

Chapter 7

FINANCIAL MARKET POLICIES TO REDUCE INCOME INEQUALITY

Previous chapters of this report have emphasized the role of factor prices, and particularly the wages of unskilled workers, as a key determinant of income inequality. Through their impact on family decisions about fertility, labor force participation and education, low wages promote and perpetuate high levels of income inequality. The returns to labor are also importantly affected by the amount of capital with which workers can operate. As economies develop and capital becomes less scarce, the return to labor tends to rise and the return to capital tends to fall, and these changes in factor returns are reflected in lower income inequality.

Here is where financial markets come in. Financial markets provide the institutional framework within which savings are mobilized and intermediated to generate the productive investments required to raise workers' productivity and wages. If financial markets are not functioning effectively, domestic investment will not match its potential, and the scarcity of capital will adversely affect not only prospects for economic growth, but also the distribution of income.

But there is more to the story because the scarcity of credit that comes with inadequately functioning financial systems is likely to be particularly severe for small businesses and potential entrepreneurs, whose financial needs may be more expensive to service (as a proportion of the typical loan size) than larger businesses, and whose creditworthiness is more difficult to assess. The severe shortage of credit will restrict the capacity of small businesses and microentrepreneurs to obtain access to the working and physical capital required to raise their productivity and expand their businesses, thus leaving those working in the sector with severely reduced earnings capacity.

Finally, inefficient financial systems offer particularly poor terms to small savers who, if located in underserved rural markets, may even be locked out of the opportunity to place their savings in a financial institution. They may therefore be faced with the need to invest in very low-earning or risky assets, such as currency or

durable goods. This reduced access of low-income families to deposit and other nonlending services of the financial system may also worsen the distribution of income.

Reforms to improve the functioning of the domestic financial system and ensure that it adequately supports productive investments by entrepreneurs and small businesses thus have the potential to improve income distribution, while at the same time promoting economic growth and efficiency. This chapter details the linkages between the operation of financial markets and the distribution of income. It also discusses concrete reforms that could improve the functioning of financial markets, particularly their capacity to support the small enterprise sector in which so many of the region's low-income wage earners are employed.

FINANCIAL MARKETS AND INEQUALITY: WHAT ARE THE LINKAGES?

Shallow Financial Markets Are Associated with More Inequality...

It is not easy to measure the quality or efficiency of a domestic financial system, especially in terms of such dimensions as its ability to reach small entrepreneurs and businesses. Despite this difficulty, there is evidence that financial systems matter. A recent study by Li, Squire and Zou (1998) finds that deep financial markets, as measured by the ratio of the broad money supply to GDP, are strongly associated with lower income inequality.¹ The study argues that this measure of financial depth has one of the largest quantitative impacts on the Gini coefficient among all the variables that were considered. In the results reported in Chapter 4, which controlled for a different and

¹ The study employs the Deininger and Squire (1996) set of Gini coefficients for 49 developed and developing countries from 1947-94. It uses five-year averages of these and all explanatory variable data.

somewhat broader set of explanatory variables, the relationship between income inequality and financial depth was somewhat weaker. But while weaker, the correlation between financial depth and income inequality was still negative, providing some corroboration for the earlier finding that deep financial markets are associated with less inequality.²

...And Latin America Has Shallow Financial Systems

In the 1960s, financial depth—measured either by the ratio of the broad money supply to GDP or financial system credit to the private sector as a percent of GDP—was only about 25 percent higher in the emerging East Asian countries than it was in Latin America. But the region's macroeconomic and financial instability, financial repression and relatively slow growth during much of the following decades slowed its financial development. East Asian financial depth steadily pulled away, and it now stands at two to three times the Latin American average. Latin America also has shallow financial systems compared to the industrial economies. To the extent that shallow and inefficient financial markets contribute to inequality, then, there is good reason to believe that Latin America's financial systems contribute to a meaningful and growing share of the difference between the region's high income inequality and the lower degree of inequality observed in other regions such as emerging East Asia and the industrial economies.

Why Do Financial Markets Matter? A Macroeconomic Channel

Financial markets pervade the economic system and affect income inequality in a number of ways. Deep financial markets facilitate the accumulation of capital, raising labor productivity and wages while driving down the returns to capital.³ As seen in Chapter 4, this tends to improve the distribution of income, because so much capital income accrues to a relatively small group of higher-income individuals, and because the accelerated rate of economic development promotes all of the development-related transitions that tend to be equalizing.⁴ The initial impact on wages is amplified over time, because the higher wages that come with increased capital accumulation eventually influence family decisions about labor force participation, fertility and education in ways that reinforce the initial beneficial impact of higher wages on income distribution.

Access to Credit is Unequal

If financial markets are weak, credit is not only limited in general but is particularly inaccessible to low-income individuals and small businesses. This reinforces the adverse distributional consequences of weak financial systems, because it limits the ability of small-scale and low-income producers to obtain the credit they need to produce more efficiently and expand their businesses. Scarcity of credit may also discourage potential entrepreneurs from entering the labor force. This is likely to be particularly important for secondary earners in a household. If a woman has access to credit, she can obtain the materials required to start a small business to supplement the family's income. This in turn enables women to work part-time and at irregular hours, thus posing less conflict with family responsibilities than would working in the formal sector. However, without access to the requisite credit, a woman may be restricted to such a small scale of operation, or to the use of such labor-intensive and inefficient methods, that she is forced either to work at a very low level of productivity and income, or to abandon the venture and stay home. Inadequate access to credit may thus be one explanation for the finding of Chapter 2 that women who work in the informal sector earn particularly low wages.

There is plenty of evidence that the banking system provides limited credit to small enterprises. Table 7.1 reviews a number of studies that indicate that few of these firms, generally less than five percent, have ever received credit from the banking system.⁵

Even the lending institutions that lead the way in making microloans in Latin America have small loan portfolios compared with the formal financial system (Table 7.2). And even when semiformal sources (nongovernmental organizations and credit unions) are included, total credit going to microenterprises is less than 1 percent of the \$425 billion that commercial banks provided to the Latin American private sector in 1995, and probably about

² One reason why we found a weaker correlation between financial depth and income inequality may be that we controlled for several variables, such as capital intensity or the level of development, that may be mechanisms through which financial depth is affecting income inequality.

³ King and Levine (1993) is among the most influential studies on the relationship between the depth of the domestic financial system and economic growth. Their results suggested that a 10 percentage point rise in the ratio of private banking system credit to GDP is associated with an increase in the annual GDP growth rate of about one-third of a percentage point. Ghani (1992) finds an even larger growth effect, approximately half a point. Westley (1994) discusses several channels through which increased intermediation may result in productivity and growth rate gains.

⁴ See Wolff (1991).

⁵ IDB (1995) estimates, based on existing survey and other evidence, that less than 5 percent of Latin American microentrepreneurs have access to credit from the banking system, which is corroborated by Table 7.1.

Table 7.1. Where Are the Banks?
(Share of Micro or Small Enterprises with Credit from Banking Institutions)

Country	Share	Reference	Survey	Source
Mexico	4.5% received credit after start-up 1.9% received business start-up credit	Microenterprises ¹	February-May, 1994	INEGI (1994, pp. 31-36)
Guyana	1.9% received credit for current operations 3.4% received business start-up credit	Microenterprises ²	November 1995	Bresnayan (1996, Tables C-10, C-11a)
Dominican Republic	4.2% received credit for current operations	Micro and small enterprises ³	1993-1995 (four surveys)	Pons and Ortiz (1995, Table 4.13)

¹ Nonmanufacturing firms with up to five employees, manufacturing firms with up to 15 employees.
² Firms with less than 10 employees.
³ Firms with up to 50 workers.

Table 7.2. Leading Banking Institutions That Make Microloans in Latin America
(Real Loan Rates and Volume)

Country	Lender	Microenterprise credit: Real loan rate (%)	Volume of microenterprise loans outstanding (US\$ millions)	Number of microenterprise loans outstanding (thousands)	Microenterprise credit: Average loan size (US\$)
Bolivia	Banco Sol	42	30.2	57.7	523
Bolivia	Caja Los Andes	34	8.6	17.9	480
Chile	Banco de Desarrollo	44	17.6	17.5	1,006
Colombia ¹	Corposol/Finansol	52	11.7	32	366
Ecuador	Banco del Pacifico	27	4	4	1,000
El Salvador	Banco Agrícola	na	14.8	9.3	1,591
Guatemala	Banco Empresarial	21	2	0.84	2,381
Guyana	Bank of Nova Scotia	18	1.2	9	133
Panama	Multicredit Bank	31	8.6	1.45	5,931
Paraguay	Financiera Familiar	83	4.5	4.66	966
Peru	Banco Wiese	26	19	4.76	3,992
Mean		38	11.1	14.5	762
Total			122.2	159.11	

¹ Data for 1993 from Christen, Rhyne, and Vogel (1995); all other data are from 1995-96, as reported by Baydas, Graham and Valenzuela (1997).

1 percent of banking system credit going to businesses in the region.⁶

In contrast, it has been estimated that microenterprises account for approximately 20 percent of Latin American GDP.⁷ Although the concept of microenterprise used in these estimates may not be entirely comparable,

⁶ The figure of \$425 billion is obtained from IMF (1997, line 22d). It represents total private credit extended by commercial banks in the 26 borrowing member countries of the Inter-American Development Bank at the end of 1995. This \$425 billion omits other banking institutions' credit to the private sector and thus is an underestimate of total banking system credit. However, consumer lending (credit cards, residential mortgages, etc.) is perhaps 25 to 30 percent of total banking system private credit, the bulk of it going to traditional business lending in such sectors as industry and commerce. Hence, any overestimation is probably slight (the two omissions tending to cancel each other out). Total microenterprise credit from the banking system, NGOs and credit unions can be estimated between \$2.3 billion and \$4 billion (calculations based on Baydas, Graham and Valenzuela, 1997; Acción Internacional, 1997, and WOCCU, 1996).

⁷ From Westley (1997).

it would appear that, relative to their output, these firms receive a disproportionately small share of credit from formal and even semi-formal sources.

Unsatisfied Demand for Credit from Small Borrowers

Does this minimal use of credit mean that small borrowers need less credit, or that they face highly restricted access to it? It is difficult to measure access to credit directly because limited use of it could in principle reflect either minimal demand or a restricted supply. However, there is evidence that small borrowers face more restricted access to credit than do larger borrowers. A number of studies have presented evidence that small borrowers show clear signs that their activities are restricted by the inability to obtain credit, and that larger borrowers are less affected by such credit constraints. (Box 7.1 surveys some of these studies.)

Another piece of evidence that smaller enterprises have many high-return projects waiting in the wings, frustrated by lack of finance, is the very high loan rates routinely

paid by these firms when formal credit is made available to them (see Table 7.2). Moreover, when good microlending programs are started up, they often attract huge demand despite charging high real loan rates. Banco Sol in Bolivia is only 10 years old (five years as an NGO followed by five years as a bank) and already has one-third of the total clients served by the entire Bolivian banking system. And, as the numerous impact studies surveyed by Sebstad and Chen (1996) make clear, owners of smaller firms, including those below the poverty line, do derive substantial income gains from access to credit, with the gains typically increasing over time as additional larger loans are extended to them.

These studies also report substantial employment creation by microloan programs. There is good reason to believe that this job creation expands opportunities primarily for low-income workers, since microenterprise employees and self-employed microentrepreneurs (30

Box 7.1. Credit Constraints

National surveys of microenterprises and small businesses often ask about the major business problems they face, including lack of finance. Although these self-reporting data are properly deemed less reliable than market data, they are useful to detect credit constraints in market data. It is often difficult to determine statistically whether businesses that receive no formal credit simply are not demanding it or are judged not to be good credit risks, or whether they are really being rationed by the financial intermediaries. Because of this difficulty, evidence of credit constraints based on analyses of market data is limited.

Among the few studies to distinguish credit constraints from observed market behavior using reasonably recent Latin American data are Mushinski (1995) and Barham, Boucher and Carter (1996). Based on data from three regions in Guatemala, these studies find that smaller firms desiring bank credit received it much less often than larger firms. However, credit unions in these three areas provided loans to a substantial percentage of these smaller, bank-rationed firms. This suggests that these companies were creditworthy enterprises. Jaramillo, Schiantarelli and Weiss (1996) estimate the Euler (accumulation) equation for capital stock allowing for adjustment costs in a panel data set covering 420 Ecuadorean manufacturing firms over 1983-88. They find that smaller firms faced significant credit constraints both before and after interest rate ceilings were removed in Ecuador, while larger firms never did. Since smaller firms are defined as those with a capital stock of up to \$600,000 in 1975 prices, this study shows that even fairly sizable firms with substantial collateralizable assets can face credit constraints.

Asking firms directly if they want to obtain credit but cannot get it can also show whether microenterprises and small

businesses face a credit constraint. Nonetheless, these data must be interpreted with care, because they are not based on actual behavior, the price of credit is rarely made explicit (though may be understood to be "market rates"), and not all firms desiring credit would be deemed good credit risks by financial intermediaries.

Pons and Ortiz (1994) provide perhaps the most straightforward estimate of this type. Based on a national survey, they find that 42 percent of the smaller enterprises in the Dominican Republic would like to have credit and do not, and another 16 percent are not sure. (The remaining 42 percent did not want credit for a variety of reasons, including the fact that some already had it.) The impact of credit market restrictions extends even beyond this sizable group, however, as there are an unknown number of households that would like to begin their own businesses but do not for lack of credit to finance their start-up or subsequent operations.

Several other national surveys ask about major business problems, including credit constraints. In Guyana, Bresnayan (1996) finds that 62 percent of microenterprises face a severe or very severe "lack of cash in running their business," as opposed to a constraint that is "not severe." In the same survey, 39 percent cited the lack of finance as affecting the ability of the firm to grow. Magill and Swanson (1991) find that lack of sustained access to finance is by far the biggest problem that microenterprises face in Ecuador, placing ahead even of lacking markets. EIM/International's (1996) survey of Trinidad and Tobago and ESA Consultores (1996) survey in Honduras both find that market opportunities are the biggest problem microenterprises face, followed in each case by lack of finance.

and 40 percent, respectively) together make up about 70 percent of Latin America's low-income earners.^{8,9} To the extent that microcredit programs create jobs for such earners, these programs are likely to contribute to strongly lessening income inequality. In addition to all of these credit effects, the provision of deposit services, particularly in rural areas where liquid savings facilities are often unavailable, can also increase the income levels of low-income households, which are disproportionately located in rural areas.¹⁰

How the Absence of Deposit and Other Nonlending Financial Services Hurts the Poor

Even very poor households in rural areas save, if only to carry over income from one harvest to the next. In the absence of a financial institution offering deposit accounts, however, savings must be done in nonmonetary form (building materials; livestock, crops and other capital and inventory; jewelry and other valuables, etc.) or by

holding cash.¹¹ These forms of savings have serious disadvantages, including erosion of value with the passage of time (due to wear and tear or to inflation), possibility of theft, high transaction costs that typically accompany the conversion of illiquid assets into cash (with a likelihood of additional losses if a sale must be made quickly because of an emergency), and problems of indivisibility (one cannot slaughter half a cow, sell half a ring, etc.).¹²

With their savings in commodities, rural households that suddenly find themselves in need of cash may be

⁸ Within the context of these household surveys, microenterprises are defined as firms with five or fewer employees.

⁹ "Low-income" wage earners are defined as workers in the bottom 30 percent of the wage distribution. The statistics discussed here are based on a simple average of results from household surveys for 14 countries.

¹⁰ The discussion of Small Cap Rural Banks below outlines some of the mechanisms through which this might occur.

¹¹ See Gadway and O'Donnell (1995).

¹² In periods of rapidly rising prices, commodities may, of course, serve as an inflation hedge, much as a reasonably priced deposit account does. The other disadvantages of holding savings in nonmonetary form, however, still apply.

forced to choose between borrowing from informal markets at high interest rates or paying the high transaction costs (and facing any indivisibility problems) associated with converting illiquid physical assets into cash. Access to a liquid savings account would allow rural families to meet their routine and emergency liquidity needs more easily and cheaply, and thus avoid erosion of their income and wealth. A deposit facility might also help poor farmers increase their incomes by giving them a readily available cushion of financial support in case their crops fail. This might allow them, for example, to shift out of a lower risk, diversified cropping pattern, and specialize to a greater extent in higher valued crops, with the knowledge that they have saved resources readily available to meet their families' most urgent needs in case things go badly. Finally, with more liquid savings services available in the rural areas, the supply of funds used for informal lending may expand, driving down the informal lending rate and widening the use of such credit. This may particularly benefit smaller farms and enterprises and lower-income households, which, lacking access to formal loans, may disproportionately use informal credit.

What Obstacles Impede the Credit Relationship?

Before discussing potential policies to promote a more adequate functioning of the credit market, we need to understand why credit markets are so complicated, and why smaller and lower-income borrowers face particular obstacles in obtaining credit. After all, the financial landscape is littered with failed institutions whose mission it was to provide credit to various underserved groups, but which were in the end incapable of solving the underlying problems.

A fundamental problem lies in the first step in a credit relationship: the creditor must give a borrower money based on a promise of repayment. Although the lending institution will do its best to ensure that it is lending to borrowers who are going to be able and willing to repay the loan, there are no assurances that the borrower will not renege on his promise. The credit relationship thus depends upon ways of ensuring both *ability* and *willingness* to repay loans. This is a complicated matter under any circumstances, but even more so in emerging markets like Latin America, and the problems are particularly severe for small borrowers.

To ensure *ability* to repay, lenders may rely upon a careful review of a borrower's balance sheet, business plans and track record, and after a loan is granted may monitor the use to which the funds are put. All of this is, of course, expensive—especially so if accounting stan-

dards and disclosure practices are not high. What is more, these costs are likely to be particularly high as a share of the typical loan size for small borrowers, which means that simple economics often dictate that small borrowers have to pay higher interest rates for credit, a point whose policy implications are discussed below.

Ensuring *willingness* to repay is equally important, and in many ways more complicated. There are four main mechanisms to ensure that borrowers with the financial capacity to repay a loan will also have the incentive to do so: punishment, collateral, reputation and relationships.

Punishment relies upon the capacity to impose, through the legal system or in some other way, a penalty on debtors who do not repay. Delinquent debtors may be thrown in jail or suffer other punishment. While this punishment provides no relief to the lender who has suffered from the default, it does provide incentives for borrowers to repay if they possibly can. While effective in many circumstances, enforcement mechanisms that rely upon punishment cannot solve all problems. Even where judicial systems operate well, enforcement of a claim through the judiciary can be a drawn-out, complicated and expensive process. If it were too often necessary to rely upon this expensive process, many credit contracts would be too expensive to support. This is all the more true of small loans that are required by microenterprises and small businesses, for which the legal costs of enforcing repayment through judicial proceedings would be prohibitive. If they are going to be able to serve smaller borrowers, therefore, financial systems need to seek more efficient ways to ensure willingness to pay.¹³

Collateral is one of the most important of these mechanisms. In a collateralized loan, the borrower pledges to the lender that, in the event of a default, he will turn over some item of value—the “collateral”—thus protecting the lender at least partly from the cost of the default. When collateral works well, it can provide important protection to the lender and thus greatly improve access and reduce the cost of credit to the borrower. However, collateral in general works less well for small borrowers than it does for large enterprises and wealthy individuals.

¹³ This is not to say that punishment strategies are irrelevant. An interesting example is the role of post-dated checks in the Paraguayan financial system. It used to be difficult in that system to enforce repayment of a claim through the legal system. But another way was found to use the legal system to enforce debt claims. Since it was illegal to write post-dated checks, a lender would require a borrower to write a post-dated check in the amount that would come due when the loan matured. If the lender repaid the loan in full and on time, the post-dated check would be returned to the borrower. If the borrower defaulted, the lender could present the post-dated check, exposing the borrower to a serious risk of jail. This mechanism apparently worked well until the law was changed, decriminalizing the writing of post-dated checks.

Collateral works best when it is the object that is to be purchased with the proceeds of the loan, and when that object has substantial value to someone other than the borrower. Mortgages work well because in the event of a default, the buildings and property that are seized by the lender can be sold to some other user at a reasonable price. It works less well when the object being financed is something like a specialized industrial machine or tool, which may be of little value to any other business and thus provides little security to the lender. And collateral is much less useful to support loans needed to finance the accumulation of intangible assets or working capital, which may be particularly important for small businesses or microenterprises in many services or retail trades. In principle, such a loan could be collateralized with property other than the object whose purchase is being financed by the loan. A business owner, for example, could in principle secure a loan to finance working capital for his business by offering his home as collateral. However, many legal systems limit lenders' ability to enforce such pledges, and even when such pledges are permitted, they provide a solution only for borrowers wealthy enough to own collateralizable assets. Having said all of this, collateral is an essential instrument of a well-functioning financial system, and the section that follows proposes reforms to improve the operation of collateral in the region.

Reputation is another mechanism commonly used to ensure willingness to repay loan obligations. Borrowers may have an incentive to repay if they perceive that default would limit their access to future additional credit. An advantage of reputation is that, in principle, anybody can develop a good one, regardless of income level. And indeed, a technique of many successful microenterprise lending programs is to grant progressively larger loans to an individual or group, with a default resulting in loss of access to future loans. There are two main problems here. The first is information. In a world with many lenders, a borrower might hope to default on a loan from one lender but then obtain credit from another lender, who he hopes does not know about the previous default. The solution to this problem is credit bureaus or other information-sharing institutions. A second problem is that a solution based on the borrower's reputation may make it difficult for new borrowers, who face a "catch-22": no credit history means no reputation, but no reputation means no credit and therefore no possibility to develop a credit history. Successful attempts to bring credit to microenterprises are often based on developing ways to permit borrowers to develop a credit history with a microlending institution.

Finally, *relationships* are another important mechanism to ensure willingness to pay. If a lender has an ongoing relationship with the borrower in some other area, it may be possible to use that relationship to enforce repayment. Or the lender may be able to take advantage of relationships that the borrower has with others, as in the case of group lending. In group lending, the loan is to a group of borrowers, and a default by one results in loss of access to further credit for the entire group. If the other members of the group know one another and interact in a number of different capacities, they may be better able than the lender to persuade a potentially recalcitrant borrower to honor his repayment obligations. Group lending is another of the techniques commonly used by successful microlenders.

Credit Can Reach the Poor

Having discussed in such detail the many obstacles to the credit relationship, and how they particularly complicate the situation of small borrowers, it is worthwhile to remember that credit can, despite these obstacles, reach the poor. In Bolivia, a large percentage of the clientele of several microenterprise finance institutions (MFIs) are poor borrowers:¹⁴ Banco Sol (36 percent), Caja los Andes (26 percent), FIE (20 percent), Prodem (81 percent), and Sartawi (76 percent). The first three institutions serve urban areas, and Banco Sol and Caja los Andes are regulated financial institutions, while Prodem is an NGO (in 1996 when the data were collected). The last two MFIs are NGOs that serve rural areas. The extremely high percentages of poor among the borrowers of these latter two MFIs partly reflect Bolivia's high rural poverty rates, together with the MFIs' mission to bring credit to poor microentrepreneurs. Together, these five institutions have 167,000 microenterprise clients,¹⁵ of whom 67,000 are poor, suggesting that credit can reach poor microentrepreneurs in substantial numbers. In fact, many more poor have been reached than are even indicated by this last number, considering the employment effects noted earlier. In addition, even considering only firm owners, the five poverty percentages given above understate the share of poor microentrepreneurs who were assisted by the five MFIs. While many MFI clients start off poor, after several loans some of their incomes will have increased beyond the poverty line. Even better than just serving poor customers, the institutions seem to be helping to lift their borrowers out of poverty.

¹⁴ Gulli (1998, p. 12).

¹⁵ *Ibid.* (p. 13).

FINANCIAL MARKET POLICIES TO REDUCE INEQUALITY

What can be done to make financial systems more efficient, and in particular to promote expanded access to credit by smaller enterprises? Most countries in Latin America have already taken important steps in this direction by stabilizing their economies, eliminating interest rate ceilings, dismantling subsidized and targeted credit programs and other forms of state-imposed credit allocation, and lowering reserve requirements to prudential levels. These changes have greatly expanded the capacity of the private financial system to serve domestic borrowers, and have been particularly conducive to the delivery of financial services to smaller firms. The liberalization of lending interest rates makes it possible for financial institutions to charge the high interest rates such lending often requires. By fostering greater competition and efficiency in serving traditional large-firm customers, liberalized lending interest rates encourage intermediaries to look for new and unexploited market segments, such as smaller firms.

For countries that have yet to eliminate interest rate ceilings or create more competitive financial markets, these are certainly important steps to take toward providing smaller firms with increased financial services, and thereby attempting to reduce income inequality. However, little formal or even semiformal credit has become available to microenterprises, and many smaller firms face significant credit constraints. Reforms to promote broader availability of credit might include appropriate regulation and supervision of banking institutions that lend to microenterprises, improving the legal and institutional framework for secured transactions, reducing informality, establishing or strengthening credit bureaus, improving the legal framework for leasing and factoring, facilitating the development of small capitalization rural banks, modernizing and supervising credit unions, “downscaling” commercial banks to serve microenterprises, and “upgrading” NGOs into full-fledged financial institutions.

Appropriate Regulation and Supervision of Banking Institutions that Lend to Microenterprises

Most countries in Latin America have prudential banking regulations and supervisory practices that—because they are typically designed with traditional commercial bank lending technologies and large loan sizes in mind—may unintentionally and unnecessarily impede lending to microenterprises. Box 7.2 describes the salient features of the microlending technology that has been used suc-

cessfully by a large number of financial institutions around the world and in the region to make small loans (e.g., \$100 to \$1,000) while at the same time achieving commercial bank-level delinquency rates (2 to 3 percent) and containing administrative costs. This technology is fundamentally designed to ensure willingness to repay, in addition to verifying borrowers' ability to repay.

This lending technology differs in important ways from that which is appropriate for lending to larger customers. Applying supervisory norms appropriate for larger loans to microenterprise lending may unnecessarily drive up the cost of microloans and reduce supply.¹⁶ Areas where adaptations of the regulatory framework might improve microlending are cited below.

Operational restrictions. As noted in Jansson and Wenner (1997), most Latin American countries place minimum and sometimes maximum limits on the number of hours per day and days per week that branches of regulated financial institutions can operate, usually mandating at least five days per week and five to eight hours per day. This often poses a particular problem for microlenders, who may wish to open branches in marginal urban or rural areas where demand is not sufficient to justify such lengthy hours. Banco Sol in Bolivia, for example, has complained of having wanted to open branches in some areas for only two days per week.

Documentation requirements. Bank superintendencies throughout Latin America typically require that regulated banking institutions gather extensive documented information in the course of granting each loan in order to help the lender and regulator assess loan risk. Among the standard requirements for business loans are the borrower's past three to five years of balance sheets and income statements, documents establishing the value of physical assets owned, and information on existing liens. Some countries require notarization of these formal documents, with notary costs ranging as high as \$40 per loan,¹⁷ clearly a burdensome requirement for a \$500 credit. As explained in Box 7.2, individual microenterprise loans are normally extended on the basis of a current cash flow analysis of the combined household and business, and, perhaps even more importantly, on the basis of a character assessment of the borrower. Group loans are extended on the basis of group guarantees and screening. Unless reporting requirements are adjusted to fit the nature of the methodology being used to make microloans, the already-high administrative costs of making these loans will be further increased.

¹⁶ See Jansson and Wenner (1997) and Rock and Otero (1997).

¹⁷ Jansson and Wenner (1997, p. 35).

Box 7.2. The Microlending Technology

In group lending, credits are granted to small, self-formed groups. These groups serve three purposes. First, they screen out bad credit risks, since the whole group is held responsible if anyone in the group defaults, and hence they reduce the costs of gathering information on creditworthiness. Second, they exert social pressure in the event a borrower fails to repay. Third, they offer the potential to further reduce administrative costs by allowing the bank to make and service a single group loan in place of several individual loans.

Individual lending is grounded in a detailed investigation and assessment of the borrower's character and willingness to repay. Initial loan screening often includes visits to the business site and home, and talks with neighbors and business associates. An analysis is also performed of the cash flow (ability to repay) of both the business and the household. Loans are generally extended based on these assessments, rather than being secured with physical collateral, of which the microentrepreneur typically has little, and which would in any case entail prohibitive costs to seize and sell. Thus, in contrast to traditional bank lending, group and particularly individual microlending is said to be information-intensive instead of intensive in the use of physical collateral.

The remaining elements of the microlending technology apply to both individual and group lending.

- Repayment is further encouraged by a progressive lending scheme in which borrowers are first given very small loans and short loan terms. If successfully repaid, the loan amount and term are progressively increased in subsequent rounds of borrowing. In addition to rewarding repayment, this also serves to establish a credit history for borrowers who typically have none to begin with, allowing the lender to decide whether to make larger, riskier loans based on this history.

Capital requirements. For example, Argentina has risk-weighted capital adequacy standards in which the required capital increases with the interest rate that the lender charges. Indeed, for loans that charge a very high interest rate, the required capital is 69 percent of the loan amount (six times the basic 11.5 percent requirement). This makes sense for normal lending because high-lending interest rates are generally associated with a high risk of default. However, with microloans, high loan rates are the result of high administrative costs, not necessarily of high default risk, and unless this is reflected in capital requirements, the costs of making microloans will be unnecessarily increased. A way needs to be found to distinguish between high administrative costs and high default risk when basing capital requirements on lending interest rates.

Emphasis on collateral. As noted in Box 7.2, traditional bank lending is collateral-intensive while microlending

- Frequent repayment schedules are employed to facilitate monitoring of borrowers.

- Incentive pay is used to help solve the principal-agent problem, with a loan officer's remuneration determined to a significant degree by loan volume and portfolio delinquency rate.

- Staff are drawn from the local service area, so they have better access to information about potential borrowers.

- To help keep delinquency rates low in larger microlending programs, specialized software is used that tracks individual loans and provides daily delinquency reports to loan officers. Delinquencies are followed up the next day or soon thereafter.

- In order to reduce the borrower's transaction costs and the intermediary's loan default losses, loan officers spend much of their time in the field, screening new clients and checking on old ones, particularly those who are delinquent. The lender's administrative costs are held down by using inexpensive transportation (e.g., motorcycles), directly entering field-collected data into portable computers (in lending programs of larger size), and maintaining relatively modest branch offices, in keeping with the fact that the program serves a clientele of more limited means.

- In order to increase the value to borrowers of the lending institution's credit services, and thus encourage loyalty and repayment, the loan approval and disbursement period is normally very rapid (often a matter of a few days).

- Microloan interest rates are set considerably above average commercial bank lending rates in order to cover the higher administrative cost margins of making much smaller loans. These cost margins are typically 15 to 30 percentage points or more, depending on average loan size, total program volume (due to economies of scale), and other factors.

is information-intensive. Yet both systems are capable of producing high rates of repayment. Accordingly, the common practice of requiring 100 percent specific loan provisions for any noncollateralized loans whose repayment is overdue by even a single day, or general provisioning of 20 percent for all noncollateralized loans (late or not) vs. 1 to 3 percent for collateralized loans, may exaggerate the difference in the risk of loss between collateralized lending and microlending, and thus unnecessarily raise the cost of making microloans.

Improving the Legal and Institutional Framework for Secured Transactions

In much of Latin America, poorly formulated laws and inadequate or nonexistent legal registries impede using

either movable goods or real property as collateral to secure loans. While this problem affects firms of all sizes, its greatest impact is on small firms. This problem has three major components—in the creation of security interests, in the perfection of those interests, and in enforcement.¹⁸

The *creation* of security interests means making a legal agreement to assign some object as collateral for a loan. However, the laws of many Latin American countries impose important restrictions on the kinds of goods that may be used as collateral. Many countries do not allow for a “continuing security interest,” so that if the pledged asset is sold, the creditors often cannot automatically attach the proceeds (as creditors can, for example, in the United States and Canada). Another useful device frequently not available in the region is the “floating security interest.” In Uruguay, for example, if a bank lends \$50,000 against 100 head of cattle, it must identify a particular 100 head by tattoo or other means, which makes loan monitoring very expensive. By contrast, in the United States and Canada, a loan can be based on a floating security interest in “\$50,000 in cattle,” which provides much better security to the lender.

The *perfection* of security interests means ensuring that there are no prior superior claims on an asset that a borrower has pledged as collateral. To do this, lenders must be able to search for such claims in a legal registry. In Latin America, this is often unnecessarily difficult. In Uruguay, for example, the lender must know the date of the prior pledge; one cannot search by the name of the borrower or by using a description of the pledged asset. This process is even more cumbersome in Bolivia, where claims are filed chronologically and one must look through the entire registry for prior pledges. Further complications arise when, as occurs often in Latin America, one needs official permission to search a registry. This permission may be difficult to obtain, perhaps involving uncertain access, bribes or delays. Much can be done to create accurate registries that are accessible to the public and inexpensive to search. Strengthening or privatizing public registries is one possibility, as is introducing competition among public registries or permitting private registries to compete with public ones.

Finally, collateral is of little value if the pledge cannot be *enforced* in the event of a default. But enforcement is often slow and costly in the region, where a lengthy legal process involving the courts is typically required, rather than a rapid administrative procedure outside the court system. With their attendant risks and costs, such delays undermine the usefulness of all collateral, and particularly the use of movable property as collateral. During the lengthy period of time it takes the lender to

repossess and sell the pledged equipment or inventory, the collateral may be sold or moved out of the economy, machines left to rust, grain to rot, or cattle to die or be slaughtered. The resulting decline in the usefulness of movable collateral is particularly problematic for smaller and less wealthy borrowers, since while wealthier businessmen and larger businesses are likely to have real property assets, small firms may have only their inventory, or perhaps some equipment, to pledge as security for a loan. This means that improving the legal and institutional framework surrounding collateral is of particular importance to small borrowers.¹⁹ Recognizing the potential importance of these reforms, several countries in Latin America have recently examined the issue of overhauling their secured transactions laws, including Argentina, Bolivia, El Salvador, Honduras, Mexico, Peru and Uruguay.

Reducing Informality²⁰

Banking institutions typically lend only to officially sanctioned businesses, not to unregistered enterprises.²¹ These unregistered firms tend to be very small and owned by low-income individuals. One way to improve their access to credit is to encourage formalization by reducing the barriers to formality. (The other strategy, discussed later, is to strengthen the unregulated financial institutions, such as NGOs and in many cases credit unions, that willingly lend to firms in the informal sector.) Formalization would increase access to bank credit and also permit firms to register their business property, which can then potentially be used as loan collateral.

Costs of formality. The costs of simply registering a business can be very substantial. In an actual experiment to set up a small garment factory in Lima, de Soto (1989) found that it took 10 months, involved 11 separate and time-consuming procedures with various ministries and other state institutions, and cost \$1,232 in fees, bribes and lost profits, all of which equaled nearly three years of

¹⁸ See Fleisig, Aguilar and de la Peña (1994) and Fleisig (1995a; 1995b).

¹⁹ Microenterprise loans, on the other hand, are less affected by collateral problems, because in contrast to small firm loans, they are normally based on a character assessment or on group guarantees rather than collateral. Nonetheless, microenterprise credit could become more available if improvements in collateral systems were to give their suppliers access to credit, and make it easier for suppliers to offer credit to microentrepreneurs.

²⁰ “Informality” is used in this chapter in the classic sense of denoting a firm that is unregistered (and out of compliance with tax, labor and other codes), rather than a firm with few employees. The latter (ILO) definition is used in other chapters of this volume.

²¹ See de Soto (1989), Loayza (1996), McPherson and Liedholm (1996), and Orlando (1998). As an example of the high cost of borrowing, de Soto notes that in Lima in 1985 the nominal borrowing rate for informal firms was 22 percent per month, versus 4.9 percent for formal firms of comparable size.

Table 7.3. Gini Regressions for 14 Latin American Countries, Using Loayza's Informality Measure

Variable	Regression 1	Regression 2	Regression 3
INFORMAL	0.45 (2.00)	0.41 (1.63)	0.50 (1.73)
Constant	30.15 (2.73)	37.9 (1.68)	28.6 (1.06)
EXPSURVEY	-6.66 (3.97)	-7.06 (1.66)	-7.41 (1.69)
MEANAGE		-0.22 (.40)	-0.28 (.47)
MEANSCHOOL			1.18 (.68)
R ²	0.32	0.36	0.44

Note: The countries covered by the regression are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Panama, Peru, Uruguay and Venezuela. The table reports regression coefficient estimates, with t-statistics in parentheses. Explanatory variables: INFORMAL - Loayza's informality measure; EXPSURVEY - dummy variable equals 1 if the Gini coefficient is based on a household expenditure survey, equals zero if based on a household income survey; MEANAGE - mean age of the population; MEANSCHOOL - mean number of years of schooling completed for the population aged 25-64.

wages at the minimum salary level. Tokman (1992) also finds high access costs to legality in other Latin American countries. The time to register a small firm in his group of Latin American countries was 10 months on average, ranging from about one month in Bolivia, Brazil and Chile to two years in Guatemala. By contrast, Chickering and Salahdine (1991) report that a similar procedure takes about three or four hours in Florida or New York. Clearly, streamlining registration procedures could go a long way toward encouraging formalization of enterprises in Latin America.

Formal enterprises also face ongoing costs in the form of income, payroll and other taxes; minimum wages and mandated fringe benefits; constraints on and additional costs of dismissal; and compliance with government-imposed procedural and paperwork requirements. On this last point, de Soto (1989) surveyed 37 formal firms operating in sectors with high levels of informality and found that 40 percent of the working time of administrative personnel was spent complying with the government's bureaucratic procedures, a cost that seems clearly exorbitant. The question of whether state-imposed taxes and regulations make labor costs too high and dismissal restrictions too strict is treated in Chapter 6 of this volume. It is argued there that most countries in Latin America would be well advised to reduce many of these barriers to formality as a way to increase formalization rates and extend labor code protections and benefits—as well as

the other advantages of formality, including better access to capital—to a larger percentage of earners.

Land titling. Greater integration in the formal economy could also be achieved through programs to regularize the land titles of small farmers and urban squatters. Among the many benefits of such a reform would be to provide beneficiaries with a potentially acceptable form of collateral and thus greater access to credit.

Does informality contribute to inequality? To answer this question, we employed estimates of the size of the informal sector in 14 Latin American economies to explain the average value of the Gini coefficient of income inequality over 1982-92. Although the data sample is limited, and it is generally difficult to explain inequality in the Latin American cross-section alone, we do find that greater informality is significantly associated with greater inequality, as the preceding discussion has suggested (Table 7.3). This result is consistent with Chapter 2 of this report, which showed that earnings tend to be somewhat lower and are much more concentrated within the informal sector than in the formal sector. This holds out the hope that policies to reduce barriers to informality may improve the distribution of income.

Credit Bureaus

As we noted above, knowing a borrower's reputation is one way to help ensure repayment of a loan, since even the smallest borrowers can, in principle, develop a reputation. However, this requires some arrangement to facilitate the gathering and sharing of information about borrowers' credit histories. This is the purpose of credit bureaus, which typically gather together the credit histories of all banking system borrowers, or all such borrowers with loans above a certain size. Improving the functioning of credit bureaus, and encouraging them to cover the population of small borrowers, thus has the potential to improve small borrowers' access to credit. Ways to achieve this include establishing public credit reporting systems or, where they already exist, extending their coverage to smaller banking system loans, and ensuring widespread access to this information by the lenders and, for reasons of accuracy and transparency, by the borrowers themselves.

Candidates for these reforms include a number of countries in Latin America that currently do not have a credit bureau, including Costa Rica, Honduras, Panama, Guyana and Belize. Several other countries have credit bureaus with substantial loan size cutoffs (of approximately \$20,000 or more), which do not track many loans to smaller firms. These include Brazil, Colombia, Para-

guay and Uruguay. At the other end of the spectrum, a number of countries have very extensive loan reporting systems. For example, the credit bureaus in Bolivia, Chile, Ecuador and Venezuela cover all loan sizes, while the Argentine system tracks loans down to \$50. A recent example of reform is Peru, where until 1996 the superintendency's database included only loans of \$5,000 or more. Today, all loans there are tracked.

Leasing and Factoring

Leasing and factoring offer ways for firms that currently have little or no physical collateral to obtain loans, and thus may be of special interest to smaller firms. Unfortunately, a variety of legal, regulatory and tax obstacles may impede more widespread use of these instruments to obtain durable equipment financing (in the case of leasing) or loans based on accounts receivable (in the case of factoring).

In *leasing*, the lending institution buys and retains ownership of a piece of equipment that the firm would like to use. The enterprise uses the equipment and pays a monthly rent (which represents interest on the credit outstanding plus amortization). This arrangement offers the advantage over a collateralized loan in that the lender, as the owner of the equipment, does not have to be concerned about creating or perfecting a security interest—it can be sure that no one else has a legal claim on it. In addition, if the firm defaults on its lease and the lending institution takes possession of the equipment, it can sell it immediately in the second-hand market (since it is the owner), avoiding the lengthy proceedings required to obtain a court order to sell the pledged asset. However, the lender often must still go through a long legal process to take possession of the equipment, since it resides on the firm's property. Thus, with leasing one escapes some but not all of the problems associated with secured transactions. To facilitate leasing, the legal system should permit parties to contract for rapid and low-cost repossession of leased equipment in cases of default.

Unnecessary tax and regulatory barriers to the widespread use of leasing should also be avoided. For example, since banks were allowed to enter the leasing business in Chile in the 1980s (as partial or sole owners of leasing companies), leasing has become one of the major ways that credit has been made available to smaller enterprises. As another example, if bank loan interest payments are tax deductible but lease payments are not, leasing will not flourish. In Argentina, until recently, there was a double taxation problem. The leasing company paid the 21 percent value-added tax when it bought the equip-

ment, and then the lessee paid it again when it leased the equipment. Only recently has legislation repealed the former levy, eliminating this problem.

A pioneer in the microcredit field, Bangladesh's Grameen Bank, has also recently been demonstrating the feasibility of microleasing. The Grameen program began with leasing power looms to poverty-level weavers in the Dhaka Zone in 1992 and has since expanded to cover a wide variety of products (including sugarcane grinders, power tillers, battery chargers, ballpoint pen production machines, baby taxis, and mini transport) and to all 14 zones covered by the bank's operations. As of October 1996, the Grameen Bank had booked \$1.5 million in leases, with an average lease size of \$760 and a default rate of 1.5 percent. Nearly 20 percent of the lessees had moved into ownership of the equipment financed. The leasing program is open to second-time borrowers from the bank's microloan program, with leasing terms of up to three years and rental payments collected on a weekly basis.²²

In *factoring*, the firm obtains a loan by making use of a somewhat nontraditional form of movable property collateral, its accounts receivable. This form of finance may be of particular interest to smaller firms, since they are often labor-intensive and may not have significant amounts of real property or even equipment that could be used to secure a loan. If, however, the smaller firm has substantial accounts receivable, particularly from large, bankable firms (for example, because they supply parts, other inputs, or services to these large firms), the smaller firm may be able to secure low-cost financing. This is because the interest rate charged on its receivables financing is primarily a function of the credit rating of the large firm, rather than of its own credit rating.

Since factoring is merely a special case of using movable property collateral to secure a loan, the obstacles to wider availability of such credit include all of the barriers to the use of movable capital discussed above. Hence, to expand the use of factoring—and thus the opportunities for smaller firms to obtain credit—the law must allow security interests to be created using invoices as collateral, there must be a way to verify that no one else has a prior claim on these invoices, and there needs to be a low-cost means for lenders to enforce their security interests in case of default.

²² For more on microleasing and the Grameen Bank's program, see Gallardo (1997).

Small Cap Rural Banks

Financial services are generally much less available in rural than in urban areas of Latin America. This, together with the fact that rural areas typically have much greater concentrations of low-income households, means that improving the delivery of financial services to smaller farms and other rural enterprises may be a useful strategy for creating more equal income distribution. One interesting approach is to permit the creation of small capitalization rural banks, as has been done in Indonesia and the Philippines. In the case of the Philippines, Agabin and Daly (1996) note that there are some 745 small “cap banks” serving 75 percent of the country’s secondary and tertiary cities and towns and supplying small loans to a large share of the Philippine countryside. The minimum capitalization required for bank start-up is between \$77,000 and \$770,000 (depending on location), which is significantly less than what is required to open a large urban bank.

The idea behind small cap rural banks is that in the countryside there are local entrepreneurs who understand the local culture and agriculture, and know many of the potential borrowers as well. Some of these entrepreneurs would make excellent bankers, but many do not have access to the several million dollars of capital normally required to start up a bank. This requirement was typically written with larger, urban commercial banks in mind, and may not be appropriate for rural areas. The minimum capitalization requirement exists for two reasons. First, it helps ensure that the intermediary will have a healthy start-up of operations, without difficulties in obtaining an appropriate location, purchasing equipment, meeting initial payrolls, making initial loans out of capital, and so forth. Second, it helps to avoid moral hazard problems by placing a significant amount of the owner’s capital at risk so that he or she does not make excessively risky loans and is not so tempted by the lure of fraudulent schemes, loan kickbacks, etc. These purposes might require smaller capitalization levels in less prosperous rural areas, or might be more efficiently served through a special regulatory regime such as higher capital-loan ratios. Policymakers may want to consider making such adaptations to the prudential regulatory framework to facilitate the creation of small cap rural banks.

Though this chapter has thus far focused primarily on credit solutions for the income distribution problem in Latin America, providing deposit services can also help to increase the incomes of poor households and thus potentially lessen inequality, particularly if these services are provided in rural areas with large poor populations.

Modernizing and Supervising Credit Unions

Credit unions provide credit and deposit services in rural areas that are often too isolated or sparsely populated to support a bank branch. They have also traditionally played and continue to play the role of a “poor man’s bank” in both urban and rural areas of Latin America, serving lower- and some middle-income households and smaller firms that banks have served less well. Credit unions are also the dominant supplier of microenterprise credit in Latin America, though total supply is still quite limited. Modernization and supervision of credit unions offer the possibility of increasing the quantity and quality of credit and deposit services delivered to lower-income households, thus lessening income inequality.

Credit unions throughout the region were established from the 1950s through the 1970s with a strong social welfare purpose in mind. Many were organized by Catholic priests and U.S. Peace Corps volunteers. They typically lacked professional management, were weak at loan recovery and at earning and retaining profits for future expansion, and usually kept loan rates low in order to benefit borrowing members. Low lending rates meant that deposit rates were also normally kept low, but with substantial grant and soft loan funds available from external donors, many credit unions grew rapidly despite the lack of deposit mobilization, loan recoveries and retained earnings. With the drying up of much of these donor funds in the 1980s and 1990s, the credit union movements in many Latin American countries became moribund.

Rehabilitation (or modernization) programs and prudential regulation and supervision have shown great potential for improving the performance of the region’s credit unions, including their sustainability and outreach. Rehabilitation programs that began in the mid to late 1980s in Guatemala and the Dominican Republic have produced excellent results, while those in Honduras and Bolivia have also made substantial strides. (Box 7.3 presents highlights of the Guatemala case.)

Modernization programs must of course be tailored to the particular weaknesses and needs of the credit unions being rehabilitated. Among the major weaknesses in credit union policies and practices commonly addressed in these programs are low wage levels, poor labor quality, low deposit rates and weak deposit mobilization, low loan rates and little capitalization of profits, opaque financial information and undisciplined financial practices, and inadequate risk management. Obviously, such major failings seriously jeopardize the performance and sustainability of credit unions and their ability to reach large numbers of households with quality financial

Box 7.3. Credit Union Rehabilitation in Guatemala

When the technical assistance team from the World Council of Credit Unions arrived in Guatemala, it found that credit unions there suffered from all of the problems described in this section and more: uncompetitive salary levels, low deposit and loan rates, little institutional capital, erratic provisioning, poor quality of financial information, and weak risk management practices. Working with a group of 20 of the largest and most promising credit unions, the team helped overhaul key prices, policies and practices, and improve or establish auditing and control, strategic planning, marketing, information and other systems. The effort was highly successful by nearly any measure.

From program initiation in 1985 until its end in 1993, the delinquency rate on the consolidated portfolio of the 20 credit

unions fell from 30 percent to 7.9 percent. Provisioning of loans overdue more than one year increased from 36 percent to 100 percent. Institutional capital rose from 4.5 percent of assets to 10.7 percent, while total assets in real terms increased at an average compounded rate of 17 percent per year. The total number of credit union members nearly doubled. With the modernization program having created a base of financially solid, well-managed credit unions, growth then further accelerated. In the next four years (1994-97), real assets nearly tripled and the number of members nearly doubled. At the same time, financial solidity was maintained, with the delinquency rate on the consolidated portfolio falling slightly to 7.5 percent and the consolidated capital/assets ratio increasing somewhat to 11.6 percent.

services. In addition to addressing these principal problems, modernization programs often improve other important areas of credit union operations and management, including strategic business planning, internal auditing and controls, general personnel and incentive policies, marketing, and information systems.

Supervision. Bringing credit unions under the financial supervisory umbrella helps impose much of the financial discipline they have traditionally lacked, and which they need in order to provide more and better financial services. But superintendencies in only five Latin American countries currently supervise credit unions (Bolivia, Colombia, Ecuador, Mexico and Paraguay), and all of these programs were begun too recently to assess their impact on credit union performance. A number of important differences between supervising credit unions and banks stem from differences in the credit unions' ownership structure (cooperative instead of stock company) and resulting governance issues; the fact that credit unions make a large number of small, often uncollateralized loans (so that reporting requirements and the methods used to assess portfolio quality must be adjusted); and the probable need for tougher provisioning and capital adequacy standards due to the greater volatility of credit union earnings, which in turn is the result of a frequent lack of geographical diversification of the loan portfolio, the effect of credit union governance problems and a tendency (partly born of cooperative philosophy) to slip into lax loan collection procedures.²³ Like supervision of intermediaries that specialize in microlending, then, supervision of credit unions requires a number of special considerations in order to be carried out effectively. When done well, however, credit union supervision, like rehabilitation, has the potential to contribute to economic development and reduce income inequality.

Downscaling and Upgrading

Downscaling refers to efforts by commercial banks and other similar banking institutions, such as financing companies, to offer loans to microenterprises, while upgrading refers to the process of turning NGO microlenders into regulated financial intermediaries. Downscaling is important; all but three of the financial institutions listed in Table 7.2 are intermediaries that have downscaled, the exceptions being Banco Sol and Caja los Andes in Bolivia and Corposol/Finansol in Colombia, which are upgrades. For several reasons, banks are attractive platforms from which to begin offering services to a large number of microfinance clients:²⁴

- They are regulated institutions, fulfilling the conditions of ownership, financial disclosure and capital adequacy that help ensure prudent management.
- They have the infrastructure, including branch networks, from which to reach out to a substantial number of microfinance clients.
- They have well-established internal controls and administrative and accounting systems to keep track of a large number of transactions.
- Their ownership structures, made up of private capital, encourage sound governance, cost-effectiveness and profitability, all of which lead to sustainability.
- They offer deposit services as well as loans.

Downscaling operations typically focus on transferring the lending technology (see Box 7.2) to the commercial bank and fitting it into the framework of the en-

²³ See Poyo (1998).

²⁴ This discussion is taken from Baydas, Graham, and Valenzuela (1997).

tire institution in as cost-effective a manner as possible. The impact of downscaling programs on income inequality may not be very great, at least at first, as banks may not reach down to the poorest microentrepreneurs.²⁵ They may choose instead to serve the larger and wealthier microentrepreneurs, finding this to be more profitable if there is little competition as yet in this market segment. Over time, of course, additional competition may appear, and some banks may find it profitable to lend to lower-income firm owners.²⁶

By contrast, upgrading operations typically start with a financial NGO that is committed to reaching low-income microentrepreneurs.²⁷ The difficulty here is that most such NGOs do not possess the skills or mindset that would enable them to become regulated financial institutions. Those that do must learn many of the same financial disciplines described earlier for credit unions: keeping loan rates up (despite the high costs this imposes on the group they are trying to assist); containing costs and earning and capitalizing profits (to help ensure sustainability and underwrite future growth); and provisioning adequately, controlling risks and submitting themselves to the prudential regulatory norms imposed on deposit-taking institutions. They must also become proficient at looking after the vastly more complex liabili-

ties side of their operations: liquidity management, asset/liability matching, selection and pricing of appropriate deposit instruments, and so forth. Offsetting these costs is the leverage provided by deposit-taking, which allows the former NGO to greatly expand its credit outreach, as well as to provide valuable savings services to its target population. Training programs designed to assist in the process of upgrading may thus be a cost-effective way of expanding access to credit to small, low-income borrowers.

A combination of downscaling and upgrading occurs when commercial banks or other banking institutions decide to work in tandem with financial NGOs to serve microenterprises more effectively. This can be done by combining the financial expertise and better access to funds and supervision of commercial banks with the financial NGOs' knowledge of and closeness to microenterprise clients.

²⁵ Judging from their average loan sizes in excess of \$2,000, this would appear to be true of several downscales listed in Table 7.2.

²⁶ Even wealthier microentrepreneurs, however, may hire low-income workers, which would have important beneficial impacts on income distribution.

²⁷ Evidence of this commitment is seen in the low average loan sizes of the three upgrades in Table 7.2.

REFERENCES

- Acción International. 1997. 1996 *Annual Report*. Somerville, Mass.: Acción International.
- Agabin, Meliza, and Jorge Daly. 1996. An Alternative Approach to Rural Financial Intermediation: the Philippine Experience. Chemonics International, Inc., Washington, D.C.
- Bank of Japan. 1996. *Economic Statistics Monthly* 8(1) January. Tokyo.
- Barham, Bradford, Stephen Boucher, and Michael Carter. 1996. Credit Constraints, Credit Unions, and Small-Scale Producers in Guatemala. *World Development* 24(5): 793-806.
- Baydas, Mayada, Douglas Graham, and Liza Valenzuela. 1997. *Commercial Banks in Microfinance: New Actors in the Microfinance World*. Microenterprises Best Practices Working Paper, USAID and Development Alternatives, Inc., Washington, D.C.
- Bresnayan, Jr., Edward. 1996. The Microenterprise Sector in Guyana. Regional Operations Department 3, Inter-American Development Bank, Washington, D.C.
- Chickering, A., and M. Salahdine. 1991. Introduction and the Informal Sector Search for Self-Governance. In A. Chickering and M. Salahdine, eds, *The Silent Revolution*. San Francisco: International Center for Economic Growth.
- Christen, Robert. 1997. Issues in the Regulation and Supervision of Microfinance. In R. Rock and M. Otero. *From Margin to Mainstream: The Regulation and Supervision of Microfinance*. Acción International Monograph Series No. 11. Somerville, Mass.
- Christen, Robert, Elisabeth Rhyne, and Robert Vogel. 1995. *Maximizing the Outreach of Microenterprise Finance: The Emerging Lessons of Successful Programs*. Washington, D.C and Cambridge, Mass: Harvard Institute for International Development and USAID.
- Deininger, Klaus, and Lyn Squire. 1996. Measuring Income Inequality: A New Data Base. *The World Bank Economic Review* 10(3) September.
- de Soto, Hernando. 1989. *The Other Path: The Invisible Revolution in the Third World*. New York: Harper & Row.
- Deutsche Bundesbank. 1995. Monthly Report 47(3) March. Frankfurt.
- EIM/International. 1996. Characteristics and Constraints of Small Businesses in Trinidad and Tobago: Final Report National Baseline Survey. A Sample Survey among 2,104 Businesses. Small Business Development Company and EU, Port of Spain/Zoetermeer.
- ESA Consultores. 1996. Estudio de la Pequeña y Micro Empresa en Honduras. USAID, Tegucigalpa.
- Fleisig, Heywood. 1995a. The Power of Collateral. Private Sector Department Note No. 43. World Bank, Washington, D.C.
- _____. 1995b. The Right to Borrow. Private Sector Department Note No. 44. World Bank, Washington, D.C.
- Fleisig, Heywood, Juan Carlos Aguilar, and Nuria de la Peña. 1994. How Legal Restrictions on Collateral Limit Access to Credit in Bolivia. World Bank Report 13873-BO, Office of the Chief Economist, Latin America and the Caribbean Region, Washington, D.C.
- Gadway, John, and Michael O'Donnell. 1995. Rural Finance and Small Farmer Liquidity. Inter-American Development Bank, Washington, D.C. Unpublished.
- Gallardo, Joselito. 1997. *Leasing to Support Micro and Small Enterprises*. Policy Research Working Paper No. 1857. World Bank, Washington, D.C.
- Ghani, Ejaz. 1992. *How Financial Markets Affect Long-Run Growth: A Cross-Country Study*. PRE Working Paper No. 843. World Bank, Washington, D.C.
- Gulli, Hege. 1998. Microfinance and Poverty: Questioning Common Beliefs. Microenterprise Unit, Inter-American Development Bank, Washington, D.C.
- INEGI. 1994. Encuesta Nacional de Micronegocios. Aguascalientes, Mexico.
- Inter-American Development Bank. 1995. The IDB and Microenterprise: Promoting Growth with Equity. Microenterprise Unit, Inter-American Development Bank, Washington, D.C.
- International Monetary Fund (IMF). 1997. *International Financial Statistics* 50(8) August.
- Jansson, Tor, and Mark Wenner. 1997. Financial Regulation and its Significance for Microfinance in Latin America and the Caribbean. Microenterprise Unit, Inter-American Development Bank, Washington, D.C.
- Jaramillo, Fidel, Fabio Schiantarelli, and Andrew Weiss. 1996. Capital Market Imperfections Before and After Financial Liberalization: An Euler Equation Approach to Panel Data for Ecuadorian Firms. *Journal of Development Economics* 51: 367-86.
- King, Robert, and Ross Levine. 1993. Finance and Growth: Schumpeter Might Be Right. *The Quarterly Journal of Economics* 108(3): 717-37.
- Li, Hongyi, Lyn Squire, and Heng fu Zou. 1998. Explaining International and Intertemporal Variations in Income Inequality. *The Economic Journal* 108: 26-43.
- Loayza, Norman. 1996. The Economics of the Informal Sector: A Simple Model and Some Empirical Evidence from Latin America. World Bank, Washington, D.C. Unpublished.
- Magill, John, and Donald Swanson. 1991. Ecuador Micro-Enterprise Sector Assessment: Summary Report. GEMINI Technical Report No. 8, USAID, Washington, D.C.
- McPherson, Michael, and Carl Liedholm. 1996. Determinants of Small and Micro Enterprise Registration: Results from Surveys in Niger and Swaziland. *World Development* 24(3): 481-87.
- Mushinski, David. 1995. Credit Unions and Business Enterprise Access to Credit in Guatemala. The College of William and Mary, Williamsburg, VA. Unpublished.
- Orlando, María Beatriz. 1998. How Informal Are Microenterprises? The Role of Human and Physical Capital on Institutional Participation in Urban Mexico. Department of Economics, Tulane University, New Orleans. Unpublished.
- Pons, Frank Moya, and Marina Ortiz. 1994. Indicadores de las microempresas en la República Dominicana 1993-1994. Fondomicro, Santo Domingo.
- _____. 1995. Indicadores de las microempresas en la República Dominicana 1994-1995. Fondomicro, Santo Domingo.

- Poyo, Jeffrey. 1998. A Conceptual Framework for the Regulation and Supervision of Credit Unions: How Does It Differ from Stockholder-Owned Banking Institutions? Paper presented at the conference "Building Modern and Effective Credit Unions in Latin America and the Caribbean, Inter-American Development Bank, Washington, D.C.
- Psacharopoulos, George. 1993. Poverty and Income Distribution in Latin America: The Story of the 1980s. Latin America and the Caribbean Technical Department, World Bank, Washington, D.C.
- Rock, Rachel, and María Otero. 1997. *From Margin to Mainstream: The Regulation and Supervision of Microfinance*. Acción International Monograph Series No. 11, Somerville, Mass.
- Sebstad, Jennifer, and Gregory Chen. 1996. *Overview of Studies on the Impact of Microenterprise Credit*. AIMS Project Working Paper, USAID Office of Microenterprise Development, Washington, D.C.
- Tokman, V. 1992. The Informal Sector in Latin America: From Underground to Legal. In V. Tokman, ed., *Beyond Regulation: The Informal Economy in Latin America*. Boulder: Lynne Rienner.
- Westley, Glenn. 1994. *Financial Liberalization: Does It Work? The Case of Latin America*. DES Working Paper No. 194, Inter-American Development Bank, Washington, D.C.
- _____. 1997. *Credit Union Policies and Performance in Latin America*. OCE Working Paper No. 355, Inter-American Development Bank, Washington, D.C.
- Wolff, Edward. 1991. The Distribution of Household Wealth: Methodological Issues, Time Trends, and Cross-Sectional Comparisons. In Lars Osberg, ed., *Economic Inequality and Poverty: International Perspectives*. Armonk, NY: M.E. Sharpe Publishers.
- World Council of Credit Unions (WOCCU). 1995. *1994 Statistical Report*. Madison, WI: WOCCU.
- _____. 1996. *1995 Statistical Report*. Madison, WI: WOCCU.