Microfinance:
From Village to Wall Street

Tor Jansson

Inter-American Development Bank

Sustainable Development Department

Micro, Small and Medium Enterprise Division

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Washington, D. C.

Sustainable Development Department
Best Practice Series

Cataloging-in-Publication provided by the
Inter-American Development Bank
Felipe Herrera Library

Jansson, Tor.

Microfinance : from village to Wall Street / Tor Jansson.
p.cm. (Sustainable Development Department Best practices series ; MSM-113)

1. Microfinance--Latin America. 2. Capital markets--Latin America. 3. Microfinance-- Law and legislation--Latin America. 4. Banks and banking--State supervision--Latin America. I. Inter-American Development Bank. Sustainable Development Dept. Micro, Small and Medium Enterprise Division. II. Title. III. Series.

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The views and opinions expressed herein are those of the author and do not necessarily represent the official position of the Inter-American Development Bank.

November 2001

This publication (Reference No. MSM-113) can be obtained through:

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Foreword

This paper presents a synopsis of the current state of the microfinance industry in Latin America. It provides a rough assessment of the achievement and outreach of the industry; it offers revealing information on the financial performance of 20 microfinance institutions; and it outlines some of the major issues currently facing the industry. The underlying theme of the paper is the microfinance industry's gradual integration into established markets and structures, specifically as it relates to financial regulation and supervision and the industry's access to financial and capital markets.

The paper is written for people with a reasonable amount of financial literacy, but with limited knowledge of microfinance per se. However, even seasoned experts may find some parts of the paper interesting, particularly a section comparing the performance of microfinance institutions in Bolivia, Colombia and Peru to that of commercial banks. The reader will notice that microfinance institutions in those countries appear to defy the conventional wisdom, which says that they are particularly vulnerable to a deteriorating economic environment.

Finally, it is worth pointing out that the content and structure of the paper is partly a function of the fact that it builds on a chapter that was incorporated into the Bank's yearly publication *Economic and Social Progress in Latin America*. The most significant change compared to that version is a more extended treatment of two of the three topics mentioned previously: the performance of microfinance institutions and the access of these institutions to commercial sources of financing. New data and discussion have been added to these sections to provide for a more nuanced analysis of the current state of affairs and the challenges ahead.

Alvaro R. Ramirez
Chief, Micro, Small and Medium Enterprise Division

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The State of Microfinance in Latin America

Microfinance: An Emerging Industry

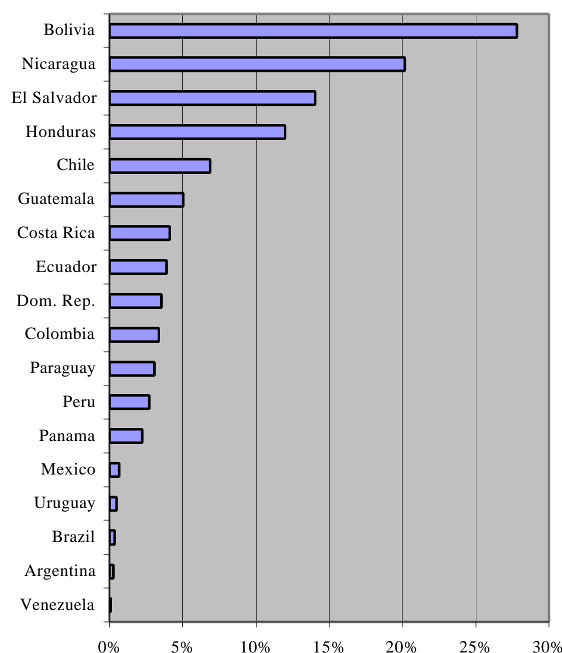
It started out small and simple. In villages and towns around Latin America and the Caribbean, poor people had to find ways to compensate for the lack of financial services from commercial banks in their areas. In some cases they created informal groups among friends and neighbors where borrowers and lenders took turns; in other cases they relied on the flexible but exorbitant terms offered by the local moneylender; in yet other cases they sought out a local credit union or nonprofit organization providing basic financial services.

Given poor people's lack of assets, the organizations providing credit to them had to rely on measures other than collateral to assess credit worthiness and encourage repayment.[1] As a result, they would typically only lend for entrepreneurial activities and base the lending decision on a careful analysis of the person's character and the business' cash flow. As part of this process, they would interview the applicant's family, neighbors and business contacts, and reward good clients with larger loans at lower rates.

Over time, some nonprofit institutions became very good at this activity and started to grow rapidly. During the 1990s, their growth has continued and in many cases accelerated. Today, organizations providing financial services to low-income entrepreneurs (so-called microfinance institutions, MFIs) constitute an undeniable element of Latin American and Caribbean financial markets. Together, they serve more than 1.5 million small and mostly poor entrepreneurs (see Figure 1) throughout the region. If the microenterprise lending of credit unions—which serve low as well as middle class clients for both consumer and business purposes—are added to the total, an impressive 3 million microentrepreneurs receive their financial services through microfinance institutions.

The early success of nonprofit grassroots organizations in serving this sector has led to two important developments. First, commercial banks, realizing that there might be a profit to be made in microfinance, are starting to pay serious attention to how they can serve this segment of the market. Second, between grassroots nonprofit organizations and profit-driven commercial banks, there is an emerging breed of profes-

Figure 1: Share of Microenterprises With Credit From an MFI



Source: Glenn Westley. 2001. Can Financial Market Policies Reduce Income Inequality?, IDB Occasional Paper
Note: Data for total microenterprises is from 1999 or 1998 (except in the case of Peru where it is from 1997); data for microenterprises with MFI credit is from 1999. The data does not include credit unions.

[1] Given the difficulties in executing on collateral in most Latin American countries, any collateral offered by low-income entrepreneurs is virtually worthless to the lenders. See Hernando de Soto (2001) for an in-depth discussion of the difficulties in representing and using capital, including collateral, in many developing countries.

sional financial institutions that specialize in microfinance. These are former nonprofit organizations that have requested and received a license to operate as regulated and supervised finance companies or banks. There are about 35 these "reconstituted" institutions in Latin America today.

As a result of the increasing professionalization and commercialization of microfinance in Latin America, the field of microfinance, once dominated by small non-profit organizations, is now lead by formal financial intermediaries. These institutions—downscaling banks and specialized financial intermediaries—today serve as many clients and provide three times as much credit as the non-profit organizations (Christen 2000).

Although many Latin American microentrepreneurs are still without access to financial services, the group as a whole is served by an increasing number of different financial institutions, ranging from very small nonprofit organizations to very large and diversified commercial banks. The institutions differ in many ways, including their legal form, strategy, clients, services, and sources of funding, but they all contribute to serving the region's microentrepreneurs with much needed financial services (see Table 1).

The target market is not all that these institutions have in common. Information on microfinance institutions during the past 3 to 4 years has demonstrated that they also share another trait: the potential for great financial returns. If well run, microfinance institutions can generate returns that make most commercial banks green with envy. In fact, microfinance institutions are at the forefront of proving the age-old adage that doing good and doing well are not necessarily mutually exclusive.

Table 1: Typology of Institutions Serving the Microenterprise Sector

	MULTIPURPOSE FINANCIAL INSTITUTIONS	SPECIALIZED FINANCIAL INSTITUTIONS	SPECIALIZED NON-GOVERNMENTAL ORGANIZATIONS	GENERAL NON-GOVERNMENTAL ORGANIZATIONS
PURPOSE OF MICROFINANCE ACTIVITIES	New market Image Philanthropy	Social impact Profitability	Social impact Sustainability and growth	Social impact Sustainability
LEGAL FORM	Banks, finance companies and cooperatives	Banks and finance companies	Foundations Associations	Foundations Associations
CLIENTS	Various; micro-enterprises are small share of portfolio	Small and microenterprises	Microenterprises	Microenterprises
SERVICES	Various and targeted to the specific market segment. Individual credit. Savings.	Individual credit, group loans. Limited offerings of leasing, factoring etc. Savings.	Individual credit Solidarity loans Village banking	Individual credit Solidarity loans Village banking
SOURCES OF FUNDING	Savings Shares Bonds Commercial loans	Commercial loans Shares Savings	Commercial and soft loans Guarantees Donations	Donations Soft loans Guarantees
EXAMPLES	Banco del Comercio (Costa Rica) Banco Solidario (Ecuador) MultiCredit Bank (Panama)	Fin. Calpia (El Salv.) Caja los Andes (Bol.) CMAC Arequipa (Peru) FinSol (Honduras) Fin. Vision (Paraguay) Ademi (Dom. Rep)	WWB Cali, Bogota, Popayan, Medellin, Bucaramanga (Colombia) F.E.D (Ecuador) Adopem (Dom. Rep)	Fundasol (Uruguay) Fundacion Carvajal (Colombia)

Source: Adapted from Tipología de Instituciones Financieras para la Microempresa en América Latina y el Caribe, Fernando Lucano and Miguel Taborga, IDB 1998

Emphasis on Growth, Efficiency and Profitability

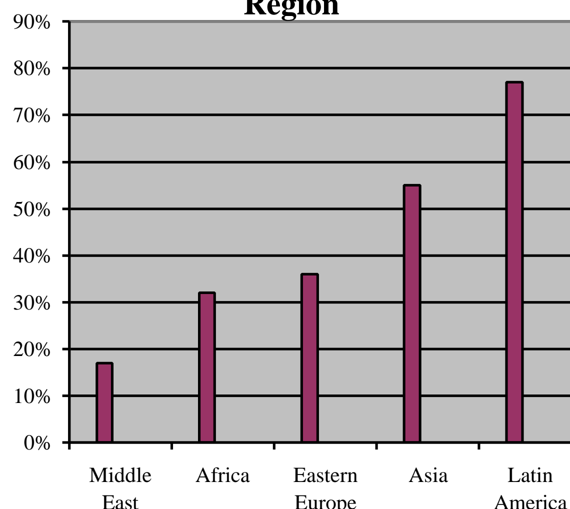
In a regional perspective, Latin America is clearly leading the way in transforming microfinance from a subsistence activity to a profitable business. In no other region of the world are there as many financially sustainable microfinance institutions (see Figure 2). For a long time, the conventional wisdom held that microfinance could not possibly be a sustainable, much less profitable, business. However, microfinance institutions in Latin America are in the process of disproving this particular piece of conventional wisdom.

Not only are many Latin American microfinance institutions sustainable, but in several cases they are also very profitable. In Bolivia and Peru, which have the most developed microfinance market in Latin America, the most profitable financial institutions during 1999 and 2000 were not traditional commercial banks, but transformed microfinance institutions.

Microfinance institutions in other countries are following suit, proving that poverty alleviation can be combined with good business practices. Colombia, El Salvador and Dominican Republic are all examples of countries with very strong and successful microfinance institutions, some that have become licensed and supervised, others that have remained as nonprofit foundations (see Table 2).

While the general trend is very promising, microfinance instututitons do of course experience ups and downs. BancoSol, for example, which is the largest and most well-known microfinance

Figure 2: Percentage of Financially Sustainable MFIs by Region



Source: The MicroBanking Bulletin, September 2000. Data based on a sample of 114 microfinance institutions worldwide.

Interpretation: In Latin America, 77% of the MFIs reporting to the MicroBanking Bulletin are financially sustainable; in Asia, 54% of reporting MFIs are financially sustainable (etc.).

Table 2: Financial Performance of Selected Microfinance Institutions, 2000

	BancoSol	WWB Popayan	Financiera Calpia	CMAC Tacna
Country	Bolivia	Colombia	El Salvador	Peru
Institutional Form	Bank	Non-profit foundation	Finance Company	Fin. institution owned by municipality
Portfolio (US$ thousand)	77,700	6,400	38,500	8,400
Portfolio Growth (1999-2000)	-5.4%	40.9%	25.9%	38.4%
Active Clients	60,976	22,663	35,910	12,978*
Avg. Loan Balance	$1,274	$281	$822	$1,187
Return on Assets	1%	21%	3%	6%
Return on Equity	4%	28%	13%	38%
Portfolio Yield	28%	51%	31%	43%
Debt/Equity	5.3	0.36	3.53	5.6
Operating expenses / assets	12.5%	11.9%	13.6%	9.3%
Loans > 1 day past due	12%	1%	6%	6%

Source: MicroRate, www.microrate.com
*Number of loans outstanding

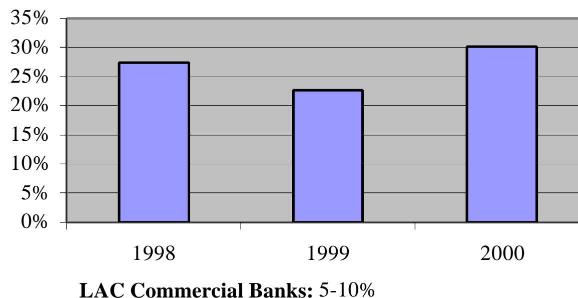
institution in the region, is currently going through tough times. In 2000, it saw its portfolio contract by 5% and eked out a modest return on assets of 1%.

As the microfinance industry has grown and matured, donors and investors have become more concerned with measuring the financial performance of these institutions. Donors want to make sure their assistance is creating sustainable institutions, while investors want to see if the institutions offer real investment opportunities. As a result of this demand for objective and reliable information, a limited number of firms have sprung up to provide specialized assessment services of microfinance institutions. The most prominent of these firms are MicroRate, which focuses on Latin America, PlaNet Finance, which focuses on Africa, and M-CRIL, which focuses on Asia. In addition to their role as assessors, these firms also serve an important role in gathering and synthesizing information on the industry as a whole.

The information provided by these assessment firms shows that microfinance is more than sustainable—in many cases it is also highly profitable. A sample of 20 leading Latin American microfinance institutions[2] indicates that they are rapidly expanding their reach *and* achieving impressive financial returns.

First, in terms of growth, these microfinance institutions have easily outpaced commercial banks by registering growth rates above 20 percent since 1998. After a slowdown in 1999, the growth rate picked up again in 2000, exceeding the rate achieved in 1998. Undoubtedly, this rapid growth rate is another factor in explaining the high levels of profitability of microfinance institutions.

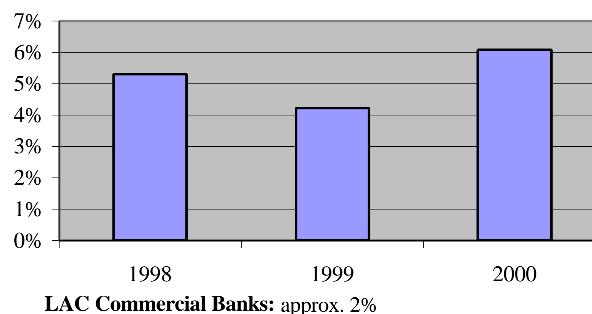
Figure 3: Portfolio Growth, 20 MFIs



LAC Commercial Banks: 5-10%

Second, looking at return on assets, the group of microfinance institutions also put commercial banks to shame. Over the past three years, the group has achieved a return on assets of 4 to 6 percent, well above the typical return achieved by commercial banks in Latin America (see Figure 4). Even in 1999, a year characterized by economic and financial troubles in the region, the return on assets remained above 4 percent.

Figure 4: Return on Assets, 20 MFIs



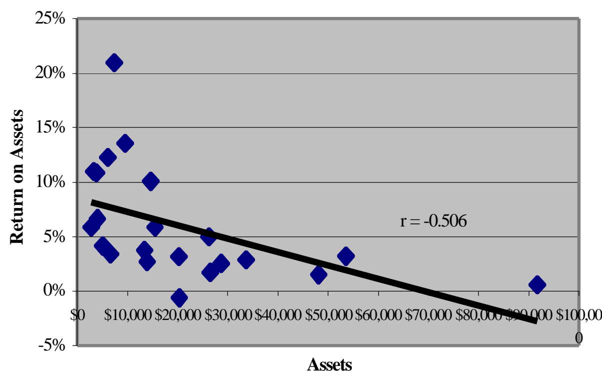
LAC Commercial Banks: approx. 2%

Although the presence of economies of scale in financial services is well established, this does not necessarily mean that small institutions are less profitable. In fact, the same sample of Latin American microfinance institutions shows that smaller institutions are more profitable than larger ones, at least as of December 2000 (see Figure 5). At the same time, smaller institutions do tend to have lower levels of efficiency (defined as administrative expenses as a percentage

[2] Caja los Andes (Bolivia), BancoSol (Bolivia), Fie (Bolivia), Finamerica (Colombia), WWB Bogota (Colombia), WWB Bucaramanga (Colombia), WWB Cali (Colombia), Wwb Medellin (Colombia), WWB Popayan (Colombia), Adopem (Dominican Republic), Financiera Calpia (El Salvador), Finde (Nicaragua), Financiera Vision (Paraguay), CMAC Arequipa (Peru), CMAC Ica (Peru), CMAC Sullana (Peru), CMAC Tacna (Peru), CMAC Trujillo (Peru), Crear Arequipa (Peru), Crear Tacna (Peru). As these are some of the largest and best-performing MFIs in the region, this is not necessarily a random or representative sample. However, it is the set of MFIs for which information is available.

of assets). Apparently, what small institutions lack in efficiency, they make up for in higher interest rates. Presumably, they operate in unsaturated markets where clients have less access to financial services from other providers. This allows the smaller MFIs to charge interest rates that not only guarantee their sustainability, but also allow for future growth.

Figure 5: Size and Profitability, 20 MFIs

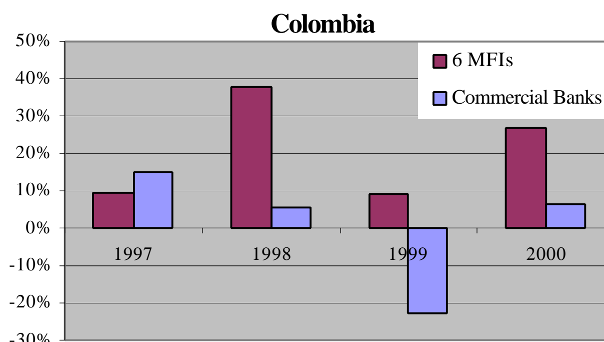


MFIs Battling Economic Recession in Bolivia, Colombia and Peru

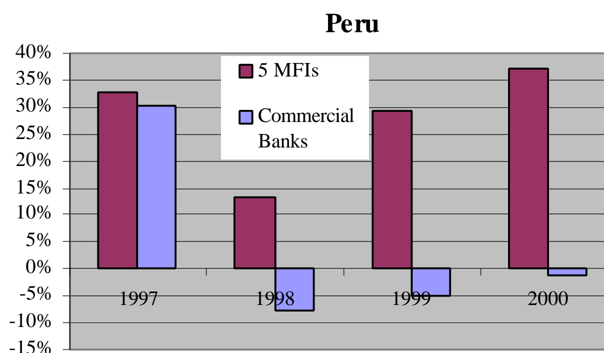
It is certainly reassuring to note that MFIs seem to stack up well against commercial banks on a general region–wide basis. However, a question that has haunted researchers and practitioners of microfinance for the past years is what happens in time of recession. Can MFIs, which lend to poor people without collateral, weather a downturn in the economy, or will they buckle under the pressure of defaulting clients? A closer look at microfinance institutions in the Andean countries of Colombia, Bolivia and Peru (three well-developed microfinance markets) offers some interesting insights in this regard[3].

All three countries suffered severe economic slowdowns in the late 1990s. The initial catalyst of the slowdowns occurred in mid-1997, when financial markets imploded in many parts of Asia. The swell of the Asian financial crisis reached the shores of Latin America in 1998 and 1999. While large countries like Argentina, Brazil and Mexico grabbed the headlines, Bolivia, Colombia, and Peru were equally or more severely affected. In these countries, other factors also added to the repercussions of the Asian cri-

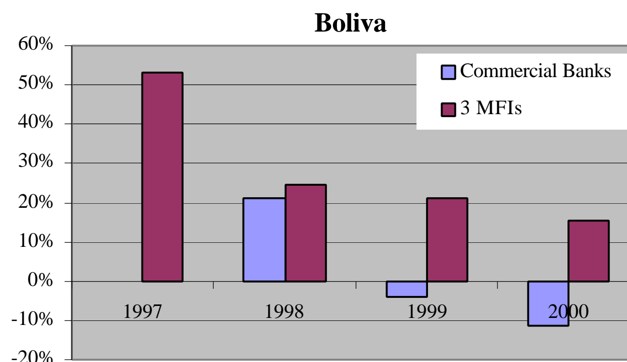
Figure 6: Portfolio Growth (US$)



Source: MicroRate; Colombian Banking Superintendency



Source: MicroRate; Peruvian Banking Superintendency



Source: MicroRate; Bolivian Banking Superintendency

[3] **Bolivia:** BancoSol, Caja los Andes, FIE; **Colombia:** WWB Bucaramanga, WWB Medellin, WWB Bogota, WWB Cali, WWB Popayan, Finamerica; **Peru:** CMAC Arequipa, CMAC Trujillo, CMAC Sullana, CMAC Ica, CMAC Tacna.

sis: civil war in Colombia; the “el Niño” weather phenomenon in Peru; and the crackdown on coca production in Bolivia.

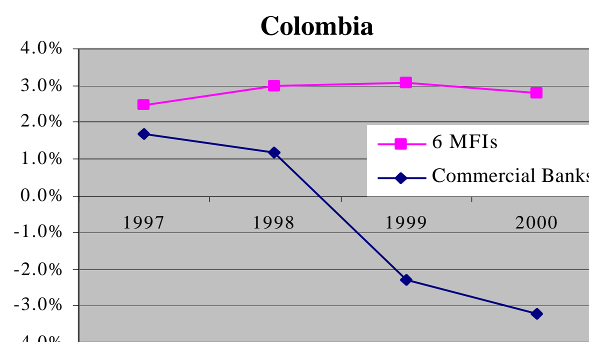
The economic slowdown in these countries quickly showed up in the financial statements of commercial banks: loan portfolio growth stagnated, profitability fell, and loan delinquencies began to rise. Before long, the countries’ bank supervisors had to work overtime to deal with the growing number of failing institutions. Microfinance institutions were not immune to the economic malaise, but in most cases the industry leaders held up as well—or better—than their more established counterparts in the commercial banking sector.

In terms of growth, microfinance institutions in all three countries outperformed commercial banks in every single year since 1997 (see graph). After tough times in 1998 and 1999, portfolio growth for microfinance institutions picked up markedly in 2000, reaching 47.9 percent in Peru and 26.8 percent in Colombia, perhaps indicating that the worst was over for microfinance institutions in those countries. At the same time, commercial banks continued to languish, posting anemic growth rates, followed by a slight improvement in 2000. Though the Bolivian microfinance institutions outperformed their country’s commercial banking sector as a whole every year, the trend has been toward slower growth rates. This trend is due in part to Bolivia’s economic slowdown but also to the fact that the Bolivian market is reaching greater maturity and market penetration (von Stauffenberg 2001).

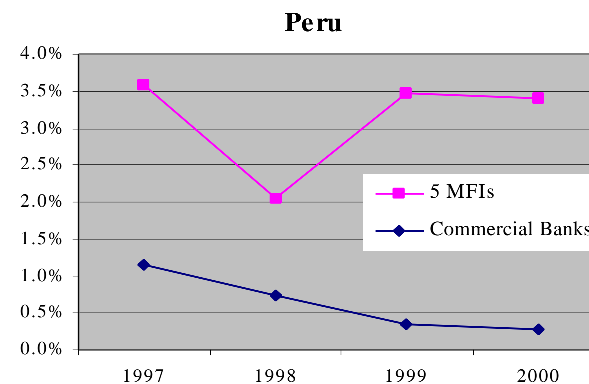
Amid the economic slowdown, commercial banks saw their profits plunge and, while Bolivian and Peruvian banks ultimately managed to hang on to break-even returns, Colombian banks experienced a virtual free fall. This abysmal performance looks even worse when the banks are compared to microfinance institutions. While these institutions certainly saw their profits affected by the tough economic climate, they still managed to maintain healthy returns thoughout the period.

MFIs also largely outperformed commercial banks in terms of portfolio quality. In Colombia, loan delinquency rates stayed at low levels near 3 percent for microfinance institutions throughout the 1997-2000 period, but rose to double digits for commercial banks. In Peru, remarkably, microfinance institutions had worse delinquency rates than commercial banks until economic conditions had worsened to the point of

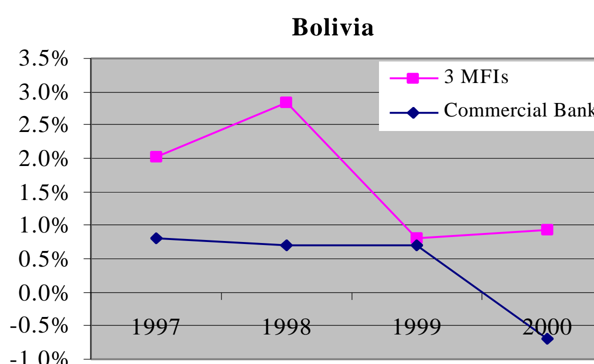
Figure 7: Return on Assets



Source: MicroRate; Colombian Banking Superintendency



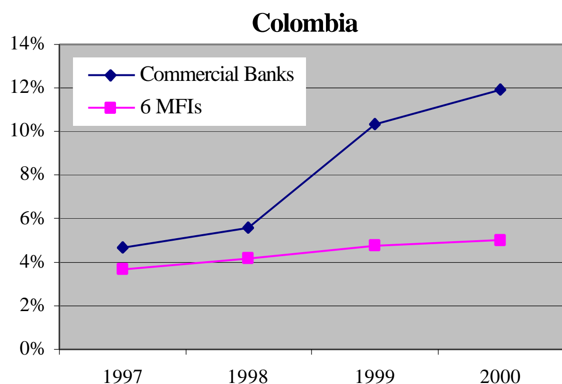
Source: MicroRate; Peruvian Banking Superintendency



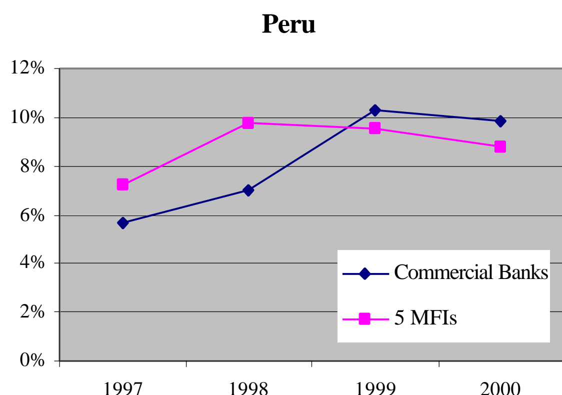
Source: MicroRate; Bolivian Banking Superintendency

actual recession in 1999. After then, MFI delinquency rates were better than those of commercial banks'. In Bolivia, MFIs outperformed commercial banks in every year except 1999.

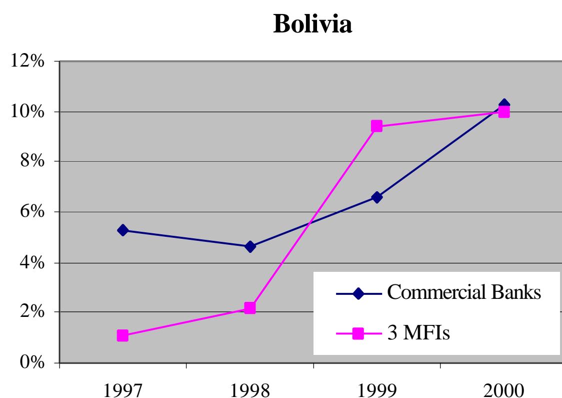
Figure 8: Loan Delinquency (>30 days)



Source: MicroRate; Colombian Banking Superintendency



Source: MicroRate; Peruvian Banking Superintendency



Source: MicroRate; Bolivian Banking Superintendency

In sum, Latin American microfinance institutions have been remarkably resilient amid the recent economic slowdown, largely outperforming commercial banks in their respective countries. In Colombia, Bolivia and Peru microfinance institutions clearly outpaced banks in terms of growth and profitability and, while the difference is less striking, also put banks to shame in terms of portfolio quality.

What makes MFIs resistant to recession? It may be precarious to generalize from 14 MFIs, but certain patterns are evident.

- Close ties to and knowledge of borrowers and local markets.
- Solid screening and incentive mechanisms to identify and encourage good clients.
- Strong ownership structure, with owners who have financial resources and sufficient investment to closely monitor the MFI.

Microfinance institutions also seem to benefit from two other factors: First, microentrepreneurs generally have strong repayment ethics, perhaps because of a desire to prove themselves as well as fewer alternative sources of financing. Second, during economic recession, consumers tend to go down-market to cheaper and simpler goods, many of which are produced by microenterprises. For these reasons, microfinance institutions may enjoy some insulation from economic conditions that leave other financial institutions reeling (Robinson 2001).

The growth and financial success of Latin American microfinance institutions has led many to seek licensing as supervised financial intermediaries. For them, this is often seen as the natural step towards greater outreach and long-term sustainability, as well as a way to begin offering savings services. In many countries, however, the existing framework of financial regulation poses quite a challenge to financial entities that want to offer microfinance services.

Getting the Regulatory Framework Right

Motivations for Regulatory Reform

When in 1992 the Bolivian supervisory authorities granted a bank license to a small non-profit microfinance organization, they started a process that would transform the Latin American microfinance industry. The nonprofit foundation, Prodem, reconstituted itself as a commercial bank, taking the name BancoSol. For the next five years, Bolivian authorities struggled to adapt the regulatory framework and supervisory practices to effectively monitor and address the particular challenges arising from the unique activities of this new and unusual institution. In 1995, as a result of the experience with BancoSol, the Bolivian authorities took another significant step in the regulation and supervision of microfinance. This time they created a new form of financial institution, the Private Financial Fund (PFF), which could accommodate nonprofit institutions prepared to offer microfinance services in a regulated and supervised setting.

These events, coupled with similar action by Peruvian authorities who in 1995 also created a new institutional form for microfinance (the so-called EDPYME), started an important trend in Latin America: the reform of financial laws, regulations, and norms to accommodate microfinance. Since then, other countries (including Dominican Republic, El Salvador, Mexico and Brazil) have followed suit with modifications of their own.

The reason for undertaking these reforms can be found in one trend and one imperative. The trend: the increasing number of large nonprofit foundations (typically with tens of thousands of clients) who want to mobilize deposits and term financing from the public to grow their lending activities. The imperative: the supervisory authorities' obligation to regulate and supervise institutions that engage in these activities.

But does microfinance require special prudential regulations to thrive? Do existing frameworks really need to be changed? If so, what changes are needed? The answers lie in the distinctive features of microfinance; that is, the ways in which it differs from conventional banking.

Distinctive Features of Microfinance

First, the ownership structure of specialized microfinance institutions is distinct from that of conventional financial institutions (commercial banks and finance companies). Conventional financial institutions have profit-minded shareholders with deep pockets who can offer additional capital in a time of crisis and who constantly push for high performance and returns. In contrast, a specialized microfinance institution is usually majority owned by the non-governmental foundation from which it was formed. Typically, this nonprofit cannot always provide significant financial support at a time of crisis, and since social purpose rather than profit motivates it, efficiency and profitability might not be its primary aims.

Second, the clients of specialized microfinance institutions are different from those of conventional financial institutions. Typically, they are low-income entrepreneurs with rudimentary family businesses, little or no collateral and limited formal documentation. As such, they are usually regarded as high-risk borrowers.

Third, the credit products of specialized microfinance institutions are distinct from those of conventional financial institutions. Loans are typically smaller and shorter term and carry a higher interest rate. As a result, the loan portfolio of microfinance institutions has a unique risk profile: it is more atomized, which decreases risk, but it is uncollateralized, which increases risk. It also tends to be more geographically concentrated.

Fourth, the lending methodology of microfinance is different from conventional lending. Character and cash flow analysis plays greater roles, while the use of collateral and formal documentation play lesser roles. Loans are in many cases repaid in weekly or biweekly installments, rather than monthly. This methodology is appropriate for the clients of microfinance institutions, but it results in high operating expenses. Operating expenses (relative to assets) of specialized microfinance institutions are generally at least 60 percent higher than for commercial banks (Jansson and Taborga 2000).

For all the reasons mentioned, microfinance institutions have a unique risk profile and supervisory authorities may regard them cautiously. The institutions are characterized by high operating costs covered by high interest rates generated from a large number of short-term, uncollateralized, and geographically concentrated loans—not an encouraging profile from a bank supervisor's perspective. Not only can loan delinquency rapidly get out of control if management is lax in monitoring the portfolio, but since operating expenses are high and loans are not backed by collateral, a nonperforming portfolio will have an immediate and drastic impact on the institution's bottom line.

Given the distinctive features and risk profile of microfinance, some regulatory and supervisory practices have to be adjusted to control risk and protect depositors in microfinance institutions. Creating a reasonable regulatory framework is not impossible, but neither is it simple. Exactly what needs to be done depends on the nature and characteristics of the existing framework, so every country is to some extent unique. However, it is possible to discern some general principles.

Step 1: Define What Needs to Regulated

The first step in creating an appropriate regulatory framework for microfinance is to define the objects of new or modified "microfinance regulation." In other words, exactly *what* are supervisory authorities supposed to regulate? In essence, there are two possible objects of regulation: the activity and the institution. To adequately address the distinctive risk profile of microfinance, regulations have to cover both objects.

Regulations relating to documentation guidelines, guarantee requirements, and loan loss provisions are all based on the type of activity performed by financial institutions for example consumer, commercial or mortgage lending. Mi-

Table 3: Distinctive Features of Microfinance

Category	Conventional Credit	Microcredit
Ownership and Governance	Profit maximizing institutional and individual shareholders	Downscaling bank or Upgraded NGO In the latter case, shareholders are mainly nonprofit institutional shareholders
Client Characteristics	Diverse formal businesses and salaried individuals. Geographically dispersed clients.	Low-income entrepreneurs with rudimentary family businesses and limited formal documentation. Located in specific geographic area.
Product characteristic	Larger amount Longer term Lower interest rate	Smaller amount Shorter term Higher interest rate
Lending Methodology	Collateral and formal documentation Monthly repayment	Character and cash flow analysis through on-site inspections Weekly or bi-weekly repayment

Source: Created by author, using information in Rock and Otero (1996)

croenterprise loans do not fit neatly into any of these categories, so before any regulations can be proposed, the activity of microcredit needs to be defined.

In many countries, the task of adopting a single definition of microcredit is complicated by the fact that governments, through various agencies and ministries, recognize several different definitions of microcredit and microenterprises simultaneously. To the extent that supervisory authorities have dealt with the issue, they typically define microcredit by the characteristics of the loan (as in Bolivia, where business loans below $20,000 are considered microcredits for most purposes), or by the characteristics of the client (as in Peru, where loans for productive purposes to clients with less than $20,000 in assets are considered microcredits). The first approach has the advantages of simplicity, clarity and enforceability, but it may inadvertently include a fair number of loans that are not really for microenterprises. The second approach clearly defines the target group, but it may be difficult for supervisory authorities to verify that loans classified as microcredits actually went to microentrepreneurs.

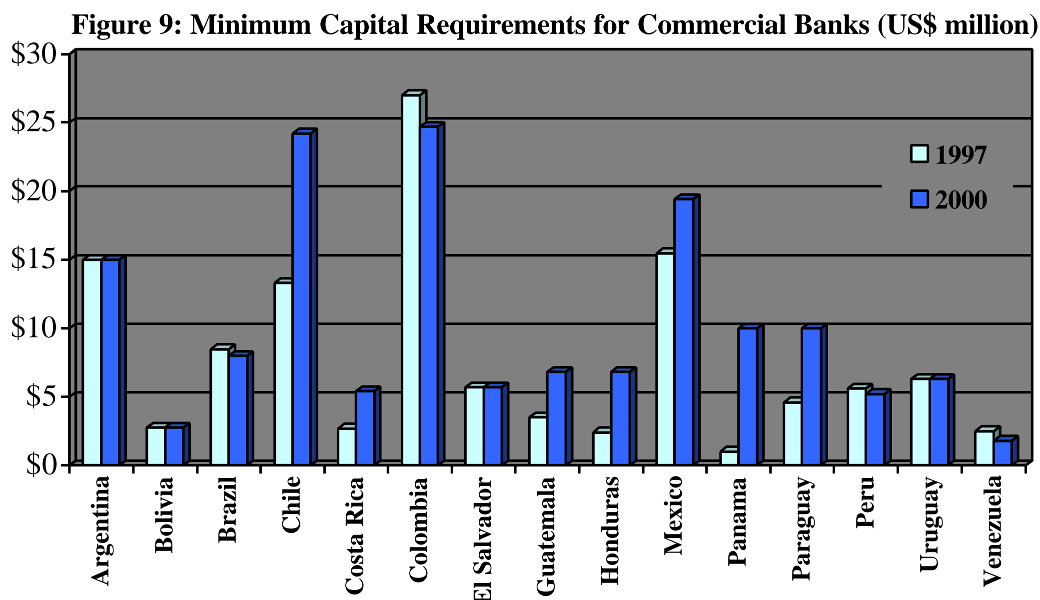
But defining the *activity* is not enough, since much of financial regulation is based on the *institution*. For example, although commercial banks are allowed to offer a virtually unlimited range of services and products to the public, finance companies are restricted in several important ways (e.g., no checking accounts and, in most Latin American countries, no savings accounts). Also, different institutional forms often have different minimum capital requirements and, in some cases, capital adequacy standards. In order to achieve a comprehensive regulatory framework for microfinance, the regulatory framework has to offer an institutional form (existing or new) through which microfinance services can be offered in a reasonably efficient and sustainable manner.

Currently, Latin American microfinance NGOs that wish to become regulated entities often times face a very unattractive choice: they can either seek a license as a commercial bank, which involves demanding entry standards (for example, initial capital requirements, which have increased about 45 percent in the region since 1997), or as a finance company, which may not permit deposit-taking. For microfinance institutions, where the permission to capture savings goes to the fundamental reason for becoming a regulated financial entity, this restriction can be a critical obstacle.

Step 2: Use the Definition of Microcredit to Tailor Regulations

Once a definition of microcredit is adopted, supervisory authorities can use it to enact various

Figure 9: Minimum Capital Requirements for Commercial Banks (US$ million)



regulatory modifications that will accommodate microfinance in a responsible manner. For example, if there are interest rate restrictions in the country, microcredit may be exempted. Given the high cost of the microcredit methodology, microfinance institutions are particularly vulnerable to such interest rate restrictions. Interest rate caps will also cause commercial banks to restrict lending to low-income clients since the amounts are small (which makes it costly relative to the amount lent) and the borrowers are typically considered "high risk." The definition of microcredit also allows the superintendent to tailor guarantee, loan documentation and loan loss provision requirements to account for the distinctive features of microlending.

Some Latin American countries have implemented special rules for loans below a certain size. These modifications allow microfinance institutions *and* traditional commercial banks to apply an appropriate credit methodology and lower operational costs. At the same time, they enable supervisory authorities to monitor the risk of these institutions' activities.

Supervisory authorities in Bolivia, Brazil, El Salvador and Peru have addressed the institutional side of microfinance regulation by establishing new institutional forms entirely or partly for the purpose of microfinance. This allows microfinance NGOs to reconstitute themselves as licensed and supervised intermediaries with relative ease. However, such a step does not automatically entail permission to mobilize deposits. Most superintendencies prefer that new institutions take a slow approach to accepting deposits since it requires more sophisticated management of liquidity and other functions. In Peru, for example, it only takes $245,000 in capital to constitute an EDPYME, but the institution needs $1 million in capital and good risk ratings for two years to qualify to capture deposits. Even then, the permission to take deposits remains at the discretion of the superintendency; so far, no EDPYME has been cleared for this activity (Sotomayor 2001).

In the case of Bolivia, with arguably the region's most advanced regulatory framework for microfinance in the region, the government created an institutional form (the PFF) that is broad enough to allow such entities to undertake microfinance as well as operations typically performed by traditional finance companies. PFFs are able to accept savings deposits (subject to a special review and clearance by supervisory authorities), offer a number of other financial services and use chattel, such as jewelry, as collateral for loans.

The PFF's relatively broad range of permitted operations, coupled with a reasonable minimum capital requirement of about US$830,000, eliminates the need to create a new, separate entity specifically and only for microfinance (of the seven PFF's in Bolivia, five specialize in microfinance). This arrangement prevents a proliferation of institutional forms, such as has occurred in Peru, and greatly eases the work of supervisory authorities. Consequently, supervisory authorities should first consider making some reasonable modifications to an existing institutional form, before creating an entirely new one.

It is important to underscore that the purpose of modifying regulations for microfinance is not

Box 1: Simplified Documentation Requirements in Bolivia

In Bolivia there are special guidelines for evaluating individuals who will borrow the equivalent of US$20,000 or less. For wage earners, financial institutions may use their salary as the sole indicator of repayment capacity. In the case where a fixed salary is not the principal source of income, the financial institution has to consider the assets, debts, and cash flow of the applicant's "socioeconomic unit" (i.e. business and/or household). However, when loan terms do not vary from those of previous loans and the borrower has a good repayment record, the financial institution is permitted to forego a new evaluation of the borrower's payment capacity. These rules allow financial institutions to streamline lending operations to repeat clients, something particularly important to MFIs which have thousands of them.

Source: Resolution SB No. 062/94, Art. 11, 1994

simply to exempt this activity from critical review by supervisory authorities. In some cases, standards should be made stricter to counter the particular risk profile of microfinance. In essence, the modifications are intended to eliminate requirements that raise the cost of microfinance without offering better control of risk, and to introduce new measures and standards that will enable better control of risk without raising costs. Given the already high cost of credit delivery, microfinance can ill afford regulation that unjustifiably raises the cost of financial services to low-income entrepreneurs even further.

Step 3: Don't Forget About Supervision and Credit Bureaus

Although the regulatory framework is important, it is only half the story. The other half is supervision. Just because the supervisory authorities may have been able to design an appropriate regulatory framework for microfinance does not necessarily mean that they can effectively supervise the entities involved. Microfinance supervision spans a range of challenges, from budgetary considerations to the organizational structure of the superintendency and special training for analysts and inspectors.

In terms of budgetary implications, the inclusion of MFIs among supervised intermediaries is likely to significantly raise the cost of supervision to the authorities. Many supervisory authorities have tight budgets and are reluctant to further stretch already scarce resources. To most supervisors it is clear that their priorities must lie with large institutions whose failure can threaten the stability of the financial system.

A way to get around this problem is to let MFIs pay for their own supervision. In most Latin American countries, all financial institutions do in fact contribute all or part of the supervisory authorities' budget. MFIs should be treated no differently. However, supervision will not come cheap to the MFIs. For a medium sized MFI (10,000 clients), estimates place the cost for the supervisory authority at 1-5 percent of assets and another 1-5 percent of assets for the MFI in implicit compliance costs (Christen and Rosenberg 2000). These costs, particularly the compliance costs, tend to decrease over time.

One of the more important changes needed involves the credit bureaus that supervisory authorities and private financial entities use to track borrowers' repayment histories. These credit bureaus, which also help determine the

Table 4: Institutional Forms for Microfinance

	Bolivia	Peru	El Salvador	Brazil
Name:	Private Financial Fund, (FFP)	EDPYME	Savings and Credit Company	Microenterprise Credit Company
Year Created:	1995	1995	2000	1999
Minimum Capital:	US$828,000	US$245,000	US$2.86 million	US$60,000
Number of Inst:	6 (4 microfin. inst)	9	0	5 + 3 pending
Capital Adequacy:	10%	9.09%	12% (same as banks)	5 x liquid assets
Checking:	No	No	No	No
Savings Deposits:	Yes	Yes, if $1 million in capital + rating	Yes	No
Max. Loan Size: (% of capital or US$)	3% secured ($30,000) 1% unsecured ($10,000)	5% ($12,225)	2.5% indiv. ($71,500) 10% inst. ($286,000)	$6,000
Restricted Operations:	Trusts, foreign trade, equities, mutual funds underwriting,	Depends on capital and maturity	Foreign investments, majority stakes in other companies	Restricted to lending to microenterprises.
Supervision:	Bank Superintend.	Bank Superintend.	Bank Superintend.	Central Bank
Complementary Regulations:	Simplified loan analysis and provision reqs.	Simplified loan analysis and provision reqs.	N/a	Simplified requirements and flexible collateral

Source: Interviews with Central Banks and Bank Superintendencies of Bolivia, El Salvador, Brazil and Peru. Resolución SBS No. 259-95, Peru. Decreto Supremo 24,000, Bolivia.

overall risk of the financial system, typically only register loans over a certain size (minimum of $1,000 to 10,000 in several Latin American countries). Clearly, these limits mean that many microenterprise loans are not registered and therefore never show up on the radar screen of supervisory authorities. Also, they prevent microentrepreneurs from establishing widely recognized credit histories that can compensate for their lack of physical collateral.

Supervisory authorities in Peru and Bolivia have made efforts to include all loans in the credit bureaus. In Peru, the Superintendency of Banking and Insurance tracks every loan worth more than one sol, or about 30 U.S. cents, in its credit bureau. Similarly, in Bolivia, the credit bureau provides quick responses and free consultations on all debts of more than one Bolivian peso, or about 20 U.S. cents. To accurately gauge the risk of any borrower, both systems attempt to identify the indebtedness of a client across the entire financial system.

In the end, each country will decide what actions (if any) are necessary to foster and supervise a healthy, competitive microfinance industry. While microfinance regulation and supervision typically become issues when nonprofit microlenders in the country reach such a size and maturity that licensing them as a financial entities becomes a realistic possibility, the interest and concerns of commercial banks also have to be taken into account. Since regulation and supervision in part builds on the activity of microfinance, commercial banks that want to serve this segment of the market will also be affected.

With the emergence of large and dynamic microlenders, Latin American supervisory authorities have started taking serious notice of the importance and challenges of an appropriate regulatory and supervisory framework for microfinance. Achieving the proper mix of regulations and supervisory practices that foster a competitive and sound microfinance industry is not easy, but neither is it impossible. What is certain, though, is that it will require a sustained commitment on the part of supervisory authorities.

Box 2: The New Basel Accord

In January 2001, the Basel Committee on Banking Supervision issued a proposal for a New Basel Capital Accord to replace the existing Accord, which dates from 1988. The new proposal aims to improve the alignment of regulatory capital with underlying risks and to provide banks and supervisors with more flexibility in the assessment of capital adequacy. While the proposal is likely to improve the functioning of financial markets and financial institutions in general, it may have a negative impact on microfinance in the short to medium term.

First, under the new accord, the risk weighting on loans to microenterprises will probably change from the current 100% weight to at least 150%, because loans to these businesses are perceived as very risky and, in general, are made against little or no collateral. The proposed changes in capital requirements, in particular the use of ratings to determine risk weights, could negatively affect small loans because of diseconomies of scale (good but small loans will not be rated because of high costs and, consequently, will receive high risk weights). This may deter financial institutions from entering the microlending business and cause those already in it to drop out.

Second, commercial banks lending to microfinance institutions in second tier operations will have a greater incentive to reward borrowers that have been rated. As a result, microfinance institutions will likely face a starker choice to undergo a rating or pay higher borrowing costs. In this way, the new rules will likely stimulate the demand for ratings among microfinance institutions (both regulated and NGOs). However, rating firms will find it difficult to use current scales and practices to rate microfinance institutions, particularly NGOs, because they generally lack experience or knowledge of the particular risk profile of these institutions.

In summary, while the New Capital Accord will have a very positive effect in developed financial markets, it may have an unintended negative impact on microfinance institutions, at least in the medium run.

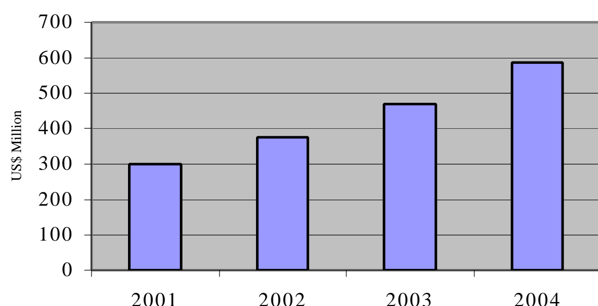
Source: Extracted from opinion formulated by the Private Enterprise and Financial Markets Subdepartment. March 5, 2001.

The Next Challenge: Integrating Microfinance into Mainstream Financial Markets

The Latin American microfinance industry is in the midst of a profound transition. While these institutions started as nonprofit foundations to help the poor, they are increasingly incorporating other objectives, such as growth, efficiency and profit into their visions and strategies. The institutions understand that these latter objectives ultimately allow for a greater outreach to a larger number of clients. Not surprisingly, it has proven a challenge to pursue all these goals simultaneously; yet, a significant number of institutions have been remarkably successful in achieving high levels of efficiency, profit and growth without straying from their original target clientele. But success has also brought a new set of challenges.

By recent estimates, the Latin American microfinance industry has a combined portfolio of approximately $1.4 billion. It has taken about 20 years to arrive at this stage, starting with a limited number of small and fragile non-profit organizations scatter across the region. But if the industry continues its current growth of about 25 percent per year, it will need this same amount ($ 1.4 billion), to finance its growth only over the next three to four years. While not much in relation to the enormous sums circulating in international and domestic financial markets, it nevertheless constitutes an unprecedented flow of funds to the sector, and especially to the microenterprises whose competitiveness and even survival may hinge on it.

Figure 10: Estimated New Funding Needs for Latin American MFIs, 2001-2004



Source: Created by the author based on information in Westley (2001), Christen (2000) and MicroRate dataset

But who will supply these funds? While it is clear that the microfinance industry will need a significant amount of financing over the coming years, it is less clear exactly from where these funds will come. Microfinance institutions basically have four options to attract the funds they need for their future growth: donors, public savings, and local and international creditors/investors. In all of these cases, however, there are important challenges confronting the microfinance industry:

Donors have historically been very important suppliers of grants and loans to the industry, but their relative importance is declining. While institutions in several microfinance markets still receive considerable loan and grant funding from donors, these resources are not keeping up with the overall growth of the market. Additionally, while the money may be cheap, it usually comes with strings attached that can have a significant nonmonetary cost to the MFI.

Savings from the public are an enormous potential source of funding for microfinance institutions. It is not only abundant, but also cheap in comparison to what it costs to borrow from local banks. However, in order to mobilize savings, microfinance institutions need to become regulated and supervised banks or finance companies (or other type of institution if available). Providing savings services also requires a greater expertise in liquidity management. As mentioned earlier, the problems and challenges associated with this process are more than trivial.

Local and international creditors (banks) and investors are particularly important for MFIs that are not allowed to mobilize deposits. However, the same institutions have the most difficulty in accessing these sources of funding. In fact, the relationship between creditors/investors and microfinance institutions in general is far from seamless. Even though some of them (for example local banks) operate in the same market as the microfinance institutions, it is often a challenge to convince them to commit resources to the sector. Local creditors and investors do not always understand the business model and they often feel that there is not sufficient transparency to make informed decisions.

Until recently, international creditors and investors were nowhere to be found as far as microfinance was concerned. During the past five years, however, the situation has changed. While purely commercial investors and creditors are still few and far between, an increasing number of international social investors are appearing on the scene. These investors confront and are stunted by the same problems as local actors, but even to a greater extent since they do not have a presence in the local market.

Initiatives to Increase MFI Access to Financial and Capital Markets

As a number of large and successful MFIs have emerged during the past 5 to 6 years, their access to commercial sources of funding has become an increasingly important issue. Reconstituted non-profit organizations, which operate as banks or finance companies, have generally come to enjoy reasonable access to commercial funding, although not always at the rates they would prefer. However, for MFIs that remain nonprofit foundations, access is much harder.

Various tools have been employed to facilitate commercial funding to MFIs. One prominent method is to create various types of funds that target microfinance institutions with loans, guarantees and equity (Table 5). Some of the funds are based on private sector initiatives, such as the Calvert Fund, while others have been formed with bilateral and multilateral resources, such as Profund and LACIF. The former tends to be open for participation by individual retail investors, while the latter are generally closed.

While equity investments in MFIs are a relatively new phenomenon, loan and guarantee

Table 5: Microfinance and Small/Micro Business Funds in Latin America

	Assets $US millions	Assets in L.A.	Investment Type
Widely Available			
Oikocredit (EDCS)	125	36%	Debt, some equity to cooperatives globally
Calvert High Impact	18	1%	Long term debt to MFIs globally
Sarona	3	2.9%	Debt, limited equity globally
NicaFund	2.3	2.3%	Debt to Nicaragua Com. Dev. Fund
Venture Funds			
PROFUND	42	100%	Equity and debt to MFIs
LACIF	11	100%	Debt and guarantees to MFIs
DEXIA	11	74%	Debt and equity to MFIs
EEAF[2]	10	100%	Equity and debt to environmental enterprise
Fondo Eco Empresa	10	100%	Equity and debt to environmental enterprise
Acción Bridge Fund	6.5	6.5%	Debt to Acción-affiliated MFIs
Terra Capital	15	100%	Equity and debt to environmental enterprise

Source: Marc de Sousa Shields "Attracting Social Investment Capital to Latin America", Microenterprise Development Review, Jan 2001.

[1] IciD: International Community Investment Deposits

[2] EEAF co-manages capital for the Corporación Financiera Ambiental.

schemes for microfinance have been in use for the past 15 years, both by multilateral and national development agencies. There is only scattered evidence on the effectiveness of these instruments, but in general they are thought to have helped the emerging industry through its infancy.

In some cases, instruments to help MFIs access commercial sources of funds have generated considerable controversy. This is particularly true in the case of guarantee schemes, which target the relationship between an MFI and a bank or the financial markets. Proponents point out that they help expand and diversify MFI access to commercial funding, promote downscaling of conventional financial intermediaries, and deepen financial markets in general. However, opponents of guarantee schemes argue that they are fraught with risks, don't really offer any additionality, and are unlikely to be sustainable over the long run.

Although guarantee schemes appeared to have achieved positive results in some cases, they nevertheless suffer from some important weaknesses. First, there is usually some duplication of work, since both the lender and the guarantor are expected to gather information to analyze and monitor the borrower. Second, by protecting the lender against loan losses, the guarantee scheme diminishes the lender's incentives to carefully screen clients and follow up on delinquent loans (moral hazard). The likelihood of losses resulting from this condition makes financial sustainability very difficult for most guarantee schemes. Finally, questions have been raised about whether guarantee schemes add much value or just help MFIs that would be able to access commercial financing anyway.

Recently, as practitioners have continued to search for new ways of connecting MFIs with commercial funding, increasing emphasis has begun to be placed on the role of information and transparency. Indeed, while the gradual integration of microfinance into mainstream financial markets promises to expand access to commercial sources of financing and capital, it also creates a new set of demands on the industry. In order to attract these new sources of capital and financing, the MFIs must impress potential creditors/investors with a high level of transparency and an attractive risk/return profile.

The lack of transparency has at least two dimensions: quality and availability. The quality of the information regarding the risk and financial performance of microfinance institutions has so far been impaired by a lack of recognized accounting standards, risk assessments, and commonly accepted minimum disclosure standards. Moreover, this problem is compounded by a lack of availability of information (many microfinance institutions do not publish financial reports more than once a year, far too infrequently to allow investors to stay abreast of their investments). As a result of all these factors, it is difficult for investors to obtain useful, reliable and up-to-date information about the risk and financial performance of many microfinance institutions.

In the late 1990s, donors began to support fledgling firms specializing in the assessment of microfinance institutions. The idea was that these specialized assessment firms could, for the first time, provide a professional and impartial evaluation of the MFIs. First and foremost it was meant to enable MFIs to understand their own weaknesses, strengths and performance. It was thus a supply-side effort to support the management of the MFI and its institutional strengthening.

Recently, this approach has changed in a subtle but important way; the focus is no longer only on the institutional strengthening of MFIs, but also on their access to potential investors and creditors. For this latter purpose, it is crucial that the MFI assessments become widely available and contain an estimation of the default risk posed by the institution.

A shift is also occurring in *how* support is provided. It is increasingly provided through demand-driven mechanisms that require a financial contribution from the MFIs themselves while empowering them to select their own assessor or rater. In doing so, MFIs select the assessment or rating firm whose characteristics and services best meet their needs, whether it be internal management concerns or the desire to attract

commercial investors and creditors. Reflecting this shift from supply to demand and from institutional strengthening to transparency, some donor agencies (IDB, CGAP) have started to create rating and assessment facilities that provide matching grants to MFIs that want to purchase rating and/or assessment services.

Both guarantees and risk assessments address the same problem related to the access of MFIs to commercial sources of financing, namely the risk arising from little transparency about the performance and risk of MFIs. In the case of guarantees, the risk for the commercial lender is either eliminated or alleviated (depending on the coverage of the guarantees); however, this does not mean that the risk disappears or even diminishes, only that the guarantor assumes it. In the case of risk assessments, on the other hand, risk is in fact decreased through greater quality and availability of information regarding the MFIs.

While donors may be justified in the belief that their efforts to improve transparency will have a measurable impact on the flow of commercial financing to MFIs, there are additional obstacles that also limit the flow of resources to the industry. Addressing those obstacles is one of the remaining challenges in achieving fuller integration of MFIs with mainstream financial and capital markets.

Remaining Problems of Transaction Costs and Liquidity

Even with improved transparency, it is not obvious that the flow of funds to the microfinance industry will increase. Indeed, to enable a greater flow of resources from private creditors and investors, particularly from purely commercial ones, obstacles related to transaction costs and liquidity must also be addressed.

Currently, creditors and investors face very significant transaction costs when they provide funds to microfinance institutions. The small amounts transacted (typically $100,000 to $1 million) give rise to high costs in relation to the amount provided. But the *absolute* costs are high as well.

It typically takes two months to a year to fund a microfinance institution, from the initial contact to the final disbursement of the loan or equity. In addition, for a $200,000 loan, the transaction cost between a financial investor and a microfinance institution generally ranges between $10,000 and 20,000 (5% and 10%) with a great variance from one investor to another, according to practices and experience (de Schrevel 2001). Triodos Bank, a Belgian commercial bank and social investor, estimates that it pays about $5,000 just in legal expenses for each debt transaction. For an equity investment, the total transaction cost can easily amount to a full $50,000. For both debt and equity, the transaction costs are mainly concentrated in due diligence, legal expenses, and custodial arrangements (Pouliot 2001).

These costs are very high by investment standards in conventional securities but close to standards in the private equity and venture capital side. The high transaction costs have the effect of distorting the actual pricing of loans to microfinance institutions. If a spread of 6 percent is charged on a one year loan, it only leaves a gross of some 3 percent over six-month Libor rates to take care of the management (usually =1.5 percent) and monitoring phase (0.5 percent), with little available to the investor when specific, country and currency risks are combined (Pouliot 2001). In short, in today's world, asset managers earn more money lending to microfinance institutions than investors themselves.

Finally, liquidity is a crucial consideration to investors in debt or equities because it allows them to instantly convert their positions into cash. Risk is therefore significantly reduced. Currently, investors in microfinance debt or equities are severely limited in their ability to liquidate their positions. There is no secondary market trading of these instruments, and every trade has to be individually negotiated between buyers and sellers, which is costly and time consuming.

The challenges of insufficient transparency, high transaction costs and nonexistent liquidity will have to be overcome before the microfinance

industry can count on having access to large and steady flows of resources to finance its rapid growth. This is particularly true for purely commercial funds, where creditors and investors need to see a competitive risk/return profile before committing their money.

Admittedly, it would be an exaggeration to claim that the microfinance industry is knocking on the door of Wall Street at this point. However, it is clearly set on a path leading in that general direction. It may still take many years before the liability/equity side of microfinance institutions is fully integrated in local and international financial markets, but there is little doubt that it is just a question of when, not if.

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