



# Donors Committee

For consideration

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**To:** The Donors Committee  
**From:** The Secretary  
**Subject:** Evaluation of MIF projects: Micro-finance

**Inquiries to:** Mr. Bernardo Guillamon (extension 1583)

**Remarks:** The attached report is one of the evaluations of the first “Groups” of MIF projects—Alternative dispute resolution (document MIF/GN-78-2), Micro-finance (document MIF/GN-78-3), Financial reform and capital markets (document MIF/GN-78-4). The summary report (document MIF/GN-78-1) brings together the initial findings from each report on the evaluations and attempts to derive general lessons and conclusions. Together, the work advanced this year in the evaluation account for approximately one third of the total universe of MIF projects which are to be evaluated by OVE during 2002-2003.

Although transmitted separately, the reports (MIF/GN-78-2, MIF/GN-78-3, MIF/GN-78-4) should be read as a single work, with the summary report (MIF/GN-78-1) providing an integrating overview of the three detailed “Groups” evaluation reports.

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**MIF/GN-78-3**

***Evaluation of the MIF Projects:  
Microfinance***

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***Office of Evaluation and Oversight, OVE***

Inter-American Development Bank  
Washington D.C.  
November 2002

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## ACRONYMS AND ABBREVIATIONS

ADC	Andean Development Corporation
ADEL	Local Development Agency
BANGENTE	Banco de la Gente Emprendedora (Venezuela)
CABEI	Central American Bank for Economic Integration
CENITEC	Technological and Scientific Research Center
FUAMPES	Salvadorean Small Business and Microenterprise Support Foundation
FUCAC	Uruguayan Federation of Saving and Loan Cooperatives
GDP	Gross domestic product
GTZ	German Technical Cooperation Agency
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IPC	Interdisciplinary Project Consulting
LACIF	Latin American and Caribbean Investment Fund
MEDA	Mennonite Economic Development Agency
MFI	Microfinance institution
the MIF	Multilateral Investment Fund
MPPMR	the MIF Project Performance Monitoring Report
NAFIN	Nacional Financiera (Mexico)
NGO	Nongovernmental organization
PFF	Private financial fund
PPMR	Project Performance Monitoring Report
SDS	Sustainable Development Department (IDB)
SLA	Saving and loan association (cooperative)
SME	Small and medium-sized enterprise
USAID	United States Agency for International Development
WGR	Working Group Report
WOCCU	World Council of Credit Unions
WWB	Women's World Banking

## EXECUTIVE SUMMARY

This document is the outcome of an evaluation of the MIF microfinance projects, forming part of the general evaluation of the MIF activities undertaken by the Office of Evaluation and Oversight (OVE). In preparing this document, 24 projects have been studied in-depth and 26 evaluation fact sheets completed, out of a total 65 microfinance projects in an aggregate amount of US\$86.2 million approved between 1993 and 2001. The projects include technical cooperation, loan financing, and venture capital investment either directly or through funds specially created for this purpose.

The first chapter describes the general macroeconomic setting in which the region's microfinance promotion projects have unfolded, which, together with the financial-sector reforms carried out in the 1990s, provided the backdrop for the emergence and consolidation of microfinance in the region. The chapter analyses market needs, evolution and segmentation, and it ends by identifying key indicators and quantifying the performance of the microfinance industry, in its role as the main instrument developed to provide financial services to microentrepreneurs.

The chapter states that in the late 1970s the increasing importance of the informal sector in developing economies began to be recognized as an important economic alternative to unemployment. Small informal businesses run by people of low incomes needed financing for survival or expansion, just like larger firms; and the entrepreneurial capacity recognized in such enterprises justified actions to compensate for their lack of access to formal financial markets. The characteristic informality of the microenterprise sector, and the fact that low-income individuals are unable to satisfy the minimum requirements for participation in financial markets, is one of the main reasons for the lack of access to formal financial services in the region's economies.

The problem of insufficient access to credit was not remedied by financial systems (even after the reforms of the early 1990s), yet financing was seen as increasingly important for expansion and even for the survival of these productive units. Lack of access explains the emphasis placed on developing alternative financing systems for this population segment since the 1980s in Latin America and the Caribbean. The shortage of financial services spawned spontaneous mechanisms for extending credit in order to smooth out surpluses and deficits in individual cash-flow situations. As a result, informal lending and borrowing groups were formed, together with costly private lenders, or cooperatives and nongovernmental organizations (NGOs) were set up to provide financial services. Given the absence of transparent information and traditional guarantee mechanisms, technologies based on the use of private information and direct monitoring emerged as specific features of informal financial markets.

The development of credit technology that began in the first half of the 1990s encouraged the growth of microcredit institutions (NGOs) and an expansion of credit services, but funding sources quickly proved insufficient to satisfy potential market demand for microcredit. Moreover, larger-scale lending operations revealed existing problems of governance in nonprofit organizations resulting from their ownership and management

structure. These circumstances helped to raise awareness of the need to convert such institutions into formal financial intermediaries (a process known as “upscaling”).

The first steps taken towards formalizing the region’s leading microcredit NGOs, which had a commitment of support from the Bank Group, involved the creation of Bancosol. This was followed by the establishment of Caja Los Andes in Bolivia and Financiera Calpiá in El Salvador, through the MIF support that contributed capital and technical assistance to facilitate their entry into the regulated financial system. Efforts to promote this upscaling predominated in the 1990s. The model spread throughout the region and explains the process by which the microfinance industry in Latin America and the Caribbean was transformed and consolidated. By the end of the decade, as a result of pioneering actions in which the Bank and the MIF were leading players, it had been shown that microfinance institutions could be both profitable and self-sustaining, and that channeling financial-sector resources to the microenterprise sector not only was possible, but the risk could be easily diluted and controlled.

The second chapter sketches the underlying strategy in both the Bank and the MIF that led to creation of the microfinance project cluster, and the role played by the MIF in this. It also analyzes the evolution of the various types of intervention by the MIF in catering to market needs. The IDB Group strategy, initiated in the 1990s and materialized in 1996, defined its vision of the microenterprise sector based on the use of tools available to the MIF, and in terms of making global loans to the various countries. It was also found that reviewing and adapting financial sector regulatory and supervisory frameworks in the region’s countries needed to be supported and fostered, while activities to disseminate best practices have been and will continue to be undertaken to promote the demonstration effect in every country.

During its lifetime, the MIF has intervened in seven microfinance areas: (i) Upscaling: conversion of NGOs into formal financial intermediaries, or creation of new financial intermediaries specializing in microfinance; (ii) Support for formalized microfinance institutions; (iii) Downscaling: support for formal financial institutions; (iv) Reform of the microfinance regulation and supervision framework; (v) Strengthening of saving and loan cooperatives; (vi) Emergency credit line to overcome the effects of natural disasters; and (vii) More recent interventions, including support for savings intermediation, product innovation and linkages between remittances and microfinance institutions.

The third chapter discusses the results of the analysis and evaluation of the project cluster. This uses the evaluation framework and methodology developed by OVE specially for the MIF evaluation, encompassing the following dimensions: relevance, effectiveness, efficiency, innovation, sustainability, additionality and evaluability. Lessons are drawn and areas of opportunity for future work are identified.

The majority of projects addressed issues of major relevance, not just because of the importance of microenterprise in most countries of the region, but also because of their lack of access to credit. Tailor-made projects, especially involving loan financing and direct or indirect capital contributions, have been particularly relevant, since they have intervened at a key stage in the development of many institutions and have made it

possible to apply lessons learned to other institutions and countries. Finally, the interest rates charged by these institutions (higher than rates in the commercial banking sector but lower than those charged by money changers), together with low arrears rates in the portfolio of microfinance institutions, show that the financial services offered are highly prized by their clients.

For the project cluster analyzed, the conclusion is that effectiveness was high, but it could have been higher still if certain risks had been better anticipated. The risks identified normally relate to the financial nature of these projects, such as a possible deterioration in portfolio indicators or failure to achieve the desired profitability. Nonetheless, their likelihood of occurrence or impact on results tend to be underestimated, although analysis and estimates of their true impact on projects have improved over time. Project effectiveness was found to have been especially high in those promoted or supported through Facility III-B (equity investment and loans). These also include the most innovative projects, in terms of both the objective being pursued and the instruments developed to do so. In the face of external events that affect project development, it was found that an unsuitable legal framework that prevents free determination of interest rates, and behavior favoring conditions of unequal competition, are the main causes of failure among many projects.

In efficiency terms, progress and changes have clearly been made to speed up operation processing times. Progress can also be seen in hiring and procurement. Nonetheless, there is still a lot to do in this area, given the existence of innovative elements such as those found in the Line of Innovation, which would also be expected to ensure more competitive and transparent executor selection processes, encouraging competition between institutions from different countries, but also offering economies of scale to be exploited in projects with many aspects in common, such as those of the Line of Activity.<sup>1</sup>

On innovation, the MIF has contributed to the development of highly innovative microfinance projects; over 60% of the projects evaluated reported strong effects in this dimension. These represented innovations in most countries by introducing “microcredit technologies,” and by supporting the first-time establishment of new types of regulated institutions offering financial services to the microenterprise sector. Dissemination work carried out in conjunction with the Bank has allowed successful experiences to be widely disseminated.

**Perhaps the most important aspect of the projects analyzed is that they have all helped to change the microfinance paradigm in the region.** After nearly ten years’ work, nobody now doubts that sound and profitable microfinance institutions can exist and that financial services can be provided to microenterprises, and to the region’s very

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<sup>1</sup> The Line of Activity was created to support the strengthening of microfinance entities, by improving their operational and management capacity. Within this Line, the MIF’s maximum contribution is limited to US\$300,000 per project, with microfinance institutions contributing up to 50% of that amount as counterpart. Operations are processed and approved by the Microenterprise Division of the Bank’s Sustainable Development Department (SDS). Competitive project selection mechanisms are expected to be applied.

poor. Most of these projects would not have been undertaken without the MIF support, partly through the funding it has provided, but also through the vote of confidence implied when it selects an institution as beneficiary of such resources. This highlights the additionality of its interventions.

Commitment to sustainability begins with the ex-ante evaluation of the executing entity, where financial and institutional capacity are fundamental criteria used to classify potential executing agencies. The fact that many executing agencies had been supported by the Bank in earlier stages of their development also partly explains the success achieved in executor selection. The design of operations involving venture capital funds or direct equity investment increasingly includes appropriate incentives to make sure objectives are achieved and that the operation is profitable. The greatest threat to the sustainability of microfinance institutions has come from unsuitable regulatory environments; this area needs to be taken more into account when designing operations.

As regards evaluation, project designs have developed adequate financial indicators, particularly in the Line of Activity. These include indicators, benchmarks, clear targets and projections for each entity, which are very useful particularly when assessing their financial sustainability. In projects that offer financing, or those where capital has been provided, evaluation and monitoring during execution have been substantially improved through direct monitoring by the MIF Investment Unit. Lastly, information was not available on the characteristic of the end clients and on the benefits that would accrue to them for any of the projects evaluated. Accordingly, the evaluation attempted to learn more about these aspects in three countries. The results of final client surveys reveal that over 90% of microentrepreneurs are very satisfied with the financial services received.

The final chapter brings together the main conclusions of the evaluation, in terms of the evolution of the MIF microfinance interventions from 1993 to 2001. It also sets out guidelines for the future and identifies the main areas of opportunity, highlighting the contribution of the MIF to the development and consolidation of microfinance in Latin America and the Caribbean. The MIF's experience with microfinance corroborates the importance of working on topics in a "cluster" framework, as previously recommended in the Working Group Report. A key element in this successful strategy was the partnership forged with the Bank, which made it possible not only to exploit the latter's historical experience in the microfinance area, but also its infrastructure and presence in the region in disseminating successful experiences.

The intervention instruments used thus far by the MIF have enabled it to make a major contribution to the development of a microfinance industry in the region. Facility III-B (loans and equity investment) is one of the most valuable instruments and has made particularly relevant and innovative contributions; the institutions thus supported have gone on to become successful examples of best practices that are replicated or imitated in the same countries or elsewhere.

The Line of Activity has generated a very large volume of operations without committing more than 10% of the resources allocated to microfinance-related projects. It has also provided an expeditious tool with which to support a second generation of NGOs, thereby

helping to consolidate a seedbed of possible candidates for formalization in the future. Nonetheless, the requirements and restrictions imposed to speed up project bureaucracy have tended to erode their innovative capacity. Although NGOs wishing to formalize (as well as successful financial institutions that want to enter this market) can continue to receive nonreimbursable resources, it is more efficient and effective to continue choosing beneficiary entities through a competitive process that uses objective criteria and makes it possible to choose executing agencies from the different countries, as originally envisaged.

Lessons drawn from the evaluation of the different projects, include the following:

- Project success is largely explained by the quality of the credit technology advisers available to the institutions. The Bank and the MIF should explore mechanisms to furnish executing agencies with a list of the most suitable entities for providing assistance in the areas typically addressed by these projects. They should also devise contracting schemes offering potential economies of scale to enable executing agencies to contract services from firms that would be very costly to engage on an individual basis.
- The most successful projects took place in countries with legal and regulatory frameworks that are favorable to the microcredit business. Accordingly, to increase the effectiveness of its interventions, the MIF should not only evaluate executing agencies, or their partners in the case of equity investment; it should also take the setting into consideration, in order to decide whether the most effective way to promote this industry in a specific country is by supporting an institution in particular, or else by promoting reforms to ensure the existence of minimum legal foundations for these enterprises.
- This calls for reflection on the accountability of the MIF as a shareholder in financial institutions that intermediate savings obtained from the public. Such institutions can be susceptible to destabilizing factors that require additional capital injections, which need to be provided rapidly when the circumstances warrant. It needs to be considered whether the MIF can best contribute capital directly, or through a venture-capital fund. The latter would allow it a more independent and active participation on the Board, as well as having resources to hand in the event of emergency.

As microfinance activity evolves and consolidates, the respective institutions engage in increasingly complex financial operations, which include taking in savings from the public. In view of this, the MIF should promote discussion on the most important indicators for monitoring microfinance activity, including those that reflect the risks of the financial business, and give more in-depth consideration to the most suitable mechanisms for appropriately managing the new risks being faced.

Although the demonstration effect has been generated, the microfinance portfolio has not yet achieved significant coverage of the microenterprise market, notwithstanding some successes. A further step needs to be taken, concentrating all efforts on the search for

ways to motivate the region's commercial banks and financial groups to cater to the microenterprise segment. Although many of the microfinance projects carried out by the MIF are deemed to be successful, their impact in terms of extending the coverage of financial services to low-income populations is still marginal. To achieve a major impact in this area requires channeling massive resources into the microenterprise sector; this can be achieved by forging links with formal financial entities.

One stage in the process seems to have reached its conclusion: a paradigm shift has occurred, demonstrating that it is feasible to lend to the poorest population sectors in a profitable and secure fashion. The challenge now is to develop a strategy for providing financial services *en masse* in order to satisfy the potential demand of the microenterprise market. This new challenge calls for reconsideration of the characteristics that the MIF should look for in financial institutions and entities to be chosen in this new stage—bearing in mind that the ultimate goal, in terms of impact, is to achieve genuine financial deepening towards the poorest population strata.

## I. SECTORAL CONTEXT OF THE PROJECT CLUSTER

1.1 The aims of this chapter are to analyze the relevance of the microenterprise sector within the overall economic activity in Latin America and the Caribbean; and to identify the structural characteristics and market failures that affect access to financial services. The detailed contextual analysis is contained in Annex I, which also includes a brief review of the macroeconomic climate in the region during the decade.

### A. Financial-sector reforms

1.2 In the first half of the 1990s, the countries of the region embarked upon a process of macroeconomic reform embracing taxation and fiscal issues, labor markets and social security. Reforms were also made to the legal framework governing the financial system; these were intended to achieve greater financial deepening and improve systemic efficiency, leading to lower real interest rates. Another implicit aim of these reforms was to make credit services available to populations that had been largely excluded, precisely because they belonged to the microenterprise sector.

1.3 Generally speaking, while some countries made structural changes earlier and others later, most introduced reforms leading to financial-sector liberalization and deregulation. These reforms made it possible to foster more active competition, reduce interest rates and facilitate participation in international capital flows. State participation was reduced accordingly, and competition was heightened by the entry of foreign investment and a broadening of the scope of banking operations. State intervention was reduced in terms of control over interest rates, imposition of high reserve requirements, and administrative allocation of credit. Support for specific sectors concentrated on instruments belonging to second-tier institutions.

1.4 Delay in implementing the necessary regulatory and supervisory adjustments, made financial institutions considerably more fragile and led to crises in the various countries. These were aggravated by a slowdown in economic growth throughout the region, compounded by higher unemployment, a consequent contraction of bank credit, higher inflation in some cases, currency devaluation, and outflows of foreign capital. Financial systems in many countries slid into crisis around the second half of the decade, forcing the authorities to adopt bailout measures and tighten prudential regulation, in an attempt to protect the public's savings.

1.5 Partly because crisis followed hard on the heels of reform, or in some cases because the reforms themselves did not go far enough, the hoped-for deepening of access to financial services for the majority of the population failed to materialize. Although the M2/GDP<sup>2</sup> ratio in Latin America and the Caribbean rose (it averaged 38% during 1993-1996 as against 21% in the 1960s and 29% in the

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<sup>2</sup> Defined as cash in circulation, plus deposits in checking accounts and quasi-money.

1970s), the levels recorded for the second half of the 1990s were below those achieved by the East Asian nations and by industrialized countries.

- 1.6 As a result, the lack of access to financial services prevailing in the early part of the decade, in Latin American and Caribbean countries, persisted without major quantitative variation in aggregate terms as the decade closed. Nonetheless, a qualitative change in access to financial services was achieved, because efforts by formal or informal entities such as microfinance institutions (MFIs), savings and loan cooperatives (SLAs), together with certain finance companies and banks, began to make services available to low-income groups including microentrepreneurs.

## **B. Market failures**

- 1.7 Various studies show that the financial repression characteristic of most countries in the region before the 1990s, compounded by the absence of a suitable regulatory framework to promote competition, largely explain the lack of financial deepening. Yet, the financial reforms introduced in many of the countries failed to extend credit access to the majority of the population.
- 1.8 Structural failings in financial markets prevent financial resources from being taken in and reallocated spontaneously to the many different productive activities that are essential for economic growth, and to those activities where the social rate of return exceeds the private rate of return. Funds intermediated through the financial sector are channeled on the basis of the private rate of return, without regard for the social return of the activities being financed. This is explained not only by the profit maximization goal driving the financial sector that intermediates the public's savings, but also by the need and obligation to protect public resources.
- 1.9 The main financial market failures generally relate to information asymmetries; positive or negative externalities; imperfect competition, and even the nonexistence of certain markets. The persistence of market failures obstructing access to financial services, even after structural reforms have been introduced, has spawned compensatory interventions, including those carried out by the IDB/MIF through various mechanisms. The development of specific credit technologies for channeling resources to the microenterprise sector is one response to the constraints imposed by market failures caused by asymmetries and lack of information, and by the very informality of the market to which they are directed.
- 1.10 The use of second-tier instruments in conjunction with other measures may compensate for some of the obstacles to accessing financial services faced by excluded population groups. Such measures include making specific changes in the regulation and supervision of the financial system, SLAs and microfinance institutions; the creation of risk centers to facilitate the management of personal

credit records; and reform of the legal framework relating to guarantees in each country.

### **C. The microenterprise sector**

- 1.11 In the late 1970s the increasing importance of the informal sector in developing economies began to be recognized as an important economic alternative to unemployment. The microentrepreneurial sector consists of business units (microenterprises) that are small not only in terms of employment but also as wealth creators; most are single-person operations. The sector is highly varied in terms of size and composition in the various countries of Latin America and the Caribbean. There are business units whose economic activity in some cases involves no more than subsistence, while others may involve capital accumulation but with no clear distinction between the firm's finances and those of the family. The sector also includes enterprises with 10 or fewer employees, whose production system is more elaborate, making use of technology and having commercial linkages to larger and more formal businesses.
- 1.12 According to a Bank report,<sup>3</sup> in 1996 there were over 50 million microenterprises operating in the region. These provided employment for more than 120 million people, and generated between 10% and 50% of GDP in the group of countries. In the mid-1990s, over 80% of business units in Latin America and the Caribbean had fewer than 10 employees, of which 80% employed fewer than five workers. According to results obtained from surveys carried out by the Bank in 14 of the region's countries,<sup>4</sup> in 1998, 63% of workers in the microenterprise sector were the microentrepreneurs themselves. The proportion was higher than this in Bolivia, Honduras and Peru, although in Mexico it was only 24%.
- 1.13 In aggregate, the microenterprise sector is estimated to have created 50% the region's jobs during the first half of the 1990s.<sup>5</sup> The microenterprise sector's share of total employment averaged 57% during the 1980s, albeit with considerable differences between the various countries. The sector's share of employment grew in Argentina and Venezuela during the last decade, but shrank in Bolivia and Uruguay.<sup>6</sup>
- 1.14 By the end of the 1990s, a majority of the region's microenterprises were either in Brazil (32.3%) or in Mexico (17.5%), with Colombia and Peru each accounting for just over 11%. The percentage in other countries was much lower, except for Venezuela which represented 5.5% of the total.

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<sup>3</sup> IDB, *Microenterprise Development Strategy*, Washington D.C., February 1997.

<sup>4</sup> Argentina, Bolivia, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Honduras, Mexico, Panama, Peru, Paraguay, Uruguay and Venezuela.

<sup>5</sup> Op cit.

<sup>6</sup> Orlando María B., Pollack, Molly, *Microenterprise and Poverty: Evidence from Latin America*, IDB, 2000.

- 1.15 Special characteristics of small business units include the following: they tend to operate outside their countries' legal and juridical frameworks; they engage in production and consumption activities simultaneously, given the total integration of business and family activities; and they lack access to financial services in the formal sectors of the economy.
- 1.16 Lack of access to financial services was seen as critical, since it prevents businesses with growth potential from expanding, and because microenterprise is so important for employment in the region. Accordingly, the need for policies to promote access to financial services by bringing them closer to financing sources, is crucial for the sustainability and growth capacity of microenterprises. Another implicit assumption underlying the pursuit of sustainability and growth was that this sector might formalize and integrate into the rest of the economy, once it had achieved a sufficient level of development. Given the importance of the sector, microenterprise growth and sustainability are key factors for business development in the countries of the region.
- 1.17 Despite efforts made by multilateral institutions and governments in many countries, a very small proportion of microentrepreneurs have access to formal financial services, because of the information shortcomings characteristic of microenterprise units. By the end of the 1990s, only 2.6% of microenterprises, covering 18 of the region's countries, had access to credit from microfinance institutions. Even this low figure indicates a major advance, however, since it represents effective access to credit for 1.5 million microenterprises, which, at the start of the decade, could not even obtain consumer credit on a private individual basis.
- 1.18 These figures do not include loans extended by small NGOs, or credits channeled through saving and loan cooperatives. The World Council of Credit Unions (WOCCU), calculates that affiliated cooperatives in Latin America and the Caribbean made microenterprise loans amounting to US\$1.654 billion in 1999, and the figure had climbed to US\$3.446 billion by 2001. Estimates made in the IDB study<sup>7</sup> show that credit extended to the region's microenterprises through all channels (formal financial sector, NGOs, SLAs) amounted to US\$2.532 billion in 1999. This was equivalent to 0.5% of total commercial bank lending in 26 IDB member countries during that year.

**D. Structural characteristics of the microfinance sector**

- 1.19 Below we describe the evolution of microfinance and popular credit in Latin America and the Caribbean, in order to understand its development as part of the informal credit market consisting of NGOs, SLAs and, more recently, a number of formal financial institutions.

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<sup>7</sup> Op cit.

## 1. Background

- 1.20 In the past a shortage of financial services for low-income populations and/or those located far from the larger urban centers in Latin American and Caribbean countries, led to the spontaneous generation of credit mechanisms to smooth out surpluses and deficits in individual cash-flow situations. As a result, informal lending and borrowing groups were formed, alongside costly private lenders; or cooperatives and nongovernmental organizations (NGOs) were created to provide financial services.
- 1.21 Given the lack of transparent information mechanisms and traditional guarantees, technologies emerged based on private information and direct monitoring. These are characteristic of informal financial markets serving populations that are excluded from the formal financial system, precisely because of market failures stemming from the absence of adequate information channels and insufficient collateral.<sup>8</sup>
- 1.22 Initially in the 1970s, financial support for the microenterprise sector was provided under a paternalistic approach that believed the important thing was to provide easy credit on attractive financial terms in order to “alleviate poverty.” In the 1980s, microenterprise was recognized as a sector with growth potential as a seedbed for small and medium-sized businesses (SMEs), which were seen as a mechanism for channeling social support.
- 1.23 The Bank led this process through the Small Projects Program, initiated in 1978, by channeling resources into revolving credit funds managed by grass-roots organizations for this purpose. Despite the efforts made, the scheme was undermined by a low rate of loan recovery, high program costs and subsidized interest rates that made it impossible to maintain the real value of the resources invested.
- 1.24 In the 1980s, some of the region’s countries began to consider it essential to provide training to microentrepreneurs (either on a voluntary basis or as a prerequisite for a loan), believing that this would not only improve their income but also turn them into acceptable clients of the formal financial sector. Although interest rates were higher and positive in real terms, a subsidy persisted because it remained impossible to cover intermediation costs stemming from the cost of the funds in the financial market. The conception of the scheme was developmental to some extent, since it financed “projects” over terms longer than one year. The final result was a high level of nonperformance, without achieving any expansion in the network of institutions willing to finance this type of entrepreneur.

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<sup>8</sup> González Vega, Claudio, *Dificultades de las Transacciones de Microfinanzas*—the microfinance challenge in Latin America: the current view, ADC, 2002. Galindo A, Millar M., *Can Credit Registries Reduce Credit Constraints? Empirical Evidence on the Role of Credit Registries in Firm Investment Decisions*, Santiago de Chile, 2001.

1.25 This period marked the emergence of NGOs with specialized lending services. By adapting procedures, methodologies of analysis and portfolio quality-control systems

**Box 1.1 Microcredit**

Small short-term loans to finance productive activities carried out by person of low income, typically microentrepreneurs.

specially designed to carry out small-scale lending operations efficiently, these entities managed to demonstrate the feasibility of financing low-income populations through profitable and self-sustaining financial arrangements. Thus, specialized technological bases were developed for managing microenterprise credit, and their subsequent development later made it possible to demonstrate the viability of the business within parameters of sustainability, profitability and control of credit risk (Box 1.2).<sup>9</sup>

## **2. Microcredit and microfinance institutions**

1.26 In the early 1990s, the Bank's Small Projects Program supported a number of microcredit programs in the region. Nonetheless, it rapidly became clear that microfinance institutions lacked the funding sources to grow at the rate needed to meet unsatisfied demand. This led to a move to convert microfinance institutions into formal financial entities subject to specialized State supervision (formalization), as a way of channeling large amounts of the public's savings into microenterprise lending. This process began through Prodem in Bolivia, which promoted the creation of Bancosol and then the conversion of Procrédito into Caja Los Andes in the same country. The process was then replicated in the transformation of Fundación Calpiá into Financiera Calpiá in El Salvador. These pioneers were subsequently joined by other entities during the decade from various countries of the region.<sup>10</sup> This process is known as "upscaling".

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<sup>9</sup> A detailed description of the characteristics of these microcredit technologies can be found in Ledgerwood, J. (1998).

<sup>10</sup> These cases have received support from the Bank and the MIF at various stages through the Small Projects Program, funding from Global Credit Programs, and capital contributed either directly or through ProFund.

### Box 1.2: Microenterprise credit technology

The term “microcredit technology” encompasses all activities carried out by a financial entity in the process of providing credit; these include borrower eligibility criteria, determination of loans to be granted, amount, term of the loan, guarantee requirements, and loan monitoring and recovery. In the case of microenterprise credit, the most frequently used instruments have been solidarity loans and individual loans, which differ from each other in that in the first case, the credit is granted to a small group of people (3-5) which is liable for the loan. The members of the group are responsible for evaluating and ensuring the creditworthiness of each individual. In the case of individual credit, the loan is granted to a single individual who assumes liability for it; and the lending institution has to obtain information and monitor the borrower’s creditworthiness. Other characteristic features of microcredit technologies include the following:

**Collection and evaluation of credit information:** Information is obtained directly from the microentrepreneur in order to evaluate his payment capacity and business viability, and to directly complete the corresponding forms. This evaluation is made by estimating the microentrepreneur’s current disposable income, based on business and family fund flows; this is complemented with records from risk centers, together with references provided by the microentrepreneur’s neighbors. Processing a new client application normally takes three days, whereas approval of a subsequent loan is usually obtained in one day.

**Graduated loans:** Microentrepreneurs receive loans of increasing size and duration, as they demonstrate their capacity and willingness to make repayments. This makes it possible to measure a client’s true payment capacity through successive operations where the first is normally for less than the client’s theoretical payment capacity. Payment discipline is stimulated by the prospect of permanent and continuous access to credit. The first loan is usually for less than US\$500 at a term of less than six months, and the amount increases as the microentrepreneur demonstrates his willingness and capacity to pay. Triple AAA clients may eventually obtain loans of up to US\$5,000 at three-year terms, only after five or six operations.

**Control of arrears:** This requires a permanent monitoring system to guarantee very rapid (next day) reaction in response to arrears in an installment (installments are very frequent: less than one month). Variable remuneration schemes are also used with credit analysts based on disbursements and recoveries, to stimulate efficiency among the sales force, both in obtaining new clients and in recovering funds lent.

**Guarantees:** Generally speaking these are nonexistent or unconventional, since priority is placed on the borrower’s payment capacity. In the case of individual credit, guarantees are symbolic and mostly represent liens on articles that are of high value to the microentrepreneur (production goods, consumer durables, or jewelry). The important thing is that the microentrepreneur with capacity to pay clearly understands that, in the event of falling into arrears, the article posted in guarantee will be lost. In the case of solidarity credit, the guarantee consists of the collective signature of the group; each member is jointly liable for the loan on behalf of the others; if one member fails to pay, the others are liable for the corresponding debt.

1.27 Also, in view of the success of microfinance institutions that had decided to formalize their activities, supported by the Bank through the Global Loans to Microenterprise Programs, a number of banks began exploring the microenterprise market during the 1990s. In some cases, such as in Paraguay, this occurred in response to competition, but elsewhere it was a recognition of a market niche that was accessible given its network coverage and portfolio of products. The phenomenon of formal financial institutions moving into the microenterprise segment has been referred to as “downscaling”.

1.28 By the end of the decade, it was clear that credit was not the only financial service that people require. The challenge, then, today is to provide access to basic services such as cheaper fund transfer under

#### Box 1.3: Microfinance

Provision of comprehensive financial services to low-income populations. Services include saving, credit, fund transfers and other non-bank services such as insurance.

appropriate security conditions, both within the country (typically between the rural and urban areas), and for fund transfer between countries.

### **3. Analysis of the development of microfinance institutions**

- 1.29 The worldwide microfinance inventory prepared by the World Bank estimated that in 1996 there were over 1,000 institutions of more than three years' standing in about 100 countries, catering to over 1,000 microentrepreneurs. In the late 1990s NGOs were estimated to be serving over 1.5 million microentrepreneurs (3 million when credit unions are included).<sup>11</sup> Of these, it was estimated that by the end of the decade, only 30 were regulated MFIs, excluding savings and loan cooperatives.
- 1.30 Annex I brings together basic financial information for 49 formal and informal microfinance institutions from the Latin American and Caribbean region, as of December 2001. These institutions have an overall asset volume of US\$1.116 billion and a portfolio of US\$843 million distributed among more than 900,000 clients. These figures do not include important formal banking institutions whose operations include microenterprise lending, such as the Banco Caja Social de Colombia, which accounts for 26% of the assets of microfinance institutions in the sample, and Multicredit Bank in Panama which contributes nearly 18%. In these two cases, it should be made clear that the microenterprise segment accounts for only part of the total portfolio.
- 1.31 In addition, SLAs comprise a group of financial intermediaries which, while not specializing in low-income populations, do provide saving and loan services to these populations and represent a major source of credit for microenterprises in Latin America and the Caribbean. In general, SLAs have specific characteristics that enable them to serve these population sectors, including a diversified client base, availability of information gleaned as a result of being rooted in the community, and their capacity to provide deposit-taking services. Savings and loan cooperatives have evolved as a means of extending financial services to rural and semi-urban sectors. The figures published by WOCCU only cover affiliated cooperatives<sup>12</sup> in Latin America and the Caribbean, representing a sample of 2,022 entities with 4.8 million members. This group of institutions manages savings totaling US\$2.7 billion and a portfolio of US\$2.3 million.

### **4. Regulation and supervision**

- 1.32 The 1990s saw major changes in regulation and supervision, but these did not occur all at the same time or address the same subjects in every country. The main changes introduced during the decade include mechanisms for market entry and exit, more stringent requirements on the information that institutions need to

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<sup>11</sup> Jansson, Tor. *Microfinance: From Village to Wall Street*, Inter-American Development Bank, Washington, D. C., November 2001.

<sup>12</sup> Many of these cooperatives also provide financial services to higher-income populations.

obtain when evaluating a loan, and increased reporting on the portfolio quality of these entities. The framework of operations authorized for financial entities in each country was also strengthened; more precise and applicable rules were established on solvency margins in relation to risk-weighted assets; and, among other things, rules were issued on liquidity and market risk-rating. Regulations were also issued governing the publication and transparency of information; uniform accounting standards were introduced; and mechanisms and instruments were developed to support the evaluation of credit risk, such as “risk centers” either in the superintendencies or else managed by the private sector.

- 1.33 While regulatory and supervisory reforms were being developed, formalization of microfinance entities was being promoted. The pioneers in each country were faced by rules typically designed to control risk in the formal financial sector, or minimum capital adequacy requirements that were more applicable to multiple banks engaging in financial operations of all types. In this setting, there was discussion of the characteristics and most appropriate regulatory framework to improve microenterprise access to the formal banking sector, as this is also a key element in explaining the success or failure of certain formalization initiatives. Issues such as the deregulation of interest rates on deposits and loans, and ensuring alternatives that encourage increased funding for these institutions under conditions of security and trust, particularly those specializing in this population segment, justify the attention paid to them by the MIF in several projects. They also explain the insistence on continuing to work on a framework of regulation and supervision for entities of that type.
- 1.34 Although in some countries<sup>13</sup> the MIF is supporting amendments to the regulatory and supervision framework, in order to facilitate the formalization of microcredit entities and enable the commercial banking system to engage in microfinance activities, elsewhere adjustments are still incipient. Broadly speaking, in these cases there are elements of regulation and supervision that need to be revised in order to facilitate the formalization of microfinance entities; notwithstanding the need to maintain a regulatory framework that ensures risks are controlled and the industry can develop under conditions of security and trust. These issues include the definition of microcredit itself, establishment of entities specializing in this segment, authorized operations, and banking supervision practices.<sup>14</sup>

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<sup>13</sup> For example, in Bolivia, Ecuador, Peru and Colombia the MIF is supporting government financial regulators through four projects totaling US\$4.32 million.

<sup>14</sup> Several authors have addressed the subject of microcredit, including Christen and Rosenberg (2000), Trigo (2000), Churchill (1997), and Jansson (1997).

## II. THE MIF STRATEGIC OBJECTIVES

2.1 This chapter aims to identify the strategy underlying actions and interventions by the Bank and the MIF to develop and support microfinance projects. This includes identifying key development factors from the viewpoints of the Bank, the MIF and the private sector, and analysis of the evolution of the MIF interventions to address market needs. These issues are all dealt with in greater detail in Annex II.

### A. The Bank's sectoral policies and strategies

2.2 The Bank's strategy has evolved considerably over the last 10 to 15 years, in line with changes in the vision of microenterprise development in vogue among academics, donor agencies, governments themselves and multilateral organizations.

2.3 Until the late 1970s when the sector was seen as a nonproductive distortion of Latin American economies, and supporting it was classified as welfare, the instrument typically used by the Bank to serve the needs of this segment was the Small Projects Program. This provided subsidized resources and quasi-donations (i.e., loans at very low interest rates, with long payback terms and grace periods), to finance revolving credit funds and projects aimed at strengthening institutions that provided financial and nonfinancial services to microentrepreneurs.

2.4 In 1989, the Bank's Seventh Replenishment identified microenterprise as a priority area, leading to the creation of the Microenterprise Division. A detailed study by this division in 1992 confirmed the weakness and lack of sustainability of the entities being supported, and proposed a methodology for evaluating microfinance institutions,<sup>15</sup> which became a very important input in defining the Bank's strategy in the microfinance segment from then on.

2.5 In addition to efforts in support of individual projects in the 1990s, the Bank contributed to the process of downscaling among formal financial entities by extending Microenterprise Global (Microglobal) Loans to governments, to be channeled to the microenterprise sector through a discount mechanism. This strategy also involved granting technical cooperation resources to financial intermediaries for the purpose of introducing credit technologies appropriate to microenterprise lending. In 1994, the Bank's Eighth Replenishment again ratified microenterprise as a priority area.

2.6 During the 1990s the Bank's strategy evolved towards a more comprehensive vision, where the efficiency and sustainability of institutions providing

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<sup>15</sup> This methodology was also published in 1994 under the title *Technical guide for the analysis of microenterprise financial institutions*, prepared by staff from the Bank's Microenterprise Division, in conjunction with professionals from the consulting firm, Interdisziplinäre Projekt Consult GmbH (IPC). It became the basis for greater regional standardization in formats for reporting and analyzing financial information relating to microfinance entities.

- microenterprise services emerged as the best long-term solution to microentrepreneurs' lack of access to credit. One of the most controversial issues at that time was a recognition that subsidizing interest rates had not succeeded in expanding the supply of credit. Interest rates needed to be positive in real terms to allow for institutional sustainability. This strategy showed that the Bank accepted the importance of making microcredit institutions commercially viable—a concept that was becoming increasingly widespread.
- 2.7 The general strategy objective was to promote conditions needed for the growth and development of the microenterprise sector in the region, by achieving specific objectives such as: (i) a favorable policy and regulatory regime; (ii) sound and sustainable institutions supplying financial and nonfinancial services to meet the demand of microenterprises; (iii) greater access for under-privileged and low-income microentrepreneurs (including women and indigenous populations) to financial and commercial services; and (iv) greater, continuous and permanent flows of funds to invest in microenterprises.
  - 2.8 This strategy centered on policy reform and institutional development, always with a country focus, based on three instruments: policy dialog, loans and technical cooperations. The strategy highlights the feasibility of using the MIF to make investments in microfinance institutions and potentially offering guarantees “to promote links between private intermediaries supplying financial services to microenterprises.” The target was to channel resources totaling US\$500 million during 1996-2001, to promote microenterprises in the region.
  - 2.9 At that time, there was a clear need to expand the range and volume of resources available to finance microcredit institution lending through formalization. But, there was no emphasis on the need for the microenterprise sector to embrace the whole spectrum of financial services in general, including saving deposits, rapid low-cost fund transfer systems and insurance, among others. This would only emerge later in the decade as MFIs faced an increasingly competitive environment.
  - 2.10 The Bank's microenterprise strategy explicitly highlighted what it saw as the MIF's main function in microfinance. In addition to taking equity positions and financing MFIs, the Fund should give priority to “...*strengthening and diversification of microfinance instruments and institutions...; improvement of nonfinancial services for small businesses and microenterprise in areas such as market information, quality control, innovation and technology transfer.*”
  - 2.11 During the 1990s, the Bank used instruments such as the Small Projects Program, the Microenterprise Global Loan Programs, the Social Entrepreneurship Program, and the MIF, through which it has channeled a total of US\$822 million to support microenterprise through the supply of financial and nonfinancial services. Lastly, it is important to draw attention to the role played by the Bank as disseminator of “best practices” in the provision of financial and nonfinancial services to

microenterprises, having produced several publications on this topic, and held seminars and forums such as the Microenterprise Forum.

## **B. Original strategic objectives of the MIF and their evolution**

- 2.12 Since the creation of the MIF in 1993, the microenterprise and small business segment is the only part of the private sector that has been explicitly singled out as a target for intervention. The Small Enterprise Facility-III is dedicated exclusively to promoting small business and microenterprise. Facility III is the only the MIF credit line able to finance, contribute capital or donate resources; from the outset it has been endowed with the flexibility needed to support development of the industry.
- 2.13 The MIF activities took place against the backdrop of Bank policies, its global strategy for this segment and the complementary programs mentioned above. the MIF activities were integrated within the IDB Group operations, as another of its intervention instruments. This made it possible to initiate intervention by supporting emerging financial NGOs through the Small Projects Program, complemented with support from the MIF for the most successful intermediaries, and then with Global Loans to finance regulated institutions.
- 2.14 The specific strategic evolution of the MIF as such was discussed in the Perry Report of 1996 and again in the Working Group Report (WGR)<sup>16</sup> of 2000. In addition, in 1999, a specific document was prepared on the microenterprise program which sought to address the following three areas: creation of capacity to develop microenterprises, relating mainly to the regulatory framework and improving specialized microfinance supervision; the development of business services and training; and lastly, promotion of microfinance in the region.<sup>17</sup> It was not until 2000 that the MIF prepared an independent document setting out its view of strategic issues in this field; but this contained a very limited concept of what constitutes an initial microfinance project cluster.
- 2.15 The Perry Report<sup>18</sup> published in September 1996, ratified the importance of the microfinance project cluster as a sector; it also highlighted the need to streamline operating processes, encourage a more proactive attitude from the MIF towards the proposals that institutions submit, and work more with the nonreimbursable fund component for strengthening institutions undergoing formalization. It is worth recording the principles enshrined in the Agreement Establishing the MIF, in the sense that its resources should “complement and supplement” the Bank’s activities, without replacing them.

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<sup>16</sup> MIF/GN-56, “Report of the Working Group on the MIF strategy”, July 2000.

<sup>17</sup> MIF/GN-50 the MIF Microenterprise Development Program 1999-2002, February 1999.

<sup>18</sup> MIF/GN-41Rev., the MIF-Task Force Report, September, 1996.

- 2.16 Among the general priorities stressed in the Perry Report, it proposed that Facility III-A should concentrate on the following: (i) technical assistance for regulated and nonregulated financial intermediaries, aimed at improving service quality, new product development, and development of their information and oversight systems; and (ii) technical assistance for the provision of nonfinancial services, including market information, quality standards and management. With regard to Facility III-B or the Investment Fund, the report suggested deepening its strategy and moving towards: (i) setting up partial guarantee mechanisms to improve the borrowing capacity of MFIs on financial markets; (ii) equity investment in emerging MFIs; (iii) investment in formal financial intermediaries wishing to cater for microenterprise and small businesses; (iv) investment in venture capital funds that would invest directly in SMEs.
- 2.17 Meanwhile, the major conclusion of WGR in 2000 was to recommend greater concentration of the MIF activities, with a strategic focus, no longer stressing the need for such activities to be consistent with Bank programs and policies, although ensuring that the resources never replace components of a Bank operation. The report suggested reorganizing the MIF intervention around “clusters”, similar to the way this has been done by the Bank in microfinance. The WGR stressed the need to focus activities in the microenterprise area on promoting three basic activities: innovation, the regulatory framework and institutional strengthening. These issues had already been addressed by the MIF at that time, and the Bank was engaged in activities relating to the regulation and supervision framework with staff from the superintendencies of the various countries,<sup>19</sup> as a result of the mandate issued to the IDB at the Summit of Americas held in Miami in 1995. It is in the WGR that for the first time one can discern a clear intention to define an independent strategy for the MIF, highlighting the importance of having internal staff to act as “cluster” coordinators, without prejudice to their consistency with Bank policy, and the importance of keeping communication and discussion open with Bank staff.
- 2.18 In short, the strategic focus of the MIF activity in the microfinance field has been defined from the Bank, and an excellent level of complementarity has been achieved among the different Bank Group programs. This is a result of coordinated work undertaken over more than a decade stemming from a long-term commitment with a strategic vision.

### **C. Analysis of strategic intentionality proclaimed in the projects**

- 2.19 From the outset, the conversion of NGOs into regulated financial intermediaries (formalization) has been a stated priority in the MIF-supported projects, because it is seen as the main way to achieve better access to credit for microentrepreneurs. To this end, work was carried out with entities that had previously received

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<sup>19</sup> In 2000, the authors of this evaluation had the good fortune to work with the ATN/SF-6428-RG project, “Microfinance policies and regulatory framework reform project”, contracted by SDS and directed by Ramón Rosales.

support from the Bank through the Small Projects Program, which displayed excellent performance and prospects for expansion. Hence the importance of equity investments under Facility III-B, to facilitate compliance with minimum capital requirements demanded by the regulations in each country. The corresponding capital contributions were sometimes made directly and on other occasions channeled through the MIF participation in venture capital funds.

- 2.20 Once the most advanced and largest entities were formalized in the first batch of projects after the MIF was created, the focus then shifted towards strengthening NGOs through technical cooperation prior to their formalization. As regards problems faced by formalized entities in gaining access to additional resources, the MIF adapted to requirements by extending credit lines when access to financing on the local market was severely restricted. At the same time, it began to explore ways of assisting MFIs in obtaining resources through instruments such as guarantees, credit lines to improve access to capital markets or financing, by posting the necessary guarantees.
- 2.21 The difficulties imposed by regulation and supervision standards in the formal financial sector, both for already formalized entities and for those in the process, led the IDB/MIF to complement its direct support by working with financial system regulators and supervisors, with the result that this became the first microfinance cluster proposed by the MIF.
- 2.22 Given the financial crises faced in various countries, and the different degrees of competition that started to characterize certain markets, several projects were designed to improve the efficiency of processes to reduce operating costs, and develop new products to improve and retain clients. That is where “microfinance” becomes an integrated concept, understood as bringing comprehensive “financial services” to microentrepreneurs and their families. This turning point in the strategic direction of the IDB/MIF is less clear in documents written on the subject. Nonetheless, if the projects themselves are studied in terms of starting date and the reality of each country, this evolution can be clearly seen, thereby highlighting the flexibility in the MIF that makes it possible to adapt to the changing reality of the microfinance business.
- 2.23 In brief, the strategic intentionality of the MIF can be grouped as follows, excluding figures relating to regulation:

**Table 2.1: Summary of strategic intentionality of the MIF interventions in microfinance**

Areas of intervention	Objectives	Instruments	Number and value of projects*
<b>UPSCALING</b> -NGOs in the process of formalization  -NGO strengthening	To create a network of efficient and self-sustainable institutions to ensure microenterprise access to credit and other financial services.	Technical cooperation: institutional strengthening of management and oversight systems; undertake feasibility and market studies. Capital contributions: minimum capital requirements. Financing: leverage their growth.	<b>6 projects</b> <b>US\$9.4 million</b>  <b>14 projects</b> <b>US\$8.8 million</b>
<b>SUPPORT FOR FORMALIZED MFIs</b>	Expansion of microfinance portfolio and improvement of efficiency. Development of deposit and lending products, and support in obtaining funds.	Technical cooperation: technical assistance. Credit enhancement: guarantees. Financing: partial or total acquisition of bond issues, and credit lines.	<b>20 projects</b> <b>US\$18.8 million</b>
<b>DOWNSCALING</b>	Introducing financial institutions to microcredit technologies.	Technical cooperation: technical assistance for microcredit technology. Financing.	<b>13 projects</b> <b>US\$10.4 million</b>
<b>REGULATION AND SUPERVISION</b>	Achievement of suitable legal framework to control microfinance risks and contingencies.	Technical cooperation for governments: reforms to regulatory framework and supervision practices.	**
<b>EMERGENCY LINES</b>	Support for MFIs suffering portfolio deterioration as a result of the impact of natural disasters afflicting their microenterprise clientele.	Financing.	<b>4 projects</b> <b>US\$23.3 million</b>
<b>SLA STRENGTHENING</b>	Support for the cooperative sector to provide comprehensive financial services to microenterprise.	Technical cooperation: institutional strengthening and definition of supervision scheme. Support for self-regulation.	<b>6 projects</b> <b>US\$8.2 million</b>

\* Does not include two operations totaling US\$7.3 million, corresponding to other topics.

\*\* These projects were evaluated under the Financial Reform Project cluster (4 projects with financial regulators in Bolivia, Ecuador, Peru and Colombia, amounting to US\$4.32 million).

## **D. Evolution of intervention modalities**

2.24 When the MIF was set up, instruments to support microenterprise and SMEs through Facility III were clearly differentiated. Facility III-A would provide support through nonreimbursable technical cooperations, while Facility III-B (the Small Business Investment Fund) would operate through loans and equity or quasi-equity investment. To begin with, microfinance operations tended to be “tailor-made” projects that relied heavily on the commitment of specific IDB staff, and whose processing and preparation were more expensive and took longer. Closure of the Microenterprise Division in 1994, as result of Bank restructuring, caused many upheavals that reduced the flow of applications and approvals in 1995, 1996 and 1997. Afterwards, it was decided to standardize the application process and adapt it to the small-scale the MIF operating infrastructure. In 1998 with the creation of the Line of Activity, the Microenterprise Unit of the Sustainable Development Department (SDS/MIC) took over responsibility for processing applications. This was complemented with more active dissemination, and the number of applications that were processed soared.

- 2.25 The Line of Activity, amounting to US\$10 million, was created to support the strengthening of microfinance entities,<sup>20</sup> by granting nonreimbursable loans to improve their operating and managerial capacity. It was decided that resources would be allocated using a “competitive selection method, ensuring broad regional coverage ... where the MFIs would submit their applications to the Country Offices to determine their eligibility ....”<sup>21</sup> In this activity line, the maximum the MIF contribution to the project is US\$300,000, with counterpart funding provided by the microfinance institutions of up to 50% of the sum contributed by the MIF. Operations are processed and approved by the Microenterprise Division of the Bank’s Sustainable Development Department (SDS).<sup>22</sup>
- 2.26 Until 1996 the average time taken between an application’s registration and its approval was longer than 12 months, owing mainly to a buildup of applications and the organizational model established by the Bank. Subsequently, as a result of efforts to speed up approval times, and then with the creation of the Line of Activity, operations have taken less time to process.
- 2.27 Lastly, the creation of the Line of Innovation was approved in 2001 as an open invitation to submit projects with innovative content. As this evaluation shows, the most innovative aspect of the process was not in the projects themselves, but the MIF’s move towards a demand subsidy scheme in which microfinance institutions’ needs are what determine the use of the resources. Based on the analysis carried out, and in order to facilitate better understanding of microfinance projects, these are grouped in seven subcategories according to the intervention instruments involved:
1. **Financing:** lines of credit or support for MFIs in issuing bonds.
  2. **Funds:** venture capital funds that provide financing and risk capital to MFIs.
  3. **Equity:** operations in which the MIF has made direct capital contributions to MFIs.
  4. **Cooperatives (SLAs):** projects related to savings and loan cooperatives.
  5. **Line of activity:** projects to provide technical assistance to MFIs, financed through this line.
  6. **Emergency:** financing lines created to support microfinance entities affected by natural disasters.
  7. **Other:** covers all other operations.

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<sup>20</sup> “Downscaling” and “Upscaling”.

<sup>21</sup> MIF/GN-47, *Line of activity for strengthening microfinance institutions*, June 1998.

<sup>22</sup> Subject to the MIF no-objection.

- 2.28 From the start of the decade and until 1998, the main instruments used to support microfinance projects were financing, funds and direct equity investment. Most of the cooperative projects supported by the MIF to date were also financed in those years. The creation of the Line of Activity substantially increased the number of operations, although value tended to be concentrated in financing (especially aimed at bringing MFIs into the capital market), and in the emergency category, involving support for MFIs affected by natural disasters.
- 2.29 From 1993 until December 2001, the MIF carried out 65 microfinance-related operations for a total value of US\$86.2 million, distributed across the various intervention categories. The Line of Activity enable it to serve a large number of institutions, with operations accounting for 48% of the total. Nonetheless, their average value is actually the lowest, representing just 10% of total resources committed. In value terms, the most important projects relate to financing and direct capital contributions, and lastly contributions through risk capital funds.
- 2.30 An analysis of resources channeled to microfinance in each country clearly highlights the case of Bolivia, where a large volume of resources has been committed. This country also has the most successful examples of microfinance development. Also notable is the small amount allocated to Chile, and the absence of projects in Brazil in Argentina, reflecting less development of microfinance activities in those countries.

### III. PROJECT EVALUATION

3.1 This chapter presents a summary of the results obtained from the evaluation made of microfinance projects approved by the MIF between 1993 and 2001. The complete version can be consulted in Annex III. The evaluation methodology, specifically developed by OVE for this purpose, grades projects under seven broad headings: relevance, effectiveness, efficiency, innovation, sustainability, additionality and evaluation. These areas were analyzed in the different stages of project development: at the time of their design (ex-ante), as well as during execution, and on conclusion or when close to finalization (ex-post). Different aspects were analyzed within each dimension, as shown in the following chart.

EVALUATION DIMENSIONS	PROJECT STAGES		
	A. EX-ANTE	B. EXECUTION	C. EX-POST
1. RELEVANCE	<i>1.A Needs diagnosis</i>	<i>1.B Demand for services</i>	<i>1.C Generation of market</i>
2. EFFECTIVENESS	<i>2.A Risk prevention</i>	<i>2.B Management of contingencies</i>	<i>2.C Project results</i>
3. EFFICIENCY	<i>3.A Resource allocation</i>	<i>3.B Administrative management</i>	<i>3.C Productivity</i>
4. INNOVATION	<i>4.A Product innovation</i>	<i>4.B Process innovation</i>	<i>4.C Demonstration effect</i>
5. SUSTAINABILITY	<i>5.A Analysis of partners</i>	<i>5.B Monitoring of partners</i>	<i>5.C Institutionalization</i>
6. ADDITIONALITY	<i>6.A the MIF Value added</i>	<i>6.B Synergy between projects</i>	<i>6.C Catalytic effect</i>
7. EVALUATION	<i>7.A Evaluability</i>	<i>7.B Monitoring</i>	<i>7.C Impact evaluation</i>

3.2 Using this methodology, 50 out of the 65 projects approved by the MIF in this period were evaluated; these involve a total of US\$79 million, representing 92% of the total approved during the period. For the 24 projects most advanced in their execution, or already executed, “Case Studies” were prepared, representative of different types of intervention. This process made use of information held at the Bank, supported by visits to the countries concerned and a survey of executing agencies. For the other 26 projects, evaluation fact sheets (*fichas*) were prepared, and a number of them were visited; but use was mostly made of information already available at the Bank (PPMRs, progress reports, evaluations, etc.), supported by interviews with experts and with Bank and the MIF staff. Appendices 1 and 2 contain examples of a “case study” and an “evaluation fact sheet,” respectively. The remaining 15 projects are mostly operations that are still at a very early stage.

3.3 The Case Studies were selected from projects approved more than two years ago, or in which over 50% of resources had already been disbursed. Diversity was ensured in terms of the strategic areas supported by the MIF and the instruments used (technical cooperation, financing, funds and equity); and care was taken to ensure adequate representation in terms of countries, in order to take account of the setting in which the projects had been carried out.

3.4 This chapter also considers the results of the OVE studies made of the microenterprise clients of three MFIs in Bolivia, Colombia and Uruguay; and it ends by summarizing the main lessons learned from the evaluation of each of the projects.

**A. Group portfolio analysis and execution indicators**

3.5 Differences in objectives and procedures between project types also affects the execution indicators typically used by the MIF to monitor disbursements, which are calculated for microfinance-related projects in Table 3.1.

3.6 Overall, the basic problem arises when disbursements begin after approval, because this takes an average of twelve months, following an estimated six months for completion of pre-approval procedures. This long period clearly corroborates the worries expressed in many studies and previous documents, which have identified operational bureaucracy as one of the major constraints facing executing entities when they apply to the MIF to fund their initiatives. This situation is aggravated by further delays after the first disbursement, when certain procedures need to be completed to justify disbursements relating to hirings or equipment procurement, as analyzed below.

3.7 Classification of the projects by type, as per the previous chapter, reveals that those related to SLAs had a very long preparation period (10 months), followed by another long stage to comply with the conditions precedent (13 months). This almost certainly stemmed from the fact that several of these projects depended on reforms being made to the regulatory framework in their respective countries, and these were slow to be implemented. Venture capital funds, meanwhile, display an average delay of 37 months between project approval and contract signing. This figure is distorted by the Gateway Fund case, however, which had to find a major counterparty among private-sector investors; and as none came forward, the project had to be reformulated. In the other venture capital funds, the fact is that at the time of fund approval, much of the essential legal work had already been done. This was not true in cases of direct equity investment in microfinance institutions, especially initially, where the finalization of Shareholder Agreements caused significant delays. Nonetheless, this experience was made use of in later operations. In these cases, where the MIF is assuming additional responsibilities, the time taken in evaluating the operations and in legal structuring is both explainable and understandable.

**Table 3.1: Average operation processing times**

By project type	Registration - Approval (proxy)	Approval - Signature	Signature - Eligibility	Eligibility - First disbursement	Approval - First disbursement	Extension (% of original execution period)	Signature - First disbursement (% of original execution period)
Financing	5	6	5	2	11	3%	20%
Capital	7	5	1	8	14	67%	59%
Line of Activity	6	2	5	1	7	12%	18%
Fund	4	37	4	0	41	0%	32%
Cooperatives	10	4	3	13	19	33%	36%
Emergency	3	0	3	3	5	13%	24%
Other	11	2	6	2	11	23%	22%
Total Projects	6	5	4	3	12	16%	25%
Fully disbursed	5	4	2	4	10	18%	29%

3.8 Lastly, the Line of Activity shows its benefits in procedural terms, because projects supported by this instrument are the quickest both to prepare and then to start disbursement; they have also needed less extension of deadlines to complete disbursements.

## **B. Analysis of projects through the dimensions of the evaluation matrix**

3.9 Below we analyze all projects evaluated through the seven evaluation dimensions: relevance, effectiveness, efficiency, innovation, sustainability, additionality and evaluation. The 50 projects evaluated in detail were individually rated in each dimension using the following grades: Low (1), Medium-Low (2), Medium-High (3) and High (4). In addition, information obtained from the “Case Studies” was tabulated in each dimension, to afford greater insight into certain key aspects. Lastly, it is worth highlighting the contribution made to this evaluation by the executing agencies survey, which enriches it by adding a project-executor perspective.

### **1. Relevance**

3.10 In terms of relevance, the evaluation sought to measure the extent to which projects addressed highly important issues in the development of microenterprise in the country. Analysis also covered the timeliness of the interventions, knowledge displayed of the market and setting, and choice of the executing entity, in order to determine whether conditions were in place for the specific intervention to achieve some success.

- 3.11 The conclusion is that in most cases, projects addressed highly relevant issues. This is explained not only by the fact that microenterprise is a large sector in most of the region's countries and suffers from the same lack of access to credit services; but also because the projects formed part of a structured intervention strategy that took advantage of knowledge accumulated by other regional institutions, the Bank itself and by the MIF, as it gained experience. "Tailor-made" projects, especially using financing and direct or indirect capital contributions, have been particularly important because they have intervened at a key stage in the development of the institution being supported. They have also made it possible to transfer lessons learned to other institutions and countries, as a result of successes achieved.
- 3.12 Lastly, the interest rates charged by these institutions, which are far higher than those offered by the commercial banking sector but below those of individual money-lenders, show that the financial services offered by the institutions, normally strengthened through the MIF projects, are highly appreciated by clients. The low arrears levels displayed in microfinance entities, are further proof of this. The evaluation also found a high level of satisfaction with the MIF services among customers in three of the region's countries (see section 8).
- 3.13 This is borne out in the general classification of this dimension for all projects evaluated. Over 80% of projects reported high levels of relevance in the ex-ante and ex-post stages. The level fell to 60% during execution, however, basically because of the absence of a market consultation culture encountered in most projects. The project cluster contained examples of high relevance, having achieved NGO formalization, or having at least helped to lay the foundations for this. In other cases, private investor participation was also achieved, and some projects managed to persuade other financial entities to enter this sector.
- 3.14 Projects promoted through Facility III-B warrant special attention. These are projects in which the MIF uses credit instruments, or takes equity positions either directly or through venture capital funds. These operations have been analyzed in detail and in-depth, and have given rise to the most successful experiences of microfinance promotion in the region.
- 3.15 For the Line of Activity, most projects aim at general strengthening of microfinance NGOs. Some of these have made the step to formalization, but others have fallen short and their future is unclear. In other cases the contribution to microfinance in certain countries is not clear, especially in Bolivia or Peru, for example, where already formalized microfinance institutions have proven their viability and sustainability, and there are many of them. In many cases projects supported through the Line of Activity arise from the IDB/MIF diffusion work; these are subject to more superficial analysis, precisely because the Line was created to streamline procedures. That objective was achieved, to judge by indicators of processing time—but apparently at the expense of other elements such as relevance. In the case of SLA development, equally relevant projects were promoted since these entities were already supplying financial services to the

- poorest and rural population strata in their respective countries. Nonetheless, most remained dependent on regulatory reforms that either never occurred, or else were delayed and/or insufficient, which affected project relevance in terms of execution and final effect.
- 3.16 Throughout 1993-2001, the average relevance rating on projects signed each year has generally been between High and Medium-High (except in the first year); there was a sharp fall (Medium-Low) in 1997, because of a single low-relevance project (Multicredit Bank). The situation recovered in 1998, before declining slightly again, coinciding with the start of the Line of Activity in 1998, and a considerable number of operations were channeled through this mechanism.
- 3.17 Having said that, coordinated work with the Bank has enabled the MIF to take advantage of previous experience gained by the IDB through small projects, microglobal loans, dialog with countries, and knowledge of the corresponding markets. As a result, project development has benefited from direct knowledge gained in previous experiences, and the development of a methodology for analysis made it possible in most cases to choose the best prepared and most dynamic institutions in each country, whether formal or informal. This meant that the entities chosen were sustainable, which underwrote the permanency of the benefits obtained from the different projects. This can explain the fact that, as shown in the empirical data included in Annex III, a large proportion of projects did not have market studies, and in addition there was the well-documented difficulty of obtaining data on the microenterprise sector in most of these countries, particularly in the first half of the decade.<sup>23</sup>
- 3.18 In terms of market impact, as upscaling operations have predominated (i.e. strengthening of NGOs, where in addition only a few have been formalized), the quantitative impact on the market has been marginal, except in Bolivia, which boasts the most successful cases. Without doubt, the project cluster supported by the MIF, which also involves all the main microfinance institutions in the region, has clearly demonstrated that providing credit to microenterprise is both feasible and profitable, thereby changing the paradigm that existed in the early part of the decade.
- 3.19 Analysis of forms of communication with clientele, shows that neither projects nor institutions have incorporated mechanisms to keep up with changing client needs, nor do they use market feedback mechanisms. This is one of the major weaknesses of institutions which, like most NGOs, have been developed in a market with quasi-monopoly characteristics. The absence of this feedback culture

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<sup>23</sup> Most countries do not even have data on microcredit channeled through formal financial entities, because until now very few banking superintendencies have required microlending to be shown separately in the portfolio breakdown of lending institutions. This is important not only for statistical purposes, but also to improve the supervision of financial institutions. In terms of risk, microcredit should be evaluated and supervised differently than consumer or commercial credit, as has been demonstrated in Peru and Bolivia, the countries with the most advanced legislation on this subject. The category was also established recently in Colombia.

also explains why it was impossible to obtain reliable information on clients' perceptions of the services received through the institutions. Nonetheless, as shown below, the impact studies conducted specifically for this evaluation highlight the excellent opinion clients have of the service provided by the institutions. This confirms the relative lack of importance attached to the cost of money compared to the speed and agility with which their applications are approved.

- 3.20 Clients' willingness to pay has been amply demonstrated in the case of microfinance institutions. Even in a crisis such as Bolivia has been through, arrears indices have remained lower than in the rest of financial system, in a market with the highest interest rates. As mentioned in Chapter I, the results obtained through financial indicators such as the interest rates that these institutions charge, and their nonperformance levels, show clearly that microentrepreneurs are interested in their services and are willing to pay for them, despite their high cost compared to average rates in the financial sector in any of these countries. Survey replies showed that 75% of cases reported having received demonstration of their clients' willingness to pay.

**Box 3.1: PROFUND – Venture capital at the precise moment: An example of high relevance**

By 1994 it had become clear that there was a need for MFIs to convert into formal intermediaries, to enable them to grow and channel a larger volume of resources to the microenterprise sector. For this purpose, ProFund was set up as a venture capital fund to contribute part of the initial capital of these entities. ProFund would make it possible to leverage resources from other investors, generate a scheme of management incentives to guarantee maximum profitability of the investment, and ensure the existence of mechanisms for total exit within a pre-established period. During this period, the recipient of the investment would have to achieve a predefined profitability, to encourage private-sector investors to participate in the sale. Profit maximization as an objective would also fulfill the function of promoting a private governance scheme to make it possible for NGO directors to manage the new entity under business frameworks. The IIC was the first IDB Group institution to be contacted, but as microfinance institutions were involved it was decided that the MIF would assess the operation, and, in the event of a positive evaluation, contribute the resources. The main promoters were Acción Internacional, Calmeadow Foundation, FUNDES, SIDI and, at the individual level, Fernando Romero.

Consolidating operations to carry out the investment has required a major effort. In fact, during the decade and in varying circumstances from country to country, the MFIs in which ProFund has invested have required both liquidity contributions and advisory services to design the best framework for their conversion. The flexibility of the fund and its managers, has made it possible to adapt to circumstances to facilitate emergency funds in moments of great difficulty, such as the financial crisis in Ecuador. The performance of ProFund has been excellent, ending its 2001 investment cycle with a portfolio that included the 11 most important MFIs in the region, covering 352,000 clients and a consolidated portfolio of US\$351 million. In addition to this, ProFund has managed to transmit knowledge acquired during this period, to institutions and potential investors, and its participation on a for-profit basis has made it possible to improve the governance of institutions and contribute to their evolution into financial intermediaries offering a wide range of financial services.

## **2. Effectiveness**

- 3.21 In this dimension, the aim is to analyze the effectiveness of projects in achieving their targets. Given the changing nature of the financial business, one of the keys to improving a project's probability of success is to conduct an adequate analysis of the risks to be faced, and to consider mitigation measures and contingency

- plans to deal with them. Effectiveness is also evaluated from the standpoint of being able to suspend operations in time when circumstances require, or adapt projects when changes in the environment make this advisable.
- 3.22 For the project cluster analyzed, the conclusion is that effectiveness has been high, but it could have been higher still if the risks had been anticipated more clearly. Given the nature of these projects, the risks identified are normally financial, such as a deterioration in portfolio indicators, or failure to obtain the desired profitability. Nonetheless, both the likelihood of this occurring and its impact on results tend to be underestimated, although risk analysis and appreciation of true impact on projects have improved during the decade. Risk identification is weakest in SLA projects. In the few cases where projects were clearly unlikely to achieve their objectives, or even to be carried out, there is a resistance to cutting losses or reformulating them, especially when this decision has to be taken by the Country Offices. This has also improved recently with the implementation of rules aiming to automate administrative actions on projects displaying serious delays in implementation or fulfillment of their objectives. In the face of external events that affect project development, the conclusion is that an unsuitable legal framework, which prevents free determination of interest rates, along with actions that foster unfair competition, are the main reasons why some of the microfinance institutions supported have not been successful.
- 3.23 In terms of grades, once again the projects receive a Medium-High rating on average, with the project cluster financed through Facility III-B receiving a slightly higher rating than those of the Line of Activity, and clearly above SLA projects which earn a Medium-Low grade.
- 3.24 During 1993-2001, the average annual classification of project effectiveness seems to improve, rising from between Low and Medium-Low in 1993 to Medium-High in 2001. The Low grading earned in 1993 corresponds to a single project of very low rating, however, and the pattern since 1994 actually displays declining effectiveness towards the end of the decade. Projects implemented up to 1995 achieved Medium-High and High effectiveness ratings thanks to some highly effective cases (ProFund, Caja Los Andes, Calpiá, WWB of Colombia, among others), before slipping back in 1996 and 1997 to Medium-Low. Between 1998 and 2001, the effectiveness rating recovered, but without regaining the levels of the early years.
- 3.25 Lastly, the effectiveness of projects in terms of the ultimate objective of consolidating credit supply for the microenterprise sector, cannot be denied. The consolidated figures from 38 of the entities supported by the MIF—either directly, or indirectly through two of the funds that finance MFIs (LACIF and ProFund)—confirm this. The microenterprise portfolio of these entities totaled US\$633 million and catered to 754,000 clients. In virtually the same period, the MIF has channeled US\$19.3 million in reimbursable and nonreimbursable resources to these entities; and if one adds financing through capital contributions and loans from ProFund and LACIF, total funding channeled to these entities

- would amount to US\$33.2 million. This gives an idea of the excellent multiplier effect achieved in the MIF interventions.
- 3.26 These portfolio volume figures still have not managed to impact aggregate lending in the countries concerned, and they have not overcome the lack of access for the vast majority that comprise the microenterprise segment, except in Bolivia. Nonetheless, the “microfinance industry”—consisting mainly of the MIF-supported entities and other international donors acting in concerted fashion—has shown that microlending is a profitable operation with a low arrears rate, provided correct risk-rating methodologies are applied. As a result, the goal of providing a sustainable model to formal financial institutions has been achieved, and in the latest the MIF stage some of them have also begun to implement these credit “technologies.”<sup>24</sup>
- 3.27 Looking in detail at the results of the evaluation of Case Studies, the fact that most of these projects involve financial institutions or financial products facilitates identification of the basic risks in the activity, particularly those financed by Facility III-B, i.e., where the MIF lends funds or takes equity positions. Risk identification is very limited in Line of Activity projects, and even more so in those with SLAs. Several of these depend on regulatory reforms but have no contingency plans in the event of the reforms not being carried out or being delayed, as in fact has happened. The same occurred in some cases of support for formalization processes that depended on a new framework being approved for converting NGOs into formal intermediaries.
- 3.28 There is a tendency for risks and their importance to be underestimated, which results in mitigation actions not being considered. A clear change can be seen with respect to this problem over time, however. As we discovered in interviews, the Donors Committee now has a better understanding that these projects imply risk, and that it is more productive to recognize them and consider mitigating actions. This has enabled the management of the Bank and the MIF to state the risks more explicitly in the respective documents.
- 3.29 Generally speaking, the identification of risks peculiar to more complex financial activities is very weak; for example, we have not found any project that identifies risks in terms of liquidity shortfall, interest rates or exchange rate.
- 3.30 Projects are more adaptable to changes in the environment when they arise from client or beneficiary needs – as is understandable given the characteristics of this type of institution. The low rating in terms of adaptation in the event of design defects suggests that design errors were few. Having said that, in several cases where external events seriously impaired project implementation or undermined the chances of achieving the results, this situation was not used to reformulate the project or to suspend disbursements, still less cancel them. Here again there are

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<sup>24</sup> Examples include Financiera Trisan in Costa Rica, Bancaf in Guatemala, and Bahncaf and Bancomer in Honduras.

major differences between projects approved through Facility III-B, which are supervised by the MIF in Washington, and Line of Activity projects which are supervised and managed by the respective Country Offices. An example described in Box 3.2 illustrates this situation.

- 3.31 In relation to adverse external events undermining project implementation, most institutions had a clear view of the performance of the regional economy during the 1990s. In some cases, such events led to a change in MFI priorities (the projects in Bolivia and Uruguay being obvious examples); while in others, project objectives could not be achieved because of deteriorating portfolio quality indicators.

**Box 3.2: ECOFUTURO – The effect of underestimating risks: Low effectiveness**

The project to support the private financial fund (PFF) Ecofuturo was developed in Bolivia between 1998 and 1999, with a view to strengthening its financial and operational management capacity during the start-up and consolidation stages. This project was important because it offered the chance to create a successful example of a regulated financial entity through the merger of major microfinance NGOs.

The economic slowdown in Bolivia and the consequent deterioration of financial entities' portfolios were external events that damaged the project. But what harmed it most was a lack of planning in creating the PFF, which meant that it began operations with major institutional and financial weaknesses that made it less likely to achieve any impact. Despite the adoption of various mechanisms for managing risks detected in the design phase, problems of institutional governance arose. One of the greatest risks involved reconciliation of the individual interests of the various NGOs, which continued to carry out microlending activities in the same market as the recently created PFF.

The weakness of the entity created, which was addressed only marginally in the MIF project, put the aim of the project at risk. This shows the importance of evaluating the entity's financial health, and making a detailed review of procedures and mechanisms for integrating the businesses of institutions that are individually quite different.

- 3.32 In contrast, the credit line for bond purchase approved for Prodem around the same date, incorporated financial indicators allowing for adequate monitoring of the institution, compliance with which depended on the availability of the credit line. Despite having delayed taking the decision, understandably given the implications of cancellation, the operation was suspended in March 2002 because the risks were seen as very high both for the MIF and for potential bona-fide bond purchasers (Box 3.3).
- 3.33 On the question of how the IDB/MIF has responded to the need to adapt projects, the evaluation concurs with the replies given by executing agencies, in that we find commitment to results, but measured in terms of disbursements. We also agree that the greatest weakness is in the speed of the IDB/MIF response to changes arising during development and implementation of a project. Having said that, there are also differences between projects that are managed and disbursed at Headquarters, and those run from the Country Offices, which display less flexibility in adaptation.

### **Box 3.3: PRODEM – Timely withdrawal: A difficult decision**

This project was developed in Bolivia in 1998 and 1999 in order to explore a new source of funding for the microfinance industry, by supporting Prodem in placing bonds on the Malaysian stock market. The project was seen as a pilot experience that could be extrapolated to other countries. And the time of design, Prodem was undergoing formalization by converting into a private financial fund (PFF). The project design was based on two components: technical cooperation resources to support a bond issue, complemented with a Stock Market Operations Credit Line for US\$2 million. The latter could be used to purchase up to 33% of each of the bond issues floated over a three-year period. In the first of these, the intention was to allocate US\$500,000 for an issue of US\$3 million (16.7%).

Basic stock-market risks were evaluated (country, financial system and market risks), together with those relating to management of the institution, and legal risks. Although these risks were adequately assessed, given the situation existing in 1998 and 1999, the impact of the looming crisis on the microcredit domain was not anticipated. The crisis raised the entity's risk indicators above the tolerable threshold, so the IDB/MIF decided not to execute.

The decision was not an easy one. It could be argued that if the project was intended to assist a microfinance institution to enter the stock market, it would be illogical to pull out just when the situation worsened, when tools such the risk premium were available to adjust project parameters. Nonetheless, the IDB/MIF support in buying this bond issue was clearly justified as a guarantee to the market of the institution's sustainability, although no formal guarantee was involved. In difficult conditions for the institution and the Bolivian financial system, this could have involved a risk that the MIF/IDB could not assume, given that the aim was to attract investors from the capital market. Accordingly, in our opinion the decision taken was correct. Nonetheless, it raises questions about the accountability of the MIF towards savers or bona-fide investors, who can use the MIF support for an institution as backing for their savings!

- 3.34 As mentioned above, there can be no doubt that the strongest proof of project effectiveness is the consolidation of real and sustainable supply over time, through entities which have now mostly become formal financial intermediaries. This gives rise to the high ratings, in terms of ex-post results, awarded to successful projects such as the creation of Caja Los Andes in Bolivia, Financiera Calpiá in El Salvador, Banco Solidario in Ecuador, and the WWB project in Colombia. Comparative performance figures for these projects and others supported indirectly by the MIF through ProFund are presented in Box 3.4.
- 3.35 Lastly, effectiveness in terms of the ultimate aim of consolidating a supply of credit for the microenterprise sector cannot be denied, as the consolidated figures from 38 of the entities supported by the MIF directly, or indirectly through LACIF and ProFund, confirm. In late 2001, the microenterprise portfolio totaled US\$633 million, catering to 754,000 clients (Table 3, Annex 3).

**Box 3.4 : Consolidation of microfinance institutions: Many cases of high effectiveness**

Many of the projects carried out by the MIF in the microfinance area stand out because of their success in achieving objectives and obtaining excellent results. These efforts have helped to make several Latin American microlending entities leaders worldwide.

Outstanding examples include Caja Los Andes and Calpiá, which were created from the formalization of microcredit NGOs and were the first to receive the MIF support using capital contributions. The leading group of institutions that have received direct or indirect support through the MIF currently have a client base in excess of 280,000, with a gross portfolio value of US\$333 million. Just five years ago they had started out with a volume barely above US\$80 million; and none of them had formalized at the start of the decade.

**Size of the most successful cases supported by the MIF, December 1996 - 2001**  
(Thousands of dollars)

	CLIENTS		PORTFOLIO	
	1996	2001	1996	2001
Banco Solidario	1,151	25,232	1,619	71,221
Bancosol	67,276	55,727	36,982	81,149
Caja Los Andes	16,431	39,027	12,236	52,634
Calpiá	18,051	36,318	11,859	31,216
Mibanco	26,225	77,942	10,311	59,923
WWB Colombia	22,847	45,276	11,692	35,215
<b>Total</b>	<b>153,977</b>	<b>281,523</b>	<b>86,696</b>	<b>33,359</b>
<b>Growth</b>		<b>83%</b>		<b>285%</b>

*Source:* Prepared by the author on the basis of figures provided by Microrate, Omtrix and the entities themselves.

### 3. Efficiency

- 3.36 The project efficiency dimension aims to measure the use made of the financial and time resources employed. It starts by identifying the quality of planning for activities and resources, and then analyses the management of timings, taking account of mechanisms used to improve the efficiency of execution and the main obstacles encountered.
- 3.37 As a general result, projects are more efficient if they do not depend on contracting processes, as happens in the case of financing or capital contributions made through venture capital funds. Projects that include other components such as training, technical assistance and equipment procurement, do not include activities planning in their design, but a description of the components involved, to which a budget is allocated. This is largely explained by the streamlining imposed on financial projects by the Line of Activity, which effectively shortens times between registration and first disbursement, but also covers more complex projects, such as those seeking to provide a framework of regulation and supervision for SLAs. The more streamlined action that this could imply in principle, is lost in execution, and executing agencies complain of difficulties

- arising from cumbersome procedures that are difficult to comply with—which, as we were able to observe, have nonetheless failed to prevent “bad” contracting. Having said that, there is a disconnect between the people who design the operations and those who authorize disbursements, which causes difficulties in project development. Lastly, there are many projects, especially in the Line of Activity, which could improve the conditions and quality of services if joint contracting schemes were considered.
- 3.38 In this dimension, the average classification of projects including Case Studies and Evaluation Fact Sheets, was again Medium-High for all projects. Those supported through the Line of Activity, however, also have Medium-High rating on average, although a lower one, while SLA projects on average gain a Medium-Low grade, and projects involving financing and capital contributions earn Medium-High. This reflects the fact that the efficiency achieved in the previous stage for Line of Activity projects is partly lost during execution, as discussed below, when entities come up against the Bank’s administrative procedures for making disbursements.
- 3.39 The average annual rating calculated for the project cluster in this dimension declined until 1996, dropping from High in 1994 to Medium-Low, before improving to Medium-High. This recovery occurred during the period with the largest number of projects supported through the Line of Activity.
- 3.40 At the detailed level of Case Studies, project planning tends to take place through a general description of components, usually without defining the resources that will need to be used, or adequately specifying execution times. Nonetheless, as is logical given the type of projects involved, the most frequently used planning instruments are financial projections.
- 3.41 In the case of credit and equity investment operations, planning is limited to a thorough risk analysis prior to approval, along with a definition of mitigation measures and a legal structuring of the operation, before proceeding to disbursement. In Line of Activity projects, a description is made of activities to be carried out in each of the components authorized within the Line (technical assistance, training or systems); and in the case of SLA projects and those classified as “Others” activities pertaining to each project are identified in detail.
- 3.42 The resources needed for these activities represent either the quantification of the capital contribution or loan to be granted; or, in Line of Activity and other projects, an estimate of the costs assigned to each of the components to be financed. Generally, neither timings nor a timetable are defined for carrying out the activities, but these are normally included as conditions precedent to starting disbursements. Terms of reference for consultants and detailed product budgeting are also absent; usually there is an estimated budget for each component. Clearly, project start-up and development times could be greatly improved if this were done prior to approval, since not only would it serve as a guideline for executing entities, but would also afford the Country Offices a better idea of the objective of

- the main contracts involved, thereby pre-empting conflicts with executing agencies.
- 3.43 Delays in project execution are mostly caused by procedures for contracting consultants or procuring equipment or system software. We also found a number of cases where the individuals who process and authorize disbursements did not understand the aim of the project and raised obstacles for minor problems. This could stem from the fact that Country Offices were not consulted or involved in the design of the project, especially in the earlier ones, resulting in a divergence of criteria at the time of implementation that makes them difficult to carry out. There is evidence of an improvement in this aspect over time, but a greater training effort is needed at the Country Office level, or the establishment of a monitoring and evaluation scheme coordinated by Head Office, either directly or subcontracted to external experts, as has recently been done in the MIF for the “quality cluster”.
- 3.44 A deeper analysis of the causes of delays, based on executing agencies’ replies to questionnaires, revealed the following: of the 42 surveys received, 14 of them (33%) did not answer the question, two (4.8%) reported that there had been no delays, and the remaining replies reported delays caused by processes for hiring consultants (54%), and procurement of equipment and systems (38%). In comparison, 42% reported delays in implementing specific components caused by difficulties unrelated to the IDB/MIF processes.
- 3.45 Among the Case Studies, less than 50% had serious difficulties either in procurement, contracting or disbursement processes, since about 20% of them were in an initial stage of execution, so the question was not relevant, or it was impossible to obtain the corresponding information. The largest percentage reported problems in disbursements, since 48% of these cases involved capital contribution or loans.
- 3.46 The very fact that one of the mechanisms used by the MIF involves loans, facilitates the disbursement process. An example of this is the second operation approved for Banco Solidario in Ecuador, which was packaged with a nonreimbursable technical cooperation to support it in developing a project on remittances with the Cajas de Ahorro in Spain (see Box 3.5).

**Box 3.5 : BANCO SOLIDARIO: Efficiency in intervention**

the MIF support for Banco Solidario in Ecuador in 2001 was provided through two mechanisms: a credit line to expand the lending portfolio to microenterprises, and a nonreimbursable resource component for a pilot project to transfer, distribute and manage remittances from Ecuadorian emigrants living in Spain. The first component is expected to finance the bank’s normal operations with medium-term funds, while the second will make it possible to offer Ecuadorian emigrants in Spain ways of increasing their savings and reducing transaction costs, based on a partnership with various Cajas de Ahorro in Spain.

The high level of efficiency achieved by this operation was based on the possibility of disbursing the credit line in two tranches. It also benefited from the broad experience of Banco Solidario in managing loans to microenterprise, despite not having experience in the remittances business. The two components were rapidly put into operation. In the case of the credit line, the prior process made it possible to assess the risk being assumed by the MIF with the entity. As regards the remittances project, this is already operating with Caja de Ahorro in Murcia and 200 clients; and it is about to start in Madrid. The software designed for remittances has represented a contribution to the Cajas de Ahorro in Spain, which is an unexpected benefit of the project.

- 3.47 In the case of institutional strengthening projects through the Line of Activity, it is worrying that one of the reasons for delays is the impossibility of obtaining a consultant or a minimum number of consultants with experience in microfinance. This is particularly serious because, after reviewing these cases, a conclusion that clearly emerges is that the success achieved by microfinance institutions that are consolidated today in the region, has been closely linked to the type and quality of technical assistants supporting them.
- 3.48 Consequently, the effort by the MIF in implementing the Line of Innovation in 2001, including introduction of a competitive bidding system, is particularly interesting because of the way resources were subsequently delivered, under a single assistance contract with the MIF, benefiting more than five institutions in each case.
- 3.49 The fact that a large percentage of entities have not reported problems with the MIF/IDB processes is largely due to the fact that 57% of cases evaluated involve entities that have previous experience with the Bank, mainly through small projects, while 25% have experience with other multilateral or bilateral organizations (particularly GTZ or USAID). This shows the importance of having acted with a coherent long-term strategy, in which other international bodies have joined and clearly contributed to the success achieved in microcredit in the region.
- 3.50 The most serious instance of lack of efficiency in the IDB/MIF procedures occurred in the emergency operation designed to support microfinance institutions in countries affected by Hurricane Mitch, in 1998. Because of administrative delays, entities received the funds that had been earmarked to support them in the “emergency” only after considerable delay (see Box 3.6).

### **Box 3.6: HURRICANE MITCH – Low efficiency: Essential haste clashed with structural rigidity**

This project was intended to help rebuild microenterprises in rural and urban zones that had been affected by hurricane Mitch, which struck, in El Salvador, Nicaragua, Guatemala and Honduras between 29 October and 5 November 1998; and to strengthen microfinance institutions operating in the affected area. The project was approved on 7 December 1998, in super-rapid time, given the urgency with which the needs of microentrepreneurs and ailing microfinance institutions had to be addressed. A US\$10 million credit line was designed with a ten-year payback term, to provide liquidity to microfinance entities catering for microenterprises in the affected areas. A further US\$2 million was approved in the form of nonreimbursable funds for technical cooperation, and US\$900,000 for administration and technical assistance in each country.

Following approval, the project was to be managed by the Bank's respective Country Offices. These carried out their task adequately: they selected the beneficiaries and oversaw disbursements to 33 entities of which 11 were in Honduras, 13 in Nicaragua, four in Guatemala and five in El Salvador. In total, 22,000 clients were catered for, mostly from the rural sector, with credits averaging US\$379 each. Slightly over half of all beneficiaries were women.

Nonetheless, the slow speed at which the loans were disbursed prevented them having an immediate effect on the liquidity of microfinance entities: disbursements were finally made between six and 12 months after the hurricane, which meant the entities had to solve urgent restructuring needs in the microenterprises affected, using their own resources. When they eventually received the funds, the effect was to improve asset solvency based on a reduction in financial costs associated with preferential credits. The slowness in disbursement was due to requirements imposed on nonformalized entities, which mostly did not have adequate administrative and financial arrangements, and because of decisions as to what legal instruments were acceptable to both the legal arrangements in each country and the Bank's own legal department.

The results obtained also raise the question of whether a loan is the most suitable and effective instrument in cases of natural emergency; and also whether this should be offered under market conditions, as was finally established in the Natural Disasters Line, which was created as a permanent instrument using resources recovered from this first operation.

- 3.51 The executing agencies highlighted major requirements especially in relation to the procurement of equipment and systems, and hiring consultants. This was confirmed by information gathered in direct interviews especially in relation to Line of Activity projects, where the "compartmentalization" imposed by the Line in many cases restricted opportunities for obtaining the necessary equipment and even of contracting suitable technical assistance. Reconsideration of these aspects would be useful, especially in connection with the possibility of reviewing hiring schemes to achieve larger economies of scale and better quality consultants.
- 3.52 Although procedures for processing an application are established in the guidelines and appendices designed by the MIF, not all projects generate the expected steps. This is partly because an organization can gain indirect access to headquarters, either through the IDB or the MIF. It was also not easy to obtain systemized information on projects that were rejected at some stage in the process, either in Country Offices or at headquarters, because the process does not indicate how these should be treated and what levels of the organization can reject them. As things stand today, it seems that any staff member, at any level, can reject or return a project, despite the lack of any protocol establishing how this should be done, and by whom, which clearly makes the procedure more opaque.

#### **4. Innovation**

- 3.53 A key element in the MIF projects should be their capacity to innovate. Accordingly, in this dimension the aim is to determine whether projects made it possible to introduce innovative elements that ultimately function effectively and are being used and imitated. The aim is also to discover whether a demonstration

and innovation effect was projected on to other the MIF projects, or whether they were implemented in the Bank's larger-scale and broader-scope operations.

- 3.54 The conclusion is that the MIF has helped develop highly innovative microfinance projects, with over 60% of those evaluated reporting a strong effect in this dimension. These represented innovations in most countries, resulting from introduction of "microcredit technologies," or the formalization of NGOs in order to expand the supply of credit to this segment of the population. It is clear that the diffusion work carried out in conjunction with the Bank has allowed successful experiences to be broadly disseminated and replicated.
- 3.55 Without doubt, the greatest innovation has been achieved by projects executed through equity or financing. While the project cluster receives a Medium-High rating as a whole, those supported through Facility III-B earned a higher grade, whereas innovation is the dimension in which Line of Activity projects received their lowest score: Medium-Low. In view of this result, the Line of Innovation approved in 2001 is an interesting scheme that combines efficiency in the selection and hiring process with the possibility of promoting greater innovation.
- 3.56 This situation is reflected in the evolution of the average project cluster ratings each year. Calculations show that project innovation declined substantially from a High rating in 1996, reflecting the effect of a large number of projects developed through the Line of Activity with low innovation content. By 2001, the average grade had recovered from Medium-Low to almost Medium-High.
- 3.57 In Case Studies where innovation was detected, this involved introducing a new credit technology to the respective country, enabling a microfinance institution to cater to the needs of microentrepreneurs. But more than anything else, it entailed first-time establishment of formal institutions providing financial services to this sector.
- 3.58 Is also important to highlight the fact that the MIF has been an innovator in designing the instruments with which it supports institutions; and once again Facility III-B has the largest number of these cases. The initial equity operations were innovative and risky, including elements that sought to ensure that the MIF support would not be limited to taking an equity position, but would also include elements to stimulate the participation of private-sector investments over time—hence the "Put"<sup>25</sup> option that was introduced first in the operation of Calpiá and Caja Los Andes, and subsequently improved with the creation and experience of ProFund. In these two institutions, innovation was not confined to formalization but included large-scale implementation of a credit technology which previously had been used in the Peruvian Cajas Municipales, in a different institutional

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<sup>25</sup> A "put" option gives the holder the right to "exit" from an investment; in other words the investment will be purchased at a pre-established price. In the MIF cases, the price of the "put" option was defined as a certain number of times the book value of the shares at the moment of exit, which was also fixed in time.

framework and country. For that reason the case of Caja de Los Andes is an example of an innovative project worth highlighting within the cluster (see Box 3.7).

**Box 3.7: CAJA LOS ANDES – A prime example of innovation in microfinance**

This operation was designed in Bolivia between 1993 and 1994, alongside Calpiá in El Salvador. The institution had been created in 1991 as an NGO named Procrédito. With assistance from IPC and support from GTZ and an IDB Small Project, it had managed to consolidate to the extent that it was possible to consider its formalization. The MIF project had the specific purpose of helping the NGO to convert to a formal microfinance institution, by putting up part of the minimum required capital. This project initially combined a capital contribution of US\$400,000 with a loan of US\$1.6 million, which finally became one of US\$1.4 million, and a technical cooperation of US\$200,000. With the capital contribution, the MIF, the Andean Development Corporation (ADC) and Swiss Cooperation (STC) ended up holding 43.7% of the equity, while Procrédito (NGO), along with two individual Bolivian shareholders, held a majority 56% stake.

At that time, support by taking an equity position was an innovation – even more so considering the credit technology used was innovative in itself. For the Bank, it was one of the first equity operations, which forced it to establish the terms of the shareholder contract and start to devise instruments that would allow it to exit from the institution. The venture capital instrument was proposed very simply, and the exit strategy merely involved a put option at a price of 1.3 times book value. After three years, in which it proved difficult to find new investors for the institution, the MIF sold its share at this price to IMI, a firm created by IPC for the purpose of investing directly in institutions where it had lent technical assistance. In the process, the MIF obtained the initially expected return of 18% per year on the capital contribution, and recovered its loan on time.

Caja Los Andes is an international example of best practices in microfinance, representing a successful conversion of an NGO into a formal entity. The individual credit technology implemented in Caja Los Andes has been imitated in Bolivia and transferred to other microfinance entities in Latin America and in eastern European countries.

The risk assumed by the MIF in capitalizing an NGO in its transformation into a PFF demonstrated its commitment to microfinance and to the then innovative idea that the provision of financial services to the poorest microentrepreneurs could be viable and profitable. The support provided to Caja Los Andes and the outcome in terms of institutional viability, sustainability and profitability, confirms that what is important in microfinance is not the goodwill of the partners involved, but knowledge and ownership of appropriate credit technology.

3.59 Innovations in processes have been achieved specifically in Line of Activity projects, because most of them involve modifying processes in order to convert a nonformal entity into a regulated financial institution. Some cases did not involve innovation but support for an institution in work carried out. An example is the second operation approved through the Line of Activity for the five NGOs known as Women's World Banking (WWB) in Colombia. While the loan granted in 1994 is among the most innovative projects, the second operation provides support for institutional strengthening through consulting services on a number of operational aspects, at a time when the five NGOs have already demonstrated their sustainability and profitability (see Box 3.8).

**Box 3.8: Women’s World Banking, Colombia – Part II. No innovation: more of the same...**

The five Colombian NGOs that form WWB constitute one of the region’s leading microlending entities in terms of financial viability and best practices. During the 1990s it received IDB/MIF funds on three occasions, to strengthen its institutional capacity, enhance its credit technology and improve its operating capacity.

The most recent of these operations was in June 2000. Its purpose was to support the five members of the WWB Association in Colombia in improving their administrative and operational efficiency, with a view to formalization. As these entities have received technical assistance and support for institutional strengthening in the past, which has put them among the leading microfinance entities in Latin America, this project seems unlikely to make genuinely innovative contributions—especially when they are about to implement a truly innovative project with support received by the headquarters of the WWB network in New York, under the MIF Innovation Line. The latter project, approved in 2001, will implement programs of credit risk evaluation on palm pilots, intelligent cards for more streamlined disbursement of funds, and systems of credit scoring both in these five affiliates and in another two in the region.

3.60 Perhaps the most important aspect of the projects analyzed is that they have all contributed to changing the microfinance paradigm in the American continent. After nearly ten years’ work, nobody now doubts the possibility of constructing sound and profitable microfinance institutions; and supplying financial services to microentrepreneurs and to the region’s poorest populations in general has been shown to be feasible. Clearly, this has been facilitated by the fact that these institutions had previous involvement with the Bank, through the Small Projects Program; but even before the Working Group recommended the MIF intervention based on “clusters”, microfinance projects were already being implemented. The lessons learned—from practical improvements as well as errors—have been widely disseminated, taking advantage of the natural links between institutions and the networks that bind them together, and also through a major effort made by the Bank in publishing studies, holding seminars and, in recent years, the Microenterprise Forum. Without doubt, this has promoted the demonstration effect not only in each country but also throughout the region. It has also influenced international donors and social investors who saw their work in microenterprise as entirely assistential in the early 1990s, but nowadays are also developing market instruments, having learnt that the important thing is to support sound and sustainable institutions that can effectively expand access to financial services.

3.61 The effect achieved in association with the Bank has also made it possible to influence government policy design. The most obvious case relates to the regulatory and supervisory framework for financial institutions in several countries of the region, where the successes achieved by a number of these institutions has made it necessary to introduce reforms. Bolivia is the leader in this domain, although the effect has spread to other countries where the rules are already being amended.

**5. Sustainability**

3.62 To achieve a genuine impact, projects need to result in self-sustainable initiatives that are maintained and continue to grow after project activities as such have

- concluded. This requires not only a shrewd initial choice of executing agencies but also adequate incentives for project execution.
- 3.63 The executing entities in the projects evaluated have proven profitable and sustainable. This is largely because the MIF demanded demonstration of a minimum level of financial viability from the outset, as a prerequisite for supporting these institutions. A requirement of this kind was logical given that the ultimate objective was to consolidate a sustainable supply of credit to microenterprise in the region, preferably through formal lending institutions. In the case of venture capital funds, what is being sought is a commitment to this principle by the other partners; and adequate incentives are being introduced for administrators to achieve this. The same incentives are also applicable in the case of loans, which are always granted under market conditions. The most significant threat to the sustainability of microfinance institutions stems from inappropriate regulatory environments, so these also need to be taken into account when designing an operation.
- 3.64 As a result, when the Case Studies and Evaluation Fact Sheets are consolidated, projects earned their highest rating in this dimension (Medium-High) matching their relevance grade. Perhaps even more importantly, both Line of Activity and other projects received a similar rating in this category. Sustainability is less clear in the case of SLA projects, for which reason the grade awarded is lower.
- 3.65 This is confirmed in the evolution of the average project classification each year: sustainability has been between Medium-High and High most of the time, only falling below this level in 1997 and in the first year with a single project that achieved a low level of sustainability.
- 3.66 Commitment to sustainability starts with the evaluation of the executing agency itself, in which financial and institutional capacity are fundamental criteria. The fact that executing agencies had also been supported by the Bank in earlier stages of their development, also helps to explain the success of executing agency selection. The design of operations involving venture capital funds or direct equity investment increasingly includes appropriate incentives to make sure the objectives are fulfilled and that the operation is profitable. Most executing agencies demonstrate a high level of commitment during execution, since the entities all share the goal of deepening financial services on a sustainable basis--which they have to demonstrate as a condition for access to the MIF.

### Box 3.9: BANGENTE – Difficult to sustain: A good idea succumbs to a difficult context

This project was initiated between 1996 and 1998, as a combined financial and administrative effort by various shareholders to create a commercial bank that would provide financial services to small businesses and microenterprise in Venezuela. The new bank was created as a joint venture between Banco del Caribe, Grupo Social, Fundación Eugenio Mendoza, Fundación para la Vivienda Popular, ADC, ProFund, Acción and the MIF. Initial capital amounted to US\$2.3 million, of which US\$343,200 was provided by the MIF. This contribution was designed with US\$800,000 approved for capital and US\$200,000 for a nonreimbursable technical cooperation. The capital contribution was made in two stages: the first amounted to US\$343,200 (15%), and the remaining US\$456,800 would be provided in the event of the authorities deciding to increase the minimum capital authorized for a commercial bank, or should the Board of Directors of the Bank decide additional capital was needed for growth. The technical cooperation, shared with ADC, which put up US\$200,000, was aimed at designing an operational structure for managing third-party services and for the bank's information system.

When the project was designed, sustainability was evaluated in terms of the quality of the other bank shareholders; and the combination between a prestigious commercial bank of sound financial results, NGOs that would provide their portfolio and know-how, and other international investors such as ADC and ProFund, was thought highly promising. Project sustainability was considered very high at that time. Since then however, the performance of BanGente has been threatened by external circumstances such as the deterioration of the Venezuelan economy, and competition from the State itself, which has created financial institutions serving the same market niche under subsidized conditions.

At the present time, BanGente has assets of US\$8.8 million, liabilities of US\$6.4 million and a net worth of US\$2.3 million. Profitability is low, with a return on assets of 1.9% during the second half of 2001. Its portfolio has 5,221 clients, with an arrears rate of 4.93% which has been rising because of the deterioration of the Venezuelan economy. Although all the services envisaged in the project are currently being provided, they are not operating at the expected levels. Its reliance on Banco del Caribe for liquidity and management means that BanGente has little room for maneuver, and its cost structure makes it unviable unless it manages to substantially reduce its costs and/or demonstrate rapid portfolio growth, which in current conditions would be dangerous. In view of this situation, minimum capital requirements for banks in Venezuela were increased, which, together with the solvency margin of 2.6 times, explains why the MIF and ProFund have proposed turning the bank into a financial services subsidiary of Banco del Caribe catering to microentrepreneurs.

- 3.67 Adverse circumstances, unsuitable regulatory frameworks and State intervention by creating subsidized public banks are some of the elements that have made it impossible even to break even. An example of this is BanGente in Venezuela, a financial institution supported through the MIF equity investment, which had all the elements needed to be successful (see Box 3.9).
- 3.68 This case reveals the importance of a propitious regulatory framework and an adequate macroeconomic environment, explaining in part the successes obtained in several of today's best-known institutions in this field. It is clear that the success of institutions such as Caja Los Andes, Bancosol, Prodem and FIE in Bolivia is explained by the commitment of the national government and the banking superintendency to support their development effectively. This element needs to be taken into account by the MIF when deciding whether it is worth carrying out specific projects in a given country, or whether it is better to focus on promoting reforms in the regulatory framework. Another successful example that has amply demonstrated its sustainability is Financiera Calpiá in El Salvador, where a partnership between Fundación Calpiá, IPC as technical adviser, and international investors such as the MIF and the ADC, facilitated the emergence of a financial institution that today is consolidated and on the point of applying to become a commercial bank (see Box 3.10).

### **Box 3.10: CALPIA – High sustainability: Calpiá is likely to be around for a long time to come...**

This project was started in February 1994, in order to support Fundación Calpiá (an NGO that had inherited the credit program of the Salvadorean Association of Small and Medium-Scale Entrepreneurs - AMPES) in its conversion to a regulated financial entity to be known as Financiera Calpiá S.A. the MIF decided to take an equity position in Financiera Calpiá, putting up a total of US\$800,000, including US\$500,000 of basic initial capital and up to US\$300,000 additional capital should an increase be requested by the private investors. The institution's initial capital was provided by the Salvadorean Small Business and Microenterprise Support Foundation (FUAMPES), the Technology and Scientific Research Center (CENITEC), the local development agency (ADEL), the Central American Bank for Economic Integration (CABEI) and the MIF. Five years after the project, in 2000, the MIF sold its holding to IPC and IMI through an international sale process. As a result, Fundación Calpiá currently owns 40.02%, IPC 9.52%, IMI 28.5%, FUNDASAL 21.68% and others 0.26% of the institution's equity. The MIF shares were sold for US\$2.7 million, representing a profit of 26.7% for the MIF.

Since the creation of Calpiá, there has been a clear and decisive commitment to ensure the institution consolidates, as demonstrated through the learning process in the credit area, its expansion geographically throughout most of the country's provinces, and its effort to increase deposits. During execution, Calpiá was consolidated as a regulated institution that has succeeded in maintaining its goal of extending credit to the largest possible number of clients, thanks to its network of offices located in practically all the country's provinces.

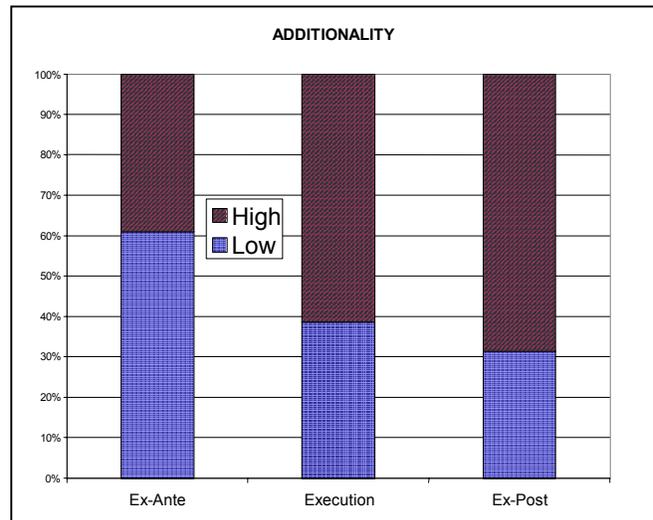
As of December 2001, Calpiá had assets amounting to US\$41.5 million, liabilities of US\$33.3 million and a net worth of US\$8.3 million. Despite the effects of the earthquake, Calpiá is posting a return of 6% on net worth and 1.03% over total assets. The institution's nonperforming portfolio has shrunk during the last four years and now stands at 3.12% of the total gross portfolio. Calpiá has a margin of solvency of 24.4%. In addition, the maturity of its liquidity, or its "liquidity gap", was negative as of December 2001, equivalent to 19.5% of total assets or 130% of short-term assets, without this implying a risk for the institution. Calpiá has 245 employees of whom 117 are credit officers, managing an average of 355 loans each; it currently serves a total of 34,530 clients with an average loan per client of US\$980.

## **6. Additionality**

- 3.69 The key issue in this dimension is to analyze the extent to which the MIF contributed, either qualitatively or quantitatively, to the development of the project. The aims are as follows: to analyze the extent to which the MIF intervention made it possible to incorporate conceptual elements into the project that were different from the original idea; to quantify the value added by the Bank in executing the projects, as well as complementarity and supplementarity with other interventions; and to determine whether there were processes, reforms or changes that were catalyzed through these interventions.
- 3.70 Now that these projects have been evaluated and analyzed as a whole, the conclusion is that the MIF value-added comes not only in the form of resources but also in terms of the quality seal its support represents. In many cases this additionality is wasted, however, because of bureaucratic delays; several executing agencies commented that by the time funds were actually received some opportunities had already been lost. Nonetheless, given the role played by the MIF in promoting this industry, it can be said that the region's microfinance sector would not be where it is today without the MIF support.

3.71 The grade given to this dimension would not seem to corroborate this last statement, however. The set of projects evaluated obtain the lowest rating in terms of additionality,

**Figure 3.1: General additionality rating**



albeit slightly higher in projects involving equity and financing, and slightly lower among Line of Activity and SLA projects. The explanation can be seen in figure 3.1, which classifies the different stages of the project process. It is in the ex-ante stage where this dimension receives the lowest rating, with more than 60% of projects reporting low additionality. This is largely because in several cases there is neither information nor

institutional memory available to answer the question “What elements of the original idea were amended in the design when the project was approved?” Nonetheless, at the execution stage, over 60% of cases reported a significant the MIF contribution. The possibility of exploiting synergies between the MIF and the IDB projects has an influence here, and the effect is even clearer in the ex-post stage, where in 70% of cases not only had the specific project been executed, but often other similar experiences were catalyzed, precisely because of the good results achieved in project execution. All of this is what has helped to establish the MIF quality seal in the microfinance area.

3.72 The project cluster’s yearly average additionality rating declined steadily until 1997, when it reached Medium-Low, having been Medium-High in 1994. In the final years of the decade, the classification recovered but without reaching the levels achieved with the initial projects.

3.73 In microfinance projects the MIF contribution is essentially measured in terms of the resources contributed. This has two dimensions, however. In some cases, the availability of resources is the key element, as in most Line of Activity projects. In other cases of equity investment or venture capital funds, the MIF support not only involves a significant monetary contribution but also symbolizes the support of an institution with knowledge of the business, contacts and access to best practices, thereby acting as a magnet to attract other resources.

### Box 3.11: LACIF – Creative financial instruments: An example of high additionality

The aim of creating a fund such as LACIF was to offer regulated and unregulated microfinance institutions credit enhancement instruments such as guarantees, direct credits and others to enable them to obtain resources to expand their portfolio to the region's microentrepreneurs. The project originated from difficulties encountered in the second half of the 1990s by microfinance institutions in the region, which, despite operating in the microcredit business on a commercial basis, did not have access to donor sources, either because they were already very large or because their high profitability kept donors away. Access to bank credit was not easy, because commercial banks did not know how to evaluate or assume the risk of a microfinance institution, and they usually demanded real guarantees that the institutions did not have. This situation seriously restricted their growth possibilities, because despite their conversion into regulated institutions, intermediation of savings in the capital market was unable to keep pace with demand arising from the growth of their portfolio.

The instrument chosen was a fund with capital contributions and subordinated debt, managed by an independent body that was required to liquidate its credits and wind up the fund within ten years. The MIF contributed US\$600,000 as capital, US\$3 million as subordinated debt and an additional US\$155,000 to contract technical assistance on various aspects.

LACIF has become an excellent complement to ProFund, financing institutions capitalized by the latter that had been unable to gain access to financing sources to permit portfolio growth. With IDB global loans, LACIF has suffered strong competition, but most of its client institutions at some point have received loans from the global lines. The MIF support at the time was decisive to obtain support from other international financial institutions. Furthermore, it is the fund where the MIF has greatest exposure to risk, not only because of the volume of resources committed (US\$3.6 million) but also because of its share of total assets, which at 48% makes it the largest individual contributor. In the stage that began following placement of the initial resources, the target is to double the value of the fund and, if possible, sell part of the MIF stake, which would facilitate genuine leveraging of the MIF contribution.

- 3.74 In operations of some financial complexity such as venture capital funds, the MIF supported by staff from the Inter-American Investment Corporation (IIC) and the Bank, has offered its know-how in improving financial and risk evaluation in these operations. It has also helped improve the structure of incentives facing administrators and management schemes, making any incompatibilities explicit. A case in point is the LACIF Guarantee and Credit Fund, in which the MIF contributed not only to its structuring, but also by giving it a radical change of direction when necessary, such that today it is a vehicle for financing under commercial conditions (see Box 3.11).
- 3.75 In cases of project cooperative strengthening, the Bank's knowledge of cooperatives and the framework of regulation and supervision governing financial activity helped define the corresponding projects. In some cases nonetheless, these were pushed forward before the legal conditions were in place, as mentioned above.
- 3.76 As revealed in interviews with Bank and the MIF technical staff, it is clear that one of the Bank Group's contributions to the microfinance industry has been *not* to support every institution that applies for funding. Consequently, the institutions that do receive support represent examples of best practices. One of a few cases where this did not happen was Fundación Sartawi (see Box 3.12).

### **Box 3.12: SARTAWI – A case of minimal additionality**

In 1999, an institutional strengthening project set out with the aim of supporting Bolivia's Fundación Sartawi in the process of transforming its credit section (rural financial services) into a private financial fund (PFF), taking advantage of its nine years' experience in rural credit. The project would offer technical cooperation resources through the Line of Activity, to strengthen the institution for consolidation as a PFF.

According to the executing agencies, the only contribution made by the MIF to the design of the project was in adjusting and determining the size of the budget. There was no interaction with other projects, and its catalytic effect was minimal because Bolivia had already generated a suitable regulatory framework for microfinance institutions. By 1999 Bolivia was clearly suffering from an economic slowdown, but there were also problems of acute competition in the microcredit sector, which should have led it to review the ultimate aim of this project. In late 1999, the Superintendency of Banks and Financial Institutions decided to tighten up the requirements for creating new PFFs given the weaknesses evident in formalized entities. This made it impossible to achieve the ultimate aim of the project, namely formalization of Sartawi. Despite this, the project was not reformulated, let alone cancelled in timely fashion.

- 3.77 It is also clear that the MIF interventions could not have been done without the support of the Bank, whose track-record and knowledge of microcredit entities and best practices ensured that the MIF actions were well directed from the outset. The links that exist between institutions and their technical advisers, together with the existence of financial instruments supported by the MIF, and the Bank's work in the field of regulation and supervision, have undoubtedly contributed to the high level of interaction between institutions and projects. The major challenge for the future is to achieve interconnection between this industry and the respective financial systems in each country.

## **7. Evaluation**

- 3.78 The final dimension involves issues relating to the evaluation of projects in their three stages. This analysis begins with project evaluability (the extent to which the projects designed are susceptible to evaluation), whether there are mechanisms for monitoring and evaluation during execution, and whether the results will be or have been measured once the project has been executed.
- 3.79 During the 1993-2001 period, the annual average rating of projects in terms of evaluation generally improved. This reflects the general learning process in terms of designing evaluation mechanisms for each project. The lowest point came in 1997 with a Medium-Low grade; but it has since recovered to reach Medium-High in 2001, again reflecting some of the progress made in project design in terms of evaluation mechanisms.
- 3.80 Project evaluability is facilitated by the fact that most of them involve institutions engaging in financial operations. For projects financed through the Line of Activity, indicators have been developed with industry benchmarks, together with target indicators and projections for each entity that are very useful especially when evaluating their financial sustainability. Accordingly, Line of Activity projects achieve the average rating in this dimension (Medium-High), and the grade is lower only among SLA projects.

- 3.81 In the case of projects that offer financing, or where equity positions are taken, evaluation and monitoring has been improved considerably by subcontracting a specialized firm. The process is complemented through direct monitoring by the MIF in Washington for these operations, and where contributions are made through venture capital funds.
- 3.82 In other cases evaluations nowadays are made through project performance monitoring reports (PPMRs), which doubtless represent an advance in monitoring the MIF projects. Compared to evaluations of the effectiveness and efficiency dimensions, the 2002 PPMRs tend to be more optimistic; but many of the differences between the two evaluations stem from different views of the evaluation tools in each case. Divergences in the efficiency dimension stem mainly from the fact that the OVE evaluation takes a longer-term view of efficiency than what is looked for in the MPPMR. In the case of effectiveness, the OVE evaluation included other criteria in addition to achievement of specific project targets, in assessing the entity's performance in this dimension (see following table).

**Table 3.2: Comparison between OVE and MPPMR evaluations**

IP/Efficiency			DO/Effectiveness		
	#	%		#	%
Projects with differences	14	48%	Projects with differences	17	59%
PPMR>OVE	11	38%	PPMR>OVE	10	34%
PPMR<OVE	3	10%	PPMR<OVE	6	21%
Difference in criteria Low/High	9	31%	Difference in criteria Low/High	6	21%
PPMR>OVE	9	31%	PPMR>OVE	4	14%
PPMR<OVE	0	0%	PPMR<OVE	2	7%
Differences of more than 2 points	0	0%	Differences of more than 2 points	3	10%
PPMR>OVE	0	0%	PPMR>OVE	1	3%
PPMR<OVE	0	0%	PPMR<OVE	2	7%

- 3.83 Lastly, no impact studies were carried out in any of the projects evaluated. To respond to some of the concerns of those who consider it important to gauge the impact of access to credit for microentrepreneurs, the next section summarizes the findings of three impact evaluations conducted specifically for this study.
- 3.84 Microfinance projects in general (the MIF ones included) have benefited from a call for transparency and comparability in accounting information, made by the Bank in the early 1990s, when it published the *Technical guide for the analysis of microenterprise financial institutions*. This document formed the basis for developing specific indicators for monitoring microfinance institutions. At the sub-cluster level the most systematic effort to improve evaluability is seen in Line of Activity projects, where the baseline information used to analyze institutions

has been standardized, along with the indicators used to measure their evolution and results.<sup>26</sup> These are also the only cases that have benchmarks.

- 3.85 In terms of project monitoring, the most widely used mechanisms are the six-monthly reports that are required of entities in nonreimbursable operations. These are only available in the Country Office, and are prepared with individual methodologies that concentrate on describing activities carried out and disbursements made. These reports could be made more useful, if a guide to drafting progress reports were produced; they should also be made available online, using a content format appropriate to the project type, which would greatly facilitate monitoring of projects and their results.
- 3.86 In the case of this project cluster, the MPPMRs are prepared only for cases not related to Facility III-B, because operations where the MIF has provided resources or invested equity are monitored directly from Washington. That is why prior to 2000 it used to make direct visits. From 2000 onwards, it has outsourced the monitoring work to the ProFund manager, Omtrix. This firm makes quarterly visits to the executing entities, and files very complete reports which senior the MIF staff then use to report to the Board of Directors and the Donors Committee on the evolution of the institutions.
- 3.87 Impact measurement is weak in most if not all projects. This is understandable in the case of the Line of Activity, given its small size and also because the whole Line has a mid-term and a final evaluation. The mid-term evaluation did not measure impact in terms of the beneficiary population, although it did measure the deepening of financial activities carried out by the institutions.<sup>27</sup> The absence of impact evaluations may also have deeper roots in a debate that has been ongoing for several years in the microfinance industry. Some stakeholders argue that the financial ratios of the microfinance institutions, along with their indices of portfolio growth and coverage, are sufficient to identify the beneficial impact of microcredit on clients. This point of view is opposed by those who claim that impact can only be determined when access to credit is shown to improve the lot of the poorest population groups.
- 3.88 Special mention should be made of atypical projects within this cluster, based on public-sector executing agencies. These include the project to intermediate savings in Bolivia headed by FONDESIF (see below, Box 3.13), and NAFIN in Mexico, which is promoting the productive investment of remittances sent by Mexicans living in the United States. The first case involves a very well

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<sup>26</sup> The main indicators refer to the size of the portfolio; the number of clients (to determine whether the minimum scale exists for sustainability); the level of arrears and the coverage of provisions for the nonperforming portfolio (which measures control of credit risk); and the productivity of the microcredit technology used, measured by average loan size and by the number of loans granted per credit analyst.

<sup>27</sup> Midterm Evaluation for LOA for Strengthening Financial Institutions for Microenterprise. MEDA, 1999.

structured project where the public facilitates and coordinates the corresponding processes. This project contains very interesting monitoring and final evaluation mechanisms. The same cannot be said of the NAFIN project, which has neither monitoring nor evaluation mechanisms in place (see Box 3.14). Implementation of the NAFIN project has not yet started.

**Box 3.13: FONDESIF – Promotion of a savings culture: Lesson learned on evaluability**

This project, which began in 2001, has the general aim of improving and expanding the supply of saving services in microfinance institutions in Bolivia, by creating a single program to receive funds from the private sector, the State, international cooperation agencies and other microfinance promotion entities. The project seeks to generate synergies between promoters under a single program to strengthen efficient, effective and sustainable intermediation of saving, promote expansion and consolidation of the supply and demand for deposit services, and support changes in the regulatory framework that this effort requires. The project was designed on the basis of three components: increase in the supply of high-quality saving services; increase in the demand for those services; and improvement in the regulatory environment for microfinance institutions that take in savings.

The project stands out for several reasons, but particularly because its design included instruments for measuring project evolution in terms of independent impact evaluations, together with impact monitoring of education and campaigns to raise awareness of the advantages of formal savings. Another impact study was carried out to identify project results through surveys of the target population and focus groups.

**Box 3.14: NAFIN – Productive use of remittances: Lessons learned on evaluability not applied**

Mexico has a large number of emigrants that send back to their country between US\$6 billion and US\$8 billion per year. Some of this may be channeled as investment flows rather than family remittances. Collective remittances of this type, which are consolidated in the United States in so-called Hometown Associations (HTAs) are a source of saving and hence investment for their native provinces in Mexico.

The project began execution through Nacional Financiera (NAFIN) in late 2001, with the aim of using emigrants' savings to create small businesses in three Mexican states, and to generate investments, infrastructure and employment and to slow down migration. The intention is to join Mexican emigrant groups with local investors and government support in the states of Hidalgo, Zacatecas and Puebla.

Despite the huge potential of this initiative, the design of the project in terms of evaluability is weak. The results are expected to be measured through the realization of its activities, and the hope of generating 20 projects for each participating state. There are no objective indicators to determine the degree and quality of project execution, such as: number of clubs contacted or affiliated to the program; the number of possible investors in each state; the number of emigrants who are going to invest; or the number of projects carried out. And no special plan was established to gauge project achievements, apart from mid-term and final evaluations. This low evaluability is likely to restrict learning from this interesting pilot experience.

## **8. Evaluation at the microenterprise level**

- 3.89 As part of the commitment assumed by OVE with the Donors Committee, in undertaking this evaluation, three evaluations were made to investigate what is happening in microfinance programs at the client level. Studies were undertaken in Bolivia, Colombia and Uruguay to gain a deeper understanding of MFI clients and to identify some of the effects of access to credit on the beneficiary

- population.<sup>28</sup> The summary of results, presented below, indicates the typical characteristics of the clients of this type of institution, highlighting the esteem in which microentrepreneurs hold the microfinance institutions from which they have obtained credit. The results also indicate a number of benefits at the household level in terms of health and education, and in greater business sustainability.
- 3.90 The studies were carried out in three entities supported by the MIF, namely Caja los Andes in Bolivia; Corporación Mundial de la Mujer in Bogotá, Colombia, and Cooperativa Nacional de Ahorro and Crédito (COFAC) in Uruguay. Their key results are presented below, and a more complete summary of the three studies at the microenterprise level can be found in Annex IV.
- 3.91 Despite a number of differences between the clientele of programs in different countries, there are similarities in the three cases studied. In most families that run a microenterprise, two or more people work. Normally businesses have a single owner; and a large percentage of microenterprises operate in the commerce sector. The decision to start the business generally stemmed from the need to continue with an existing family business or raise income levels, rather than as a way out of unemployment. Normally, microentrepreneurs work exclusively in their business, together with at least two other family members on average. In addition, about 70% of microenterprises keep business and family funds separate. This does not seem to be the result of links to microfinance entities, for the survey shows that this was the established practice before any dealings with such institutions began.
- 3.92 Generally speaking, microentrepreneurs run their businesses in very similar ways. In all three cases it was found that the most common use made of credit is to purchase raw materials, in other words working capital. Microenterprises normally also use other intermediaries for their financing, so there is less exclusivity than expected. A likely explanation for this is that microfinance is still at a very early stage of its development. Lack of exclusivity is seen not only in clients that have a history of using the entities included in the survey, but also among the control group consisting of first-time applicants for credit in those institutions.
- 3.93 In the three cases studied, microentrepreneur clients claim to be very satisfied with the attention and treatment received from the institutions. The vast majority (over 90%) of both old and new clients are satisfied with the attention, requirements, amounts granted, speed of processing, cost, installments and form of payment.
- 3.94 Finally, the surveys carried out made it possible to quantify a positive impact of access to microcredit in terms of higher spending on education, housing improvements, and greater safety at work, with fewer fluctuations in business

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<sup>28</sup> The methodology developed by USAID was used to measure the impact of microfinance institutions (*Assessing the Impact of Microenterprise Services*, AIMS, 2001).

operations. No statistically significant differences are reported in other aspects of the firm's operations, however, which is explained by the difficult macroeconomic situation currently prevailing in Bolivia and Uruguay. The recession had a major influence on replies to questions about business performance, with old and new client groups alike expressing very pessimistic views of the situation. In Colombia, on the other hand, the equivalent client groups were surprisingly upbeat. Presumably this is explained by the very positive development of the city of Bogotá that has occurred in recent years, in the midst of a country embroiled in a complex armed conflict. Clearly this initial evaluation needs to be complemented with an analysis over a longer period, in order to compare information adequately through time.

### **C. Compilation of lessons learned**

- 3.95 The experience gained by the MIF in the microfinance domain corroborates the importance of working on issues in “clusters”, since the MIF action in this field has been implementing WGR recommendations on this. The basic element of this successful strategy was the partnership forged with the Bank, which made it possible not only to gain from the latter's historical experience in microfinance, but also to take advantage of its infrastructure and presence in the region to disseminate successful experiences.
- 3.96 The work undertaken demonstrates the unquestionable contribution made by the MIF to the development of a microcredit industry in the region. The most valuable instruments used have been Facility III-B, consisting of credit, equity investment and contributions through venture capital funds. These have been particularly relevant and innovative, and the institutions supported have provided successful examples of best practices that are being replicated or imitated in the same countries or elsewhere.
- 3.97 The Line of Activity has generated the largest volume of operations without committing more than 10% of resources allocated to microfinance-related projects. It has been a more expeditious tool, providing support to a second generation of NGOs following in the footsteps of those that have already become formal intermediaries. This has helped consolidate a seedbed of potential candidates for formalization in the future. The innovation capacity of these projects is undermined, however, by requirements and restrictions imposed with the aim of streamlining project bureaucracy. The level of achievement of these projects in terms of additionality and relevance has also been declining through time. Competitive mechanisms were not applied, as envisaged in the Line of Activity proposal for identifying projects, which could have helped improve performance in those dimensions.
- 3.98 With regard to projects with SLAs, those promoted by the IDB/MIF clearly need to be structured on current and stable legal foundations in each country; they cannot rely on regulatory changes being carried out. In some cases where projects were based on the expectation of legal amendments, objectives were not achieved.

- 3.99 In the cases studied, project success was largely related to the quality of the credit technology advisers attached to the institutions. On several occasions, however, entities had to make use of local consultants without experience in microfinance (owing to lack of knowledge or budgetary constraints), which resulted in inefficient use of resources. The Bank and the MIF should explore mechanisms to provide executing agencies with a list of most suitable entities for consultancy work in the areas typically addressed by these projects; and contracting schemes are needed offering economies of scale that enable executing agencies to contract services from firms that would be very costly to engage individually.
- 3.100 It was also noted that the most successful projects took place in countries with legal and regulatory frameworks that are favorable for the development of microcredit business. To increase the effectiveness of its interventions, the MIF needs to evaluate not only the executing entities, or their partners in the case of equity investment, but also the legal and regulatory setting. This will enable it to decide whether the most effective way of supporting the development of this industry in a given country is by supporting a particular institution, or promoting reforms to guarantee the necessary legal foundations.
- 3.101 Given the competitive environment existing in several countries, provided by new microfinance institutions along with commercial banks that are entering this market segment, a question that arises is whether an informal entity will be able to survive. Accordingly, there should be discussion of instances where the MIF should promote formalization processes, and where it should encourage mergers between microfinance institutions, such as in Bolivia, the Dominican Republic or Peru.
- 3.102 Looking to the future, it is important for the MIF to reflect on its responsibilities as a shareholder in financial institutions that intermediate savings from the public. These could be susceptible to destabilizing factors that require additional capital contributions to be provided rapidly when circumstances so warrant. Acting as owner of a financial intermediary is difficult at times because of distance and because of institutional characteristics. The Fund needs to consider whether the best way of contributing capital is by taking an equity position directly, or whether it is better to do so through a venture capital fund. The latter would give it a more independent and active participation on the Board, in addition to making resources available more quickly in cases of emergency
- 3.103 As microfinance institutions engage in more diversified and more complex deposit and lending operations, and deepen their intermediation of savings from the public, the MIF should promote discussion on the best indicators for monitoring these activities, expanding their range and incorporating those that reflect the risks that are inherent to the financial business. It also needs to make a more in-depth study of the most appropriate mechanisms for managing the new risks being faced.

3.104 A stage in the process seems to have been completed, as it has proved possible to bring about a paradigm shift by demonstrating the feasibility of providing credit to the most poor in a profitable and secure manner. In conjunction with the Bank, the MIF has supported an industry that now must face the challenge of universalizing services provided until now by a few pioneering MFIs. This new challenge calls for consideration of the characteristics needed in the strategic partners to be chosen by the MIF in this stage, given that the ultimate objective in terms of impact is to achieve genuine financial deepening towards the poorest populations.

## IV. CONCLUSIONS

### A. Evaluative synthesis of the project cluster

- 4.1 In the late 1970s, the increasing importance of the informal sector in developing economies began to gain recognition as a major economic alternative to unemployment. The entrepreneurial capacity displayed by small informal businesses run by individuals of low-income, whose development required financing for survival or expansion just like larger firms, justified taking steps to compensate for their lack of access to formal financial markets. The characteristic informality of the microenterprise sector, and the fact that the poor cannot satisfy the minimum requirements for participation in financial markets, is one of the main limitations on access to formal financial services in the region's economies.
- 4.2 The problem of access to credit was not being solved by financial systems, yet financing was considered increasingly important for growth and even to guarantee the survival of small productive units. Lack of access explains the emphasis that the region has placed on devising alternative financing systems to serve this population segment since the 1980s.
- 4.3 Shortage of financial services led to the generation of spontaneous credit mechanisms to smooth out surpluses and deficits in individual cash-flow situations. As a result, informal lending and borrowing groups emerged, including costly private lenders, or cooperatives and NGOs were created to provide financial services. Given the lack of transparent information mechanisms and traditional guarantees, technologies were developed using private information and direct monitoring. These are characteristic of informal financial markets targeting populations that are excluded from the formal financial market. These technologies were developed, improved and consolidated in NGOs that have been providing sustainable financial services with expansion possibilities, as the only way of reaching this mass market.
- 4.4 "Microcredit technologies" were developed in the early 1990s, led by Acción International with the introduction of solidarity credit; and this was followed by systems of individual credit promoted by IPC. The development of credit technology made it possible for entities to grow and expand their lending services, but the sources of funds for microcredit rapidly proved insufficient to meet the potential demand of this market. Moreover, undertaking lending operations on a larger scale revealed problems of governance in nonprofit institutions, resulting from their ownership and management structure. These circumstances helped raise awareness of the need to formalize such entities to enable them to enter the formal financial sector.
- 4.5 The initial actions aimed at formalization of the region's main microcredit NGOs involved the creation of Bancosol; this was followed by establishment of Caja Los Andes in Bolivia, and Financiera Calpiá in El Salvador. Promotion of this process

- of “upscaling” dominated in the 1990s; some cases produced good results, while others failed.
- 4.6 This model spread throughout the region, and largely explains the process of transformation and consolidation in the Latin American microfinance industry. By the end of the 1990s, it had been shown that microfinance institutions could be highly profitable, self-sustaining entities; and that channeling funds from the financial sector to microenterprise not only was possible, but the risk could easily be spread around and reduced. The success of many microfinance entities in Latin America and the Caribbean has demonstrated the profitability of these institutions; in fact, their financial sustainability is stronger than that of similar institutions elsewhere in the world.<sup>29</sup>
- 4.7 Despite this evidence, commercial banks and formal financial institutions in general have approached the microenterprise sector much more slowly than expected. Moreover, this has not happened through private individuals purchasing international investors’ holdings, once the initial links have been established. Nonetheless, bank deepening, known as “downscaling”, did gather pace during the late 1990s and initial years of the new century, particularly in institutions that have approached mass banking through consumer credit. There is still a long way to go in this area, however.
- 4.8 Since the 1980s, the Bank has supported the process of development and consolidation of the region’s microfinance institutions through its Small Projects Program, by providing initial funding for institutions that have since gone on to become the leading microfinance institutions in the region. This task was taken on directly by the MIF following its creation, for which purpose two distinct but complementary instruments were also created: Facility III-A (nonreimbursable resources), and Facility III-B (investments) through which the MIF can extend credit and take equity positions.
- 4.9 Throughout its lifetime, the MIF has intervened mainly in six broad areas: (i) Upscaling: the conversion of NGOs into formal financial intermediaries, or the creation of new financial intermediaries specializing in microfinance; (ii) Support for formalized microfinance institutions; (iii) Downscaling: support for formal financial institutions; (iv) Reform of the microfinance regulatory and supervisory framework; (v) Strengthening of saving and loan cooperatives; and (vi) Emergency Credit Line.
- 4.10 In fact these areas have marked out the development and evolution of the microfinance industry throughout the 1990s, where the MIF has played a very active role through its participation in discussion and development. Through its interventions, the MIF has helped to implement what were considered to be best practices in microfinance.

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<sup>29</sup> MicroBanking Bulletin, September 2000.

- 4.11 In general, the operations carried out have mainly supported microcredit NGOs wishing to formalize. Over the last two years, projects in support of commercial banks entering the microenterprise market have also begun to emerge. In most cases, these resulted in major projects within the country and in the context of the microfinance industry, but only the most recent operations have managed to forge strong links with private capital.
- 4.12 The results achieved, in some cases at the individual level, but clearly overall, have changed the face of the microfinance industry, by proving that loans to microentrepreneurs can be made on a profitable basis, at low risk and with a surprising potential for expansion. Projects promoted or supported through Facility III-B have been especially effective; and this is also where the most innovative projects are found, both in terms of the objective pursued and in terms of the instruments developed to do so.
- 4.13 In efficiency terms, the progress made and changes introduced to improve the efficiency of hiring, procurement and supply processes are clear to see. Nonetheless, much remains to be done in this area, and there are innovative elements in Innovation Line projects, such as hiring centralized from the MIF, which it is hoped will generate economies of scale that can be exploited in projects that have much in common such as those in the Line of Activity.
- 4.14 Most of these projects would not have been implemented without the MIF support, partly through the funding it provided, but also through the vote of confidence implied by its selection of an institution as beneficiary of such resources. This has been particularly clear in projects that have received capital contributions or credit; but it has also helped projects that until now have received a Line of Activity but can now tap into other funding sources as a result of having received support from the MIF.
- 4.15 Institutions supported so far are both sustainable and profitable, with very good financial prospects. In cases where this is not true, circumstances relating to the regulatory framework or subsidized competition promoted by government, are making it difficult to conduct microfinance business.
- 4.16 Even projects developed to improve the regulatory and supervisory framework of cooperatives have proved sustainable, when they have had a suitable legal framework; and they are providing an appropriate supervisory system to monitor institutions that mostly manage the savings of the poorest population groups.
- 4.17 A stage has been completed. The necessary demonstration effect has been generated in most countries and throughout the region, to ensure that new microfinance entities continue to emerge. In the next stage, equity positions will certainly need to be taken in institutions that fail to obtain private investment. For this purpose, there is Acción International's Gateway Fund, as well as the fund that Acción manages for the MIF. Other instruments that have now emerged such as the investment campaigns of IPC, ADC, CABEI and IFC are also moving in

this direction. A valuable seedbed is provided by all the NGOs supported by the Line of Activity.

- 4.18 But now this demonstration effect has been generated, and it has been confirmed that despite successes achieved, the portfolio of these institutions has failed to generate broad coverage of the microenterprise market, a further step needs to be taken to target all efforts on seeking strategies to encourage commercial banks from the region to enter this market segment. Although many of the projects developed by the MIF in microfinance are considered to be successful, their contribution is still marginal in terms of their impact on expanding the coverage of financial services to low-income populations. To achieve a major impact in this regard requires channeling large-scale funds towards the microenterprise sector; this can be achieved through links with formal financial institutions.

## **B. Areas of opportunity**

- 4.19 Today's microfinance paradigm is not limited to facilitating access to credit for microentrepreneurs, but extends to the provision of general financial services for the region's low-income families. This includes services as basic as low-cost and secure fund transfers, both inside the country (typically between rural and urban zones), and between countries;<sup>30</sup> support for innovative projects such as intelligent cards, Internet access without the need for a network of branches, and other innovative processes in the technology area.
- 4.20 Clearly, the vacuum generated by the liquidation of most public-sector agricultural banks has not been filled by the commercial banking system. The lack of development of rural microfinance institutions is largely the result of a fall in the profitability of agricultural production, which has been hard hit by market access restrictions and subsidies in developed countries. Nonetheless, the specific reasons that have prevented or discouraged financial deepening in these areas need to be identified in each country, and alternatives explored. In addition to transfers, an essential service in rural areas is access to savings products, enabling this segment of the population to save in liquid and secure form.
- 4.21 Competitive markets, such as the Bolivian and to a lesser extent the Peruvian one, have shown that the financial needs of microentrepreneur families, and low-income populations generally, are quite varied even if their income source is a wage. Access to credit for consumption, housing or education is of the utmost importance; and the financial system must be persuaded to provide this, if the aim really is to deepen financial services towards the poorest population groups. Moreover, microenterprises have benefited from lower access costs in markets where competition between microfinance institutions is strongest (e.g. Bolivia).

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<sup>30</sup> The latter encompasses the topic of international remittances, which has already been identified by the MIF as one of its clusters.

- 4.22 Finally, social-security benefits should also be extended, through access to a full range of insurance and social providential products and systems, including voluntary saving schemes for the self-employed to guarantee them an old-age pension.
- 4.23 The MIF already has several formal microfinance institutions which would certainly be keen to enter some of these activities. A more comprehensive view of the financial business might also encompass formal financial institutions, particularly “universal” commercial banks. These might be more reluctant to approach the microenterprise segment through lending, as proposed thus far; but they might be willing to offer other types of financial services such as those mentioned above. Provision of these services would also make it possible to take advantage of a much wider network of branches than the region’s microfinance institutions currently have, with concomitant support in terms of systems and funding.
- 4.24 To enter these new areas requires reformulating instruments and frameworks, and redefining the type of executing agencies to be preferred. Future partnerships are bound to involve other multilateral agencies, “social investors”, and international banks with a presence in the region, as well as the main local commercial banks.
- 4.25 In operational terms, and in order to promote innovation still further in the most efficient way possible, advantage needs to be taken of knowledge acquired and the obvious similarities among many of these operations. This involves developing contracting and execution schemes that exploit the many economies of scale that are available in terms of operation and know-how. For this purpose, an evaluation should be made of the advantages of hiring both technical and process advisors on a centralized basis, allowing both Head Office and the Country Offices to make use of them on a needs basis and ensure better quality services to executing agencies. This is particularly important for project subgroups—such as those involving institutional strengthening prior to formalization—by making it possible to specialize the Bank’s team more effectively, or facilitating external support for project development.
- 4.26 The opportunity to find out about different projects carried out in the various countries has given an idea of the influence of the IDB/MIF organization and the role it plays in them, from the gestation stage through to implementation and final evaluation. It is useful to study the way the MIF management structure influences project creation; and it is important to be aware of the implications for a project’s development of the processes it has to comply with. In other words, it would be worth considering whether projects are being determined by the way in which the organization dealing with them operates, and by the process they have to go through to be selected.
- 4.27 In several projects studied, it was clear that the organization established in the Bank took precedence over convenience or the process established for the project. This means that projects arise in different parts of the organization: some emerge

- at the central level, others in the region's and some in the Country Offices, without following the standardized process set out in the corresponding guidelines. Although these recognize the importance of Country Offices' opinions, in several projects their participation was unclear, and in others there was even evidence that they had no participation in project selection. This suggests a task for the future in clearly establishing the degree of participation that different levels of the organization can or should have in defining projects.
- 4.28 Given the pilot nature of the MIF projects, and their suitability for trialing new concepts or methods and catalyzing improvements in the project setting, the central and regional levels both need to participate actively. Local considerations in each country are very important, so participation by Country Offices needs to be rethought, in order to give them a greater role in decision-making, accountability and oversight. This assumes that Country Offices are technically capable of meeting the challenge, or that an alternative mechanism exists outside the Bank to support project design, implementation and oversight.
- 4.29 In the different projects studied, it was also clear that the operating process they go through to be selected does influence their characteristics. It would therefore be worth considering which tasks are affecting project selection or rejection. It is also necessary to rethink the promotion mechanisms, including competitive ones, that ensure the IDB/MIF receives the largest number of projects and selects the best in terms of desirable characteristics, such as innovation, sustainability, demonstration effect, additionality and evaluability.
- 4.30 For the above reasons, now is a good time to define a standardized of promotion, to ensure the largest possible number of projects are presented and the best selected. This can be achieved through more wide-ranging work by the Country Offices, or by employing external support specializing in identifying projects that comply with the MIF expectations, at either the regional or the country level. The Line of Activity stipulates the use of competitive project selection mechanisms, but this has not been complied with. Progress made on this with the Innovation Line needs to be deepened and expanded.
- 4.31 In addition, when reviewing projects in this cluster, an attempt was made to study the degree of project rejection, in order to calculate the proportion approved; but this proved impossible because of a lack of systemized information on the subject. As it will be important in the future to have such information, a mechanism for obtaining it could be built into the operating process to identify projects that are rejected, indicating the stage at which the rejection occurred and the reasons, even in the initial stages. This would also add a considerable degree of transparency to the process.
- 4.32 In order to regain the level of innovation in institutional strengthening projects which nowadays are channeled mainly through the Line of Activity, in the future these should focus either on supporting NGOs wishing to formalize, in countries where no alternative microenterprise credit supply exists, or on strengthening

microcredit in successful financial institutions intending to enter this market. In any event, it is more efficient and effective to continue choosing beneficiary entities through a competitive process encompassing institutions from a variety of countries. Not only would this generate the inherent benefits of a clearly competitive process using objective selection criteria, but it would also make it possible to use schemes for contracting, consultancy and supervision that enhance the MIF's contribution to projects, replicating what has been designed for some of the new "clusters."