, FODEM and PRODEL. The reference group was composed of nine MFIs: ACODEP (Nicaragua), ADRI (Costa Rica), BanGente (Venezuela), CONFIA (Nicaragua), FAMA (Nicaragua), Finsol (Honduras), FONDECO (Bolivia), OEF (El Salvador), and ProEmpresa (Peru).

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3

MICROCREDIT AND THE ALLEVIATION OF RURAL POVERTY

Ben D'Exelle, Johan Bastiaensen and Miguel Alemán

1. Introduction

From the beginning, the microfinance sector has been strongly concerned with reducing poverty. Also, one of its major conceptual ideas has certainly been that the poor were not so much in need of subsidies, but rather in need of equal opportunities. Access to credit at commercial interest rates was supposed to contribute decisively to these opportunities, thereby making microcredit delivery attractive, as it is a cheap and self-sustaining means of combating poverty. Gradually, the consolidation of 'best practices' led to the growing conviction that microfinance institutions (MFIs) that follow principles of good banking, were also most efficient in permanently reducing poverty (Yaron et al., 1997). However, this rather optimistic view has recently been challenged. The more extreme versions of the 'sustainability' stream of thought, such as the influential Ohio State University Rural Finance Programme have come under attack by the 'poverty alleviation' camp. The latter finds it unwarranted to assume that there is an automatic link between financial and developmental success (Morduch, 2000). The 'microfinance schism' between the camps of 'sustainability' and 'poverty' persists. In an attempt to reconcile both approaches, several contributions were made in order to clarify their respective assumptions. (Schreiner, 2002; Morduch, 2000; Rhyne, 1998). These critical

contributions restored 'depth of outreach' - i.e. the extent to which the poor are served as an important assessment criterion besides scale and financial sustainability (Morduch, 2000). Simultaneously, the capacities and incapacities of microfinance programmes to reach the 'poor,' (Dunford, 2000; Hickson, 2001; Wright & Dondo, 2001; Evans, et al., 1999; Navajas et al., 2000) or to alleviate poverty (Mosley & Hulme, 1998) have increasingly been documented.

Within this debate on the effectiveness of microfinance in alleviating poverty, little attention has been paid to the local embeddedness of an MFI, i.e. how an MFI relates to local social networks and the prevailing 'rules of the game', including the enforcement of these rules. With the renewed explicit focus on the poor, attention has been paid to collateral issues, mechanisms that safeguard financial results, as well as the tailoring of financial products to the needs of the poor (Wright & Dondo, 2001; Hickson, 2001). However, their need to reduce transaction costs by means of innovative socio-financial technology usually requires strong articulation to local social structures. These social structures have exclusionary processes that are often at the core of poverty (Bastiaensen, et al, 2002; Bromley, 1998). Still, the issue of how the MFIs are articulated to local socio-political arenas has generally been ignored, even though the latter clearly can be expected to exert a strong influence on the capacity to serve lower population strata.

In this chapter we analyse the local embeddedness of the 'Fondo de Desarrollo Local' (FDL) in the Quilalí Valley and how it relates to the outreach of the programme. We start in Section 2 with a brief description of the study region, which includes a short historical overview that is indispensable for the comprehension of present-day political complexities. In Section 3, we present the stylized facts of the FDL in Quilalí. The main Section 4 focuses upon the nature of the FDL's local embeddedness and provides a tentative diagnostic of the social exclusion processes. The final section presents general observations and qualifications on FDL's intervention strategy.

2. The Valley of Quilalí: presentation and short historical overview

The Valley of Quilalí is located in the Nueva Segovia District (see map). It is a remote region that takes a full day's journey from Managua. The valley, also known as the Valley of San Bartolo, includes 12 communities with approximately 3000 families. Its deep fertile soils, its flat

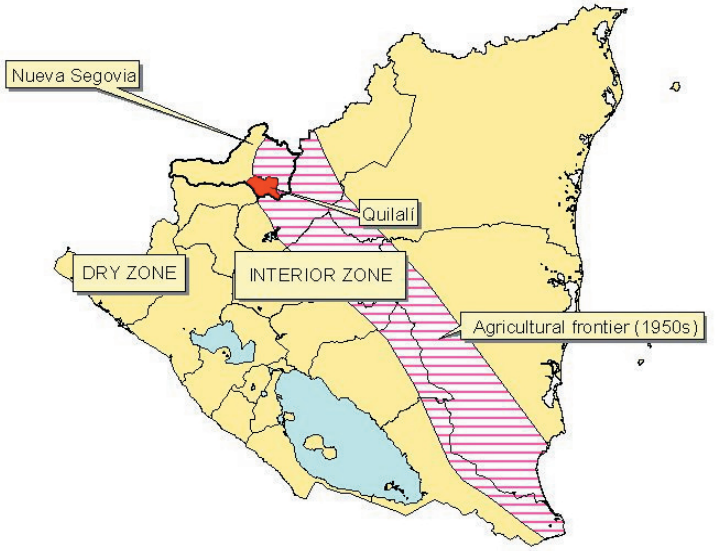
topography and its patterns of regular rainfall make it one of the zones with the largest agricultural potential in the north of Nicaragua.

This region was opened up during the 1950s as a peasant agricultural frontier. The opportunity to gain access to abundant and cheap land attracted both poor and not so poor peasants from the dry (western) region. Many of them left this region because of recurrent crises as a consequence of increasing draughts. Others lost their land to expanding large-scale coffee and cattle estates. The peasant colonization process in Quilalí was actively promoted through investments in infrastructure by the Somoza-regime. These were meant to rapidly incorporate large amounts of arable land for food, coffee and cattle production as well as to reduce growing pressures for land reform in the more densely populated western areas of the country. Both the abundance of fertile land and favourable prices for food, pigs, coffee and cattle enabled many of the immigrant peasants to accumulate some wealth and establish viable family farms. Given the prevalent favourable conditions and making use of sharecropping and broader patronage relationships with richer farmers[1], even some of the poorest migrants were successful. In this way, many of today's peasant-farmers consolidated their economic base before the end of the Somoza regime.

In 1979 Nicaragua turned a historical page with the advent of the Sandinista revolution. The new revolutionary regime implemented a centralized national project characterized by land reform and state control. These policies rapidly led to political problems with regard to the established peasant society in the agricultural frontier area. Quilalí was one of the zones of earliest and strongest peasant resistance against this Sandinista revolutionary project. It became the scene of a widespread US-sponsored armed peasant rebellion and suffered harshly in the ensuing counterinsurgency war of the Sandinista army.

Peasant resistance was partly due to the clash between the 'moral economy' of the traditional peasant-landlords relationships and the imported urban-based 'antagonistic' class rhetoric of the revolution (Horton, 1998). In fact, by means of informal relationships that traditional peasants had established with several local large landowners, they guaranteed a secure, albeit limited access to essential resources. The Sandinista agrarian reform, based on expropriation of large private estates, affected these landowners and thereby, jeopardized access to important resources and social protection for many peasants. At this time, the project curtailed the hopes the peasants might have had to establish their own private family farms and to leave behind the pros-

Map 1. Location of Valle de Quilalí.



pect of an undesired life as an agricultural labourer in a state-controlled cooperative or state farm.

The Sandinista answer to this local resistance was to strengthen the agrarian reform. Not only the large landowners were affected but also - to an ever larger extent - the sector of the medium farmers who initially had sympathized with the revolution. However, the latter turned against the revolution and many came to occupy leading positions in the armed 'resistance' (Horton, 1998). In an attempt to reduce support to these 'counter-revolutionary' forces, the Sandinista army evacuated the northern mountains of Quilalí by force. Hundreds of families were moved to the Sandinista cooperatives that had been created in the Valley and that were defended by the Sandinista army against counter-revolutionary or 'contra' forces. Dissidents either had to seek refuge in neighbouring Honduras or to join the 'contra' forces. Obviously, this increased polarization as people were compelled to take sides in the conflict.

The Sandinista agrarian reform could count on the support of the newly arrived landless peasants who originated from the arid zone. The agrarian reform had generated a large migratory wave towards the Valley in the 1980s. In this way the revolution reduced the previously existing population pressure in the arid zone. The civil conflict was also the expression of regional tensions that resulted from the problem

of landlessness in the arid areas. The landless peasants integrated into the Sandinista cooperatives in order to get access to land. But in turn the large landowners resisted the expropriation of their land, whereas the traditional local peasantry resisted integration into the Sandinista cooperatives. The Sandinista project and the resulting conflict had generated a deep transformation in the agrarian structure, by its abrupt rupture with previous 'historical'[2] relationships.

In the early 1990s, the armed conflict' ended after the unexpected Sandinista electoral defeat. The demobilization of armed forces and the return of families that had fled from violence made Quilalí one of the municipalities with the highest rate of migration. The demobilized combatants of the Sandinista army as well as the 'contra' forces were given substantial support to disarm and to reintegrate into normal life. In order to facilitate reconciliation and economic recovery, the new Chamorro government granted considerable resources to the 'contra' sectors. With this government, these 'contra' groups also negotiated new private properties, ironically through a similar process of land reform against which they had previously taken up their arms[3]. However, these agreements were not completely complied with by the central government. Subsequently, the previous 'contra' forces re-grouped in a 're-contra' movement that frequently waged (armed) protest in order to force the central government to comply with the earlier agreements. These 're-contra' sectors steadily became more organized and politically represented at the national level. Thereby, they increasingly gained access to external resources.

However, since the mid-1990s, the region faces a rapid decline of government interest and resources flowing into the region. The exception was a short, but substantial resurgence in aid in the aftermath of the disaster provoked by Hurricane Mitch in 1998. The previous dominant government support was being replaced by a diversity of non-governmental organizations (NGOs). Despite the agrarian reforms of Sandinista and post-Sandinista governments, as well as the still favourable conditions for intensive small-scale production, there is now a marked tendency towards a re-concentration of land by the richer farmers. The proportion of landless and wage-dependent families has since then significantly increased. Although the region enjoys favourable conditions compared to surrounding regions, the effects of these concentration processes are exacerbated by demographic pressure and ecological degradation. Therefore, access to fertile land has become difficult to obtain and its lack now threatens the livelihood of the local peasants.

The partial return to the pattern of patron-client relationships is at present insufficient to satisfy the demands of the growing landless sector. Indeed, the gap between the supply of land from accumulating farmers and the demand from the growing sector of 'landless' peasants has grown wider. This has led to a substantial increase in poverty levels. Unequal access to outside resources such as credit and technical assistance also plays a role in this process.

The process of re-concentration of land goes hand in hand with a very dynamic local land market as well as very high proportions of inward and outward migration. This process points to a previous logic of concentration-expulsion from land at the agricultural frontier. But by now the conditions are less favourable for newly establishing peasants at the new agricultural frontier further to the north and east. Employment opportunities have also become restricted. The landless families depend to a large extent on salaried work on coffee plantations in the highest parts of the zone and the banana plantations on the borders of the Coco River. However, Hurricane Mitch destroyed banana plantations in the Valley, followed recently by a coffee crisis, which restricted local demand for labour. This has forced many families to temporarily migrate in search of employment opportunities.

3. The 'Fondo de Desarrollo Local' in the Quilalí Valley

Our analysis relates to the experience of the local branch office of the 'Fondo de Desarrollo Local' (FDL) in the Valley of Quilalí[4]. The FDL is one of the many micro-finance institutions that are trying to fill the gap in the financial markets that was the result of the closure of the state development bank BANADES.[5] More than a decade after its creation, the FDL is today one of the largest and definitely the most rural of the non-bank credit institutions in Nicaragua. At present, its portfolio amounts to an equivalent of around 13 million US dollars (FDL, 2002) by which some 13,500 clients are served. Half of these are living in rural areas spread across the Pacific and the Interior region. Even when the institution displays a clear concern with rural development, in practice it must put 'sustainability' before any other concern.

According to the FDL's vision on development in Quilalí, local economic dynamics depend to a great extent on the consolidation of the agrarian reform sectors in the Valley. The demand for credit of these sectors has brought about a great potential to expand loan operations to poor rural producers. Since the start of its operations in 1998, the FDL has therefore grown considerably both in number of clients and in loan

volume. At present, it has 103 clients in the entire Valley. According to the FDL's internal classification, based upon a rough estimate of the total value of assets (including the value of land) almost 70 per cent of the clients are small and middle-sized peasant-farmers (Table 1). It is useful to note that the Valley of Quilalí has very few large farmers, so the choice for this region implies in itself a strategic choice in favour of peasant development.

At first sight it is clear that clients from poorer strata - small peasants (36), small merchants (4) and wage earners (11) - make up half of the client population in the Valley. However, when scrutinizing in detail these sectors, one observes that the landless or land-poor - as indicated above, a steadily growing sector - tend to be excluded from the programme. Although the FDL has relaxed collateral requirements in order to serve smaller clients, in practice the lack of land remains an important factor for not obtaining credit. Table 1 shows that the large majority of the FDL clients submit private or public property titles of land as a guarantee[6]. Others use cattle or oxen, but these alternatives too often require land ownership. In Table 1 we observe that only 7 of the 36 small peasant clients secure access to a loan with collateral types that are not related to land property. Instead they use their house as collateral or propose a guarantor, or in some case may not make use of any collateral at all. Even the poor wage-earning clients, gaining access to small loans, often use land or cattle to secure their loans. These findings are confirmed by interviews with the local FDL staff. Unless the staff has first-hand knowledge about small clients, as discussed below, they will normally not make credit available without collateral. Another consequence of this focus on land as collateral is the virtual exclusion of women, who are seldom the proprietors of land. Only 10 per cent of FDL clients in Quilalí are female.

The approval of a credit does not depend only upon an objective evaluation. The promoter also takes into account the client's recent economic record, the degree of diversification of his/her economic activity and a subjective assessment of the quality of his/her entrepreneurship. The perceptions of the promoter thereby do become a determinant factor in including or excluding certain 'types' of clients. This explains for instance why the FDL programme excludes loan applicants who are living in resettlements. According to the FDL-promoter the inhabitants of resettlements, and in particular the new resettlements built after Hurricane Mitch, display characteristics that make them inherently risky and unprofitable for the programme. These resettlements are held to be 'contaminated' by a culture that puts the recovery of any loan at

Table 1. Typology of clients and nature of collateral, FDL-Quilalí, 2002.

Collateral accepted as a guarantee for FDL *loans*	*Peasants*			*Merchants*			*Wage-earners*	*Total*
	S	*M*	*L*	*S*	*M*	*L*		
No collateral	2	-	-	-	-	-	3	5
Private document of the house	4	1	-	3	1	1	4	14
Public document of the house	-	1	1	-	-	-	-	2
Private document of farm land	26	25	2	-	1	-	1	55
Public document of farm land	2	4	6	-	-	-	1	13
Property document of cattle	1	1	3	-	-	-	2	7
Property document of oxen	-	1	-	1	-	-	-	2
Pledge	1	-	-	-	-	-	-	1
Total	*36*	*33*	*12*	*4*	*2*	*1*	*11*	*99*

Note: S=small; M=medium; L=Large. The terms small, medium and large refer to total assets of respectively less than 5,000 US dollars, between 5,000 and 20,000 US dollars and more than 20,000 US dollars.

Source. Information system of the FDL and data obtained from interviews with the local FDL staff; in four cases data are missing.

risk. The assumption is that people are accustomed to 'featherbedded' conditions and - even worse accustomed to handouts from political patrons. Therefore, commercial interest rates presumably are hard to apply. Nor will repayment be easily enforced, which exacerbates the risk of credit operations. By the same token, the resettlements would also have levels of organization that could trigger organized (politicized) resistance to repayment.

On the whole, the promoter considers credit demand to be unattractive in the area of resettlements. In his view, these are occupied to a large extent by poor dwellers who may request small loans for unprofitable economic activities with few prospects for success. In the eyes of the promoter the simple fact of living in a resettlement, is a clear indicator of a low entrepreneurial capacity and the lack of initiative:

'Families that manage to accumulate more than 1.5 or 2 hectares of land look to live on their own land, take care of their crops and raise hens and pigs. Families that live in a resettlement do not even have this illusion. For that reason we better look for clients that live on their land. Even commerce in the resettlements is bad, because shops are very small.'

The combination of perceptions and financial concerns in this case limits social outreach and excludes an important segment of the local population from access to the FDL credit.

We also observe that the FDL programme to a large extent is working with people who already receive support from other institutions, many of which also offer credit. More than 70 per cent (Table 2) of the FDL clients in the Valley also work with another institution. More than 45 per cent even work with two or more institutions apart from the FDL.

These figures illustrate that the FDL is not immune to 'multiple inclusion'. In many cases, the same farmers get access to various kinds of external resources. This is not only due to transaction costs rationing, to the detriment of less well-off producers, but also to the local intermediation of the projects, as described in the next section, which deals with the influence of the local embeddedness of the FDL promoter in four FDL villages in the Valley.

As a preliminary conclusion, we can state that land-poor, socially disconnected peasants and in particular women are relatively less attended by the FDL programme. Many of them today live in resettlements. The FDL thus falls short of attaining its full potential as a contributor to the creation of opportunities for the land-poor inhabitants of the region. For obvious reasons of creditworthiness, the FDL tends to give preferential treatment to the medium-sized and larger farmers. In line with the theoretical conclusion that a social biased credit market contributes to the land concentration by richer peasants irrespective of their (often) lower profitability (Carter, 2000), this could imply that FDL credit operations directly contribute to land concentration in the Quilalí Valley.

4. Local embeddedness of the FDL

The operations of the FDL in the Quilalí Valley started only in 1998. This explains to a large extent why most current clients came into contact with the FDL through networks around FDL staff, in particular the local promoter[7]. The local promoter has considerable discretionary power in deciding whose applications will be processed by the FDL. The application must obviously have a good credit rating. It is very important for the promoter to maintain good relationships with key actors in the community. They provide accurate low costs information about potential clients. They may also legitimize coercive steps in the event of delinquent payments.

Table 2. Other institutions serving FDL clients

Other identities (Nº)	*Frequency*	*(%)*
0	29	29.3
1	25	25.3
2	32	32.3
3	9	9.1
4	4	4.0
	99	100.0

Source: Local FDL staff; 4 missing values.

The FDL selects promoters from among the local educated youth. In this regard, the FDL considers their technical capabilities - reassessed after a short training - and their local 'connections.'[8]. Quite often, local promoters come from respected, economically stronger and politically low-profile families. The Quilalí promoter is a law student and was engaged with the post-war local Peace Commissions before starting his duties in the FDL. His father is a big commercial entrepreneur and a well-respected member of the evangelical church, 'Assembly of God'. Therefore he was acquainted with several evangelical vicars in the rural community. The promoter was member of the student government in secondary school and also a member of a catholic student group. This gave him the opportunity to make frequent visits to rural villages in the region. Thus, the FDL promoter knew many local leaders of distinct political and religious backgrounds and he was able to uphold a relatively neutral profile.

Our study in four villages reveals the specificity of the social embeddedness of the FDL and the local interface in each of them. In the same context the characteristics of the programme/promoter play a role, such as the knowledge of some communities, as well as institutional diversity at the local level. These factors help to explain the considerable variation in the outreach of the FDL programme at the village level.

The first village that was studied is large, densely populated, dominated by Sandinista leadership and with a history of agrarian reform. Since the FDL tends to associate these Sandinista cooperative structures

with a record of bad repayment[9], the promoter cautiously tried to avoid direct contact with the cooperative leaders. Lacking channels for social intermediation, he took recourse to tougher collateral requirements. Except for the loans to small shopkeepers - tied to a small fund from a specific donor - all loans were secured with land. As shown in Table 3 this excluded small farmers from the loan portfolio.

The many potential clients from among the non-farming, poorer majority did not qualify for the processing of loan requests. Entire sub-resettlements of the village are thus 'forgotten' by the FDL as well as by any other external programme of combating poverty. Nevertheless, during group interviews with rural women from one sub-settlement, we identified a strong demand for individual small business loans. This demand has so far not been identified by the FDL. One of the reasons for this is the clear lack of relationships with important local brokers who can bring these women to the forefront. The fact that they have not been served so far is also due to a lack of appropriate financial technology, such as credit channelled through solidarity groups. The latter could provide social collateral and might compensate for the lack of local connections of the promoter in the area. Other elements that come into play are the already mentioned perceptions of the promoter about people living in resettlement areas.

The second village is a mainly liberal (anti-Sandinista) community where the local promoter - similar to the previous village - had few trustworthy contacts. While working for the local Peace Commissions after the war he came to know the 'usual' representatives of the landed local elite. The assessment of the local credit portfolio clearly points to a bias in favour of the bigger farmers, some of which received relatively large loans for increasing their cattle herds. The assessment also revealed difficulty reaching smaller and particularly landless clients. It comes to no surprise that all clients in the village had to offer land as collateral. Once again it was revealed that hard physical guarantees replaced mutual confidence, which in itself is based on social relationships and local knowledge.

For years, the local elite has dominated the village committee (*comité comarcal*). This enabled them to monopolize contacts with spokespersons of various projects and thereby influence the products that were materialized from these efforts. Both the construction of the post-Mitch resettlement in 1999 and the rising land concentration have contributed to the polarization between the landless people and the land-owning groups, in particular the landed elite. This resulted recently in an electoral victory of representatives from the landless group over traditional

Table 3. Outreach of the FDL at the village level.

Client types	*Loan use*	*1*[1]	*2*	*3*	*4*	*Total*
Small peasants	Staple foods	-	1	-	7	8
	Cattle	1	-	2	-	3
	Plantains	-	3	5	-	8
	Oxen	-	-	3	1	4
Sub Total		*1*	*4*	*10*	*8*	*23*
Middle peasant-farmer	Staple foods	1		2	2	5
	Cattle	1	1	-	2	4
	Plantains	-	-	1	-	1
	Rural trade	-	-	1	-	1
	Oxen	3	1	2	1	7
Sub Total		*5*	*2*	*6*	*5*	*18*
Large farmer	Cattle	1	3	2	-	6
	Land	1	-	-	-	1
Sub Total		*2*	*3*	*2*	*-*	*7*
Small shopkeeper	Rural trade	2	-	-	-	2
Middle rural trader	Rural trade	2	-	-	-	2
Large rural trader	Rural trade	-	-	1	-	1
Wage-earners	Personal loans	-	-	4	-	4
Total		*12*	*9*	*23*	*13*	*57*

Note: 1=700 families; 2=150 families; 3=250 families; 4=50 families
The terms small, medium and large refer to a capital base of respectively: less than 5,000 US dollars, between 5,000 and 20,000 US dollars, and more than 20,000 US dollars.

Source: FDL data system.

elite leaders. However, the new leaders are inexperienced and less well connected with external programmes for combating poverty. This might affect their capability to effectively attract additional external resources. In a focus group discussion with the new leaders, we could observe that they were in the initial stages of developing ideas. They did not expect the FDL to provide answers to their basic concerns, such as access to

land and employment opportunities. In view of the promoter's view of resettlements (see before) and the policies of the FDL, the opinion of these new leaders is fairly accurate.[10]

In the third village, we found a different picture than in the previous two villages. In particular, the loan portfolio included several smaller clients and was more diversified. In Table 3 we observe that both poor farmers and wage earners (e.g. school teachers) are served by means of personal loans. In contrast with the other villages, many clients in village 3 did not have to offer land-collateral. Only 10 out of 23 clients used land as collateral. This was clearly due to the fact that the promoter enjoyed a wide variety of trustworthy contacts. During the 1980s, he had lived in a neighbouring community where his father had a large farm. In order to select the clients, he therefore could contact local informants from different social networks. His knowledge and wider connections clearly allowed for a more varied and flexible access to credit from the FDL. Consequently poor clients were included in the credit portfolio. Contrary to other development interventions, which faced biased intermediation by the local Sandinista elite, this promoter made use of his diverse local connections and remained neutral in social and political terms. He thereby served a much larger clientele in this community. Nevertheless, a more precise targeting of the poorer sectors and in particular the land-poor peasantry seemed, in our view, both possible and needed.

In a fourth community, where there had not been land reform, the FDL took recourse to a large farmer (175 hectares land and 100 animals; he gives land to 5 tenants for sharecropping) with a dominant position in the local economy. This traditional landlord plays a vital role at the interface of the FDL with his community. He convened the public meeting where the services of the FDL were presented to potential clients. He now also serves as a permanent, key reference person for advice on all loans, and a formal co-guarantor in some cases. The FDL benefits from the authority of this leader by accessing important information and ensuring the recovery of the loans. The leadership support has enabled the FDL to build up a large outreach. At present 14 producers out of a total of only 50 families are clients of the programme. However, it is a method that the FDL would never use in communities with a background of agrarian reform (see e.g. the cases of Village 1 and Village 3). However, also in this community all loans are collateralized with land, which means that access is restricted to the landowners.

Table 4 presents a schematic summary of the main points of our analysis. There is a trade-off between personal knowledge and recourse to tougher collateral policies. Indeed, one could affirm that in communities with absence of personalized and diverse contacts, it is more likely that small clients are excluded from FDL credit. In these communities the FDL is forced to take recourse to tough collateral requirements, which might result - involuntarily and unconsciously - in credit being directed to the higher social strata.

5. MFIs and rural development: how to contribute to a more egalitarian path

By analysing a case study of the FDL in the Quilalí Valley, we have tried to show how the local social embeddedness of the rural MFI helps to shape the nature of the outreach of its services. In the 1980s, the region suffered a great deal from the armed conflict between Sandinistas and Contras. After more than 15 years of conflict, the situation in the Valley of Quilalí has normalized. An economic recovery phase set in, followed by a set back from the severe recent coffee crisis. However, the recovery process in itself was already being accompanied by a swift change in the agrarian structure. In spite of good opportunities generated by the past agrarian reform and the agro-ecological potential of the region, socio-economic inequalities have once again tended to be on the rise.

Large farmers are expanding their scope of production, including cattle raising, corn production and commercial activities. As we have argued above, this spontaneous process puts pressure on the poor farmers' access to land. Rapid population growth further deteriorates the prospects of the land-poor sectors. The partial return to patron-client type of social relationships (share-cropping) is insufficient to satisfy the needs of the growing landless sector. The gap between supply and demand for land grows wider. Other employment sources, drastically reduced by hurricane Mitch and the recent coffee crisis can also not absorb the present surplus of labour.

Little land is available for the growing numbers of land-poor families. If there was, a more intensive and diversified model of small-scale production (1.5 - 2 hectares of land per family, with corn, plantains, and alternative high value crops) might be a solution to the livelihood crisis of many poorer inhabitants of the region. This might have been combined with innovative non-farming activities. To make such livelihood strategies possible, development initiatives should target

Table 4. Institutional embeddedness and access to FDL in four villages in Quilalí.

	Village 1 (700 families)	*Village 2 (150 families)*	*Village 3 (250 families)*	*Village 4 (50 families)*
Local embeddedness	Very few confident contacts; community with agrarian reform history	Confident contacts with 3 informants of the landed elite	A lot of confident and diversified contacts; community with agrarian reform history	Confident relation with the only local leader with strong power
Collateral requirement	Strict: land or other material collateral	Strict: land or other material collateral	More flexible for better-known poorer clients	Strict: land (only one exception)
Outreach	Low client/population density	Middle client/population density; limited to the landed elite	High client/population density; socially more diversified	High client/population density
Presence of other development projects	High presence, concentrated in landed Sandinista elite	High presence, concentrated in landed elite	High presence, concentrated in landed elite	Very low presence

these sectors and facilitate the transition to these alternative solutions. However, the MFIs as well as many other present-day development interventions in Quilalí have hardly been able to reach the poorer sectors and so have scarcely contributed to the prospects of a more egalitarian development. We believe that this is, at least partially, to be attributed to an incapacity to neutralize the mechanisms of social exclusion at the local level. In spite of pro-poor rhetoric of many programmes, external resources almost automatically tend to end up in the sectors that are already privileged.

Given the tendency to social exclusion in the valley of Quilali, external interventions should be managed with much more care, consciousness and responsibility. We emphasize the need to enlarge the client base of MFIs and avoid the almost automatic mechanisms of exclusion. The latter are at the core of present day processes of land reconcentration. This urgently requires looking to operate with small 'disconnected' inhabitants, especially land-poor and female producers. A diversified social interface and a realm of mutual knowledge and confidence are prerequisites to construct and maintain repayment mechanisms as well as the deepening of outreach. Such a strategy could allow microfinance institutions to become more reliable partners of the entrepreneurially viable, poorer sectors of rural societies in their search for economic alternatives. In lack of such a strategy they inevitably will be forced to adopt a more conventional financial strategy. In particular, the use of land as collateral and a preference to finance cattle raising, severely curtails the prospects of a wider outreach and deeper impact.

The role of the promoters is crucial since they operate at the interface between microcredit institutions and the members of the local communities. Their local embeddedness is vital for the viability of credit operations, both in terms of selecting appropriate clients and maintaining repayment discipline. Simultaneously it helps to confirm the legitimacy of the often severe 'rules of the game'. On the other hand, their social origin and connections may bring about less desirable results in terms of a bias in credit concessions. In part, these can be remedied by introducing appropriate wage incentives, such as the inclusion of the number of clients as a criterion in assessment evaluations. Another recommendation is to improve the selection of local promoters in this respect, by contracting (female) promoters from the poorer social strata and as far as possible diversifying the background of these promoters.

A final consideration concerns the possible negative impact of the prevailing ideology of 'strong sustainability', according to so-called

'best practice'. Of course there is no point in subsidies that would lead to a step backwards towards weak repayment and unsustainable finance. Nevertheless, the construction of a non-conventional social interface, enabling sustainable finance with the poorer sector of rural society, initially requires a good deal of time and resources. It is fair to say that investing in much needed, but experimental alternatives of the rural poor entrepreneurs is inherently a more risky strategy. A microcredit institution, such as the FDL, in its present conditions can hardly embark on such a strategy, expedient as it might appear following our argument. However, we harbour the opinion that a temporary lump-sum subsidy may help to reduce any additional risk that necessarily will have to be borne on the road to developing a more mature local credit market.

Notes

[1] For more details on the colonisation logic see Nitlapán-UCA, 1996.

[2] With these 'historical' relations we refer to the long-standing informal contracts, such as sharecropping and patronage that existed between landless peasants and large landowners.

[3] Paradoxically the demobilisation of the contra rebels was in part achieved by a new phase of land reform. Sandinista cooperatives, formed during the sandinista era, were forced to hand over part of the land they had received and additional private land was incorporated as well. To make the paradox complete, the contra rebels guided by their leaders adopted a cooperative model of organisation that bore a close resemblance to the ineffective collective sandinista model.

[4] The data for this contribution were obtained during a field study in July 2002. The main objective of the study was to perform an exploratory local socio-institutional analysis and to test a methodological instrument that was developed for this purpose (D'Exelle et al., 2002; Bastiaensen et al., 2002). The main purpose of this analysis was to generate information and hypothesis to be fueled back into the policy reflections of the FDL. Here, we try to systematize some of the findings of this study and the subsequent policy discussions with the FDL.

[5] The 18 largest micro-finance institutions are organized in the Nicaraguan Micro-finance Association (ASOMIF). These 18 institutions have increased their portfolios from US dollars 19.7 million in 1997 to US dollars 49.7 million in June 2001, with an increase from 18,700 to 125,200 active clients (Gutierrez, 2002). 41 per cent of their portfolio is directed to the rural sector, which is a substantially higher proportion than in most other Latin American micro-finance sectors. ASOMIF is very active in lobbying for legislation that will allow a further expansion of their sector of sustainable micro-finance enterprises.

[6] Mind the fact that most of the property documents are private; they are thus not fully registered, official property titles. Apparently, this does not pose many problems in terms of local legitimacy of the collateral arrangement and somewhat surprisingly the expropriation of such land in case of defaulting clients does not seem to pose serious problems. This illustrates that microfinance institutions such as the FDL can reduce the need for expensive formal land titling programmes, while relaxing the credit-collateral constraint. In fact, we found that private property documents had strong and relatively uncontested legitimacy, to such extent that the need for formal titles was not strongly felt.

[7] Previous research in Wiwilí revealed that with increasing outreach local branch offices make increasingly use of the extending network of trustworthy clients to make contact with new clients.

[8] In fact, the highly valued local promoter in Quilalí initially did not pass the technical exam, but this was bypassed because of his local 'insertion and image' and his evident appropriation of the basic rule of the game that credit always has to be repaid.

[9] See Bastiaensen and D'Exelle (2002) for an extensive analysis of an early FDL experience in a 'sandinista village' in the region of Masaya.

[10] It is worth noting that in the aftermath of this investigation Nitlapán, the 'mother institution' of the FDL, took the initiative to start operations of its complementary credit programme 'Fondo de Reconversión Productiva', targeted on more risky and

less profitable investment activities of poor producers, in Quilalí. Nitlapán and the FDL recognize that the sustainability oriented credit operations of the FDL impose excessive limits upon the capacity to work with poor producers in need of longer-term investment loans as well as credit for riskier innovative activities.

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4

MAKING THE LINK: EMPOWERMENT OF WOMEN AND VIABLE FINANCIAL SERVICES

Michelle Deugd

1. Introduction

Women in Nicaragua constitute about half the clientele of microfinance institutions: 59 per cent in urban zones and 38 per cent in rural zones. This is the result of a high concentration of women in the informal sectors and their difficulties in having access to official banks. In spite of the high participation of women in microfinance programmes in Nicaragua, there is still a debate about the effects on the standard of living of these women. There are concerns related to the indebtedness of the poorest women, the high costs of loans for women, the lack of control women have over the credit and the lack of access to general resources in order to take advantage of the loans.

This chapter focuses on the question of how to reach a balance between the optimal conditions of the financial services offered to women and the additional services, which permit them to take greater advantage of credit. This question is investigated through an inventory of information from national and international cases, impact studies and the perceptions of different participants in the microfinance field in Nicaragua. Ideas, methodologies and models were identified through the systematization of these sources of information, with a view is to improve the focus of financial services provided to women in Nicaragua.

Besides assuming most reproductive activities, women in Nicaragua play an important role in the national economy. During the last few

years, their participation in the labour market has increased dramatically from 18 per cent in 1950 to 42 per cent in 2000 and according to different forecasts this participation will continue growing (FIDEG, Agurto and Guido, 2001; CEPAL, 2000; PROMICRO/ILO, 2000). The increasing participation of women in economic activities is related to a change of attitude, through which women and society have recognized the potential of women, as well as to the impact of the economic crisis. As a result of migration and socio-economic problems in the year 2000, 38 per cent of urban families and 28 per cent of rural families had a woman as head of household. In 1996, these percentages were 33 and 20 respectively.

In spite of the high participation of women in MFIs, they only receive 42 per cent of the funds in the urban and 17 per cent in the rural sector. Both figures reflect the gap that exists between the amounts of credit made available to to women and men. MFIs usually do not differentiate between loans requested by women or men, and the consequence might be that the services are not adjusted to the needs of both. Women maintain priorities in direct relation to their productive and reproductive activities (supporting business and family at the same time), and their businesses are located in sectors that require special attention by credit programmes. All of these subjects are dealt with in this chapter.

The chapter is composed of five sections. Section 2 contains the conceptual framework used as a basis for the analysis of the Nicaraguan experience. Section 3 presents the experience in Nicaragua in relation to microcredit for women, discussing both the limitations as well as the most important lessons learned. Based on this, Section 4 presents the recommended model, which is based upon two main strategic lines. First, a financial line addressed towards the consolidation of the sector with the goal of providing a more efficient and inexpensive service, and to adjust financial products to the needs of women. And second, a social approach which searches for the articulation of financial and non-financial services, the control of women over the loans and their empowerment, as mechanisms to guarantee the positive impact of financial services. It also contains recommendations for the development of policy on three levels. In Section 5 some final recommendations and observations are presented.

2. Conceptual framework

Throughout the world most people belong to the underprivileged sector of society and an important part of them are women. Additionally, they are self-employed or work in small or micro businesses. It is very unlikely that growth in the formal sector might change this situation in the next few years. If we want to reduce poverty and develop the economic potential of majorities, it is necessary to finance the economic activities of low-income populations (Women's World Banking, 2000).

When low-income entrepreneurs and producers have access to financial services at market rates that respond to their needs, they repay their loans and use the profits to increase their assets and improve their standard of living. Higher income, particularly in the hands of women, is spent on health, education and housing, creating a new meaningful demand for goods and services. Low-income entrepreneur women use their savings to create reliable networks of social security for the family business (Women's World Banking, 2000). Moreover, it has been assumed that microcredit is an effective tool for increasing the economic and social empowerment of the clients, particularly women, as a result of the development of their entrepreneurial activities.

However, in spite of the possible contribution of financial services to improve the living conditions and empowerment of women, this will not materialize automatically. In many cases, the benefits can be marginal and may even have a negative effect on the empowerment of women (Mayoux, 2000). Therefore, this chapter introduces concepts that lead to reflection on the positive and negative effects of financial services on feminine clientele, and summarizes debates on the subject.

Women empowerment and microfinancing[1]

Many women's organizations around the world have included a component of savings and loans, as a method of increasing the income of women. There is a large variety in focus and objectives among microfinance programmes. Recently, there has been an apparent convergence of common policies, terminology and concerns pertaining to sustainability, participation and empowerment. Donating agencies and NGOs have tried to respond to their critics and to the activists that have established constructive dialogue. However, under the apparent consensus, it is possible to identify three contrasting 'paradigms' with different objectives and underlying perceptions, as well as different

prescriptions and priorities in the policies related to microfinancing and gender.

The paradigm of financial self-sufficiency is an effort to include topics of poverty relief and empowerment in the neo-liberal agenda. This paradigm is the basis for the microfinance models promoted since the 1980s by most donor agencies and the guidelines of 'best practices' promoted by the publications of USAID, World Bank, UNDP, The Consultative Group to Assist the Poor (CGAP) and the Campaign of the Summit of Microcredit. The final objective is to establish programmes that are substantial, profitable and totally independent of the economic perspective, and that can compete with other private banking institutions. They must be capable of raising funds in the international financial markets instead of depending upon the funds provided by development agencies. The main target groups, in spite of what has been said about favouring the poor,[2] are the 'bankable poor', in other words, small entrepreneurs and producers. Discussions have been focused on the establishment of interest rates to cover the costs and the separation of microfinancing from other interventions to permit the preparation of separate accounting books. The debate also covers the expansion of the programme to increase its outreach, the economies of scale and the reduction of transaction costs.

The paradigm of poverty relief is the basis for many community development programmes. In this case, poverty relief is defined in terms that go beyond the commercial revenue to include larger capabilities and options, and reduce the vulnerability of the poor. In general, the main focus of the programmes is on the development of sustainable living resources, community development and the provision of social services such as the teaching of basic literacy, healthcare and the development of infrastructure. The concern is not only to benefit the poor, but the extremely poor. In particular, debates have been focused on the importance of small savings and the facilitation of consumption loans. They also include production, the formation of groups and the possible justification of a level of subsidies for programmes that work with groups of particular clients or in specific contexts. Some programmes have developed efficient methodologies to approach poverty or to operate in remote areas.

The feminist paradigm of empowerment is firmly rooted in the development of some of the first programmes of microfinancing in the South, including SEWA and WWF in India. In this case, the underlying concerns are gender equality and human rights of women. Microfinance has been promoted as an entry point in the context of a

wider strategy to provide economic and socio-political empowerment to women has at its core the sensitization to gender and the feminist organization. These strategies also include the linkage of women to existing services and infrastructures, the development of new technologies to economize on tasks such as food processing, construction of information networks, exchange of new markets, change to new markets, and changes in policies that help overcome legislative and unionization barriers (Chen, 1996).

The balance between financial and social criteria

Independently of the paradigm applied, the major challenge for an MFI that has assumed the mission of improving the standard of living of its clientele is to find a balance between financial and social criteria. Three elements must be considered to evaluate this balance: financial sustainability, impact and outreach (Nusselder and Sanders, 2000), which can be defined in the following manner.

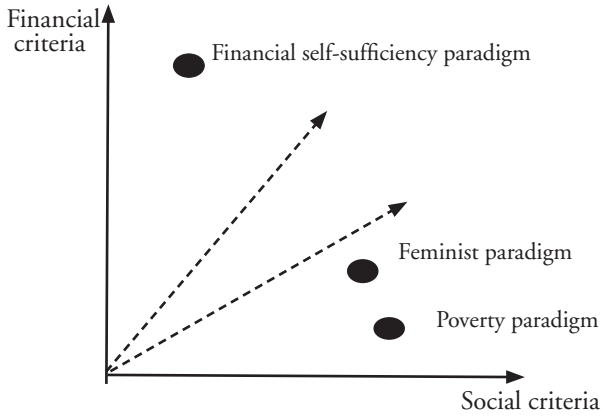
Sustainability. This is related to the present and future supply of services provided to a target population. This objective is related to financial sustainability aspects, as very few entities can continue operating without financial balance and growth. In time, this will affect their autonomy and independence from the subsidies provided by donor agencies.

Outreach. This element is related to the coverage provided by microfinance institutions to households and/or businesses, taking into account the target populations of counterpart organizations. In other words, it indicates how far a credit programme has been able to serve low-income populations with problems in gaining access to financial services, but with the potential to use the credit to improve their socio-economic position.

Impact. This criterion refers to the developmental impact of the funds granted to the target population. It includes both tangible (income level and better housing conditions) as well and intangible (empowerment, creation of new jobs, socio-psychological realization and others) indicators. This criterion is one of the hardest to measure, but at the same time it frequently determines the selection of programmes or projects financed by development agencies.

The above criteria maintain a close relationship, and there is a certain trade-off between one another. On the one hand, microfinance programmes shall offer a profitable financial service in which the income perceived from the portfolio can cover the financial and operating

Figure 1. Working approach of different MFIs, according to paradigm.



expenses, and on the other hand, they must bring their services to a low-income population highly vulnerable to external changes.

According to the objectives of each MFI and the paradigm applied, they will be inclined towards one of the three criteria, as can be observed in Figure 1.

The financial self-sufficiency paradigm, for example, places a greater emphasis and effort on financial sustainability, with the possible risk of turning it into the exclusive final objective. During the struggle to achieve profitability, the programme will not necessarily respond to the challenge of serving a low-income population, and gradually might start substituting the original target population for the medium and higher strata.

The institutions that work according to the poverty paradigm, generally achieve a satisfactory outreach and possibly an accumulation of goods from a large part of the borrowers. However, if this organization faces the progressive deterioration of its recuperation and interest collection indexes, and if it maintains high operating costs, its days will be numbered as far as financial and institutional sustainability are concerned.

Institutions that work according to the feminist paradigm will often try to offer integrated services with the goal of ensuring a positive impact upon the users. However, if such institutions do not maintain a separate accounting of financial and non-financial services, and if they

have not clarified the self-sufficiency degree of their financial services, the sustainability of such institutions might be at risk, affecting their long-term impact.

3. The Nicaraguan experience

Traditionally, credit in Nicaragua has been directed towards men. State owned and large banks did not see women as creditworthy due to a lack of collateral and resources. With the development of MFIs in the 1990s, many of which had the mission of contributing to the improvement of the standard of living of the poorest strata of the population, access to credit for women has also increased considerably. Many of these programmes designed new policies to benefit women. Particularly, policies related to collateral have improved women's access to credit. Many of these organizations accept pledge collaterals, guarantors, and in some cases a group guarantee.

According to data supplied by FIDEG, NGOs are the most important source of credit for women. Particularly in the rural areas, NGOs are very important as a source of credit for women: 83 per cent of those with access to credit obtain it through this source. In other words, if it were not for these groups, rural women would be almost completely excluded from loans (Agurto and Guido, 2001).

In spite of the improvements in access to credit for women, the amounts of the loans for men continue to be larger. According to the same source, women in the rural segment only receive 17 per cent of the amounts granted, while in the urban areas they receive 42 per cent of the funds. This is an indication that there are still obstacles that limit an equitable distribution between women and men, particularly in rural areas.

This section contains the reasons for these barriers and an analysis of the main obstacles found by women when requesting and using a loan, as well as the impact of loans on the standard of living of women.

Limitations regarding the amounts granted

The main arguments mentioned by MFIs to clarify the gap between amounts granted to women and men are:

(a) insufficient collateral from women;

(b) lack of employment and productive activities in the case of rural women;

(c) women generally do not have enough resources to back the development of a business;

(d) men perform agricultural activities for which higher investments would be required.

MFIs highlight the importance of not offering amounts that surpass the creditworthiness of the clients. In addition, they state that the amounts granted to women are lower simply because they get involved in less profitable activities and maintain businesses at low-income levels. The relationship between gender and remuneration level has been statistically established (PROMICRO/ILO, 2002). Most MFIs indicated that their female clients are satisfied with the amounts granted and that they usually receive what they need. However, the results of two impact studies demonstrate a different situation. The first study, carried out by FIDEG for the Coordinating Council of Wisconsin Nicaragua, WCCN (FIDEG, 2002), confirms that the levels of satisfaction in relation to the amounts received are 63 per cent in the case of men and 37 per cent in the case of women.

In the second study, performed in the southern part of Nicaragua (Sanders and Deugd, 2002), 78 per cent of men are satisfied with the amounts received while only 65 per cent in the case of women. In both cases, most of the women who indicated they were unsatisfied with the amount received, confirmed that they had requested a higher amount. Participants at different levels, interviewed for the study that supports this paper (Deugd, 2002), referred to discrimination towards women and that it is still hard for them to obtain higher amounts. Although they may possess the same collateral and creditworthiness as men, this observation was made by men and women alike.

Limitations to credit access

Apart from women who do have access to credit, there is a large group of female producers in Nicaragua that do not. The equal participation of women and men as clients of MFIs could give the impression as if both sexes have equal access to credit sources. However, this is only part of the real world, since men are numerically predominant as clients of the commercial banking sector. Access to credit is much harder to obtain in the case of women, who face many more obstacles. This is reflected in Figure 2, which presents the reasons why persons have refrained from requesting a loan.

Members of both sexes mentioned the risk and the inconvenience as determining factors for not requesting a loan. However, if differences

Figure 2. Reasons for not requesting a loan.

Source: PRODESUR database, Sanders and Deugd, 2002.

between both genders are analysed, we can observe that for women there are aspects more important such as the very short terms, the requirements and the lack of collateral. In the case of men, having their own resources is mentioned as the explanation for not requesting financing. The following figure demonstrates the importance of adapting the terms, the requirements and the collateral to the needs of women to improve their access to credit.

Costs of credit

According to the 'Living Standards Measurement Survey in 1998' (LSMS, 1998) women received loans with interest rates generally higher than 48 per cent while men paid interest rates below 48 per cent. The difference is mainly due to the type of credit requested by women and the source of the loan. Women request mainly commercial short-term loans, while a considerable number of men receive loans for agricultural and livestock activities, with lower interest and longer terms. Although, since April 2001 the interest rates are regulated by the Central Bank, commercial loans are still more expensive than loans for the agricultural and livestock sector, particularly in cooperatives. There is a marked tendency of transferring the costs from nominal rates to up-front fees, charged at the beginning of the loan. This would imply that the difference between the costs of credit for women and men might even have become larger. As a matter of fact, loan terms are shorter to

women, who are by consequence forced to take out loans more often. Needless to say, with each new loan there is a fee to be paid.

There are reasons for the differences in the costs of agricultural and commercial loans. Supposedly, loans in the commercial sector produce a faster return and profits are higher than in the rural sector. However, one should also take into account differences between profitability rates *within* the commercial sector. Usually women participate in less profitable commercial activities than men and in those cases the costs of the loan imposes a relatively higher burden for women.

The high operating costs presented by MFIs in Nicaragua are another reason for the high costs of loans granted to women. Particularly, in the area of NGOs that work with women, there are a large number of small organizations that combine credit with other work components, resulting in a low level of financial services efficiency. In spite of their good intentions, there is a risk of dispersion in attention and priorities, as their operating costs remain high, with few prospects of use and exchange of experiences among the NGOs. Various studies report operating costs between 25 and 40 per cent for Nicaraguan MFIs specialized in microcredit for women.4 In contrast, successful institutions in other Latin American countries, such as WWB-Colombia and Bancosol-Bolivia, report operating costs between 16 and 18 per cent.

During the First Conference on Entrepreneur Women in Nicaragua in 2000, the difference in credit costs for women and men was mentioned as one of the most important points of discrimination between the sexes, as well as the main constraint to the equitable business development in the future.

The impact of loans on the standard of living of women in Nicaragua

Comparing three impact studies performed in 2002 in Nicaragua (FIDEG, 2002; Zamor et al., 2002; Sanders and Deugd, 2002), it may be inferred that in general the impact perceived by women, as a result of the credit received, is positive. The loans are considered as an indispensable source for their business and/or personal development. Moreover, all studies indicate the importance of access to credit for women of different strata.

The three studies analysed the perception of impact at different levels. They find that the percentage of female clients that perceived a positive impact at the business level ranges between 86 per cent and 95 per cent. The majority of the changes identified were related to the nature of products sold, in 44 per cent of the cases, such as the diver-

sification of the product, a wider array of supply and better quality of the products offered. Second in importance was the increase in sales. Only between 5 and 11 per cent of the clients mentioned that they did not perceive a positive impact in the business.

In relation to the impact perceived at the family level, it is noticeable that the loans have had a positive impact, particularly on the living standards of the client's children, such as education, nutrition and health (between 28 and 30 per cent).

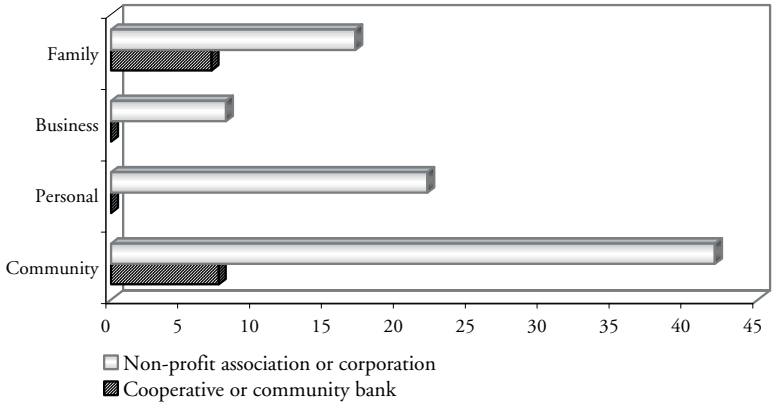
As far as decision-making processes within the family are concerned, there has been little impact, particularly in the position of women in relation to men. Available data suggest that there is a negative impact on the workload of women, since they are more involved in their businesses. However, their workload in the household remains the same, with no change reported in the distribution of household tasks. It is also striking that in the three studies a considerable part of the respondents (between 18 and 28 percent) did not refer to any positive impact on family life.

The impact at the *personal level* is an important element for female clientele and is generally discussed in detail during participatory workshops. Many women emphasize the increased level of independence achieved through their work with support of the loan. Many stated as well that there was a positive impact on their self-esteem and their ability to initiate new activities. In the three studies the changes in self-esteem (25 per cent) and independence (23 per cent) were the two most important aspects of the impact perceived.

In the same context, other research gives reason to expect that a positive impact at the personal level does materialize more often with organizations that offer financial and non-financial services. According to a document by Zamor *et al.* (2002) there is a larger positive perception in relation to changes in self-esteem in those organizations that work in a comprehensive manner, i.e. by offering both financial and non-financial services.

Notwithstanding the available prima facie evidence in non-material areas, only a few studies provide statistical proof that access to microcredit will translate into tangible changes in female living standards. In order to fill this gap, a research team of CDR-ULA recently carried out research in the southern part of Nicaragua, with a view to analyse the socio-economic impact at the household level. To this effect, a survey was done with – partly overlapping – groups of respondents at different times (in 2000 and 2002, at the request of the project IFAD-PROSESUR). The results of this research, however, are not par-

Figure 3. Zero impact at different levels.



ticularly encouraging. The impact on living standards5 of women is positive when measured as average data holding for the entire clientele. However, in the case of women and men belonging to the lower income stratum, many respondents reported a negative rather than a positive impact. The negative impact among the poorest strata was observed, in particular, in rural areas. It was equally observed among poor men and women, but it should be borne in mind that destitute poor population strata are mainly made up by elder women and single mothers. In other words, any negative impact of micro-credit among the poor is disproportionately felt among female population (Sanders and Deugd, 2002).

The study prepared for PROSESUR found, in general terms, a more positive perception of the impact in credit unions and solidarity groups, rather than in non-profit associations and corporations. This is observed in Figure 2, presenting the percentage of clients that did not perceive any changes. According to the results of the workshops held to collect this information, the possibility to participate in the decision-making processes of credit unions and solidarity groups worked as a stimulus in the development of personal talents. The latter including self-esteem and communication skills, these abilities are indispensable for the development of any business.

4. Development of political instruments

Taking into account the mixed record of MFIs when it comes to improve the position of women, there is a need to develop methodological models and instruments focused on overcoming limitations mentioned above and increasing the impact on women's living standards. The greatest challenge is, in this regard, to adjust the focus and working methods in applying a gender perspective, while striking a delicate balance between the MFI's economic development, access to other (non-credit) resources and the empowerment of women. These objectives would justify a model with two main strategic lines. First, a 'financial' axis would address the issues of sustainability and financial efficiency, whereas a second axis, as a 'social' line, would focus on the impact of microfinance, the control of women over their loans as well as their level of empowerment, mainly to be achieved by improving access to other resources. The balance between these two strategic lines could foster, at least, some degree of drawing together of the previously defined paradigms, thereby taking advantage of established MFI experience.

The 'financial' strategic line

The development of this line should be directed towards the financial self-sustainability and efficiency of MFIs, in order to ensure the availability of funds for secure and sustainable loans at competitive interest rates. By the same token, products may become more demand-adjusted, in order to improve the women's access to credit and so enlarge the outreach of microfinance. Successful MFI experiences in Latin America, such as WWB-Colombia and Bancosol-Bolivia, have demonstrated the importance of sound fund management, as a necessary basis to reach the poorest target groups, most of them women. Taking advantage of economies of scale and higher levels of operating efficiency, those MFIs were able to extensively attend their target groups.

These experiences demonstrate that to improve women's access to financial services, it is necessary to develop a sector of well performing and competitive microfinance institutions. They must be capable of offering to their clients not only short-term and medium-term credit, but a fully fledged package of tailor-made products, in savings, insurance, remittances and short and medium-term investments.

The first step in developing a competitive and efficient sector is to reduce the operating costs of MFIs. According to a study carried out on behalf of the Embassy of the Netherlands (CDR-ULA and Faceta Central, 2002), in Nicaragua, the number of MFIs has increased dra-

matically during the last decade. There is now a large number of small microfinance institutions. Usually, 250,000 US dollars is considered as the minimum portfolio needed by an institution to be sustainable, provided that it maintains acceptable levels of efficiency, reimbursement and costs control. The stated document reports 70 per cent of financial institutions in the country to operate below that standard. Among them are many MFIs focused specifically on the improvement of the standard of living of women. This requires strategies to maximize economies of scale and analyse the prospects for establishing alliances, networks, and the avenue towards one large and strong MFI, specialized in financial services for women.

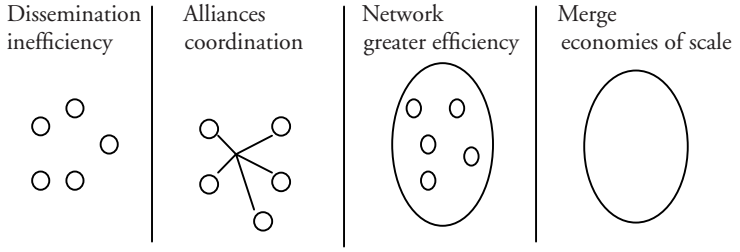
Institutional links will allow better use of the institutional experiences and knowledge obtained in a learning-by-doing process, as a base for innovated product-service combinations. Moreover, it will be possible to coordinate training processes, joint institutional development and even the common purchase of, for instance, software packages.

The way of bringing together gender focused MFIs or even fostering mergers between them requires close attention. This is a thorny process that would possibly consist of four stages, which are presented in Figure 4. In the first stage, all MFIs are working separately, without any coordination, duplicating their efforts and not taking common stock of lessons from the past of using jointly available resources. In stage 2, the strategic alliances between MFIs would be forged with a view on improving coordination and better use of available knowledge and resources. In stage 3, the MFIs intensify their cooperation, which would then extend to the development of new products, organization of staff training, introduction of parallel administrative methods, including conjunctly purchasing software. Only in the fourth and last stage, a merger of various MFIs would come through, with ensuing scale advantages.

The figure is not meant to suggest that it is necessary to continue the process until the very last stage, or that the process would be irreversible. The central issue is the importance of facilitating a joint institutional process of coming to maturity, aimed at scale enlargement and corresponding economies, in accordance with special circumstances of women and reducing their transaction costs when accessing financial services. The process is neither clear-cut nor straighforward, as it will mostly depend upon the vision and determination of the participants.

To none of the stakeholders in the process, is it possible to impose any of the above models. The experience with WWB-Colombia

Figure 4. Stages in institutional coordination models.



(Women's World Banking, 1999) has demonstrated that attempts to externally formalize a merger do not work if the initiative is not borne by the institutions themselves. To impose the process would provoke internal tensions and cause external conflicts between institutions. It implies that the process might stop before the ultimate stage of merger has been reached, so as maintain the independence of each organization involved. This could make the case for arrangements, which - in practical terms - would allow for microfinance franchising networks.

The 'social' strategic line

For women to get more control over their loans as well as access to profitable markets, financial and non-financial services should in one way or another go in hand in hand. Time and again it has been demonstrated that it is not enough to just improve access to financial services that would automatically trigger a positive impact. The risk is rather in credit-only services, that men catch control over the money disbursed to women. Another scenario is that women, due to lack of experience and without other resources, would not be able to fully exploit their loans. This increases the risk of over-indebtedness, particularly for the poorest women.

This does not mean that MFIs themselves would have to develop non-financial services. It is very well possible that institutions parallel to MFIs would be equally well able or even more so to offer non-financial services to borrowers. This would create alliances between MFIs and specialized NGOs,[6] tested to explore synergies between different services in order to deepen impact. Non-financial services should be focused on areas of both business and personal development, the latter related to women empowerment. In many cases it has been demonstrated - PROMUJER in Bolivia and Peru, and in Nicaragua PROMUJER in coop-

eration with ADIM - that it is possible to enhance women control over and use of financial services, resulting from empowering exercises.

Therefore, the institutional coordination should be focused on the following areas:

(a) mechanisms to increase control and decision making of women over disbursed loans, through participative processes with results to materialize in intra-household domains.

(b) access to other resources, particularly training, education and organization, to connect women with the basics for developing their productive assets;

(c) Integration of women into more profitable market segments, through specific training, organization and support to commercialization efforts.

This model does not mean that the institution offering non-financial services alone should take care of 'developing the gender aspect'. Fully applying a transversal gender perspective in earnest means that each institution would assume the challenge of translating it into the respective fields of oNGOing business.

Institution building aspects

The elaboration of two strategic lines requires specific actions to be taken at each institutional level. Within MFIs a first step would be to review current human resource management regarding: equal opportunities for female and male staff, performance against appropriate indicators and sensitivity of personnel regarding gender subjects. A key element in this regard is to balance the number of men and women doing fieldwork, particularly in rural areas, and to lower the access barriers to rural women who request a loan. Moreover, sound human resource management clearly has positive bearing on the efficiency of MFIs.

Microfinance institutions have a role to play in search for efficiencies and integration in the market. Product development needs to be adapted to the needs of their clientele, including productive as well as reproductive needs. Special activities could therefore be prepared within networks, such as market studies, informal meetings, pilot programmes and product validations. These mechanisms could be used to test the usefulness of other tools and policies, regarding issues such as collateral requirements, amounts and terms of new loans.

For the understanding of the work of MFIs and their partners, it remains essential to regularly carry out impact studies. The emphasis would then be on designing sensitive monitoring models aimed at

identifying results for male and female clients. Another tool is that of base line and panel studies to compare effects of microfinance over a longer time span. Involvement of and coordination between partners would help to ensure better use and ample discussion of the results, allowing for a critical feedback. There should be more latitude to discuss both more and less successful experiences, since this would stimulate the fine-tuning of MFI policies.

Development agencies should, by all means, take the lead in the development of networks and merger processes. As a matter of fact, their position is independent and supposedly unbiased. They may play a coordinating role and thereby facilitate the validation of methods to achieve scale enlargement and linking of non-financial to financial services.

The national government would be in charge of improving the legal framework with a view to promote savings, a vital financial service for women. It also has the responsibility of improving women's access to key resources beyond micro-finance, in particular in legal issues (e.g. property titling for women). It may stimulate the opening up of profitable markets for women producers. The government, development agencies and MFIs should frequently meet in platforms, in order to ensure that successful experiences and methodologies by some are duly exchanged and replicated by others.

5. Final observations

The MFIs find themselves in a complicated and dynamic environment, as their financial intermediation have a multitude of sometimes contradictory effects on their target groups. The activities of MFIs are in no way to be compared to those of a furnisher, whose task is finished upon delivery of a particular chair or table. MFIs are rather in a continuous process of change, as they have constantly to respond to a dynamic socio-economic environment. In terms of gender, additional efforts are needed for an adequate product design and methodology, as the situation of female borrowers is more complicated for bringing about economic and social change. A model is needed that permits serving this group with financial services that are easily accessible and involve low costs. On the other hand, they should adjust to the special needs of women in order to have a larger impact. Inter-institutional coordination between MFIs is critically important, when all want to

take advantage of existing know-how, lessons learned and strategies for scale enlargement.

Financial services alone do not necessarily imply an improvement in living standards. Services that encourage the development of women in a broader sense are also needed. Empowerment processes have to be integrated into an action framework that allows for the improvement of the social and economic conditions, as this will foster women's independence, strengthening their negotiation position and reducing their vulnerability. Financial and non- financial services are so to be seen as mutually complementary: by offering them both services the link is made between empowerment and the viability of microfinance.

Notes

[1] This section has been extracted from the paradigms defined by Mayoux (2000). These paradigms have been presented and discussed during the last Regional Meeting for Central America, Mexico and the Dominican Republic; Nicaragua 18-21 July, 2000. They are part of the most recognized source for the analysis of the subject of gender and microcredit.

[2] For example, in the documents of the summit on microcredit and the title of the same CGAP.

[3] The term equality is used here not in the sense of uniformity, but of equal options and opportunities. It is used instead of 'equity' since the conservative right has used this term to justify existing gender differences and divisions.

[4] Source: data obtained from studies prepared for COSUDE and PROSESUR, both in 2002.

[5] This refers to an index composed of several indicators, such as the level of education, food safety, number of rooms per family, type of flooring material, access to electric power, value of goods and means of transportation, as well as savings. The indicators were established on the basis of a statistical analysis that, in this particular context, identifies the most appropriate indicators to measure the standard of living.

[6] This model has been validated by the FODEM – Cenzontle alliance in Nicaragua. Since this is a relatively new initiative, it is not possible to anticipate results yet.

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5

MICROFINANCE: SUSTAINABILITY, OUTREACH AND IMPACT

Arie Sanders and Michelle Deugd

1. Introduction

During the last few years the impact of microfinance programmes has rapidly gained importance among development agencies. After some years of debate on the financial sustainability of microfinance institutions (MFIs), once again the subject of the effects of their intervention at the target group level is increasingly receiving attention. There is consensus that he creation of a microfinance industry through donations or soft loans would become irrelevant if it does not serve low-income populations and does not contribute to the improvement of their socio-economic conditions.

This article will analyze the experience of the Project for the Arid Region of the South Pacific (PROSESUR) during the development of a microfinance market in the southern area of Nicaragua. In 1997 PROSESUR initiated activities to promote a process of sustainable growth and improve socio-economic conditions by increasing the agricultural production of 14,500 rural families in 20 municipalities in the regions of Rivas, Carazo and Managua (FIDA, 1993). To achieve these objectives, the project created an important fund to bolster the financial market. The designers of the financial service component proposed several innovative mechanisms for the implementation. One of them was to channel credits through private local MFIs. PROSESUR established a credit fund called FONDECA (Fund for Peasant Development) in order to finance small producers in the development of agricultural activities, rural micro enterprises and commercialization.

This chapter comprises seven sections. Section 2 contains the conceptual framework. Section 3 describes the background of the microfinance situation in Nicaragua and a brief description of the MFIs related to FONDECA. Section 4 explains the methodology applied during the study. Section 5 shows the results of the study. Section 6 analyzes the connection between the three concepts applied and Section 7 contains the conclusions.

2. Conceptual framework

During the 1990s, the microfinance sector experienced globally an accelerated growth rate. As of December 31, 2000, 1,567 microfinance institutions worldwide served more than 30 million people, out of which 19 million lived under poverty conditions (Microbanking, 2001).

The microfinance sector includes entities such as: non-governmental organizations (NGOs), savings and loans cooperatives, community banks, banks specialized in microfinance and to a lesser extent, commercial banks. During the last decade, MFIs have searched for ways to achieve financial sustainability while offering services to an underprivileged population. This is supposed to result in a win-win situation. The MFI generates sufficient income from interest rates and fees charged to the loans, while the population can access funds to finance productive as well as non-productive activities. From this perspective, sustainable MFIs have better opportunities to contribute to the struggle against poverty (Schreiner, 1999).

Today, MFIs are beginning to offer a wider range of financial services. Although some of them have been able to continue offering traditional services, only those that have reached an important level of effectiveness have been able to reduce restrictions in the use of disbursed loans. These institutions recognize that funds are fungible and are aware of the fact that borrowers are looking for a high financial return and/or the satisfaction of their urgent demands, including balancing consumption or medical expenses. Consequently, MFIs are concentrating efforts on training clients, to promote the careful use of funds and the reimbursement of the loans in spite of how they were spent. Many MFIs offer incentives such as interest rate reductions and automatic access to new loans to promote high reimbursement levels, which are essential for the maintenance of the institution. Others apply the group loan methodology to take advantage of social mechanisms among borrowers

and ensure the recuperation of funds. Successful MFIs recuperate most of their loans and their losses are between two and four per cent of the investment (Microbanking, 2001).

In global terms, there are three criteria to be considered to evaluate the activities of MFIs (Nusselder and Sanders, 2000). These criteria are:

(a) institutional sustainability. Related to present and future services offered to a target population;

(b) outreach. This point has to do with the coverage of households and/or businesses achieved by the microfinance institutions, considering the target population of counterpart organizations; and

(c) impact. related to the effect of the loans on the development of the target population. These criteria include both tangible (income level and home improvements), as well as intangible indicators (the generation of employment, and the socio-psychological fulfilment among others).

The criteria above are closely related to each other and there is a certain degree of trade-off between them. On the one hand, microfinance programmes must offer a profitable financial service, in which the income of the portfolio covers financial and operating expenses. On the other hand, these programmes have to bring their services to an underprivileged population who are highly vulnerable to external changes.

3. Microfinance in Nicaragua

The development of the MFI sector

In Nicaragua, as well as in the rest of Central America, the macroeconomic reforms introduced during the last decade have produced a decline in the active participation of the state in the financial market. Promotion and development banks have been closed (National Development Bank, BANADES in Nicaragua), privatized (BANADES in Guatemala) or have been receding due to lack of recapitalization (BANADESA in Honduras). The withdrawal of the state has left a void in the financial supply that has not been assumed by private banks. However, as time passed by, the void has been partially filled by private initiatives such as multilateral and bilateral projects, NGOs and the cooperative sector (Nusselder and Sanders, 2002).

The microfinance sector in Nicaragua is characterized by the participation of a large number of institutions. It has been estimated that more than 300 organizations are offering loans, including organizations that offer multiple services. Many of these organizations handle relatively small portfolios (less than 100,000 US dollars) and can hardly take advantage of economies of scale. However, some organizations such as CONFIA and FINDESA have achieved successful growth levels and have been able to extend their portfolios throughout time (from 3.5 million US dollars in 1998 to 22 million US dollars by the end of 2001) and to become financial entities regulated by the superintendency (BCN, 2002). It has been estimated that the total loan portfolio of MFIs amount to 120 million US dollars. One estimate puts the number of clients at 85,000 persons (Helms, 2001), but more recent evidence suggests this figure may be considerably higher (see Chapter 2).

An evaluation of the microfinance sector must consider aspects related to the sustainability of the institutions, their coverage and the penetration of their portfolios. In general terms, there are only a few MFIs in Nicaragua that have reached self-sufficiency. Apparently it is difficult to turn microfinance into a profitable activity. As far as coverage, there is a clear bias towards the supply of microcredit in the urban sector. This concentration can be explained by the type of financial products offered by MFIs (short-term loans addressing trade and services) and the lack of qualified demand in the sector due to limitations in investment opportunities (Sánchez, 2000).

Credit resources of FONDECA

The resources of the peasant development fund (FONDECA) have been channelled through nine MFIs active in the areas of the project. Some of them have opened offices or branches in the areas of intervention as a result of the availability of funds. Consequently, during the execution of the project, access to credit has been extended to underprivileged residents of such areas. By the end of 2001, FONDECA had channelled approximately 6 million US dollars.

Each MFI operates according to its own credit policies and experience. Among the MFIs analyzed in this study, there are three savings and loans cooperatives, one corporation and five civil associations. Some differences found in the policies applied by the different institutions are related to the shape of their internal organization.

By the end of 2001, the nine MFIs mentioned above were managing, through their portfolios, about 30 million US dollars. However, the size

of individual loan portfolios may diverge notably. Three out of these nine MFIs were managing about 70 per cent of the total fund.

MFIs offer their financial services in the areas of the project through 14 branches. Their penetration in the area is relatively high; an average of 34,000 inhabitants per branch, while the average of traditional banks is 25,000 inhabitants per branch.

The average amounts supplied by FONDECA through the MFIs range between 400 and 1,700 US dollars, while the average amount for all MFIs in case is 830 US dollars. Loan regulations applied by some MFIs include a system for client rating. In this system, the borrowers initially receive relatively small loans. Once they have demonstrated their creditworthiness, they are granted subsequent loans with correspondingly higher amounts.

Regarding loan terms, MFIs do not register meaningful differences in comparison to the banking sector. All of them offer relatively short-term loans mainly for working capital. Only a few credit lines are available for medium or long-term investments with the exception of some lines specially designed for house loans. These conditions stem from the preference of MFIs to achieve a high turnover of capital and a minimization of credit risks.

Most MFIs have introduced a set of guarantees to reduce their credit risk. The methodology known as scaled guarantees consists of backing a loan with a guarantee directly related to the amount granted. In other words, higher loans are backed by much more solid collateral than those required for lower amounts. This methodology serves in part to regulate the amounts granted and therefore, most of the loans disbursed are below 800 US dollars. Only in one case, a mortgage is required to obtain any type of loan.

With the exception of credit unions, interest rates applied by MFIs are regulated by the central bank of Nicaragua and are adjusted monthly. Unsure about the monthly adjustments, most MFIs charge a monthly fee on loans granted with a view to stabilize income from loan operations. The ultimate goal of this strategy is to ensure full coverage of institutional expenses.

4. Research methodology

The rating system, known as Sistema Unico de Calificación (SUC), was applied to assess the financial sustainability.[1] This system is based on the analysis of six indicators directly related to the financial performance of

the microfinance institution. A relative weight is assigned to indicators within the system depending on their relevance within the analysis. The maximum rate given by the SUC for financial performance is 70 points. Below a level of 40 points, the rating is not considered prudent. Table 1 shows the indicators and their benchmarks and weight.

A methodology developed by The Consultative Group to Assist the Poor (CGAP) (Sharma *et al.*, 2000) is applied to determine the outreach of MFIs. Its approach is based upon the determination of the poverty level of the clientele served by a programmeme and compares the results with those of non-clients in the same universe (area of intervention). The process establishes a relative comparison of poverty levels between the groups in question and determines from the results if the group of clients has a poverty level higher, equal to or lower than non-clients in the area.

In total, there are six groups of indicators that have a close relationship with poverty: level of education, condition of the dwelling, food security of the household, ownership of goods, access to credit sources and geographic location. Additionally, indicators have been selected to obtain a strong correlation with an indicator of reference. In this case, indicators are related to footwear and clothing expenses per person during the last twelve months, assuming that wealthier people will spend more.

A referenced poverty index was created based on the six groups of indicators. The creation of such index required the application of a methodology in order to weigh each indicator according to its importance as to obtain a total. In this case, factor analysis was applied to isolate and assign a load to the poverty component represented by each indicator. This subsequently allows for computing values on the poverty index for each household. The values on the poverty index of clients and non-clients may then be compared (Henry *et al.*, 2000).

The first survey carried out to measure the outreach of FONDECA was implemented in 2000. The study included a sample of 240 client households – 30 from each MFI – and 120 non-clients as a control group. The selection of the clients was based upon the combination of two criteria for breakdown: by MFI and by municipal area, funded with FONDECA resources. A second survey was carried out in 2002. The comparison of both studies requires some consistency between surveys. For this reason, it was necessary, to the extent possible, to hold interviews with the same persons who participated in the first round (both clients and non-clients). It was accordingly possible to interview

Table 1. Indicators to analyse the financial performance of MFIs.

Indicator	*Formula*	*Bench mark*	*Weight*
Adaptation of capital	$\frac{\text{net portfolio}}{\text{total equity}}$	< 10	15
Potential loss (% of the gross portfolio)	$\frac{\text{potential loss}}{\text{gross portfolio}}$	< 5 %	15
Financial self-sufficiency	$\frac{\text{total income}}{\text{total costs}}$	>= 1	15
Capitalization of surplus	$\frac{\text{profits + reserves}}{\text{assets}}$	>= 5 %	10
Delinquent portfolio> 30 days (% of the gross portfolio)	$\frac{\text{delinquent portfolio>30 days}}{\text{gross aortfolio}}$	<= 10%	10
Financial operating efficiency	$\frac{\text{operating costs + prov.}}{\text{average portfolio}}$	<= 15%	5
Total			*70*

approximately two third of the number of clients and non-clients from the original survey.

5. Results of the study

Sustainability of the credit supply

The sustainability of the supply is related to the financial services offered by the MFIs at present and in the future. MFIs that at present experience difficulties meeting their operating costs with the income generated by their assets, and that face obstacles in obtaining sufficient subsidized funds, are in a way doomed to fail in the near future. This would obviously affect the future credit supply for poorer population strata. It is therefore justified to watch performance trends over several years, in order to assess the likeliness of an imminent crisis in credit supply.

The results of the six SUC indicators during the last three years of operations of the nine MFIs have been computed to evaluate the sustainability of supply. The average results are presented in Figure 1.

In general terms, the performance of the nine MFIs is satisfactory. On average, they are above 40 points. The lineal trend shows a constant increase and reflects an increasingly better financial performance of the MFIs involved. The trend can be mainly attributed to the monitoring services offered by FONDECA to the MFIs with regard to the profitability of their assets. The monitoring scheme enables FONDECA to maintain rigorous standards as well in the selection of MFIs.

The outreach

From the perspective of the financial institutions, the outreach determines the absolute number of households and/or businesses served. The concept also considers the penetration of the financial services among specific sectors and/or groups such as women, small agricultural producers and traditional fishermen.

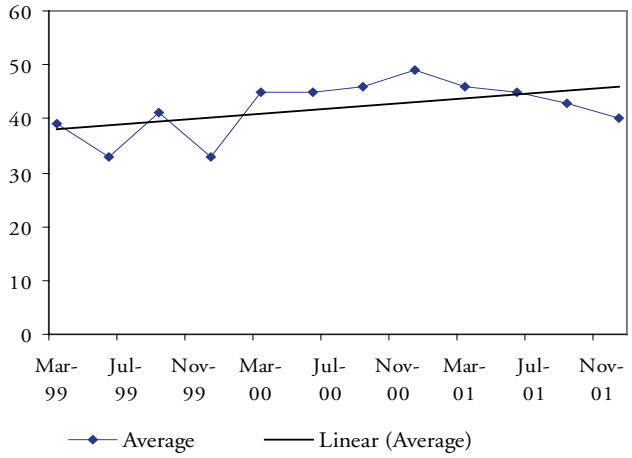
Since 1998, FONDECA has registered an increase in credit resources disbursed by MFIs. According to information provided by PROSESUR, the total amount disbursed between 1998 and 2001 was 5.6 million US dollars. As for the clientele, it has remained at 2,600 people per year, representing a total of 13,000 clients or 3 per cent of the total population in the areas of intervention of the project. An important accomplishment is that the average amount of the invested portfolio has been constant throughout the years, which shows that MFIs have remained working with micro-entrepreneurs.

However, there is a trend towards the concentration of the credit portfolio and the clientele which has led to a decreasing growth rate in the operations of MFIs. Based upon national indicators and interviews with local managers of MFIs, the concentration is to be attributed to the stagnating national economy in the period 2000-2002. Other factors have been the introduction of Decree 176, which imposes restrictions on the interest rates applied by MFIs, and the conditions in the project area of PROSESUR, which gave signals of market saturation in the same period.

By comparing the results of the surveys carried out in 2000 and 2002, it was possible to establish that more than 30 per cent of the clients interviewed during the first study were no longer clients of FONDECA in 2002. Out of this group, more than 80 per cent did not turn to any other source of financing.

The PROSESUR project includes 20 municipalities in Rivas, Carazo and Managua. However, the financial activities of FONDECA are concentrated in only five of these municipalities. According to information

Figure 1. SUC index of 9 MFIs, financial indicators, 1999-2001.



Source: Sanders and Deugd, 2002

supplied by the project, by the end of February 2002, the municipalities with larger volumes of transactions were Rivas, Jinotepe, Diriamba, San Marcos and San Rafael, which received more than 55 per cent of total credit disbursements. This pattern is strongly influenced by the geographic policy applied by participating MFIs, which channel resources towards profitable sectors such as trade and services. Also, they prefer to work with target populations located at a distance short enough to keep the costs of client supervision low. The difference found between municipalities is also related to their urban or rural status. In the rural sector agriculture is still the predominant activity, considered by most MFIs as very risky. As mentioned in Chapter 2, rural credit demand is limited since there are few possibilities of investing in profitable areas.

The participation of women within the portfolios of MFIs related to FONDECA has been high since the beginning. This is due to the orientation of MFIs towards activities that permit a high turnover of capital, such as trade, which are being developed mainly by women. By the end of February 2002, out of the 2,500 borrowers, 1,530 were women (61 per cent). In volume terms, women received 44 per cent of the total amount disbursed, which means that the average received by a female borrower is approximately half of the amount of a male client.

The depth of the portfolio, by poverty level, is measured by comparing the poverty indices of clients and non-clients. Three categories were devised to represent the different socio-economic levels of the clients. To eliminate disparities between groups of clients and non-clients, their poverty indices had to be identical (Table 2).

In 2000, 42 per cent of the clients belonged to the more affluent stratum, while 26 per cent belonged to the poorest groups. In the course of the following two years, the clients interviewed in 2000 improved their socio-economic position in relative terms, in comparison to non-clients.

A diamond graph was developed based on the information obtained on the coverage and penetration of the portfolio. The following indicators are represented:

(a) participation of women;

(b) participation of clientele residing in the rural areas;

(c) education level of clients;

(d) poverty stratum of clients.

According to Figure 2, the clientele of FONDECA is composed of men and women who reside in urban areas, whose education level is above average and who belong mostly to the relatively less poor stratum in the project area. When compared with the results obtained in 2000, the number of clients belonging to the relatively higher stratum has increased. This change might be rooted in the impact of the credit programme among clients.

Change registered on poverty index

The determination of impact is obtained by comparing the data gathered during the 2000 survey with data for 2002. This analysis compares the difference registered in the poverty index between both surveys. In order to observe statistically significant differences between clients and non-clients, measured as a score on their poverty index in relation to other variables, a discriminant function was used, based on the Mahalanobis methodology. The aim of this function is to determine which of the independent variables is more effective to distinguish between clients and non-clients, as well as to establish if the variable change in poverty index presents a statistically significant contribution to being determined as a client in 2002. The function includes variables such as education, size of the family, food safety, value of productive and non-productive assets, economic sector and difference in poverty index as independent variables, as well as the classification of client vs. non-client as dependent variable. The results are presented in Table 3.

Table 2. Distribution of clients and non-clients by stratum, in percentages.

No-client	33	33	33
Client 2000	26	32	42
Client 2002	24	31	45

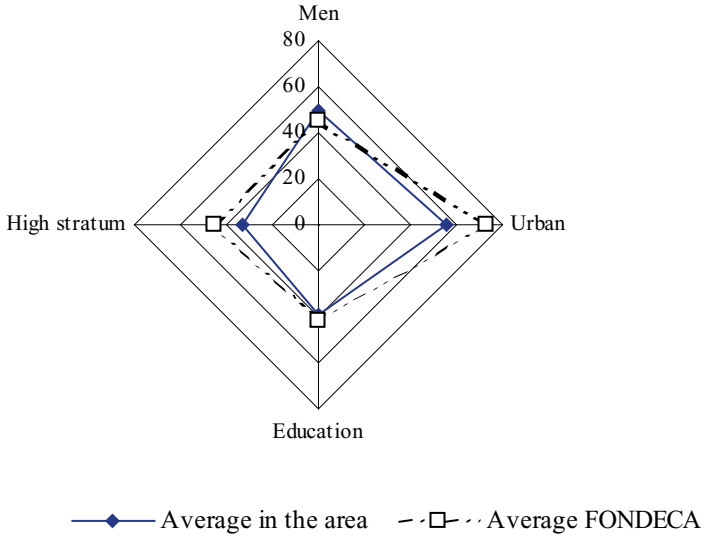
Source: Sanders and Deugd, 2002

Table 3. Discriminatory function.

Variable	
Level of education	0.433*
Number of rooms per relative	0.409*
Main occupation (1= agriculture; 0 = other)	-0.405*
Change in poverty index	0.360*
Savings (1= yes; 0 =other)	0.342*
Sector (1 = rural; 0 = other)	-0.330*
Clothing expenses per person during the last 12 months	0.314*
Classified as stratum 3 (1= yes; 0 = other)	0.307*
Value of non-productive assets	0.301*
Access to electricity	-
Percentage of the family of age 15 or above	-0.184
Value of means of transportation	0.149
Sufficient food during the last 12 months	0.006
Central point per group	
Being a client	0.873
Not being a client	-0.772
Canonical correlation	*0.65*
R^2	*0.42*

Source: Survey PROSESUR and CDR-ULA

Figure 2. Outreach of FONDECA by subsector.



The discriminant function presents a canonical relation of 0.65. However, only 42 per cent of the variance is explained ($0.65^2 = 0.42$). The central points of the groups represent the average aggregated value of the variables of the function for each case. As shown, the central point for clients of MFIs is positive, implying it is positively related with independent variables.

Within the function, only the first nine variables have a statistically significant discriminatory loading (<± 0.30). The variable average education level of relatives over 15 years has the highest discriminatory effect. Households with higher education levels have indeed better access to MFIs.

The correlation between the variable difference in poverty index and being a client is positive and significant. The clients of MFIs have achieved better socio-economic conditions to a larger degree than non-clients. However, this is partly related to the fact that clients already enjoy a better position prior to receiving a loan, and are therefore assessed more favourably by MFIs. In broad terms, the impact of credit programmes is higher among persons with initially higher resources.

The difference in change of position between clients and non-clients is determined by variables such as the number of rooms per relative, being economically active in the agricultural sector, living beyond urban areas, higher clothing expenses per person, initially belonging

Table 4. Classification of clients and non-clients.

Group	*No of cases*	*Forecast*			
		Non-clients		*Clients*	
		numbers	%	numbers	%
Non-clients	73	34	46.6	39	53.4
Clients	155	16	10.3	139	89.7

to Stratum 3 (less poor) and having non-productive assets. The other variables do not exert a statistically significant influence in the analysis, but, as a group they do increase the canonical correlation.

Through the function it is possible to determine whether a case belongs to the group of clients or non-clients. Table 4 shows the results of the forecasts. The function obtains an average of 76 per cent of classifications correct. Put differently, 24 per cent of the cases belong to one of the two groups, but possess the characteristics of the other one.

At first sight, the function does not seem to have a high explanatory power. However, the classification of the cases through the function is acceptable. It is possible to observe a difference between clients and non-clients through the nine variables. The discriminatory function made evident that persons who have received loans from the FONDECA fund during the last two years improved their financial situation, even if only part of this improvement can be related to the fact that they had previously had an access to credit.

6. Connection between the two concepts

Sustainability and outreach

Compatibility between financial sustainability and the outreach of the portfolio remains a core issue in the debate on the relevance of microfinance in pro-poor policies. In our study, the financial sustainability of the MFIs was measured by using the 2001 average and the six indicators related to the financial performance of the SUC methodology. The four indicators developed in Section 5 were used for the outreach. These indicators represent a group of characteristics common to persons who are normally excluded from the financial services provided by the formal

sector (Paxto, 2002 and Cuevas, 2000). These characteristics are: being a woman (M), living in the rural areas (R), being poor (P) and having a low education level (E). A composed index of clients (C_{cl}) and non-clients (C_{nc}) was established using these characteristics, the results of which were compared to obtain the level of outreach of the MFI:

$$\text{Outreach} = \sum_{n=1}^{n} (C_{cl} - C_{nc}) \qquad (1)$$

The variables applied to compute the level of outreach achieved by the portfolio are compared to the characteristics of non-clients in the areas of intervention. The formula to apply these four characteristics is:

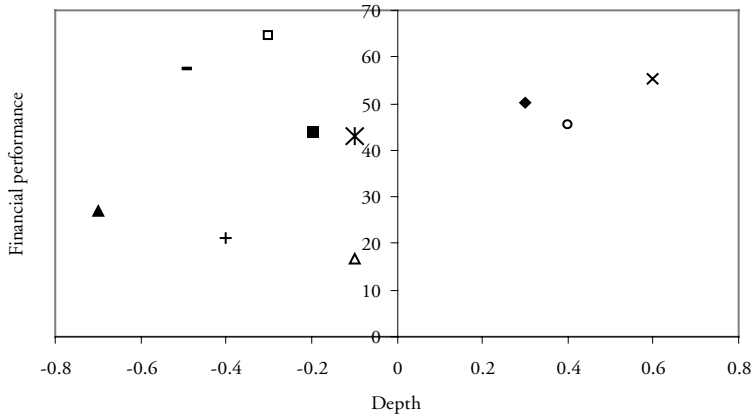
$$\text{Outreach} = (R_{cl} - R_{nc}) + (P_{cl} - P_{nc}) + (M_{cl} - M_{nc}) + (E_{cl} - E_{nc}) \qquad (2)$$

A positive index reflects that the MFI clientele could be characterized as follows: women, living in rural areas, poorer and with less education than non-clients. Figure 3 presents the relation between the financial performance and the outreach achieved by each one of the MFIs by the end of 2001.

It was not possible to find a direct relationship between the outreach of a portfolio and the financial performance of the MFI. In theory, a linear relationship was expected between an unsatisfactory performance and a high outreach of the portfolio. In other words, MFIs whose clientele present characteristics that make it difficult to obtain credit in the formal sector, face more difficulties in becoming sustainable due to the high costs related to the services provided to such groups.

However, the figure shows that it is possible to serve a clientele whose characteristics are not considered very favourable. Four of the total cases register satisfactory performance and high penetration among poorer strata. Two of the cases register good performance, however their penetration is lower, mainly due to the fact that they carry out their activities in the urban sector. In our study, more than 1,800 clients of FONDECA present the typical characteristics of those who are normally excluded from financial services in the formal sector.

Figure 3. Relation between financial performance and outreach.



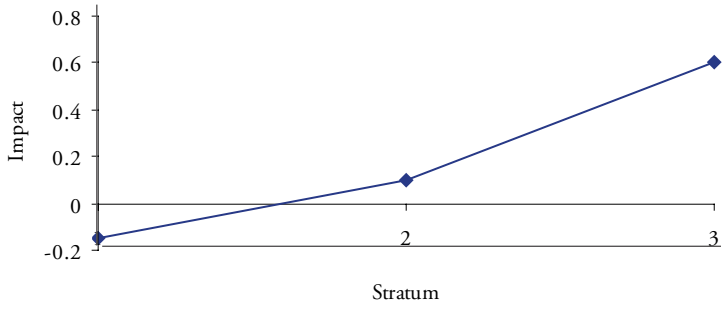
Outreach and impact

Not all households can make use of the same resources to carry out their work or the same human capabilities to maximize their productivity. Their individual characteristics have a bearing on the reactions and strategies developed in response to internal and external changes. The type and extent of the impact of credit programmes at the household level is related to such characteristics. Other studies equally show that the impact of credit programmes on the productive activities of poorer households is limited, since the loans tend to be used mainly to reach reproductive stability. In the case of households with more financial and human resources, a more significant impact can be observed on productive activities.

By means of an ANOVA analysis, it was possible to assess the relationship between the impact on clients and their economic stratum. The variable that measures the difference in the poverty index between 2000 and 2002 was used as an impact indicator. Figure 4 shows this indicator as a function of the client's economic stratum.

The figure shows that the impact at the level of the third stratum, i.e. of the less poor, is larger than in the case of the first stratum with the poorest households. The impact observed among the latter was even negative, mainly due to the presence of a group of clients from the rural sector. Stratum 2 and 3 register a positive impact and represent 70 per cent of the clients in the research sample. The relationships proved to be statistically significant at the one per cent level.

Figure 4. Relation between economic impact of credit programmes and economic stratum of clients.



7. Conclusions

The success of a microfinance programme can be measured according to three dimensions: financial and institutional sustainability, the outreach of the target group and its developmental impact. Its future may be at risk if one of the three objectives is sacrificed in favour of another. An entity leaning towards financial viability should neither abandon its aim of serving its target group, nor harm its interests while going in the opposite direction. FONDECA, through its MFIs, has demonstrated that it is possible to establish synergy between the three dimensions while creating a win-win situation. The specific conclusions of this study are in line with these dimensions.

There is no doubt that FONDECA has played an important role in the development of the microfinance sector in the southern region of Nicaragua. The MFIs related to FONDECA have demonstrated a positive trend in their financial performance. As of December 31, 2001, six out of the nine MFIs showed favourable results, thereby fulfilling an essential condition to future success. The total amount granted as of December 31, 2001, amounted to 6.6 million US dollars and in total they served about 2,500 families, representing a total of approximately 12,000 people. The clientele is concentrated mainly in urban municipalities, which explains in part the high participation of women. 45 per cent of the clients interviewed belong to a stratum with relatively higher resources. More than 1,300 of the families who received their loans through FONDECA belong to the strata with the lowest resources.

Nevertheless, a major finding of the study was the high desertion rate of the clients. 30 per cent of the interviewees during 2002 were registered as clients, although they were no longer using the financial services offered. A high turnover of clients implies high costs and risks to an MFI, making it difficult to achieve a real impact at client level throughout time.

In general terms, financing has created a positive impact upon the standard of living of MFI clients. This impact is significant among clients located in urban areas and who belong to the more affluent strata. On the other hand, it has not been possible to identify a positive impact among the poorest clients and rural males, who demonstrate an accelerated impoverishment rate. It cannot be excluded that they are worse off due to an, at least, temporary overindebtedness.

FONDECA has demonstrated that the challenge is for organizations to flourish even if their clients are poor. However, there is clearly a case to make to adjust the supply of microfinance to the clients' needs, when one takes into consideration the large group of non-participants in rural areas, the high drop-out rate among clients, and the clients who belong to different financial institution at once. In other words, it is necessary that MFIs switch their focus from being managers of supply to becoming demand driven with a capability to react to market signals. Delivering credit to underprivileged families is not necessarily enough to help them escape poverty. Even so, microfinance constitutes an instrument to promote the flow of funds towards households and contributes to greater food security and steady growth of production.

Note

[1] The applied mechanism to evaluate IMFs has been developed by the Instituto Nicaragüense de Apoyo a la Pequeña y Mediana Empresa (INPYME).

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REGULATION AND SUPERVISION OF MICROFINANCE

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1. Introduction

Since the end of the 1990s, the debate on the future of microfinance in Nicaragua had intensified when the possibility emerged of creating a legal framework for this sector. This chapter will deal with the question how this framework may benefit the evolution of this sector and what foreseeable difficulties should be addressed for the incorporation of microfinance institutions (MFIs) into the formal financial sector. In the case of Nicaragua, the banking sector has gone through a painful process of restructuring and consolidation. Whereas this was also the case elsewhere in Latin America, some countries have also established a legal framework specifically for the microfinance sector. This reform process has not yet been completed, and changes to the legal framework are now being evaluated in the light of new practices initiated during the last decade.

While the mainstreaming of microfinance in the formal financial sector is relatively recent, the challenge to protect the integrity of the financial system and the interests of depositors remains the same. What makes the difference with the 1970s and 1980s is the smaller number of conventional banks, serving a minority of clients with greater prosperity. On the other hand, the number of microfinance entities that serve the poor has expanded enormously in Nicaragua (Blijdenstein *et al.*, 2002). The regulation of MFIs has led some observers refer to the need to increase the minimum equity level required in relative terms,

but to reduce this in absolute terms (Schmidt, 1999). However, the consequences in terms of costs and benefits for supervising authorities and public resources have so far received little interest.

This article is composed of four sections after this introduction. Section 2 presents an overview of the main elements included in the legal framework of the microfinance sector, such as the legal base and objectives, subjects and implementation modes. Section 3 analyses in greater detail the costs and benefits of supervision, taking into account the differences between commercial banks and regulated MFIs. Section 4 discusses the present context of the legal framework for the microfinance sector in Nicaragua. Section 5 presents the conclusions of the analysis as well as a number of challenges that lie ahead for the sector as a whole.

2. The regulation of microfinance

a. Base and objectives

The term regulation refers to the set of rules used by the state, through the use of its coercive powers, to restrict the actions of participants in the financial markets (Gonzalez Vega, 2001). It is a framework that players in the industry must respect when carrying out their financial operations. In establishing the legal framework, the state circumscribes the playing field and thereby guarantees the integrity of the financial system, in particular where its payment functions are concerned. On the other hand, the term supervision relates to the mechanisms of active surveillance used to verify and enforce the application of this framework in ongoing financial business. This is the operational side of the system that is designed to ensure observance of the established set of laws.

The prime objective of regulation is to protect the financial system against harmful practices considered excessively risky. These practices could undermine the national payment system. At stake is the prospect of a banking crisis spilling over into the solvency and liquidity of other institutions, which might create a domino effect. The second objective is to protect small depositors, who are not aware of the risks assumed by the financial institutions. These two objectives require the presence of a supervising authority that is both impartial and independent of the interests of any particular actor in the financial sector. In the same context, there is often a third objective of the regulation, i.e. that is to maintain competitiveness in the financial sector. The operation of a

sufficient number of participants is necessary to ensure free allocation of capital and provision of payment services to the real sector of the economy, while allowing free competition for clients (Valenzuela and Young, 1999; Fiebig, 2001).

When it comes to regulation and supervision, prudential and non-prudential aspects are vitally relevant but distinct. A non-prudential regulation has to do with general requirements, such as registration and licensing of the institutions, information about ownership, publication of financial statements, external audits, delivery of information on delinquent clients (credit bureau), as well as rules on the application of interest rates. Non-prudential aspects refer more to the conduct of business than to its viability (CGAP, 2002). Rules of non-prudential nature are important, but they do not compel the supervising authority to issue a verdict on the financial health of the institution.

Responsibilities related to prudential regulation and supervision are radically different. At this level, the soundness of actors operating in the financial system is at stake. The application of defined standards in the financial balance, accounting and other guidelines are necessary to determine the fitness of the financial institution. These aspects require an elaborate system for the delivery of useful information, as well as on site inspections that go beyond regular auditing exercises. It is obvious that the costs of the prudential supervision are much higher than the costs of a non-prudential regime.

Although the state is the first and natural actor in areas of regulation, it is not the only one. Other parties are the owners of the institution (interested in defending its equity, especially when they have invested resources of their own), apex institutions formed by the intermediaries themselves, as well as providers of external working capital. These four types of regulators need to interact, as they require similar information from the same institutions, although with differing interests. However, there is a problem in the field of responsibilities: the regulation and supervision of the state cannot replace the policies and controls of either the owners or external financial sources (Fiebig, 2001).

This subject is directly related to the administration and property structure of the institutions. When financial institutions receive large amounts of private capital, they tend to have a tougher supervision structure, unlike institutions with public interest investors and/or with numerous small shareholders. Accountability mechanisms may even be more problematic in the case of non-profit financial entities. Their internal procedures are usually slower and less focused on resolving urgent problems of solvency and liquidity.

Subjects of regulation and supervision

There is no standard approach for regulating and supervising financial intermediation in developing countries. In Latin America a segmented regime is common, which means that institutions are divided into categories. Commercial banks form part of the regulated entities and they are authorized to carry out the entire range of financial operations at national and international levels. Other credit institutions (financial corporations), which receive funds from the public but are not allowed to manage current accounts, are authorized in some countries but have been eliminated in others such as El Salvador.[1] Microfinance institutions constitute a third segment, at times licensed to receive deposits from the public. The latter is the case in Bolivia (private financial funds) and Uganda (microfinance institutions authorized to receive deposits). A fourth category is MFIs which only grant loans and do not receive savings, at least not voluntarily.

In fact, only the first three types of entities are subject to external regulation and supervision, depending on the type of operations performed. A segmented regulation entails in many cases a different approach for each group. General banking laws coexist with special laws for non-bank institutions. Credit unions often occupy a special position. In some cases they are subject to some sort of state supervision (Ecuador and Costa Rica), while in other countries supervision has been relegated to apex institutions (Guatemala, El Salvador and Peru). This is not to say that all credit unions are incorporated into a legal framework, because supervision often depends upon a minimum level of equity.

Beyond their typical diversity, regulated financial institutions embody different economic goals. Credit unions have their statutes basically formulated under a non-profit principle. However, in practice they wish to offer services to their associates at an externally acceptable price, but to an internally acceptable cost. Financial corporations and commercial banks, including those specialized in microfinance, pursue profits on paper and in practice.

A commercial approach has been predominant in the microfinance market during the last two decades. Its evolution towards an 'industry', for example in Bolivia, would not have been possible if the public and social interest alone had been maintained (Rhyne, 2001). Therefore, the development of a legal framework might consider the regulation of microfinance as an activity. From a contrary perspective, commercial as well as non-profit entities should be able to perform microfinance

intermediation, albeit in a wider array of financial services. It is the risk profile of microfinance that has to be regulated, rather than specialized institutions themselves (Valenzuela and Young, 1999).

In many Latin American countries, community MFIs operate outside the formal financial sector, be it village banks (Costa Rica, Haiti), Cajas Rurales (Honduras) or municipal or departmental associations (Guatemala), which are specialized in granting loans. Some of them are also involved in the mobilization of savings, both compulsory as well as voluntary. In most cases, the self-selection process of the members virtually turns credit unions into closed institutions. The saving volumes they mobilize may be substantial. However, until now there are no examples of community-based intermediaries which, having grown to scale, have been legally regulated.

Consequently, the type of savings captured is closely related to the type of intermediary (Table 1). In the case of commercial banks, the situation is quite simple, since they alone receive voluntary savings from the public. In the case of MFIs, credit unions and community based finance groups, the situation is more diffuse due to the source (public vs. members) and to the type of savings (voluntary vs. compulsory). In grey areas national authorities have adopted diverging positions, ranging from a permissive attitude (Bolivia) to an absolute ban on any type of non-bank savings mobilization. The overall trend among national monetary authorities is to forbid deposits captured by non-banks. This is due to the fact that non-supervised savings are a public risk, and, moreover, supervising these small institutions is hard to do in an efficient manner.

Those in favour of greater flexibility claim that institutions with a proven) track record should, within an established framework, be allowed to receive savings from their clients. Regarding unregulated entities, some sources believe that it would be a mistake to ban community entities from receiving savings just because they are too small or too distant to establish effective supervision (Wright, 2000). In a rural setting, it would then be preferable to allow an intermediary to receive deposits within communities, rather than take away the opportunity to save altogether (Christen and Rosenberg, 2000).

Following this argument, the risks posed to the integrity of the national financial system that may stem from compulsory savings, are generally considered to be low. There are various considerations:

(a) in most cases, depositors of compulsory savings owe money to the same institution. The possible default of the institution reduces the client's financial risk;

Table 1: Savings by type of intermediary.

	The public (voluntary)	*Members (voluntary)*	*Member clients (compulsory)*
Banks and finance	yes	yes	no
Savings and Loans	no	yes	yes (El Salvador)
Microfinance institutions	no	yes (FFPS, Bolivia) no (EDPYMES, Peru)	yes (EDPYMES, Peru) no (Foundations
Community entities	no	sometimes	sometimes

(b) compulsory savings are usually very modest and their restricted access usually makes that requests for a massive refund are unlikely; and

(c) intermediaries with compulsory savings constitute a small part of the national financial system and the risk of a contagious string of bankruptcies is limited.

It is for these reasons that in circles of CGAP (2001) it is considered sensible to leave sufficient latitude for the free development of organizations that offer microsaving services. Entities entitled to mobilize savings would include the following:

(a) local organizations that promote savings among members at the community level with personal knowledge of the clients they serve and who are in control of their operations;

(b) organizations withholding compulsory savings as collateral for loan repayment; and

(c) organizations that develop pilot programs based on experimental methods, in which savings are entirely backed by means of an external guarantee.

Even though these organizations promote savings among a specific group of clients, it would be better to leave them out of a legal framework. But in cases where saving mobilization is carried out at a larger scale and the border between members and non-members clients gets blurred, there would be arguments for making them accountable to an external supervisor (Valenzuela and Young, 1999). Conclusive rules do not exist in this respect. Rather, there seems to be a trade-off mechanism between the benefits of protecting depositors and the direct costs of the supervision. Moreover, the fact that they are supervised

may create obstacles to innovation and competitiveness in the sector (Hardy, Holden and Prokopenko, 2002).

Some consensus is emerging that regulation should be as simple as possible, so that regulated institutions may continue be innovative. Guidelines issued by supervising bodies are easier to modify than adopting laws through the parliamentary approach. By the same token, there is a preference to limit the range of regulated institutions to three categories: commercial banks, credit unions and an additional type of non-bank intermediary (Gonzalez Vega, 2002).

As far as non-bank MFIs is concerned, there are serious doubts as to whether or not credit-only institutions should be subject to prudential regulation and external supervision (Hanning and Katimbo-Mugwanya, 2000). The arguments for questioning the need to regulate credit-only MFIs are the following. First, there is no risk of depositors being potentially harmed, since they are non-existing in the case of credit-only institutions. Second, there is no real threat to the national payment system in case of a defaulting MFI. Third, the supervision of an MFI is expensive, both for the supervising entity as well as for the supervised institution.

On many occasions, however, representatives of the MFI sector have demonstrated their interest in achieving some type of a regulatory framework. Their motives include:

(a) the willingness to become officially recognized by national authorities, which serves as 'certification' to clientele and external funding sources;

(b) the belief that regulation and some status of recognition will contribute to improve their financial performance; and

(c) the prospect that, once in a system of supervision, MFIs will be able to diversify financial services, in particular saving services, offered to their clients.

Moreover, among donors there is a marked inclination to promote a framework for regulation and supervision. The reason for this is to extend the number of specialized MFIs and thereby serving a larger clientele among donor target groups. Donor agencies are also increasingly keen to rely on a kind of 'watchdog' for the sector that could assist in monitoring intermediaries, which in many cases they are unable to supervise themselves. Legitimate as they may be, these motives do not seem to relate directly to the original purpose of regulation.

Regulation and supervision modes

By and large, there are four different forms of regulation and supervision in the financial sector. Currently, these models are all in consideration for the MFI sector, each of them with a different degree of delegation of responsibilities (Berenbach and Churchill, 1997; Wright, 2000; CGAP, 2002):

Regulation within the present framework. MFIs with a proven track record and complying with requirements applied to commercial banks, can decide to become regulated institutions. There are examples such as Grameen (Bangladesh), Banco Solidario (Ecuador) and Banco Confia (Nicaragua). The minimum amount of equity is generally higher than 5 million US dollars, a level considered high in some cases and prohibitive to aspiring MFIs in others. Moreover, the credit technology applied by MFIs – mostly based on loans without publicly registered collateral – leaves little room for a substantial number of MFIs to become formally regulated institutions. There are some experiences (Chile) in which the banks have used the existing framework to initiate microcredit operations, thus increasing their clientele (Christen and Rosenberg, 2000).

Self-regulation. This alternative assumes that institutions – individually or collectively – will commit themselves to provide information to a selected body on a truthful, uniform and consistent basis. This would assume: the presence of an audit mechanism to verify the authenticity of financial statements, the presence of an appropriate framework for internal controls and risk management and an institutional structure designed and functioning to check performance, render accounts and apply sanctions. This model has been implemented in the credit union sectors in Guatemala and El Salvador.

Combination of self-regulation and delegated supervision. This option is a rather hybrid approach which combines, on the one hand, the responsibility of MFIs to comply with a set of criteria for information and financial performance, and on the other, the national supervising body contracting an audit or consulting firm to carry out the routine in-house analysis. In this way, investors and depositors would be able to receive public information and be better prepared to make decisions on how to allocate their resources.

Specific regulation for microfinance institutions. Some countries (Peru, Bolivia, Uganda) have introduced a regulatory framework especially designed for the MFI sector. In some cases, specialized technical

units have been created either within the superintendency or with an external body, under responsibility of the former.

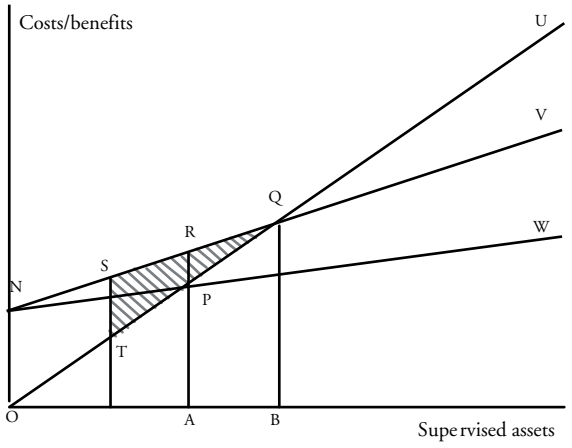
Although each alternative has its advantages and disadvantages, there are more arguments against the self-regulation of model B (Gonzalez Vega, 2001). There are no successful experiences known to date. More importantly, there is an inherent problem of conflicting interests among the parties responsible for supervision of institutions. Self-regulation does not preclude that in one way or another the supervised entity might have a stake in the supervising body. Model C is also not free of obstacles to objective and impartial supervision, especially when the supervised entities are indirectly represented in the supervising entity. The exposure to conflicting interests is more worrisome as the consequences of supervision become more drastic, e.g. when recapitalization is required or *in extremis* a closedown of the MFI. Both possibilities are costly, to the owners of the institution as well as to the supervising entity. The latter eventually is obliged to use the foreign currency reserves of the central bank.

3. Costs and benefits of supervision

Although over the last decade valuable experience has been gained in the supervision of microfinance institutions, there is, until now, little known evidence on its cost-benefit structure. The costs of supervision obviously depend on the system selected and will probably prove to be more expensive in the case of a delegated supervision than if performed directly by the superintendency.[2] In the specific case of the MFI sector, there would be reason to compare the costs of supervising individual intermediaries to the costs of supervising the commercial bank sector (Figure 1).

For analysing the difference between the two segments, let us consider a simple costs structure of a supervising body, where the X-axis represents the volume of supervised assets (basically the credit portfolio), while the costs and benefits of supervision are shown on the Y-axis. The supposed benefit, measured in supervision fees – and indirectly the volume of savings and public resources protected – is expressed as a straight line in OU. The costs of supervising the commercial bank sector are represented by the line NW, which shows that the fixed costs of supervision are high (due to costs of authorization, information systems and other parts of its operating capacity). The slope is rather gentle due to the low marginal costs of supervised bank assets. When

Figure 1. Costs and benefits of the supervision of financial institutions.



the volume of supervised assets surpasses OA, the benefits exceed the costs of the supervision after point P. This explains why supervising authorities in Latin America prefer to increase the required minimum level of assets – and thereby the level of minimum equity – beyond the OA, so as to ensure a net positive result of supervision.

The situation is different in the supervision of MFIs, who basically face the same level of fixed costs at ON. However, the variable costs for the supervision of microcredit are considerably higher – just as this is the case in managing their loan portfolio – due to the large number of operations subject to be overseen.[3] The result is that the break-even point is not reached in P, but in Q. This requires a level OB in the size of the operations, implying that MFIs should possess a correspondingly higher solvency level – in absolute terms – than conventional banks.[4] If they had only a level OA in assets, the supervision of MFIs would produce a deficit to the extent of PR.

The main problem in the segment of microfinance is that the majority of specialized MFIs, possibly interested in becoming regulated, do not have the minimally required level of equity. In terms of the previous figure, the volume of assets subject to supervision is not OB, but OC, which is less than half of it. Consequently, the supervision would produce an even higher deficit, to the extent of ST, since the level of fixed costs is invariable.

The figure depicts the normal situation of supervision. When it comes to insolvency or eventually bankruptcy of the intermediaries, the public costs are much higher, particularly in the case of conventional banks. However, supervising authorities and MFIs take different positions in view of the prospect of losses, incurred by regulated MFIs.

Supervising authorities seek to put the required minimum level of supervised assets beyond the break-even point of costs and benefits. At the same time they wish to minimize the risk of having to use public funds to bailout an intermediary. Another option would be to try to partially compensate the costs of supervising MFIs with resources from the segment of commercial banks, whose supervision is not as costly.[5]

MFIs aim to reduce the required level of supervised assets, while also minimizing the regulation costs and the costs of being supervised. Although they might be willing to pay for the costs of supervision, MFIs would obviously be better off if these are transferred to the supervising bodies, donors or clients.

Apart from these opposed interests, there are external stakeholders of microfinance (donor agencies and institutional investors) who would prefer to see intermediaries increasing their outreach while improving performance. Nonetheless, few stakeholders are prepared to bear the costs of supervision, since this activity is not often carried out in proximity of ultimate target groups. As is known to be the case in Nicaragua, the target groups determine the rationality of donor support strategies in many instances (Blijdenstein *et al.*, 2002). This creates a vacuum in financing sources for a viable scheme of effective supervision.

4. Regulation in Nicaragua

Context

The financial system in Nicaragua, even after experiencing a period of restructuring and consolidation between 1997 and 2001, remains relatively weak in Central America. Its volume of total assets in 2002 amounted to 1,920 million US dollars, while the total liabilities hovered around 1,800 million US dollars, the lowest in the region. In 1997 – before the restructuring process started – the banking density, measured by number of branches open to the public, was of one branch for every 33,000 inhabitants, while the average in the region was 19,000 inhabitants.

The reorganization of the banking sector, which in many cases consisted of closing down state-owned banks,[6] contributed to a drop in international reserves of about 130 million US dollars between the end of 1999 and the end of 2001. As a result, aggregate domestic credit fell from 14,100 million córdobas (1,230 million US dollars) in June 2000 to 9,000 million córdobas (630 million US dollars) in June 2002, then picking up to a total of 10,300 million córdobas (710 million US dollars) by the end of 2002. Although aggregate savings deposits proved to be less volatile, monthly fluctuations reflect significant volumes of private savings lost in the course of the restructuring process.[7]

Although the relation between savings, investments and volume of domestic product in developing economies is intricate and inconclusive, it is striking that the position of Nicaragua in the mobilization of savings is just starting to improve, compared to other countries in the region. In the case of Nicaragua, two elements gave reason for concern.

First, private savings were negative during the second half of the 1990s and it was not until this decade that they became positive and on the rise. Second, in spite of the consolidation of the banking sector, the spread between lending and borrowing rates increased between mid-2000 and the end of 2002 from 8.9 to 16.7 per cent. This trend does not seem to reflect greater competitiveness and efficiency in the banking sector, but rather the opposite.

However, requirements for starting banking operations in Nicaragua have become stricter. The reform of the general banking law (Law 314) was introduced in 1999, before the most serious banking crises occurred. The new law stipulates a minimum share capital of 120 million córdobas (8.2 million US dollars), both for banks and non-banks. This level is higher than required in the other four countries in the region where the minimum varies between 5 and 7 million US dollars. At present, individual shareholders cannot own more that 20 per cent of the share capital, while loans to an individual borrower are limited to a maximum of 15 per cent.

After the string of bank defaults, interventions and closures, the superintendency of Banks was enabled to strengthen its apparatus and scope of operations. The norms for assessing credit portfolios and provisions for delinquent loans became much stricter. In order to reduce possibilities for fraud, the banks were obliged to publish the names of their directors and shareholders. On top of this, the National Assembly adopted, in December 2000, an insurance scheme for bank deposits up to a maximum of 20,000 US dollars.

The regulation of microfinance

Although MFIs have been in operation since the beginning of the 1990s[8], their operations have not been recognized within the legal framework, at least not in positive terms. As of 1999, the possibility of raising savings in unregulated institutions was prohibited.[9] In the same year, the legislature did introduce Law 374 for the regulation of loans between individuals, putting an interest rate cap to those MFIs that have 'as their main objective the provision of financial services to the public, as long as there is no regulatory framework in force'. Every month the central bank now publishes the maximum interest rate, as a weighted average of the banking sector. Law 374 has led to a reduction of nominal lending rates charged by MFIs, on average to less than 18 per cent. This was the legislature's de facto response to the public concern that MFIs charged excessive interest rates. Therefore, it came to the defence of the microcredit borrowers of MFIs whose interests supposedly had to be protected.

Law 374 refers to the creation of a legal framework especially designed for the microfinance sector, on which discussions had been ongoing since the past decade. ASOMIF (the Nicaraguan association of microfinance institutions) has presented several proposals, recently in the form of a bill for the promotion and regulation of microfinance.

The proposed bill for microfinance deals with the organization, registration and operation of MFIs created as associations and foundations, established with non-profit objectives. Contrary to earlier versions, financial corporations are no longer considered as actors in the sector, the activities of whom shall respond to 'the public and social interest' (Article 1). The required minimum entry level for an MFI is in the bill established at a minimum of 2.5 million córdobas (170,000 US dollars). Equity reserves would be fed mainly by the MFIs' net surplus, since 'microfinance institutions will not be allowed to distribute surpluses among associates, directors, employees or third parties, and shall invest all of them in activities that fit the purposes of the institution' (Article 9).

In asset management, MFIs would be able to award loans, accept bills of exchange, grant fiduciary guarantees, carry out investments (not listed in detail), perform discounts, factoring and financial leasing, as well as to act as fund managers on behalf of third parties.[10] MFIs would be allowed to offer loans to individuals or corporations up to a maximum 5 per cent of their equity. The banking law (Article 46) would be applied to establish the interest rate, which includes the ability to

'freely agree upon interest rates'. Therefore, interest rate cap introduced by regulating Law 374 would no longer apply. Regarding liabilities, IMFs would be allowed to receive and hold from their borrowers, fixed term deposits under conditions approved by the superintendency. They would also have access to second tier credit funds and programs especially designed for small entrepreneurs, among others. [11]

Regulation and supervision activities would be assigned to a microfinance regulating committee. The new committee would be attached to the superintendency of banks and composed of one member from the superintendency, one representative of the non-profit MFIs (ASOMIF) and a third member from the ministry of industry (MIFIC). This committee would keep the registry of MFIs and approve of non-prudential rules in general (Article 24) that would be compulsory to all institutions. The committee would also approve of regulations related to a system of supervision and the rating of MFI. One or more audit firms specializing in microfinance would be entrusted to carry out external and periodic inspections.

The committee would have a secretariat, headed by the secretary whose functions would be to keep registry of MFIs up to date and to take care of administrative and technical functions. The costs of this unit, however, would have to be borne by MFIs. The regulating committee itself would be entitled to issue guidelines, warnings or sanctions in case of non-compliance on the side of MFIs. In unusual conditions, such as imminent insolvency or recurrent non-compliance of the entity, the committee would have the power to demand a plan of normalization. In extreme cases, this could lead to the suspension of the MFI and withdrawal of its operating license.

When assessing the proposed bill for microfinance, one should admit that its adoption would unmistakably contribute to an improved public standing and recognition of microfinance activities. The implicit elimination of the interest rate cap contained in regulating Law 374, would be very positive. In fact this law has not only produced higher up-front fees, but also a marked imbalance between regulated and non-regulated institutions. Another favourable element is the gradual elimination of the 'taboo' on the mobilization of savings. Capturing deposits would be carried out under certain legalized conditions and would depend more on the abilities of the intermediary than on legal constraints.

However, the proposed bill for microfinance is also surrounded by question marks. Microfinance intermediation seems exclusively reserved to non-profit entities (associations and foundations). This would imply

that commercial banks and non-bank corporations would be implicitly excluded from the activity. If this were indeed the case, the logical outcome would be the existence of two segments of microfinance without a level playing field for all actors alike: banks, financial entities, credit unions and other MFIs.

Since microfinance would be the exclusive domain of non-profit entities, it is unlikely that private investors would prefer to get involved with MFIs, as they would be kept out of the distribution of any financial surplus. This would contradict the experience in countries such as Bolivia (Banco Sol, Caja los Andes) and Ecuador (Banco Solidario), where private investments on a commercial footing with the prospect of receiving dividends proved to be important for the development of the sector.

The ban proposed by the bill for microfinance on raising savings from the public 'under no circumstances' raises doubts about the purpose of the new law. If there are no depositors to be protected, or risks posed to the national payment system, then why implement a regulation scheme at all? This would only make sense if limited exclusively to non-prudential regulations. However, the bill for microfinance refers to a 'deficit in minimum share capital', as an abnormal case in which a normalization plan would be justified. The bill thereby does include a prudential norm, which in its self would require the creation of a supervising agency.

The national association of MFIs would play a predominant role in the prudential supervision, as it would assume the responsibility for the functions of the secretariat. But its 'administrative, executive and technical activities' may perilously expose the association to a conflict of interests: on the one hand it already fulfils the role of an interest group acting in the interests of its members. On the other hand it would be responsible for supervising operations. In the best case this would lead to frictions with affiliated first tier organizations who would have to pay for the fees charged by the supervisor: estimated in other countries at around 40,000 US dollars or 2 per cent of fixed assets.[12] In cases worse than that, competing first tier MFIs might indirectly obtain a say in whose doors would remain open and whose would have to be closed.

Another question relates to the future of MFIs that would not be registered but would continue intermediation without being explicitly licensed. If these MFIs do not have a future, it would be appropriate to clarify their prospects with a strategic plan for the entire sector. The objective of such a plan would be to promote mergers and acquisitions between MFIs. A sector plan, once approved and from the drawing

board put into practice, would require a firm position from national stakeholders. In the face of multiple donor agencies, each of them with a vested interest in MFIs, a regulating committee needs a strong hand if it decides to suspend the operating license of only one entity. A policy of registration and licensing would, therefore, also require a 'code of conduct' for donor agencies that work with public resources from overseas.

In synthesis, the bill for microfinance proposes what theoretically has been advised against: in particular the prudential supervision of credit-only MFIs, and the self-regulation with delegated supervision. This mechanism is not free of conflicting interests between the supervising agency and the MFIs. On the other hand, what is externally advised is not proposed in the bill: a sector approach for microfinance as a regulated activity (instead of limiting it to just a segment interested entities), more room to manoeuvre when dealing with small savings services, and a viable payment scheme for the supervision, according to the capacity to pay among all regulated institutions.

5. Final observations

In microfinance discussions the saying goes 'do not regulate what you cannot supervise' (Hannig, in Valenzuela and Young, 1999). Regulation and supervision require effective capacity to fulfil the corresponding duties. However, the theoretical discussion about regulation and supervision raises questions beyond the technical viability of this service. If the criterion is to strengthen the microfinance sector in Nicaragua, fundamental questions emerge in relation to the scheme proposed, pertaining particularly to its ambiguity (prudential character or not), but also to shortcomings (hybrid supervision with a double role for the association of IMFs) that have been conspicuous in the bill for microfinance.

Considerations that are not in favour of a prudential legal framework for microfinance in Nicaragua relate to the weight of the microfinance sector, which is insufficient to threaten the security of the national payment system. Also, there are no public savings that need to be protected. For these reasons, as far as public interests are concerned a parallel cannot be drawn with commercial banks. But a case can be made to promote the competitiveness of the regulated financial sector. If that is the purpose behind the bill, the question arises why it would exclusively apply to the category of non-profit organizations. It would

be more expedient to view microfinance as a regular business activity on a level playing field, to be performed by any entity, for profit or not.

A brief analysis of the cost-benefit structure of a supervising entity confirm the prima facie evidence, in the sense that prudential supervision for MFIs would be much more costly than for commercial banks. Transferring these costs to supervised MFIs could easily provoke either insolvency or a dramatic increase in costs of credit. The latter would obviously be charged to the borrowers. This would hardly be appreciated in a country where MFIs, at present are not viewed as beneficial and unselfish. Also, they do not presently receive legal protection. Extra financial costs would thus only add insult to injury.

A regime of prudential supervision for microfinance in Nicaragua would only bear fruit if an enabling environment is in place in accordance with market principles, geared towards a balanced expansion of microfinance. Some of these factors are the following:

(a) the elimination of the interest rate cap introduced by regulating Law 374 as a goodwill sign that MFIs are not viewed as 'antibodies' to the financial system;

(b) a gradual authorization to raise savings from the public as a complementary instrument for the development of MFIs. This should be done within a framework to foster a saving culture promoted by the state (Thirlwall, 1999). This would provide greater depth to the national financial system;

(c) a strategic plan for the development of microfinance in the country, aimed at greater autonomy of MFIs and consolidation of the sector. This would amount to a lower number of entities operating at a larger scale. It is obvious that this would require a mechanism for harmonization, planning and coordination (Wright, 2001), which in Nicaragua is absent to date;

(d) acceptance of the fact that the supervision of microfinance institutions is an activity with relatively high costs that cannot be supported exclusively by the supervised entities, the government or donor agencies. A costs-sharing mechanism should be devised to reduce the fixed and variable costs of supervision (requiring from the start a considerable volume of extra investments) as well as a mechanism for the generation of income, shared by the state and the private financial sector.

There are basically two foreseeable scenarios for the future regulation of microfinance. The first is one of stagnation, in which many entities would depend upon external financing without any possibility

to diversify financing sources, unable to transfer costs to their clients or achieve expansion through economies of scale. According to this scenario, the regulation of MFIs in the formal sector would be excluded due to a watertight separation between commercial banks and the chronically subsidized MFIs.

A brighter scenario would be a steady reduction of the gap between the commercial regulated sector and the unregulated segment of MFIs, through a prudential system for commercial banks and some kind of step-by-step regime for non-bank institutions. A non-prudential regulation (including a credit bureau compulsory to all intermediaries) would be a critical first step. A second step would be the introduction of a supervision scheme for a limited number of larger sized MFIs with ample coverage and a proven track record. In order to expand the frontier of microfinance towards larger outreach and better performance, the legal framework for the sector needs to be built on the existing potential and earlier experiences. There is no need to invent a fifth wheel for the wagon.

Notes

[1] In El Salvador, the law for non-bank financial institutions deals with microfinancial institutions (Book 4º, Article 157): ' It will be possible to constitute savings and loans corporations, with a share capital equal or higher than ten million colones (1.4 million US dollars), whenever they are dedicated to the promotion of small and medium businesses. Such corporations can be authorized to grant all types of loans, intermediate international resources and those from the Multisectorial Investment Bank, and receive savings deposits from their beneficiaries'.

[2] The costs also depend upon the character of the supervision executed: on-site inspections to detect risks will cost more that off site observations, followed by recommendations and monitoring of corrective actions. The on-site supervision includes checking the quality of the assets, the performance of management and the internal control systems. Special attention is granted to the full performance of external audits. In 1999, the costs of a supervision in Bolivia reached 42,000 US dollars per year, budgeted for 36 days of off-site inspection and 70 days of on-site inspection. The fee charged by the superintendency is 0.1 per cent of the total assets. Trigo (1997), Monje *et al.* (1999) and Rhyne (2001).

[3] The observation in that sense was that the total costs of supervising the assests of an MFI institution are 30 times higher than in case of assets of a commercial bank (CGAP, 2002).

[4] If the Schmidt (1999) requirement of a relatively larger level is added to the requirement of solvency in absolute terms, the microfinance sector would require the need to double their equity levels.

[5] In Ecuador the superintendency oversees 27 credit unions the costs of which are compensated by income generated by supervising the commercial banks.

[6] Banks owned totally or in part by the government were closed, such is the case of BANADES (National Development Bank), Banco de Crédito Popular, BANIC (Nicaraguan Credit Bank) –– and private banks such as Pribanco, Banco Sur, Interbank and Banco del Café. Moreover, Banco Mercantil was merged with Bancentro (Central American Credit Bank) using the name of the latter.

[7] Between July and August 2000, when two private banks went bankrupt, the total volume of deposits decreased from 19,200 to 17,000 million córdobas, which is more than 11 per cent, reflecting a loss of 188 million US dollars.

[8] Microfinance was initiated in Nicaragua in the course of support programme for microbusinesses (PAMIC) that started in 1992, through a network of associations and foundations known as the PAMIC network.

[9] A relatively large MFI with operations in the rural areas, was instructed in 1999 to return an estimated amount of 200,000 US dollars to its depositors since savings mobilization was considered illegal outside of the regulated financial sector.

[10] The latter introduces the concept of trust fund (fideicomiso) which as yet does not have a legal base in Nicaragua.

[11] It is the case of FNI (Nicaraguan investment financial corporation) and FCR (rural credit fund) both owned by the state. Until now, unregulated MFIs do not have access to FNI resources.

[12] The delegated character will, unlike the case of e.g. Ecuador, not lead to any costs sharing with the supervision of commercial banks.

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