Making Sense of the Commercialization

of Microfinance in Latin America

Lessons for Nicaragua

Patricio Lanuza
St. Antony's College
Oxford, UK

May / 2004

lanuzap@ibw.com.ni

Abstract

The application of a simple principle, derived from economic theory and the experience of key countries, surprisingly manages to explain most of the confusion around the microfinance industry in a manner that is both consistent and original.

TABLE OF CONTENTS

"Too much capitalism does not mean too many capitalists, but too few capitalists." –

GK Chesterton - The *Uses of Diversity, 1921*

Introduction

Microfinance is a term coined recently, but its popularity has spread quickly. It is attractive to both the left and the right as a poverty reduction strategy; to the former as a way of reaching the poor immediately and to the latter as a way of reaching them efficiently. A phenomenon simultaneously loved and analyzed by camps traditionally engaged in uncompromising struggle can not be expected to be explained and understood without quite a bit of controversy and confusion. For the novice approaching the subject from the academic standpoint the magnitude and diversity of existing analysis can be overwhelming. Writings on the subject continue to pile up and have taken gigantic proportions. Two warring camps have entrenched themselves behind positions that not necessarily contradict each other but rather tend to emphasize more forcefully a different aspect of the same truth. On the one hand there is the “best practices” school formally sponsored by western development agencies, which tends to emphasize a profit-driven approach, and on the other, critics of a purely for-profit approach, which tend to emphasize coverage. Both positions have merits and limitations but most of the available literature tends to take one position or the other making it very confusing to obtain a coherent view of the microfinance phenomenon. This confusion has had concrete implications for the development of the industry and if continued might put it in peril, as explained below.

Latin America provides a fertile ground to evaluate the implications of each approach. The microfinance industry started in the region as a non-profit effort financed by donors and development agencies, and recently has taken a turn towards “commercialization” or the provision of microfinance through the market. In this area, Latin America has taken the lead relative to other regions of the world. The turn toward commercialization started to gain strength in the late 90s in Latin America and by now the region already offers a variety of interesting experiences for study.

Commercialization has raised the issue of whether a profit orientation shifts the focus of microfinance away from the poor and towards relatively richer borrowers, the so called "mission drift" effect. This drift is suggested by the fact that the average loan balance at for-profit operations is far higher (at least three times in Latin America) than average loan balance at NGOs. NGOs point out that commercialization might cause drift if serving the poor were less profitable than serving richer borrowers. The best practices school's position is that serving the poor is profitable, but in their writings they also worry about mission drift. So, is it or isn't it profitable? Is it perhaps that serving existing borrowers is profitable but serving *new* borrowers is not because of market imperfections commonly associated to financial markets? Is it perhaps that serving the poor is profitable but some providers choose to sacrifice some profitability to maximize social gain? Or is it perhaps that there are certain techniques oriented to serving the poor profitably which are being ignored in Latin America?

A drift away from the poor questions the very nature of microfinance. How is it then to be defined? Is it to be defined by the borrower's relative wealth or by the lending technique used? In certain cases credit card companies have entered the market niche traditionally served by microfinance operations with credit techniques which are completely different from those typical of the microfinance industry, and yet they are serving the exact same group. Although group loans were originally considered the hallmark of microfinance, today there is a widespread shift towards individual loans which are more typical of standard financial practice. As a result, the line between standard finance and microfinance is becoming increasingly blurred.

Donor support, interest rate caps, and subsidized interest rates are abhorred by the best practices school because they are associated with inefficient intervention into a market-driven process. Yet hardly any microfinance operation is fully independent of donor or International Financial Institutions' (IFIs) support, interest rates are higher where competition does not ensue (and despite commercialization sometimes it does not), and many borrowers who benefit from microfinance remain under the poverty line and in need of a relief that could be efficiently delivered via a subsidized interest rate. However the point is well taken that adding controls and relying on donors is hardly an effective way to entice private sector capital into the industry.

How is one to make sense out of this mess?

The purpose of this essay is to shed light on the issues debated by combining analysis of the economic principles behind microfinance with case studies of Bolivia and Chile while drawing lessons for Nicaragua. Bolivia is the poster child of the best practices school and is commonly hailed as the most successful case in the continent. It offers several interesting features for analysis including the success of BancoSol, considered the prototype for commercialization in the region, the introduction by the government of innovative regulatory measures to accommodate microfinance, and the problems caused by the arrival of consumer credit companies in a recessionary context. Chile is barely ever mentioned in the literature but when analyzed consistently in the context of the economic principles outlined below it reveals a unique and potent lesson regarding the role of government in supporting the expansion of coverage. Nicaragua is a special case in that it has managed to attract considerable resources from NGOs and achieved very high coverage levels while lagging behind the region in terms of commercialization. This essay intends to use the economic principles and case studies outlined to highlight potential pitfalls and suggest policy lessons to Nicaragua as it enters the commercialization process.

The essay is organized as follows: A set of four economic principles underlying microfinance is first given. Then the cases of Bolivia, Chile, and Nicaragua are reviewed in that order and in light of the economic principles outlined. Finally, a number of concluding remarks and policy lessons for Nicaragua are given.

Economic Principles

The economic principles underlying the theory and practice of microfinance are four and put in the simplest and more concise form are as follows:

1) Peer monitoring is a *necessary* element of microfinance.

The economic theory behind microfinance, which won economists Spence, Akerlof, and Stiglitz the Nobel Prize in 2001, is simple: lending takes place in a context of asymmetric information between the lender and the borrower. The greater the asymmetry, the less likely it is that the loan will be made. The reason is that the borrower has an incentive to incur risky behaviour with the lender's money; if the risky behaviour pays off the borrower keeps the rewards, if it fails the lender loses his money ("moral hazard"). This means that if the lender does not know the borrower and his project well, the latter is likely to lie about his prospects to enhance his chances, which might lead to riskier loans ("adverse selection") (Stiglitz, 1974; Akerlof, 1970).

To make lending possible the information asymmetry needs to be closed as much as possible. This means that the lender needs to evaluate the customer thoroughly before disbursing the loan, monitor him constantly and ultimately have access to some kind of collateral. These requirements basically shift out the poor from the financial markets (they are "rationed" out of the market) for two main reasons: (1) getting to know them and monitoring them would be too *expensive* and unprofitable given the small amount of each loan involved; and (2) the poor have no collateral to offer.

The revolutionary contribution of microfinance was the introduction of group loans, where people collateralize each other's loans and are given *increasing* loan amounts to motivate repayment, effectively replacing collateral with the repayment incentives created by the group dynamic ("peer monitoring") and the promise of larger loans. The scheme effectively transfers a substantial portion of the bank's costs of screening, monitoring and enforcement to the borrowers themselves (Stiglitz, 1993). A key factor is that the people in the group *know* each other. They choose the members of the group (members cannot be related by blood) and monitor themselves. Each loan is given individually but no additional loan is given until *all* loans in the group are repaid, effectively cross-collateralizing the whole cumulative group loan amount.

This reliance on the group dynamic to neutralize the information asymmetry is at the heart of microfinance and any form of finance that does not use some kind of group system is *not* microfinance properly speaking: it is standard finance. There are three types of microfinance methodologies and they all have this peer-monitoring component: (a) Solidarity Groups where groups of 3-20 people are given loans and each group is independent from the others, (b) Credit Unions where the members of defined groups like churches, workplaces, and associations own the institution, *save* and lend to themselves (savings or investments from non-members are not allowed), and (c) Village Banks which is a concept analogous to the credit union but the associative unit is the village and loans are formally cross-collateralized whereas in the credit union the group pressure to repay is applied more informally. Also, village bank members are usually poorer than credit union members (Rhyne and Otero, 1992).

The commercialization of microfinance entails relying on solidarity groups to reach scale and attract independent private capital. Credit unions and village banks are limited in terms of scale by their very nature of being organized around closed membership groups whose numbers are checked by the need to avoid diluting the peer monitoring effect.

Generally, it could be said that the intensity of peer monitoring decreases as the wealth of the borrower increases. This means that above a certain loan size loans could be made individually as in standard finance. Reed and Befus (1993) mention an additional "microfinance" category called "transformation lending" associated to those customers who graduate out of the group loan system as they gain size, build credit history, or become able to provide some kind of collateral. These are considered to be in limbo, too big for microfinance and too small for the conventional lenders. As a result, some microfinance institutions have moved to service these profitable larger clients individually and continue to call it microfinance. But it is not so, it is standard finance and this mixing of individual with group loans has created a great deal of confusion. Above these "transformed" microenterprises, the credit ladder reaches the conventional sector with salaried workers served by credit card companies and formal SMEs and large enterprises served by conventional banks.

If today most microfinance institutions in Latin America are moving away from group to individual loans and competing with credit cards, one must conclude that they are not serving the poorer layers of society or that if they are, they might be using the wrong technique with potentially disastrous consequences. For instance, consumer credit techniques are not appropriate for microfinance and could lead to higher default rates as illustrated by the Bolivian case below.

Latin American microlenders are less profitable than Asian ones partly because the former tend to use more commercial debt than savings to finance their operations (MIX, 2002) but also possibly because in Latin America a majority of commercial microloans are handled individually whereas in Asia the group-loan methodology prevails (IFPRI, 2000). Asian commercial microlenders' depth of outreach[1] is better than Latin America's (Asia: 50% vs. LA: 77%) (MBB, 2002), showing that there is no necessary divorce between depth of outreach and profitability as long as the proper technique is used. Asia's depth of outreach might be even better than the one suggested by the figures if one considers that inequality is higher in Latin America than in Asia. Gini coefficients for all Central American countries (except Costa Rica) are in the 0.50s, Bolivia is at 0.45. Indonesia, India, and Bangladesh are all in the 0.30s[2]. Using individual loans instead of group loans appears to have limited growth in Latin America's commercial institutions. Asian commercial microbanks, like BRI Unit Desa and

[1] Depth of Outreach is defined as Average Loan Size divided by Real GNP per Capita
[2] Source: World Development Indicators, World Bank, (2002)

Grameen, boast client populations in the millions, whereas their counterparts in Latin America are in the low thousands (BancoSol in Bolivia had 67,000 clients in 2002).

2) Lenders have an incentive against providing the *first* loan to a *poor* individual or group who has never received a loan before.

The principle in question is simply the *externality* that ensues every time the returns on an upfront investment (like the costs of acquiring information on creditworthiness) can be easily appropriated by a competitor at a lesser cost (Román, 2003). Software development offers an example of this situation where the returns on the large upfront development costs can only be appropriated by banning the free copying of the software; copying being basically a zero-cost activity. If licenses were not available the software would simply not be produced.

Microfinance clients are analogous to the software. The first lender has to invest upfront resources in (a) educating the population in a given area on how to form the groups, (b) train the groups on the rules of the game, a process which could take up to a month, and most importantly (c) build the group's credit history by allowing it to transition from lower to larger loan amounts while running the high risk of default and delinquency costs associated with unknown borrowers. Once the customer has been trained and his honesty proven, the borrower is considered to be effectively "bankarized" or worthy of credit; however, as soon as this point is reached, a competitor might step in and snatch the client away by underselling the prior lender.

It must be noticed that the competitor could *always* undersell the initial lender because having invested nothing, it has an absolute advantage. However, banks do not compete by trying to offer lower interest rates because the initial lender would only fail to match the lower interest rate offered for clients whose worthiness is dubious (another instance of "adverse selection") and this is no exception. Technically, the competitor is not underselling the first lender by offering a lower interest rate but is simply *not* charging the bankarization costs that the first lender incurred on his behalf. The externality applies to all borrowers but more strongly to poor borrowers. A well-off borrower can post collateral or grant access to a stable salary stream to a prospective lender to ameliorate the risk associated to unknown borrowers and the incurrence of upfront bankarization costs would not be very significant.

Alternatively, the lender could require the borrower to enter into a contract providing for repayment of bankarization costs if he leaves early to a competitor. Given the small size of the loans however, legal enforcement of the contracts would be prohibitive. Thus, credit card companies for instance usually do not pursue legal means against defaulting borrowers and rather rely on the threat of reporting the delinquency to a credit bureau thereby spoiling the borrowers' credit standing and future access to credit. This threat does not work in relation to bankarization costs because the very reason the person is leaving the current lender is that *another* lender is offering him a loan with better terms than the one he currently has, therefore for all practical purposes his credit is intact as he continues to receive credit. Campion and Valenzuela (2001) point out that in an expanding market the very competition for clients may preclude lenders from reporting their borrowers to credit bureaus for fear of making them obvious to their competitors who may then proceed to tempt them away, thus making it even more difficult to enforce any kind of payment through threats to credit standing.

What the externality means is that a *competitive* microfinance market will *not* expand the service frontier unless external intervention is applied from agents less sensitive to profitability like NGOs and governments. The implications of this conclusion are momentous, yet this "bankarization externality" is barely mentioned and then only as a side issue in most of the literature from both debating camps (except in the case of Chile where it has been wisely applied as shown below). This is not surprising because in the beginning there was no competition and expansion went unhindered; but once the demonstration effect of the first movers sparked new entrants, competition has predictably kept the service frontier at the level where it started at least in Latin America: within the richest layer of the poor (Christen and Drake, 2002). Because microfinacing works by increasing loan amounts over time, the increasing size of the loans makes it look as if there has been mission drift when in fact there has been no drift. This conclusion is supported by Christen who argues that in Latin America there has been no drift because the very poor have *never* been served (Christen, 2000).

Ignoring the bankarization externality may lead to misleading conclusions like claiming that the microfinance market in countries like Bolivia, Chile, and Nicaragua is reaching "saturation"; this conclusion is widespread and is becoming almost common wisdom. Román (2003) for instance states that "the Chilean banking system practically reached the limits of bankarization during the 90s" (p.63). The conclusion is usually based on anecdotal evidence from the microfinance providers who are struggling under competition. In fact, Westley (2001) reports in a study produced for IADB that only 2.6% of 58 million microenterprises has access to microfinance services in Latin

America. Bolivia, which had the highest penetration rate[3] in the continent was at 27%, Nicaragua at 20%, Chile at a mere 7%. This suggests that competition today is for *existing* clients and further deepening of the service frontier has been compromised by the bankarization externality. Anecdotal evidence also exists of NGOs entering markets in Bolivia quickly losing their clients to competitors (Rhyne, 2002a) as well as in Peru where Mibanco switched to poorer segments in 1998 as banks skimmed the wealthiest borrowers (Mibanco had no competition within *poor* market segments at the time) (Campion, Dunn, and Arbuckle, 2000). Understanding the implications of the bankarization externality is vital if microfinance expansion is not to come to an abrupt halt.

When industry analysts talk about saturated microfinance markets while worrying about mission drift and reduced outreach, they contradict themselves. In a saturated market drift makes no sense because the moment drift happens a hole is created and the market is no longer saturated. Christen (2000) finds it "interesting [..] that commercial banks are entering the microfinance market at or near the same [average loan] level as pioneering NGOs that preceded them" (p.34). In light of the bankarization externality, there is nothing interesting about it; this behaviour is precisely what is to be expected from commercial banks targeting already bankarized clients.

Another source of confusion needs to be cleared out before proceeding forward. Some authors have disregarded the bankarization externality because they confuse the upfront costs of learning how to operate a microfinance business with the upfront costs of bankarizing clients. This is dangerous because if attention is paid only to the externalities

[3] Penetration Rate is defined as Number of Microenterprises using Microcredit divided by Total Number of Microenterprises in the Country
Credit Unions are not included in the numerator; however, they tend to have higher loan averages than microlenders and also serve the middle class (Westley, 2001)

derived from the initial learning process, it might seem as if no intervention is needed *after* the techniques are mastered. However, the bankarization externality requires constant intervention to keep it from hindering coverage growth.

3) Without competition, interest rates might be higher than otherwise for *proven* borrowers.

A central postulate of the new information economics is that banks do not raise interest rates indiscriminately because of adverse selection. Unknown borrowers are considered more risky, consequently interest rates charged to them should be higher. However, above a certain level the interest rate would be so high that *mostly* borrowers sponsoring extremely risky projects would be attracted. Still, a few borrowers within the group might come up with valid projects but they are harder to identify among the large population of unacceptable applicants. As a result rates are not raised above a certain level in order to avoid increasing the population of undesirable borrowers. This postulate holds *only* when the identity of the borrowers with good projects is *not* known. Once the identity of the "good" borrowers is known competitive dynamics are like those in any other market; without competition the borrower would be charged a higher rate than otherwise.

So, when it comes to microfinance we find that competition is a double-edge sword: good for keeping interest charges in check but bad for expansion because of the bankarization externality. One solution to the expansion problem would be to divide the market into territories assigned or "licensed" to a particular provider, but this would have to be accompanied with an interest rate cap to avoid abuse. Alternatively, a situation like the one seen today where expansion is usually undertaken by NGOs and governments, which are less sensitive to the bankarization externality, calls for the elimination of interest rate caps since competition makes them redundant.

4) If after repaying principal and interest on a loan, a borrower keeps an amount greater than 0 but less than a minimum acceptable subsistence level, then it is more efficient for the government to provide the differential amount than the whole subsistence amount.

Given society's desire to raise the standard of living of the poor to a minimum acceptable level, it is more efficient to have the poor produce as much as possible *above* the cost of capital and then subsidize the deficit needed to reach the desired income level rather than giving them a transfer for the whole amount corresponding to the desired income level. One way of delivering the subsidy is by using a subsidized interest rate. It is vital to understand that the borrower has to produce more than the actual cost of capital (the loan); otherwise raising him to a minimum subsistence level would entail transferring the entire amount corresponding to such income level *plus* bearing the un-recovered capital costs.

Controversy exists on whether Grameen Bank, the pioneering microfinance institution with 2.4 million borrowers in Bangladesh, is profitable or not. Some critics argue that Grameen's customers are too poor to be served profitably (the average loan at Grameen is $1/10^{th}$ of the average at Latin American commercial institutions). The economic principle considered here might help understand why the controversy has appeared. Grameen, which is owned by its own customers, openly states that its objective is not to maximize profits but to make enough profits to assure sustainability and to pass through as much benefit as possible to the poor (Yunus, 2003). Grameen might be maximizing the social benefit to the community while sacrificing financial profitability (Schreiner, 2003); but this does not necessarily mean that Grameen can not be profitable. It might only mean that it has deliberately chosen not to be so.

Growth Dynamics in a Competitive Environment:

The Bolivian Case

Bolivia boasts the highest market penetration rate in Latin America at about 27.8% (Christen, 2000) and the first self-sustaining commercial microfinance operation, Banco Solidario, more commonly known as BancoSol. In Bolivia, NGOs have taken the lead in forming the microfinance market. BancoSol is a "transformed" NGO, as it was spun out of the non-profit PRODEM in 1992.

Thereafter, following in the footsteps of BancoSol, several commercial operations have appeared in Latin America as transformed NGOs like Caja Los Andes also in Bolivia, Mibanco in Peru, and Financiera Calpiá in El Salvador. Also, specialized private providers as well as many commercial banks entered the microfinance market throughout the region, a phenomenon known as "downscaling" and usually explained by the need of local commercial banks to find new niches as financial liberalization increases competition for large corporate clients. In Latin America, the tendency of commercial operators (*not* NGOs) to serve the richest layer of the poor is not the exception but the rule. Today, the average loan for the region as a whole is near US$1000 which is high considering the average GNP per capita of the countries where most of the industry is concentrated. Bolivia for instance with a GNP per capita figure about a third higher than that of Indonesia and India shows a loan average at least three times greater. Rhyne

(2002a) states that "MFIs in Bolivia *never* served the extremely poor [..] 78% of BancoSol clients clustered just below or just above the poverty line, with most of the rest clearly non-poor [..] only NGOs served people below the poverty line" (p.132) and Valenzuela (2002) states that "outreach is generally modest among most of the forty-two banks surveyed" (p.53). Despite their limited coverage, commercial operators already control 75% of the funds allocated to microfinance, a situation exactly opposite to that of a decade ago when commercial players barely participated in an NGO-dominated market (Christen, 2000). The commercial market has not and is not drifting *downwards* in the direction of the poor. Data from the financial regulator (SIB) show client growth in Bolivia decreasing from rates above 100% during the mid-90s to a virtual standstill in the late 90s. Many reasons can be advanced to explain this phenomenon.

As suggested above, when competition for clients intensifies the bankarization externality is triggered creating a disincentive for expansion; and in late 90s Bolivia competition has been savage. Rhyne (2002a) reports how the NGO ProMujer has become completely dependant on donor funding as its new clients are quickly poached away by competitors after a few loans. ProMujer targets the poorest segments of society and the fact that its clients are being stolen proves that they can be profitably banked, but it also shows that it does not pay to bankarize them.

Another reason competition has undermined growth in Bolivia is that it has forced microfinance operators to give up lending techniques based on peer monitoring and switch to individual loans. BancoSol started out with an average loan of US$250 using solidarity group techniques in 1992. Partly because of competitive pressures from consumer credit companies and partly because the group loan methodology provides for increasing loans to motivate repayment, it eventually reached the current US$1200 average loan level at which it makes more sense to graduate clients to individual loans (it makes sense because group loans tend to stop working once this level is reached as customers who could be serviced individually refuse to subsidize the credit for the rest of the group). Because of competition, the focus has changed from gaining clients to keeping them, and thus BancoSol has gradually relegated group-lending to a secondary role, which reinforces its bias towards richer customers. Poor clients, as explained above, can only be served profitably by using peer monitoring based techniques. Of course, the fact that customers are increasingly able to take on more debt could be considered a measure of success, but this is irrelevant if the experience can not be repeated for the large number of microenterprises who *never* received an initial loan from which to start growing nor will probably ever receive one if group loans are phased out.

Interestingly, at the time of transformation in 1992, BancoSol had perhaps unwittingly acknowledged that bankarizing clients was not part of the business. PRODEM, the original NGO that spun out BancoSol, transferred all its *profitable* clients to BancoSol and signalled that its new mission (PRODEM's) was to "continue to operate existing offices that were not yet profitable and open *new* offices in other cities. Once these offices became profitable, they could be sold to BancoSol." (Glosser, 1994, p.236) Funding for PRODEM would continue to come from donors, *not* from private profit-seeking investors. The business strategy of BancoSol itself at inception, at a time when competition was limited, already acknowledged the fact that expanding the market was *outside* of its profit oriented activities and should be carried out by a non-profit operation.

Predictably, as commercial operators have come to dominate the business - openly sneering at institutions that are "donor-dependant"-, growth has come to a standstill.

Finally, the most common reason given to explain the slowdown of the industry in Bolivia is the late-90s recession coupled with a crisis of over-indebtedness among borrowers, as explained below.

Microfinance under Attack: The Consumer Credit Invasion

In 1999, a group of demonstrators wearing sticks of dynamite strapped to their chests took over the offices of the Superintendency of Banks (SIB) demanding full forgiveness of outstanding debt. The incident crowned months of protests by debtors against microfinance institutions, including BancoSol, blaming lenders for every social ill in the country. From 1997 to 2000, the microlenders' consistently solid repayment performance was shattered as the rate of default escalated from 2.4% to 12.6% (Rhyne, 2002). For the casual observer the obvious culprit behind this situation was the ongoing recession which had prompted the government to crack down on microenterprises' informal trade along the frontier; but on closer inspection another culprit appeared: Chilean consumer credit companies. When BancoSol started to analyze defaulting borrowers, it became clear that most of them had loans not only at BancoSol but also at other credit institutions, especially consumer credit companies and that the total debt was far in excess of the borrowers' repayment capacity.

Consumer credit is a recent arrival in Bolivia where it came via Chile, a country that has traditionally been at the forefront of the consumer credit movement albeit directed primarily to the *middle* class, not to microenterprises. In Bolivia, however, the approach was different. Companies like Acceso FFP, the largest consumer lender in

Bolivia and owned by the large Chilean conglomerate Empresas Conosur, came into Bolivia with the deliberate strategy to target the middle class. But this view soon changed and a decision was made to include microenterprises as well *without* changing the lending technique. To understand why they did this one has to consider how consumer credit companies operate. Their credit systems are called "credit factories" and emphasize statistical default analysis rather than strict individual customer analysis. What this means is that profitability is dependent on volume because the greater the number of clients, the more predictable it becomes to achieve a targeted default rate which in turn is used to calculate the minimum interest rate required to achieve profitability.

Of course, consumer lenders did not proceed to capture virgin clients but "piggybacked on the microlenders. The technique was simple: lure the good clients away from microlenders by offering them larger loans" (Rhyne, 2002a, p.122). Consumer credit companies dismissed the microlenders' techniques as inefficient and appropriate for "charity-type" activities and treated the stolen clients as they would any other. What they were missing is that microenterprises are fundamentally riskier than typical middle class clients who have a salary stream and presumably some degree of existing assets. Peer monitoring is designed to alleviate the additional risk by allowing peer pressure to enforce repayment but they ignored this. They were setting themselves up for a rude awakening; the problem was that they dragged the microlenders along with them into the abyss.

As consumer credit companies came in aggressively offering greater loans to existing clients, microlenders were pushed to follow in a typical case of coordination failure. "The situation sets up a classic dilemma: if all parties (lenders) were to engage in restrained behaviour (lending within the client's limits), the results would be good for everyone (low defaults). However, it would be foolhardy for a single lender to exercise restraint without knowing if others will follow. Therefore no lender maintains a restrained manner and everyone is worse off (high defaults throughout the system)" (Rhyne, 2002b, p.217). Another way in which consumer lending can cause overlending is by breaking the balance between loan and productive capacity in the borrower. A microlender lends to enable *production* by providing funds for working capital or fixed assets thereby simultaneously creating a source for loan repayment whereas a consumer lender lends to enable *consumption*, which has no necessary connection to increased repayment capacity in the borrower.

Of course, the question remains as to why would the borrower accept loans beyond his repayment capacity? The explanation involves both moral hazard and the fact that consumption financed by easy credit has an addictive component. A borrower that indulges into too much debt might rationalize it by betting on the possibility of earning more by pursuing a risky project or hoping for improving macroeconomic conditions. Rhyne (2002b) emphasizes the addictive component more forcefully when she claims that "we can take it as a trait of human nature that many people are susceptible to borrowing too much if a lender is willing to lend" (p.216). Addictions are anathema for economists who tend to regard people as "rational actors", but then it is hard to find a person whose passions have not overruled his reason at one time or another. Temptation to indulge in consumption might be even greater for poor people who suddenly find themselves with immediate access to a great range of goods that before were accessible only in their wildest dreams. Moreover, the poor might need the money to satisfy basic needs like food, medicine, and shelter, making the temptation even worse.

The credit bubble eventually burst and by mid-1999 the consumer-lending movement crashed. Acceso FFP was intervened by the SIB and eventually phased-out of the market while writing off over 86% of its US$93 million portfolio. The loss for Acceso FFP was almost complete, which corroborated the contention that credit factory techniques lacked the essential elements that made lending to microentrepreneurs work. Microlenders fared not only better than the consumer credit companies but also better than traditional banks did during the recession years (Theodore and Lubiere, 2002). The reason for their resilience is attributed to their sounder lending methods and relatively more conservative regulation by the SIB. Still, there is a general perception that Bolivia's pristine repayment culture has been irreparably damaged.

A disturbing argument has arisen against group lending from the fact that the majority of delinquency at BancoSol since the crisis was concentrated in its solidarity portfolio (group loans) apparently because when all members in the group are weakened at the same time (as in a general crisis) they are less likely to help any given troubled member. This might be true, but it ignores the glaring fact that the solidarity portfolio corresponds exactly to the *poorer* clients who because of their smaller size simply can not be serviced with individual loan techniques. The alternative is not to give them individual loans, but to give them no loans at all. Very poor clients according to Rhyne (2002a) prefer to be serviced in groups to increase the loan size by leaning on each other. Of course, BancoSol could move on (as it is doing) to use primarily individual loans

(78% of loans were individual in 2000) but then the poor are not being serviced, which is the *raison d'etre* of microfinance.

Bolivia's regulatory response to the crisis was effective and aimed at bringing back the correspondence between debt levels and repayment capacity. "The SIB introduced certain measures in early 1999 designed to put the consumer credit business on better footing. The most important provision limited the client's total debt service to 25% of salary" (Rhyne, 2002a, p.125). The crisis also helped highlight the need for credit bureaus so that the borrowers' debt capacity could be ascertained prior to disbursing a loan. In Bolivia, as in most Latin American countries building an all-encompassing credit bureau system has proven difficult because private agents are not allowed to access information collected by SIB from regulated financial institutions due to secrecy laws. Chile is the only country where an NGO can request a report from the SIB with client authorization. Efforts have been made to create private credit bureaus that collect voluntary information but success has been limited.

Savings

The ability to provide savings services to microenterprises was not given priority in Latin America until recently with the appearance of transformed NGOs like BancoSol and some consider it a missed opportunity for the region. Wherever savings services have been offered, they have successfully attracted a considerable number of depositors to the point where some microbanks are entirely financed through depositors' savings (like BancoSol). Savings are as important for the microenterprise as loans because (1) they constitute an alternative source of self-financing, (2) allow depositors to earn a positive rate of return, (3) can be used for collateral to enable larger loans and build credit rating, (4) provide an opportunity for the microbank to assess the customer's ability to generate cash, (5) maintain liquid funds for emergencies and special occasions, and (6) enable customers to avoid having to save through undesirable means like cash which is subject to robbery or saving in kind which is usually illiquid and subject to onerous charges if the need arises to convert it into cash (Robinson, 1992).

From the standpoint of the microbank, the best practices school suggests that savings are desirable because (1) they relieve the operation from depending on donors (Otero and Rhyne, 1994) and (2) ensure the long term sustainability and growth of the institution (Robinson, 1992). Financing the operation through commercial loans is difficult because most banks do not lend to microlenders unless guaranteed by an international organization and is also expensive because interest charges are usually far above what savers would earn.

The first contention on donors is weak. Morduch (2000) makes the obvious point that donor dependency is not necessarily a bad thing when there is no evidence that aid money will dry up any time soon. In any event, unless competition is controlled somehow donations or government subsidies will continue to be needed to expand the market because of the bankarization externality. Otero and Rhyne argued in 1994 that only those institutions that had become independent of subsidies and grants had been able to reach large numbers of clients. That is probably true but it is also true that competition was not an issue at that time and providers could easily and effectively recover their bankarization costs without worrying about competitors snatching their clients away. Today the story is very different.

The second contention on sustainability and growth is more solid. Given the large size of the microenterprise sector in Latin America, it is not realistic to expect it to be covered by donations. Westley (2001) states that the amount of funds dedicated to microfinance in Latin America (approx. US$2.5 billion), represents less than 0.5% of the US$500 billion that the banking system normally channels to the private sector in the region, even though microenterprises are responsible for at least 20% of the region's GNP. It would be desirable both to capture funds from microsavers as well as channel more capital from conventional savers towards microenterprises. There are only two ways to do this: (a) by force through government intervention, or (b) by assuring the profitability of microfinance institutions to entice private sector participation. The market-based economic model prevalent in the region today tends to discourage option (a), whereas (b) is only possible if microbanks are able to collect savings or merge with a larger bank in order to have access to cheap deposits while managing the bankarization externality to maintain expansion.

Regulatory Innovations

Just as banks need to control their borrowers because of the asymmetry of information between borrower and lender and the moral hazard effect described above, depositors need to control banks for the same reason. However, given the size of any given deposit, it does not make sense for any particular depositor to invest the resources required to monitor the bank. This market failure calls for the government to step in and regulate the bank on behalf of depositors.

In the case of transformed NGOs like BancoSol, the regulatory process has been an uphill battle because the regulators are not familiar with microfinance nor do they consider it very significant relative to the larger banks. One of the primary roadblocks is usually linked to the fact that the original NGO usually ends up owning the regulated microbank it has just spun off. The problem is that NGOs are non-profit operations and the regulator requires a for-profit investor holding the bank's equity to make sure it has a vested interest in maintaining the bank's profitability and financial health. The solution entails having higher capital requirements to provide more cushion against deposit losses. According to the Basle Agreement, which sets international banking standards, a bank should have liabilities not greater than twelve times its equity. For microfinance banks the threshold is usually set at six times to increase protection (White and Campion, 2002).

An important regulatory breakthrough achieved in Bolivia has been the creation by the SIB of a specialized regulatory window to enable smaller private companies to enter the microfinance market. Encouraged by the success of BancoSol, the SIB introduced the FFP (Fondo Financiero Privado) regulations spelling out charter requirements and supervisory structures specifically designed for microfinance institutions. The regulations provide for a lower paid-in-capital threshold than conventional banks and more appropriate for microfinance (US$1 million for FFPs as opposed to US$5.6 million for banks). FFPs can provide loans and limited savings services and many lenders are already operating under this classification (Theodore and Loubiere, 2002).

Dealing with the Bankarization Externality through Policy Innovation: The Chilean Case

There is no case where the microfinance market has been formed by the private sector alone; in most cases it has been the effort of NGOs that has broken ground with the private sector coming in behind them aiming at the same "bankarized" client group. Chile's microfinance experience is unique because it is the only country whose microfinance market was created by the government as opposed to NGOs and because the effect of the bankarization externality on expansion is not only acknowledged and addressed but constitutes the foundation for the industry's development strategy.

The fact that NGOs are the primary drivers of microfinance expansion represents a problem for richer countries that relatively speaking fail to attract as many NGOs. Generally, poorer countries like Bolivia, Nicaragua, and Honduras who attract a greater number of NGOs present far higher market penetration rates than the richer (GNP / capita > US$4500) countries in the region (Christen, 2000). Chile presents the highest penetration rate among the richer countries at 7%, far above Brazil, Mexico, and Argentina who are all *below* 1% (Westley, 2001). To supplement the lack of NGOs, the Chilean government created a program to deliver subsidies to financial institutions in order to entice them to enter the microfinance market, as explained below.

Market Development Strategy

The government subsidy was designed to cover the initial costs of setting up the administrative operation and more importantly, address the bankarization externality directly by covering the costs of bankarizing each customer. The subsidy was given on per customer basis and it was understood to be temporary with the expectation that after two or three credits backed by subsidies the customer would have been transformed to a regular customer of the financial institution. The subsidy was calculated on the basis of processing overhead costs for each transaction and the higher default rate associated to new customers. The government funds are *not* characterized as subsidizing the interest rate, which according to standard economic theory would result in inefficient allocation of resources, but at subsidizing the learning process at the bank and the transformation of the borrower to regular status or bankarization. In other words, subsidies are covering genuine non-recurring costs to enable the industry to take off and expand. They are not geared to subsidize lending to unprofitable projects (Román, 2003).

The subsidy program started in 1992 and by the end of the decade had managed to bankarize 123,000 clients and was considered a success with some quarters talking about "saturation". Many private banks were involved in the program including Citibank, BHIF, and Corpbanca but the bulk of the market was captured by Banco del Desarrollo, Banco del Estado de Chile, and Banefe-Bansander, a division of Banco Santander (Román, 2003).

Chile is conspicuously absent from most of the best practices school writings, which tend to emphasize independence from government involvement and usually recurs to examples where NGOs have transformed into commercial banks without any *government* subsidy (of course the NGOs are subsidized but externally). There is another reason why the best practices school tends to ignore Chile: the involvement of Banco del Estado, a *government*-owned financial institution (albeit run independently and on a for-profit basis)[4]. Ignoring the Chilean experience has been rather unfortunate however

[4] On the bias against government involvement see Morduch, 2000.

because it contains a very potent lesson regarding the implications of the bankarization externality on expansion and the need for intervention to neutralize it.

Differences of Lending Technique

However, there is one sense in which one could agree that the Chilean experience may not necessarily be relevant: Chile is not doing microfinance properly speaking. None of the banks involved in the program is using solidarity group lending or any other technique commonly associated with the industry and based on peer monitoring. Instead they have focused on individual loans served through a system that combines techniques from consumer credit and standard credit to established companies. But as explained below, this difference does not invalidate the lessons derived from the Chilean experience.

The process of "transformation lending" was associated above to financial services offered to those clients who have graduated from group-loans and could be serviced individually but "are still too small for conventional banks" (Reed and Befus, 1993). What that statement implies is not that they are too small for conventional banks simply but too small for banks using conventional techniques. Individual loans to small clients can be safely made by using "information intensive" techniques, where the bank studies the client intensely prior to issuing the loan and monitors him constantly rather than relying heavily on collateral as with conventional loans. Intense analysis and constant monitoring are then combined with the consumer credit techniques explained above which are tolerant of higher default rates (7% as opposed to <2% in microfinance) while ensuring profitability by charging higher rates and late payment fees. Some Chilean microbanks lean more towards information intensity lending whereas others more towards consumer credit techniques, but they all need to maintain the information intensive approach in one way or another. Pure consumer credit techniques have had disastrous consequences in the microfinance niche where predictable salary streams and personal assets are not available as shown by the Bolivian experience visited above.

The important point however is that information intensive techniques are *expensive* because they require personalized attention for each customer, which means that only relatively larger loans can be delivered in this manner. Further, Zuñiga (2003) claims that banks in Chile always ask for some kind of guarantee, which clearly could not be provided by the poorer market segments. Therefore, without peer monitoring one could safely predict that the larger and poorer segments of the Chilean market remain without service.

In fact, Román (2003) states this explicitly in his analysis of the Chilean market when he says that "the market has oriented itself strongly to the larger microenterprises and with greater market potential", that "there persists important levels of credit rationing among microenterprises", and that "only the most precarious economic units who are very numerous (especially self-employed workers) still lack coverage" (p.31). According to Christen (2000), there are approximately 1.2 million microenterprises in Chile of which 130,000 have employees (other than the owner). A safe assumption would be that those microenterprises who can afford to have employees are better off; this number (130,000) agrees roughly with the 123,000 clients who have been bankarized through the Chilean subsidy program, leaving around 1 million own-account microenterprises (zero employees) outside of the market. Effectively, only the top layer (loans >US$1000) of the microenterprise market has been bankarized (Román, 2003). Although in the Chilean case the bankarization externality has been neutralized through the subsidy, the market stopped growing because the poorer segments can not be reached profitably with the current individual loan techniques. A peer-monitoring based technique needs to be introduced to make outreach possible.

Of course, the fact that peer monitoring techniques are not being used does *not* invalidate the need to intervene to neutralize the bankarization externality for *individual* loans. Making individual loans to the richest layer of the poor *also* entails incurring upfront bankarization costs which are unlikely to be recovered under competitive conditions. Bankarization costs for individual loans to the poor are different from those typical of group loans and include (1) training on how to operate the enterprise as a formal business capable of providing financial statements while providing the bank with relevant information, (2) cash flow analysis, visits to the business and validation of references before disbursing the loan, and (3) high risk and delinquency associated to unknown borrowers incapable of providing collateral (this is a cost for group loans as well).

Regulatory Innovations

From the regulatory standpoint, Chile illustrates the need to accommodate the particularities of the microfinance business into the banking system's regulatory framework to make sure industry growth is not strangled.

Chile used to have in place an interest rate cap to control usury which had initially been set based on the characteristics of historical financial practice prior to the advent of microfinance and did not discriminate among loan types. Microfinance rates are higher than conventional rates because despite the use of cost-reducing techniques based on peer monitoring, which in Chile are not even in widespread use anyway, the costs of servicing so many small borrowers is quite high. So, a typical rate on a microloan could be in the vicinity of 100% per year in real terms, which would be deemed usurious on a conventional loan but is actually quite reasonable for microfinance (prior to microfinance some borrowers were paying near 1000% / year to street lenders) (Ramírez, 2004). Because the cap was restricting microfinance operations, the bank regulator (SBIF) allowed for the creation of several cap levels based on the size of the loan to accommodate microfinance while keeping an eye on usury (Román, 2003).

During the early 80s, Chile suffered a severe banking crisis that prompted the government to renationalize banks that had been recently privatized. The problem had been caused by the conflict of interest that arose when a few private holding companies managed to acquire a majority of the state companies being privatized as well as the banks that lend to them. The regulator was unaware of the conflict of interest because the holding companies were "closed" (*sociedad anónima*) and it was difficult to see who the real owners where. In order to avoid this problem in the future, SBIF introduced a set of regulations designed to discourage the use of closed companies whose ownership is difficult to control. The measures increased capital requirements for loans to closed companies and supervision of them by the regulator.

Unfortunately, small companies are usually formed as closed companies to protect the personal estate of the owner. Therefore, the new measures created a disincentive to serve them even though the original intention was to discourage *large* closed companies. This situation has not yet been solved but it highlights the need to manage the regulatory process to accommodate the needs of microfinance; an endeavour made difficult by the fact that regulators most of the time are not familiar with the particularities of the industry and even if they are, tend to devote little time to it because it encompasses only a small fraction of the financial sector and is unlikely to threaten the overall health of the financial system, which is the regulator's primary concern. As stated above, the percentage of private financing going into the microfinance sector is meagre (<0.5%). Incidentally, Chile's current concern with the ability of small closed companies to access credit more easily betrays the bias of the system towards serving the richest layers of the poor. Own-account microenterprises would not even bother with incorporation under any kind of formal entity since they operate in the informal sector.

Normally micro-loans are more resilient to recession than other types of loans because the regulator places more stringent requirements on microlenders. But in Chile's recent economic downturn the microfinance sector has shown the worst default rates (5% as opposed to the average 1.7% for the whole system). On closer inspection the result makes sense. Román (2003) points out that the macroeconomic adjustment program undertaken by the government with its accompanying interest rate hike affected microfinance disproportionately because large companies have access to international capital markets while microenterprises obviously do not. But, another reason suggests itself when one notices that the technique favoured by Chilean microbanks has a strong component of consumer credit for which higher default rates are typical (7% under normal conditions).

High Market Penetration without Commercialization:

The Nicaraguan Case

In the late 90s Nicaragua already had the second highest penetration rate in Latin America with 20.2%, behind Bolivia, which had 27.8% (Westley, 2001). As opposed to Bolivia, Nicaragua has continued to expand the microfinance market considerably since then; according to a recent study the share of microenterprises with access to financial services has almost duplicated from around 160,000 clients in the late 90s to 310,000 in 2002 (Blijdenstein, Nusselder and Rosales, 2002, quoted in Sanders and Nusselder, 2002), which means that the country today is probably close to a 50% penetration rate. Competition is reportedly high with almost 300 institutions providing microfinance services (Sanders and Nusselder, 2002).

Given the bankarization externality, how can Nicaragua have such a high penetration rate with so much competition? The answer is that the primary players in the market are non-profit microlenders (NGOs). Nicaragua has the least commercialized microfinance market in Latin America with for-profit providers accounting for 6% of total clients served and 16% of total funds. NGOs have led the way in expanding coverage growing from 84,000 clients in 1998 to 227,000 in 2002 accounting for 74% of total clients and 60% of total funds invested. The rest (about 20% of clients and 22% of funds) is controlled by savings cooperatives (credit unions) (Sanders and Nusselder, 2002).

Because NGOs are prevalent one would assume that outreach to the poorer layers of the population is significant. The numbers however tell another story; as everywhere else in Latin America, the for-profit providers' average loan is about US$1000 and the average for NGOs is about US$300 (Sanders and Nusselder, 2002) but if the poorer layers of the population were being covered the numbers should be lower. Nicaragua's GNP per capita is 75% of Bolivia's and 20% of the Latin American average. Profitable commercial institutions in Asian countries with similar GNP per capita levels (~US$600) operate with an average loan level of US$300 and NGOs in those countries are at US$150 (MBB, 2002). The difference is probably worse if one considers that Nicaragua is one the most unequal countries in the world with an income Gini coefficient of 0.6, whereas Asia's is in the 0.30s[5].

Why is this happening if NGOs are driving the market? There are several reasons. One of them is use of inappropriate lending techniques. Most institutions are using individual loans as opposed to group loans. Apparently, the population is inimical to group loans because they relate group dynamics to the government-imposed communalisation of life that characterized the Sandinista period during the 80s (CGAP, 2001). Today, only a handful out of 93 NGOs is able to service clients efficiently at the US$300 average loan level (Sanders and Nusselder, 2002), which suggests that the wrong technique is being used.

Another reason why coverage is not deepening is that competition among NGOs is starting to slow expansion down. McIntosh and Wydick (2002) suggest that the market has finally saturated as evidenced by the increasing competition (perhaps it would be more correct to say that the market has finally become competitive as evidenced by it appearing increasingly saturated). But, why is competition suddenly turning so intense among NGOs when they are non-profit operations? The answer may be that they sense the coming of commercialization. They know from the example of BancoSol in Bolivia,

[5] Source: World Development Indicators, World Bank, (2002)

Mibanco in Peru and other successful microbanks in other countries that the inevitable effect of commercialization in a fragmented industry is consolidation under a few large institutions capable of collecting savings. As a result, NGOs in Nicaragua are scrambling to achieve scale which will be the defining attribute when it comes to becoming Nicaragua's dominant microbanking institution. Scale is important not only because of efficiency but also because regulated institutions must meet minimum capital requirements (capital of at least US$10 million for banks) to be able to offer the full range of financial services, particularly current accounts.

Industry Outlook

There are two regulated "financieras", FINDESA and CONFIA, which are the only for-profit microfinance institutions in the country and serve the richest clients (average loan US$1000). A financiera has lower capital requirements than banks and is able to collect savings but can not provide current accounts, which is what the poor mostly need. These two have a head start in terms of regulation but have a problem in terms of growth. Most clients in Nicaragua today (>74%) are serviced individually with information intensive techniques by NGOs. Financieras need to get a handle on the alternative techniques if they expect to gain scale. The obvious move would be to merge with an NGO, the financiera gaining client volume and know-how and the NGO gaining savings capability. CONFIA already took the lead recently when it merged with a relatively large NGO and constitutes the only merger of this kind ever accomplished in Latin America (CGAP, 2001).

NGOs control most of the clients and are grouped under an umbrella organization called ASOMIF which speaks for the industry before the government. In early 2004, ASOMIF finally succeeded in passing a law through the legislature providing exclusively for the regulation of microlenders who are not big enough to become "financieras", i.e. most NGOs. The law removes limitations on interest rates and creates a body of law especially designed for small microlenders. A minimum capital requirement level of US$200,000 has been set but microlenders under this law will not be allowed to collect savings *yet* (La Prensa, 2004). Eliminating caps on the interest rate is expected to increase profitability (although caps were already being circumvented by the charging of commissions) as a preliminary step before allowing the collection of savings. It must be clear that this law is different from the one devised for *financieras*, which have higher capital requirements and are able to collect savings already. ASOMIF is well positioned to take the lead in the next stage if it can coordinate an agreement among its members to achieve scale while the regulatory framework is becoming increasingly friendly.

In early 2004, a credit bureau began operations in Nicaragua inspired on the Bolivian system and to date has grown to include 92,000 or about 1/3 of the active market (La Prensa, 2004).

Concluding Remarks and Policy Lessons for Nicaragua

Based on the economic principles outlined at the beginning and the analysis of the experiences in Bolivia and Chile, the following points could be made about the Nicaraguan case:

- *Competition is now very intense and its negative effects on expansion must be understood and taken into account.* Competition might be easier to manage after the industry consolidates by allocating territories to different competitors to stimulate expansion. This would make external donations and government subsidies less essential for expansion purposes. However, territoriality might be difficult to enforce or impractical if too many competitors remain. In the meantime, the industry's need for donations and aid not only continues to be paramount for expansion but is now greater than ever as competition intensifies in an increasingly commercial context.

- *Government can play a vital role in the development of the industry.* Chile illustrates a smart way in which government powers can be used effectively to enhance industry expansion. By directing a temporary subsidy to the market bias against new borrowers, the government managed to incorporate a considerable portion of the population into the mainstream financial system. Banco del Estado has played an important role by strengthening the demonstration effect for private banks. According to Román (2003), there is no evidence that government ownership has hindered that bank's purely business-like approach to the industry.
- *Using the wrong techniques might hinder expansion, outreach to the poor, and profitability.* The microfinance market in Nicaragua is not saturated, especially in the rural sector and most of the services are concentrated in the richer departments of Managua and Matagalpa (Sanders and Nusselder, 2002). Still, the penetration rate is very good. Because of its precarious economic situation, Nicaragua has managed to attract substantial resources from donors and NGOs which have contributed greatly to bankarize a substantial share of the microenterprise population. But expansion can be curtailed by using the wrong techniques. There is clearly an over reliance on individual and relatively high loans that needs to be reduced by pushing group loans

more forcefully. It has been shown in Asia that group loan techniques can make operations with average loans as little as US$100 financially self-sufficient.

- *Regulators must be aware of the dangers of over-indebtedness that result from intense competition among providers and the pernicious effects of consumer credit techniques on microfinance as illustrated by the Bolivian case.* The formation of an all-inclusive credit bureau needs to be encouraged in order to enable providers to keep track of clients' overall indebtedness, and limits (as a % of salary or income) should be put in place to avoid uncoordinated credit spirals as it happened in Bolivia.
- *Create especial regulatory window (FFPs) to enhance private access with lower capital requirements than those for banks.* Nicaragua is clearly following the Bolivian model with the creation of an independent regulatory window for microfinance that was just recently passed in the legislature. The next stage would entail increasing capital requirements to the Bolivian level from US$200,000 to US$1 million and setting up appropriate leverage limits to allow private microlenders to collect savings under the FFP concept pioneered in Bolivia. US$200,000 seems low, might encourage fragmentation and end up overwhelming the regulator's capabilities. Prudence dictates this should be done once it is clear that those NGOs that have chosen to become regulated institutions are profitable since most (85%) today are not (Sanders and Nusselder, 2002). Of course, not all NGOs should be expected to become regulated and they should not be encouraged to do so once the savings function is consolidated around a few large institutions, since the outreach focus of NGOs will continue to be required for expansion. In the meantime, all efforts should be made to accommodate larger microbanks into the regulatory framework to enable

the collection of savings from the poor. Savings are not only needed to ensure sustainability but also are as important to the poor as an alternative source of finance.

- *Government subsidies can be used to entice conventional banks to enter microfinance.* Something that is striking about the microfinance industry in Nicaragua is the complete absence of private banks. Nicaragua has one the smallest and least competitive banking industries in the region which might explain why. Where foreign banks have entered the market in Latin America, local banks have been pushed downwards as competition increases for large corporate clients (Miller, 2000b). Nicaragua has failed to attract foreign banks and competition remains low; understandably banks feel little pressure to enter microfinance. In this environment, banks might need a stronger incentive to enter the market, which could be delivered in the form a subsidy to address start-up costs as it was done in Chile.
- *Releasing constraints on the interest rate makes sense given increasing competition.* But the competition might decrease as the industry consolidates calling for some kind of interest rate control, which should discriminate between standard and microfinance loans the way it was done in Chile.

The commercialization of microfinance, far from calling for a disengagement of non-profits agents like governments and NGOs, calls for the continuation and even intensification of their involvement under a renewed understanding of their roles. Otherwise, commercialisation might have the unintended effect of limiting the size of the microfinance market and the number of successful micro-capitalists.

References

Akerlof, G. (1970), "The Market for Lemons: Qualitative Uncertainty and the Market Mechanism," *Quarterly Journal of Economics,* Vol. 84, pp.488-500

Berenbach, S. and D. Guzmán (1992), "The Solidarity Group Experience Worldwide" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

BID (2003), "Apoyo del Grupo BID al Sector de la Microempresa (2000-2002)," Banco Interamericano de Desarrollo, Departamento de Desarrollo Sostenible, División de Micro, Pequena, y Mediana Empresa, Washington

Campion, A., G. Dunn, and J. Arbuckle (2002), "Creating a Microfinance Bank in Perú" in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Campion, A. and L. Valenzuela (2001), "Credit Bureaus: A Necessity for Microfinance" in *The Commercialization of Microfinance,* eds. D. Drake, and E. Rhyne, Kumarian Press, Connecticut

CGAP (2001), "Microfinance in Central America and Mexico: Profile and Challenges," Consultative Group to Assist the Poor (CGAP), Washington

Chaves, R. and C. González Vega (1994), "Principles of Regulation and Prudential Supervision and Their Relevance for Microenterprise Finance Organizations" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Christen, R. and D. Drake (2002), "Commercialization: The New Reality of Microfinance" in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Christen, R. (2000), "Comercialization and Mission Drift. The Transformation of Microfinance in Latin America," CGAP, Washington

Glosser, A. (1994), "The Creation of BancoSol in Bolivia" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Hoff, K and J. Stiglitz (1993), "Imperfect Information and Rural Credit Markets: Puzzles and Policy Perspective," in the *Economics of Rural Organization: Theory Practice and Policy,* World Bank, Washington

Holt, S. (1994), "The Village Bank Methodology: Performance and Prospects" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

IFPRI (2000), "Rural Financial Policies for Food Security of the Poor", *Policy Brief No. 6*, International Food Policy Research Institute (IFPRI), Washington

La Prensa (2004), "Microcrédito, Mas Alla de la Sobrevivencia," Article in La Prensa on February 17th, 2004, Managua

La Prensa (2004), "Microfinancieras Buscan Transparencia Gigante," Article in La Prensa on February 16th, 2004, Managua

Magill, J. (1991), "Credit Unions: A Formal-Sector Alternative for Financing Microenterprise Development" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

MBB (2002), MBB Benchmarks by Peer Group, Microbanking Bulletin (MBB), MBB Issue No. 8 November 2002

McIntosh C. and B. Wydick (2002), "Competition and Microfinance," University of California at Berkeley, Unpublished Paper

Microrate (2002), "Financiera Nicaragüense de Desarrollo, S.A.," Rating report from Microrate

Miller, T. (2004a), Personal Interview, March 22nd, IADB Office, Washington

Miller, T. (2000b), "Microfinance Lessons Learned in Latin America," IADB, Washington

MIX (2002), "Benchmarking Latin American Microfinance," A report from the Microfinance Information Exchange

Morduch, J. (2000), "The Microfinance Schism," *World Development,* Vol. 28, No. 4, April 2000

Otero, M. and M. Chu (2002), "Governance and Ownership of Microfinance Institutions" in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Otero, M (1994), "The Evolution of NGOs Toward Financial Intermediation" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Otero, M. and E. Rhyne (1994), *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Ramírez, A. (2004), Personal Interview, March 22nd, IADB Office, Washington

Reed, L. and D. Befus (1993), "Transformation Lending: Helping Microenterprises Become Small Businesses" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Rhyne, E. (2002a), "Commercialization and Crisis in Bolivian Microfinance" in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Rhyne, E. (2002b), "Microfinance Institutions in Competitive Conditions" in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Rhyne, E. and M. Otero (1992), "Financial Services for Microenterprises: Principles and Institutions" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Robinson, M. (1992), "Savings Mobilization and Microenterprise Finance: The Indonesian Experience" in *The New World of Microenterprise Finance,* eds. M. Otero and E. Rhyne, Kumarian Press, Connecticut

Román, E. (2003), "Acceso al Crédito Bancario de las Microempresas Chilenas: Lecciones de la Década de los Noventa," *CEPAL Serie Financiamiento del Desarrollo,* Santiago de Chile

Sanders, A. and H. Nusselder (2003), "El Mercado (Micro) Financiero en Nicaragua," Workshop on microfinance in Nicaragua organized by CEDLA-CDR, Ámsterdam

SIB (2002), "Cartera Vigente por Organización de Microfinanzas," Datos de la Superintendencia de Bancos y Entidades Financieras, Bolivia

Schreiner, M. (2003), “A Cost-Effectiveness Análisis of the Graneen Bank of Bangladesh,” Center for Social Development, St. Louis

Stiglitz, J. (1974), “Incentives and risk sharing in sharecropping,” *Review of Economic Studies,* 41, pp. 219-55

Stiglitz, J. (1993), “Peer Monitoring and Credit Markets,” in *The Economics of Rural Organization: Theory Practice and Policy,* World Bank, Washington

Theodore, L. and J. Loubiere (2002), “The Experience of Microfinance Institutions with Regulation and Supervision” in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Valenzuela, L. (2002), “Getting the Recipe Right: The Experience and Challenges of Commercial Bank Downscalers” in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Westley, G. (2001), “¿Pueden las Políticas de los Mercados Financieros Reducir la Desigualdad del Ingreso?,” *Serie de Informes de Buenas Prácticas del Departamento de Desarrollo Sostenible*, IADB, Washington

White, V. and A. Campion (2002), “Transformation: Journey from NGO to Regulated MFI” in *The Commercialization of Microfinance,* eds. D. Drake and E. Rhyne, Kumarian Press, Connecticut

Yunus, Muhammad (2003*), Banker to the Poor,* Aurum Press, London

Zúñiga, Sergio (2003), “Caso de Estudio: Microcrédito como Herramienta de Desarrollo Regional,” II Encuentro de Microfinanzas, Santa Cruz, Bolivia