

**SECTION TWO**  
**CASE STUDIES: PROMISING RURAL FINANCE**  
**ORGANIZATIONS AND PRODUCTS**

## RURAL FINANCE ORGANIZATIONS

### **CENTRO DE ESTUDIOS SOCIALES SOLIDARIDAD, PERU: THE NGO-BANK-SMALL FARMER LINKING APPROACH**

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#### INTRODUCTION

A linking approach between a commercial bank and a loan-providing NGO appeared in Peru as a reaction to the classic reluctance of the official banking system to channel funds to small-scale agriculture. The linking experience between the Wiese Bank (Banco Wiese) and the Centro de Estudios Sociales Solidaridad presented in this chapter is one of the most successful cases of bank-NGO linking in Peru. Two factors explain its success. First, the NGO's strength and organizational structure enabled it to set up a unit specialized in lending, by making the most of the information available and the prestige that it has in certain geographic areas where the approach has been implemented. Second, the prestige and dynamism of the Lambayeque branch of the Wiese Bank in the northern city of Chiclayo, Department of Lambayeque, gave the project a capital base and credibility.

Following a brief description of the main actors involved in this linking model, the product offered and the service system will be analyzed in section 2; the third section will examine the performance of the approach that generated the experience analyzed here. The main challenges to the model will be explored in section 4 and, finally, conclusions are drawn in the last section.

## Brief Description of the Initial Linking Approach and Actors Involved

### The Centro de Estudios Sociales (CES) Solidaridad

The CES Solidaridad is a non-profit NGO. It was founded in 1980 in the city of Chiclayo, Department of Lambayeque, located approximately 800 kilometers north of Lima. In its beginnings, its activities were mostly directed to popular education and social development in *campesino* communities, mainly in the area's agricultural cooperatives.

The CES Solidaridad's first lending projects go back to the mid-eighties, when a program of rotating funds linked to technical assistance was implemented. The project failed due to severe recovery problems. Later on, the Center made further attempts at operating rotating funds and had better success, starting in 1992, with the introduction of sheep in some communities, and in 1993 with the introduction of alfalfa seeds. That same year, Solidaridad established contacts with the European Community to manage a credit fund for urban micro business, called Development Fund for Micro Business, FONDEMI (Fondo de Desarrollo de la Microempresa), run from Banco Continental counters. Based on this, the Business Development Area (Área de Desarrollo Empresarial) was created within the Credit and Technical Assistance Unit (Unidad de Crédito y Asistencia Técnica), which is in charge of providing credit and technical assistance services to rural and urban, small and micro businesses. The Unit offers various financial products segmented according to the target group it focuses on (see Table 6.1).

**Table 6.1. CES Solidaridad Financial Products and Clients**

| Products                                      | Clients  |
|---|--|
| Linking with Wiese Bank, operating since 1994 | Small farmers  |
| FONDEMI <sup>a</sup> , operating since 1993   | Small urban producers                                  |
| Village banks, operating since 1994           | Urban and rural women                                  |
| Solidarity groups, operating since 1993       | <i>Campesinos</i> dedicated to subsistence agriculture |

<sup>a</sup> *Fondo de Desarrollo de la Microempresa* (Development Fund for Small Business), funded by the European Union.

Source: CES Solidaridad.

Linking between the Wiese Bank and the CES Solidaridad began to develop in 1994, according a shared responsibility model. As will be seen further, the implementation of this product by the CES Solidaridad came to be thanks to the Bank's initiative. A negotiation process between the Bank and the NGO preceded the approval of the CES Solidaridad's proposal of initiating work with the San Isidro Farm Users' Cooperative (Cooperativa Agraria de Usuarios (CAU) San Isidro), made up of small farmers and sugar producers owning six hectares. In 1994, all clients

were consequently the members of CAU San Isidro, located in the province of Ferreñafe, Department of Lambayeque, with a line of credit that had come from the Corporación Financiera de Desarrollo, COFIDE (Financial Corporation for Development), and only in early January 1995 did the Program expand to other clients.

### The Wiese Bank

Founded in 1943, the Wiese Bank remained a very traditional commercial bank until the late seventies. It only operated in Lima and its main clients were mining companies. In the second half of the eighties, the Bank launched a highly ambitious expansion process. It diversified its clientele and opened offices in Peru's main provincial cities. Following this expansion, the Wiese Bank became the second largest bank in the Peruvian banking system by the nineties.

Despite being a traditional bank, some precedents explain why the Wiese started to finance small and micro businesses. The Bank sat on the Board of an NGO, Community Action of Peru (Acción Comunitaria del Perú), an affiliate of Acción Internacional, specialized in microcredit. Furthermore, in the seventies, it had financed some electrification projects in marginal areas with very successful recovery rates.<sup>1</sup> Based on these experiences, in 1991, the Bank decided to fund a group of micro business owners headed by a former domestic worker who had worked for the owners of the Bank. At first, the experience turned out to be quite chaotic. On one hand, funds were channeled through checking accounts that the business owners involved had no idea how to manage and, on the other, Bank employees, especially cashiers, had no experience with this type of client. A former Bank employee described the experiment as generating tremendous line-ups at the Bank's main offices, which no one knew how to prevent. To solve this problem, the Bank hired a consultant from an NGO.

Resolving the problem and, more importantly, noting the willingness to pay demonstrated by the micro business owners, encouraged Bank owners to create the Small and Micro Business Office GPM (Gerencia de Pequeña y Microempresa). The consultant who had managed to solve the problem was hired to run the sub office dealing with the problems of micro business owners. In 1992, the GPM, along with urban NGOs, began to grant loans to small and micro businesses. At the end of 1992, it decided to penetrate rural areas, with an NGO from Lima, using the linking approach. In mid-1993, in view of the success the program had in Lima, the GPM decided to extend it to other provinces. GPM employees visited various provincial branches to explain how the Program worked, and then assessed which branches had appeared the most receptive and offered the best conditions to implement it. The Chiclayo branch was chosen to launch the experience in the provinces.

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1 Financed through electricity bills.

At the end of 1993, with the help of GPM members, the Chiclayo branch issued a call to the area's main NGOs working with small farmers, in order to introduce them to the linking approach and invite them to take part. At first, three NGOs were invited: the CES Solidaridad, the region's most important NGO, the Social Studies and Rural Development Center (Centro de Estudios Sociales y Desarrollo Rural, CESDER), and the Research, Consulting and Promotion Center (Centro de Investigación, Capacitación, Asesoría y Promoción, CICAP), with which work began in 1994. Later on, in 1995, another NGO, the Regional Promotion Institute (Instituto de Promoción Regional, IPR), joined the Program but left after completing one year. In late 1998, only CESDER (whose employees created the AGROSER company) and the CES Solidaridad had active portfolios at the Wiese Bank, while CICAP was in the process of strictly recovering its portfolio due to late payment problems. This is how the CES Solidaridad had come to join the Program.

According to former GPM employees, a certain degree of resistance on the part of the Bank had to be overcome. In fact, Bank workers knew little about, and were suspicious of, NGOs and small and micro producers. This is why it was fundamental that the head of the GPM also be one of the Bank's Directors to drive the Program and convince middle-management that it would work. The fact that the Assistant Manager had previously worked for an NGO also eased the contact with these organizations.

One of the most difficult moments that the linking approach went through occurred in 1995, when the NGO with which the Bank was experimenting in financing small rural producers in Lima underwent severe problems in managing the program and recovering loans.<sup>2</sup> This generated fears among certain banking officials, most of all among middle-management. Nevertheless, thanks to the confidence and support of the Bank Directors, the program continued on.

## DESCRIPTION OF THE PRODUCT AND APPLICATION OF THE LINKING APPROACH

### The Product

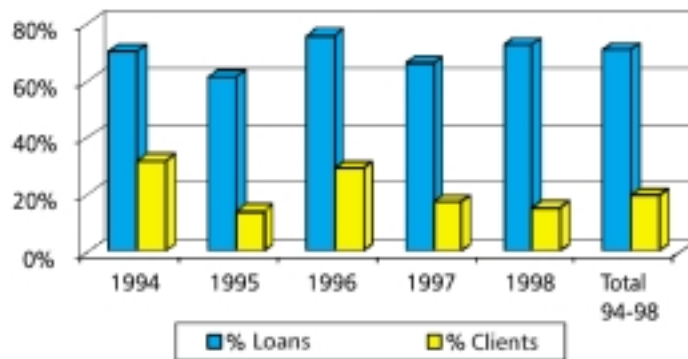
The loans offered as part of the linking approach are individual, but the selection of clients is done through groups, a condition established by the CES Solidaridad for recruiting new clients. The loans are clearly agricultural and concentrated exclusively on rice and sugarcane crops. The minimum loan registered for 1998 was US\$ 1,000 and the top amount exceeded US\$ 12,000.

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2 Ex GPM employees attribute the failure of the linking experience with this NGO to a bad choice of NGO on the part of the GPM. The decision was made relying on the NGO's prestige and its recognized promotion work in the rural sector, but no adequate assessment was made of its ability and experience in managing a credit program for rural producers. The NGO's weaknesses were not apparent at first because of the small portfolio it managed; however, when the portfolio began to grow, problems arose.

Since its beginnings in 1994, the Linking Approach Program has been the CES Solidaridad's main financial product in terms of loans, with proportions generally over 70 percent (see Figure 6.1). Nonetheless, with respect to the number of borrowers, its importance has been much less. In 1998, clients of the linking approach only represented 15 percent of the total clientele of the CES Solidaridad. This data is explained by the greater amounts lent through this approach, given its concentration in agricultural activities, and the presence of other products characterized by a huge number of clients, such as village banks, which represent 67 percent of the total clientele.<sup>3</sup>

**Figure 6.1. Proportion of the Linking Program in CES Solidaridad's Total Portfolio**



Source: CES Solidaridad.

### Terms

The terms established for loans granted through the linking approach respond to the nature of the agricultural activities financed. Normally, the terms for rice are from 8 to 10 months; for sugar, from 14 to 20 months. Changes to the term structure of loans disbursed from 1997 to 1998, as shown in Table 6.2, are due to a shift in the importance of the financed crops; rice was more important in the 1998 portfolio (around 60 percent) than in 1997. This is why, in 1998, none of the loans disbursed had a term of over 15 months.

<sup>3</sup> The Linking Program is called *Programa de Responsabilidad Compartida por el CES Solidaridad* (CES Solidaridad Shared Responsibility Program). Together, the four products (Village Banks, FONDEMI loans, linking and Solidarity groups) invested a total of US\$ 4.3 million in 1998.

**Table 6.2. Disbursed Amounts According to Terms at the End of the Period (US\$)**

| Term            | 1997      | Percentage | 1998      | Percentage |
|-----------------|-----------|------------|-----------|------------|
| 7 to 10 months  | 246,820   | 12         | 1,654,475 | 53         |
| 10 to 15 months | 370,229   | 18         | 1,478,346 | 47         |
| 16 to 20 months | 1,439,781 | 70         | -         | -          |
| Total           | 2,056,830 | 100        | 3,132,821 | 100        |

Source: CES Solidaridad.

### How the Linking Approach Operates

As mentioned above, the linking approach is characterized by a loan contract involving the presence of three actors: the CES Solidaridad of Chiclayo, the Wiese Bank and small farmers. The features of these actors' intervention are listed below.

- (i) The NGO is in charge of the selection task. In the case of the CES Solidaridad, the work it had carried out in the area since its creation (social development, technological transfers, and some rotating funds) allowed it to acquire a very comprehensive understanding of potential borrowers. This gives Solidaridad a significant comparative advantage over other agents who do not have such information, when screening farmers as possible loan recipients.

The CES Solidaridad is also known to the Wiese Bank and its clients, either as an account holder or through transfers and surety bonds. In addition, its owns goods that could be put up as collateral.

The Center has on hand a technical team and an organizational structure, which are both recognized by the Wiese Bank as well suited and solvent to conduct client screening and deliver technical assistance.

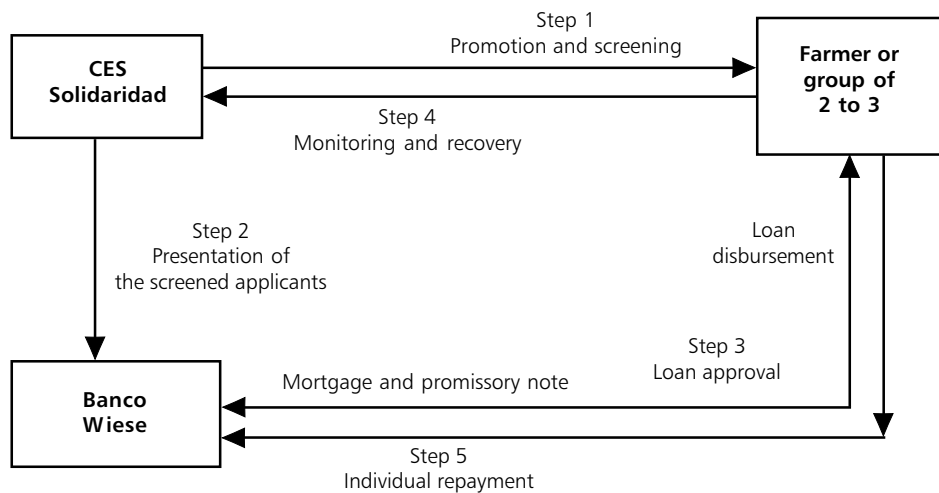
- (ii) The Wiese Bank is the second most important bank in Peru and, at the time when this case study was conducted, it was right in the process of merging with the Sudameris Bank, the Italian bank that owned the Lima-Sudameris Bank in Peru. As pointed out above, the Wiese Bank is very old and, in recent years, has undergone important expansion into Peru's main cities. This Bank is a pioneer in working with NGOs to finance urban small and micro business and, in 1992, it started to work with NGOs in rural areas. Up until 1999, it was one of the few banks which had a Small and Micro Business Office.
- (iii) Rice and sugar producers from the Lambayeque and Chancay Valleys are small producers who own an average of 5 to 10 hectares; they started out their activities after the land of the agricultural cooperatives created during the seventies' land reform was split up. These producers have received

technical support from the CES Solidaridad ever since it was founded. The majority has property titles and a large number of them have received loans from the state-owned Agricultural Bank (Banco Agrario), until its liquidation in 1992. Before taking part in this Linking Program, most had had no access to formal financing.

### The Technology

Functioning of the linking approach analyzed in this case study is outlined below (Outline 6.1):

#### Outline 6.1. Bank-NGO-Farmer Linking Approach



The Wiese Bank signed an agreement with the CES Solidaridad by which a line of credit was opened to provide farmers screened by the NGO with working capital.

The Bank sets maximum amounts on loans according to number of hectares and crop type. At a more operational level, the Bank establishes the terms and conditions of the contracts; that is, loan characteristics, their requisites and reimbursement methods. In 1998, the loan conditions established by the financial institution were the following: an individual amount no lower than US\$ 3,000 and no higher than US\$ 18,000, current banking compensatory and delinquency interest rates, and terms depending on the evaluation and signing of a promissory note (*pagaré*) to the Bank.<sup>4</sup> The contract also stipulates that the Bank has the power to suspend granting new loans when the portfolio delinquency rate is over 5 percent of the

<sup>4</sup> Of course, interest rates may vary without previously consulting the CES Solidaridad. The annual interest rate at the start of the program was set at 14 percent and, in 1998, at 26 percent, in dollars.

total current loans. The main general terms of the contract in place between the NGO and the Bank are shown in Table 6.3.<sup>5</sup>

Every year, the Bank organizes an official meeting with representatives from the CES Solidaridad. These "evaluation workshops" serve to examine the results of the Program. The financial institution then makes its decision on the line of credit that the NGO would be granted the following year.

**Table 6.3. Commitments Established in the Linking Contract<sup>a</sup>**

| CES Solidaridad's commitments   | Bank's commitments   |
|---|--|
| <ul style="list-style-type: none"> <li>• To define with the Bank the evaluation methods for loan applications.</li> <li>• To conduct technical, economic and financial assessments of the projects presented, according to parameters set by the Bank. This assessment shall in no way replace the Bank's own evaluation.</li> <li>• To promote the credit program among the sector's associations and economic groups.</li> <li>• To coordinate and organize with the Bank and other relevant institutions services to borrowers including advise, training and technical support.</li> <li>• To conduct regular loan monitoring and evaluation in order to assist and guide borrowers in solving their overdue payment problems.</li> <li>• To report to the Bank monthly about the state of the portfolio.</li> <li>• The relevant information found on loan applications and the monitoring reports presented to the Bank are under its exclusive responsibility, as well as the consequences that may ensue should the information prove false.<sup>b</sup></li> </ul> | <ul style="list-style-type: none"> <li>• To inform the CES Solidaridad and borrowers on the operating capacity of the Program and send them all the information regarding the evolution of the loans granted, in a timely fashion.</li> <li>• To report at least once a month to the CES Solidaridad on transactions in the line of credit, loans granted, list of overdue payments and the current liquidation of unpaid loans.</li> <li>• Loans are granted in Peruvian or foreign (US\$) currency, according to clients' requests.<sup>c</sup></li> </ul> |

<sup>a</sup> The contract was valid until the year 2000. Any of the parties could pull out at any moment without prejudice, by delivering a notarized notice 30 days before the fact. In such a case, all the loans granted by the program would be completely transferred to the Bank.

<sup>b</sup> "Relevant" information is understood to mean: type and state of crops, main activity, applicants' economic situation and equity, applicants' ability to pledge their own collateral, and information concerning use of the loan and the applicants' ability to repay.

<sup>c</sup> In practice, all loans were granted in dollars.

<sup>5</sup> This contract was similar to that signed with the other NGOs.

### *Client Promotion and Screening*

CES Solidaridad promotes the product in the areas where it operates and where it finds most appropriate to do so. In general, this is carried out by calling farmers to meetings to explain the product's characteristics. Information is disseminated in strategic locations. Farmers can also personally visit the NGO's offices to obtain information on the financial products the institution offered.

### *Requisites*

When farmers wish to take part in the linking scheme, they must form groups of two or three applicants. In practice, these groups self-screen. An indispensable condition to form a group is that its members grow the same product and own neighboring plots, in order to reduce supervision costs. In addition, a group coordinator, who will be in charge of liaison and will call future meetings, must be chosen. In many cases, the coordinator takes on the task of guiding, and even introducing and recommending, new loan applicants.<sup>6</sup> The group practice has demonstrated that, in almost every case, borrowers join on the recommendations of older members.

Once the groups are formed, applicants must fill the loan application, to which they must attach the following documents:

- (i) Exact copy of property title, obtained from Public Records. This document provides information on the land: if it is mortgaged, for how much and with whom.
- (ii) Proof of residence.
- (iii) Sworn statement of personal property by the applicant.
- (iv) References from the area.

The private credit bureau Infocorp and the Comité de Productores de Chiclayo (Producers' Committee of Chiclayo) are also consulted to check if the applicant has debts pending. At the screening stage, the analysis of the documents constitutes the first step in the evaluation. The loan officer focuses chiefly on whether or not the applicant has debts and a property title.

Once the required documents have been received, a personal visit to each group member is carried out to check the information; particularly, personal details and collateral offered. Based on the visit, the loan officer works out the household's cash flow and, if it turns out to be positive, a credit report about each member is written and a file is opened.

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<sup>6</sup> Coordinators do not receive any special treatment from the CES Solidaridad; except in some cases, they may receive an advance on their loan with the Bank, but must always respect the conditions imposed in the contract.

The file must include the location and quality of the land, as well as access to irrigation, among essential production factors. It constitutes the first filter used to assess loan applicants. Once the file has been analyzed, the loan officer recommends pursuing the evaluation or terminating it, according to the applicant's ability to repay. If the decision is to continue on, the land is appraised, and the amount that may be mortgaged is determined and must be at least double the amount of the requested loan. After the document is notarized, it is entered in Public Records.

Once all the requisites have been pre-approved by the CES Solidaridad, a list is sent to the Bank with the complete files for review, evaluation and approval by the Bank. The final reports are endorsed by the Program Coordinator.

### *Guarantees*

Loan guarantees have evolved through time. When the Program first began, in addition to cross guarantees, a collateral fund equivalent to 20 percent of the loan was required to be deposited in a Wiese deposit account, which was charged in case of non-payment. However, in October 1995, the Bank decided to request the farmers' mortgages on each plot as collateral and, consequently, problems began to arise in its relationship with other NGOs, especially in Lima. Since then, all loans have had to be backed by real guarantees, for a value at least double that of the loan.

This has reduced the importance of groups in the screening process. Until 1999, the creation of a group was enough of an initial requisite, as proposed by the CES Solidaridad, but later on, as farmers demonstrated their ability to pay, they could have access to loans completely on their own. The change in the type of collateral required has reduced the effective interest rate paid by producers and has apparently meant the exclusion of some producers who had no land titles or were unwilling to mortgage their land.

### *Loan Approval*

Once the files have been received at the Chiclayo branch, Wiese Bank experts examine them. The Bank may approve an application or turn it down it and. In the latter case, applications are returned to the CES Solidaridad for a new evaluation, although, in practice, very few cases are rejected on the base of a single application, due to the rigorous assessment carried out by the NGO's loan officers. The estimated percentage of loan applications the Bank rejects is 5 percent, a rate similar to that of producers' applications rejected by the CES Solidaridad.

Once the Bank has approved the loan, farmers go to the branch office to sign the loan contract, which includes a promissory note and cross guarantees. Here, three cases may come up:

- (i) The Bank approves the loan as applied for;
- (ii) The Bank approves an amount lower to that requested on the loan application rationing by quantity;
- (iii) The producer plants more than initially planned.

In cases when an amount lower to that of the loan application is approved, the decision is announced to producers who then decide whether they still want the loan or not. Usually, clients accept the amount offered by the Bank. In the third case, when producers plant more than initially planned in the project, the amount of the loan may be raised. In that case, an assessment similar to that for a new loan is conducted, and a fixed commission limited to 4 percent (see "Cost" below) is charged on the additional amount lent.

Once both parties agree on the amount, disbursement generally takes place in two installments, 70 percent of producers received their loans in two installments in 1998, the first on signing the contract, and the second, three months prior to harvest. The terms are 8 to 10 months for rice and 14 to 20 months for sugarcane, which includes a grace period of more or less two months for farmers to market their products, and corresponds to the expiration date on the promissory note. In practice, this means that the loan is liquidated when the rice and sugarcane are sold. However, as an internal management practice, the CES Solidaridad agrees with clients that the payment take place following harvest in order to motivate them to pay off the loan in a timely fashion and not to spend the money from crop sales on activities other than their reimbursement.<sup>7</sup> This provides a significant amount of time to keep payments under control.

### *Client Monitoring*

The technical services that the CES Solidaridad provides are crucial for the preventive monitoring of clients, to check the use farmers make of their loans and, at the same time, to offer technical advice on crops regarding irrigation and controlling weed and pest control. Their other activity is to remind farmers of their commitment to pay when harvest is coming up, normally, one month prior to the due date. In addition, spot checks of a random sampling of groups and areas are organized with Bank technicians. In total, at least one visit per month is conducted throughout the entire season.

Furthermore, since the 1996-97 farming season, an efficient monitoring system had been implemented which, on a visit to producers, noted if the harvest was approaching or had already started. Farmers were asked if they would rather store or sell their crops. Those who chose storage were advised to place their crop in three rice mills or four sugar mills authorized by the CES Solidaridad, in order to

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<sup>7</sup> Also helpful is the fact that loan schedules are not given to clients, in order for them not to wait until the due date to make their payment.

control warehousing and prevent the crop from being hidden. This makes the mill an extra monitoring “agent” who reports on the progress of milling and sales.<sup>8</sup> This way, the possible temptation of producers to sell the product and not pay the CES Solidaridad, but use the money differently, is under control. Although producers decide when to sell their crop, the CES Solidaridad is aware of its location and can make sure money from its sale is used to pay the loan and even authorize producers to sell, which, in a sense, gives it a certain control on marketing.

When crops are no longer in the field and producers have not stored them at a mill, farmers are assumed to have sold them. In this situation, a letter is sent to producers informing them that the crops are known to have been sold and that they are called upon to reimburse their debt.

At the Wiese Bank’s end, loan officers of the CES Solidaridad send notices to borrowers four weeks ahead, reminding them that the due date of their loan payment is approaching.

### *Loan Recovery*

As indicated above, at the end of harvest, loan officers remind clients of the payment they must make and the latter must then visit the Wiese Bank to reimburse the total amount of their loans. When clients default on payment, loan officers from the CES Solidaridad visit them and attempt to find out the reasons why. At this visiting phase, many are accompanied by Bank officers.

In general, when defaults are due to factors clearly independent from borrowers’ will such as pests, the El Niño phenomenon, falling prices, etc., problems are detected on time by the CES Solidaridad technical team members, who can then advise clients on how to apply to the Bank for an extension of their loan schedule. In such a case, the CES Solidaridad technical assistance team must send a document certifying the existence of a justified cause for defaulting on payment.

On the other hand, if CES Solidaridad loan officers assess that default is due to unwillingness to pay or negligence on the part of borrowers, they inform the Bank and both institutions then send a letter to the defaulting borrowers and to group members (when a group exists). The letter notifies them of the occurrence of non-compliance and provides details of the legal action to be taken to recover the amount of the loan. In addition, the Bank sends a notification to borrowers eight days after the due date set out in the promissory note. Should the producer persist in defaulting on payment, the CES Solidaridad reports to the Bank in order for collateral seizure to be carried out according to the law; defaulting borrowers are never again to be granted a loan by the NGO and their names are registered at the credit bureau of

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8 In addition, if the case requires it, the mill may be instructed to send the liquidation from the sale directly to the CES Solidaridad rather than to the producer, in order to pay off the debt in part or in its entirety.

the Superintendency of Banks. During the legal action, the CES Solidaridad supplies all the information required by both parties, Bank and borrowers to reach a mutually beneficial solution.

### Costs

For farmers, linking costs are basically of three types: the interest rates charged by the Bank, the commission charged by the CES Solidaridad, and the expenses involved in setting up mortgages, apart from transaction costs that were not calculated in the case study.

- (i) The interest rates charged by the Wiese Bank are the same as those on its commercial loans. During the 1998-1999 season, the annual rebated rate was 26 percent in dollars.
- (ii) The fixed commission that the CES Solidaridad charged is 4 percent. It covers the costs of technical assistance and credit management. When the Program first began, this commission was collected when the loan was granted, but since October 1995, 2.5 percent has been charged at the moment of disbursement and 1.5 percent after payoff, which is an incentive for the NGO to select good clients.
- (iii) The costs of constituting a mortgage ranges from US\$ 100 to US\$ 150. The process may only be carried out by specialized external legal firms who work closely with the CES Solidaridad. The cost is significantly lower than that charged in other settings for the same service, which may reach as high as US\$ 500. Furthermore, this expenditure occurs only once for new loans, since past borrowers already have their mortgage and, therefore, no longer require this service.

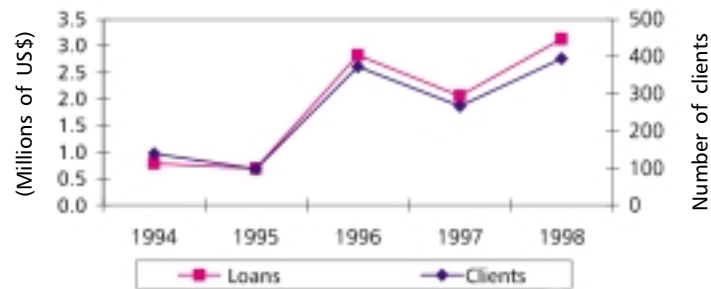
## RESULTS OF THE LINKING APPROACH

### Outreach

The loan portfolio of the Linking Approach Program has grown a great deal, as it registered an average annual growth of 41.4 percent in loans and 30.1 percent in number of clients assisted over the 1995-1998 period (Figure 6.2). In 1998, the portfolio exceeded US\$ 3 million, which represents nearly four times the loans in 1994. This demonstrates the confidence that the Wiese Bank had in the Program and in the CES Solidaridad, backed by the Program's good performance.

In terms of amounts lent through this approach, for 1998-1999, 395 producers were financed through the CES Solidaridad with a total disbursement of US\$ 3,132,821 for growing 1,350 hectares of rice and 1,150 hectares of sugarcane. In addition, the total number of producers financed from 1994 to 1998 was 1,270 and amounts lent came to US\$ 9,495,195, which represents 71 percent of the total amount lent by the CES Solidaridad's four financial programs.

Figure 6.2. Evolution of the Linking-Program Portfolio



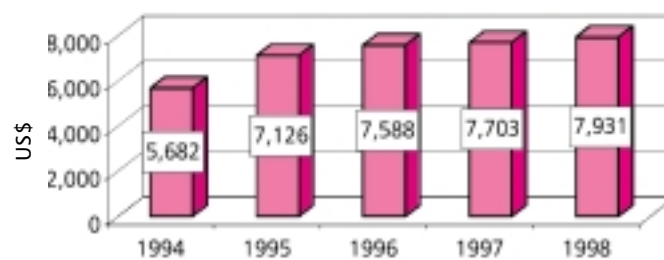
Source: CES Solidaridad.

### Portfolio Depth

The average size of standard loans in December 1998 was US\$ 9,393. In other respects, out of the total number of clients seen in 1998, 93 percent were men; in addition, 97.8 percent of the total disbursed went to men.

The average amount lent (the amount disbursed/the number of clients served) gradually rose, although in the last three years analyzed, variations were not significant (see Figure 6.3). The greatest increase occurred from 1995 to 1997, a period during which the Wiese Bank began to require mortgages instead of a collateral fund amounting to 20 percent of the loan. This suggests that a segment of small farmers who held no property title (probably those in the worst conditions) or who disagreed with mortgaging their land were excluded from the Program.

Figure 6.3. Average Amount Invested Through Linking, 1994-1998



Source: CES Solidaridad.

With respect to the composition of the amounts disbursed according to ranges, Table 6.4 shows that, in December 1998, they were above US\$ 1,000, with a marked concentration in the US\$ 4,000-to-US\$ 8,000 range (46 percent), while barely 15 percent were under US\$ 4,000 and a similar percentage was over US\$ 12,000. This confirms the fact that loans are directed to small producers with some accumulated capital. Regarding the proportion of the rural portfolio, given its concentration in agricultural products, nearly 100 percent of the CES Solidaridad portfolio is made up of loans to rural areas.

**Table 6.4. Disbursed Amounts by Loan Ranges at Year End**

| Range (US\$)    | 1997      | Percentage | 1998      | Percentage |
|-----------------|-----------|------------|-----------|------------|
| 1,000 to 4,000  | 287,956   | 14         | 469,923   | 15         |
| 4,001 to 8,000  | 1,028,415 | 50         | 1,441,098 | 46         |
| 8,001 to 12,000 | 514,208   | 25         | 814,553   | 26         |
| Over 12,000     | 226,251   | 11         | 407,267   | 13         |
| Total           | 2,056,830 | 100        | 3,132,841 | 100        |

Source: CES Solidaridad.

## Financial Performance

As seen in Table 6.5, the results of the CES Solidaridad's Linking Approach Program since its creation until the end of 1998 were very positive. The most outstanding feature is that, from the beginning, the Program managed to cover its operating costs. In 1997, its operating income from charging for technical assistance exceeded by 30 percent the operating costs and, in 1998, that figure rose to 66.5 percent. These positive results are largely due to the model's own characteristics. The CES Solidaridad does not incur financial costs, has no liabilities and its equity is quite reduced, in view of the fact that the portfolio is not part of the NGO's assets, but belongs to the Wiese Bank.

Going through the simple exercise of assuming that the CES Solidaridad had taken on the financial costs in 1998, it would have had to raise its operating income by around 23 percent to achieve financial self-sufficiency. However, a positive trend in its portfolio balance (ROE) confirms the improved performance of the CES Solidaridad in handling the linking model. Since the funds lent are not that of the CES Solidaridad, the analysis of the return on portfolio (ROC) and on assets (ROA) turns out to be irrelevant.

It is however extremely important to point out that the delinquency rate starting from one day overdue was only 1.3 percent in 1998, even though that was the year in which the effects of the El Niño phenomenon were most felt. In 1997, that rate was even lower (1.1 percent). Furthermore, in both cases, only the portfolio including 31 to 60 days overdue payments was considered, which, with an adjustment to the technology, could have displayed an even lower delinquency rate.

Without underestimating the importance of the technical assistance that was provided, as well as efficient client screening and effective crop monitoring, it is relevant to mention that these exceptionally good results are related to two factors: (1) the design of the loan contract and (2) loan refinancing following El Niño. On one hand, the design of the loan contract gives clients a grace period of more or less two months following harvest, although, in practice, CES Solidaridad loan officers strongly encourage producers to pay off their loans only days after harvest. In fact, a term is set with individual farmers on a given date, but the NGO has a margin of two months more before classifying their loans as "overdue," even though clients have not paid on the set date. On the other hand, in 1998, because of El Niño, refinancing was applied to rice at 23 percent of the total amount lent, which meant that the portfolio at risk (overdue plus refinanced loans) was 15.1 percent of the total portfolio. According to the Head of Credit at the NGO, that was the only opportunity, in 1998, when refinancing was ever approved.

**Table 6.5. Financial Results of the Linking Program, at Year End**

| Indicator                                       | 1997      | 1998      |
|---|-----------|-----------|
| Operating self-sufficiency (%)                  |           |           |
| Operating income/ Operating costs               | 131.7     | 166.5     |
| Financial self-sufficiency (%) <sup>a</sup>     |           |           |
| Operating income/ (Operating + financial costs) | 15.9      | 22.5      |
| Profitability (%)                               |           |           |
| Net income/ Equity (ROE)                        | 21.1      | 36.3      |
| Net income/ Total assets (ROA)                  | 21.1      | 36.3      |
| Net income/ Portfolio balance (ROC)             | 0.7       | 1.7       |
| Quality of assets (%)                           |           |           |
| Overdue portfolio/ Total portfolio              | 1.1       | 1.3       |
| Productivity                                    |           |           |
| Outstanding portfolio per office                | 2,830,450 | 3,212,500 |
| Outstanding portfolio per loan officer (US\$)   | 1,415,225 | 1,070,833 |
| Number of borrowers per loan officer            | 134       | 114       |
| Number of borrowers per office                  | 267       | 342       |

<sup>a</sup> A "shadow" financial cost was assumed as equivalent to the lending interest rate in dollars.

Source: CES Solidaridad.

Finally, as displayed in the table above, loan officers' productivity in terms of the portfolio they manage is quite high, even when the average number of borrowers per loan officer is quite significant (114). The reason for this is that the average loan is large, over US\$ 9,000, which, in turn, contributes to greater portfolio efficiency.

In summary, since loans represent large sums, these results give the Program broad possibilities to expand as long as the portfolio can be increased without significantly raising operating costs.

## CHALLENGES TO THE PROGRAM

While the Linking Program between the CES Solidaridad and Wiese Bank has been successful, Wiese Bank's similar programs with other NGOs have failed. This is mostly due to the weak organizational structure of loan management in those NGOs, which the Bank did not assess in a timely manner. To our understanding, the most important elements involved in the success of the Program with CES Solidaridad are as follows:

- (i) The organizational features of the CES Solidaridad, which granted it some technical autonomy in the credit area and enabled it to make the most of the experience of the staff dedicated to the Linking Approach Program.
- (ii) The CES Solidaridad's knowledge of, and recognition in, the geographic area where the Program was implemented, as well as the training and technical assistance it provides.
- (iii) The dynamism, independence and strong commitment that the Program enjoyed at the Wiese Bank's branch in Chiclayo, which involved the office's main directors.
- (iv) The excellent communication established between the management of Wiese Bank's Chiclayo branch and the executive body and staff of the CES Solidaridad.
- (v) The degree of commitment of the CES Solidaridad in monitoring and recovery, regardless of the fact that, in this last respect, it had no official responsibility.

The fact that the CES Solidaridad has an area specialized in granting loans contributed to the professional and independent management of the Program. Its knowledge of the work area and the recognition it enjoys there facilitated screening processes and strengthened borrowers' willingness to pay. Furthermore, the Bank's dynamism, autonomy and its identification with the Program ensured its quick response to requirements for fund increases to satisfy the growing demand for loans, without the need to seek permission from the Bank's main office. In addition, fluid communication between the CES Solidaridad and the Bank allowed speedy solutions to concerns that arose when the new Program was launched and modifications were brought to important aspects of it, such as those regarding collateral, commission payment methods and the role of solidarity groups. The farmers themselves became aware of the openness of the Bank's staff. They realized that they would be welcomed by the financial institution's personnel and could express any concern about the Program.

However, with the merger of the Wiese Bank with the Sudameris Bank of Italy in 1999, (the latter now holds over 50 percent of shares and, therefore, controls the Bank), the Program entered a period of uncertainty regarding its future. The restructuring operations launched by the Wiese Bank have caused, on one hand, a sort of paralysis in the decision-making process and, on the other, the resignation of a number of Bank employees, among them, the managers of the Chiclayo branch.<sup>9</sup> Furthermore, the GPM was dismantled. The survival of the Program thereby appeared to largely depend on the policy that the Bank's new Directors would adopt with respect to the agreements made with the NGOs and to agricultural credit. Once the period of uncertainty had passed, the Wiese Bank decided not to pursue the Program.

Already in 1998, the CES Solidaridad had made the decision to create an institution for the development of small and micro business (EDPYME), based on the experience of the Business Development Area (Área de Desarrollo Empresarial), even though the latter continued to operate.<sup>10</sup> The EDPYME Solidaridad was created in February 2000 and NGO employees gradually transferred the best clients of their programs to it. This was also the methodology applied in the Linking Approach Program. The EDPYME moved to replace the Wiese Bank in the financing scheme. The staff of the new EDPYME came from the Área de Desarrollo Empresarial (four employees, including the Loan Manager and from the Wiese Bank another four employees, including the General Manager and former Head of the Chiclayo branch). At the end of 2000, the Solidaridad EDPYME used three "operators" or "agents": the CES Solidaridad, the NGO Instituto de Promoción Regional (IPR) and AGROSER, whose personnel had worked at the Centro de Estudios Sociales y Desarrollo Rural (CESDER), who also took part in the linking approach project with the Wiese Bank.

The success of the EDPYME's Linking Program will depend on the funds available to the new institution. It must be taken into account that such entities generally face limited funding availability, since the public may not deposit savings with them and COFIDE, a state-owned second-tier bank and main supplier of funds, has hardened with regard to these small entities.<sup>11</sup> This will make it difficult for the EDPYME to absorb right away the great majority of clients from the Linking Program, even more so when taking into account that these producers' demand is relatively high.<sup>12</sup>

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9 In March 2000, the investments of the Wiese Bank's Linking Program barely reached US\$ 150, 000 and an evaluation process was launched to decide if the program would be pursued. The Manager of the Chiclayo branch had resigned and was hired as Manager of the EDPYME.

10 The application to organize the EDPYME was presented in May 1998 and the Superintendent of Banks authorized it In January 1999. In October 1999, the application to operate the EDPYME was presented, the corresponding authorization was issued in January 2000 and operations were launched on February 3rd.

11 Up to 1996, COFIDE "leveraged" funds equivalent to three times the institutions' capital. Leverage is currently at only 0.5 to 1.

12 The delinquency rates of the Solidaridad EDPYME were relatively low in its first months in operation: 3.2 percent at the end of 2000 and 5.8 percent in November 2001.

Another aspect that also constitutes a challenge for the Linking Program to grow and reach a large number of farmers is the question of rural producers' land titles. The Program is carried out in an environment where most producers held property titles, which facilitated the constitution of a mortgage as collateral and enabled the Bank to adequately cover its risks. However, other areas of Peru have significantly lower levels of land titling. This situation could hinder the expansion of the Program, since guarantee funds do not adequately cover banks against risks. In that sense, two fronts have opened and must be pursued: continuing the land titling process in order to reach a majority of farmers and developing conditions for moveable guarantees (in particular, pledges) to be used as collateral. Considering the amounts of the loans in the linking scheme, such guarantees could perfectly well replace mortgages as collateral.

An important point in the Program's success has been the type of products financed and the control exercised along the entire production circuit, including marketing. In this respect, commercial banks direct their financing to products with more or less consolidated markets, non perishables (that could be subject to some form of processing and storage) and preferably oriented toward agroindustry, regardless of low added value as in the case of rice mills. Logically, commercial banks are strictly interested in financing agricultural activities with the lowest risks and, therefore, exclude products whose prices fluctuates a great deal or whose demand is very dispersed, which makes it impossible to establish any type of contact or agreement with end-product buyers. Hence, widening the outreach of linking will benefit if market conditions improve, if borrowers' production is set up to be sold as a whole, and if the demand is organized to stabilize the market.

The expansion of a program such as this one also faces the challenge of a limited work area and the institutional and organizational weaknesses of most NGOs. The comparative advantage of the CES Solidaridad is its broad knowledge of the agricultural activities of its clients and the prestige that it enjoys in its work environment, the product of years of experience in the area, which constitutes an element that considerably diminishes information asymmetry problems with the area's farmers. Evidently, in a program such as this one grows, maintaining this level of knowledge becomes increasingly difficult and costly. This is even more obvious if the NGO lacks institutional strength and adequate organizational structure required, which can lead to severe late-payment problems.

## CONCLUSIONS

By creating the GPM and establishing a close relationship between it and its directing bodies, the Wiese Bank implemented a financing scheme for small producers, using the high level of knowledge that NGOs had of their work areas. The successes of this experience launched in urban areas motivated the Bank to implement it in rural areas and expand it to its regional branches. Since 1994, the CES Solidaridad and the Wiese Bank had managed to run a program with enormous potential for financing

work capital for small farmers growing perishable goods, who had access to a relatively structured market and held property titles.

The Wiese Bank underwent difficulties in two geographic areas with other NGOs, due to the organizational deficiencies of these institutions in managing a credit program. The limited lending experience of these NGOs, their limited expertise in financial and credit-related issues, as well as their limited knowledge of their clients' agricultural activities, prevented them from responding to the demands of the Linking Program, which required a maximum delinquency rate of 5 percent for the Bank to keep financing it. Unlike them, CES Solidaridad had more lending experience and more appropriately trained staff, two agronomists and one economist, which enabled it to better administer portfolio allocations.

The success of the Linking Approach Program between the CES Solidaridad and the Wiese Bank demonstrates the importance of an appropriate organizational structure, an efficient technical team and solid information about the market where clients operate. The flexibility with which the Bank and the CES Solidaridad managed the Program also played a very important role in its success, as well as the receptiveness of clients and farmers, and the commitment to the Program displayed by the Bank's staff in Chiclayo.

The Linking Program of the Wiese Bank and the CES Solidaridad has shown that, if the most is made of the competitive advantages on hand, both the Bank's and the NGO's, it is possible to implement a program that enables the commercial banking system to reach small producers. This is why we consider that this linking model is replicable. This statement is corroborated by the fact that the model has been highly profitable for the NGO. Since the Bank increased the amounts lent and its employees expressed satisfaction with the Program, it is logical to suppose that it was also profitable for the financial institution involved.

Nevertheless, to our understanding, the extension of the Program implies that a series of conditions need to be put in place. These conditions cover three aspects: organizational, institutional and market aspects.

- (i) *Organizational aspects:* The fact that banks have offices specialized in loans to small and micro, rural and urban businesses is, without a doubt, an element that helps financial institutions grasp the characteristics of small producers and show flexibility in adopting models and programs, such as linking, that contribute to overcoming information asymmetry problems, which are crucial in financial transactions with small producers, particularly in rural areas. Promoting and motivating banks to create specialized organizational units to attend to the financial needs of small and micro businesses constitutes a first step toward the adoption by formal financial institutions of innovative models such as the one presented above.

Similarly, it is extremely important for NGOs to rely on adequate organizational structures for granting, monitoring and recovering loans, as well as on ongoing work in the area. The promotion and organizational strengthening of NGOs to adequately manage credit programs must therefore be taken into account for programs such as this one to expand.

- (ii) *Institutional aspects:* Collateral is a crucial aspect for commercial banks to work with small farmers. From this perspective, land titling is an element that must be promoted, since a mortgage on land currently constitutes the most sought after collateral for financial institutions, even when it does not ensure access to credit. Similarly, developing new forms of collateral, such as moveable collateral (mainly liens) may, in the medium term, represent an alternative to mortgages as collateral.<sup>13</sup> This will require appropriate legislation and efficient registering systems to ensure that the rights of creditors are protected.
- (iii) *Market aspects:* Commercial banks perceive, and rightly so, that the agricultural sector can be extremely risky. Nonetheless, within the sector, there is a series of products, especially non-perishables, with a much lower associated risk that may even be further reduced through agreements with companies that buy farmers' products. Organizing the supply chain and encouraging the establishment of agreements with companies that set or, at least, ensure a constant market outlet is one way of dissipating the banks' perception of risk and facilitating the replication of programs such as the one described in this Chapter.

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13 The types of liens considered by Peruvian financial legislation may be: industrial (machinery), agricultural (crops), naval (fishing boats), securities (bonds, shares) and even tools and commercial goods.