

Supporting innovation in the field

The role of IFAD's support in the sustainability
and commercial transformation of FINCA's village
banking programmes



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Printed at IFAD, October 2005

Foreword

This monograph was prepared by FINCA International, Inc. with technical and financial support by IFAD. Its purpose is to capture and share the lessons learned from a three-year partnership of the two organizations, particularly from the practitioner's perspective. The opinions and conclusions in the paper are those of the author, who wishes to express particular thanks to Henri Dommel, Raul Hopkins, Rocael Garcia, Soledad Gompf, Peter Knoll, Deb Burand, Mario Guity and Anne Folan for their support and collaboration.

Contents

FOREWORD

SUMMARY	6
Commercialization of village banking programmes	6
Main findings of the TAG review	7
EVOLUTION OF FINCA VILLAGE BANKING PROGRAMMES IN LATIN AMERICA	10
Brief history up to 1999	10
Challenges to and constraints on commercialization	11
GOALS AND ACTIVITIES OF THE IFAD TAG TO FINCA	14
IFAD's goals and the TAG to FINCA	14
Institutional assessment and strategic planning	15
Management information systems	16
Product development	18
IMPACT OF THE TECHNICAL ASSISTANCE GRANT	22
Attribution of results	22
Strengthened market position	23
Improved operating cost ratio and earnings	24
Cost per client and average loan size	26
MIS, internal controls and branching	26
Commercial borrowings	28
CONCLUSION: MAKING COMMERCIALIZATION A SUCCESS	32
The new world of liability management	32
Navigating new regulatory regimes	33
A new challenge: from accounting to client-focused MISs	34
Changing role of technical assistance	35
Conclusion	36



CHARTS

1	Clients per US\$ of donated capital	23
2	Loans outstanding	23
3	Active clients (consolidated)	24
4	Administrative costs as percentage of loans outstanding	24
5	Financial self-sufficiency	25
6	Retained earnings	25
7	Commercial funding and net assets	28
8	Portfolio at risk	28
9	FINCA loan portfolio	39
10	Portfolio at risk	39

ANNEXES

I	A brief synopsis of the FINCA international network	38
II	The village bank model: evolution over time	46
III	FINCA affiliates around the world and key statistics	50

TABLES

1	Cost per Client and Average Loan Size (US\$)	26
2	Financial services beyond village banking	48

Summary

Commercialization of village banking programmes

In September 1998 IFAD awarded a three-year technical assistance grant (TAG) to FINCA International, Inc. (FINCA). The purpose of this paper is to review the activities and results of this TAG. The US\$600,000 programme focused on two areas: capacity-building and institutional strengthening of the village banks set up by FINCA International. This paper examines the role and impact of technical assistance in enabling FINCA's programmes in the field to move towards commercialization.

Activities funded by the TAG took place from April 1999 to March 2002. Although the objective was broadly defined in terms of outreach and sustainability (rather than commercialization per se), it is widely understood that the lack of access to commercial sources of funding inhibits the prospects for growth and the overall performance of microfinance institutions (MFIs). The ability to operate within a commercial environment – and thereby gain the advantages it affords, including access to a much larger and diverse pool of resources – is a key factor in the ability of FINCA's village banking programmes to increase both the quality and volume of their services.

'Commercialization' itself is a term that broadly describes a general movement away from donor-led activities and sources of funding and towards demand-led services and non-donor or commercial financing. In the microfinance context, this includes entry into the sector by private, for-profit financial intermediaries such as banks and credit unions. From the NGO perspective, commercialization involves the use of market-based funding sources, including loans from commercial banks or savings mobilized from the public. This process might culminate in the creation of a for-profit financial institution, which is subject to prudential regulation and can attract private investment, as has been the case with FINCA Ecuador.

The commercialization of village banking programmes is a growing trend, both within FINCA and among the dozens of agencies worldwide that have incorporated village banking into sustainable microfinance institutions. These range from NGOs to commercial banks offering village banking alongside other services. A recent inventory revealed that 47 of the largest and most sustainable MFIs in Latin America currently offer village banking services, and the number of clients served by village banking programmes (410,352) now exceeds the number served through solidarity group lending

(350,607).¹ While village banking grows, however, donor support for the sector overall is waning. In response, village banking programmes are pursuing more commercial funding in order to realize their ambition of reducing poverty on a significant scale.

Main findings of the TAG review

The commercialization of village banking programmes is a logical development in the financial systems approach to microfinance. It also sets a goal for the strategic use of donor resources, namely, to help village banking programmes gain access to the vast pool of non-donor funding. The IFAD TAG to FINCA supported this objective indirectly, with a focus on FINCA's capacity to deliver services on a larger scale. By strengthening the management of their assets, the TAG laid the groundwork for village banking programmes to diversify their funding sources. This success, in turn, has launched affiliates into the new and unfamiliar terrain of managing commercial liabilities, which presents FINCA's owners and managers with a set of issues that are both wide-ranging and complex. Technical assistance continues to play a role in enabling programmes to seize the benefits of commercial funding, while avoiding its pitfalls.

The pursuit of a commercial funding strategy has driven a host of other activities and objectives for FINCA's village banking programmes in Latin America. While donor grants impose their own performance and reporting requirements, these are quite different from the conditions of commercial funding. This difference reflects the fact that donors tend to focus on programmatic aspects, such as impact or outreach to a desired clientele, while investors act out of their perceptions of risk and their expectations of return. FINCA affiliates in Latin America, with technical assistance financed by IFAD, have been successful in dealing with these perceptions and expectations. They have achieved this primarily by improving their performance and their transparency, and through the establishment of ongoing relationships with key individuals in the regional banking sector.

The present brief was prepared on the basis of a review of programme statistics before, during and after the TAG, with particular attention to a set of indicators relevant to its principal objectives. These were to increase the access of low-income people to microfinance services and to improve the financial performance of the targeted affiliates. Programme documentation (proposal, work plans and reports) was reviewed in order to gain insight into the activities financed by the TAG and their purpose. The review was complemented by interviews with FINCA staff involved in the TAG, principally those involved in the provision of technical assistance to the targeted affiliates in Latin America. The objective has not been to provide

1. The Inter-American Development Bank (IDB)/Consultative Group to Assist the Poor (CGAP) inventory of 176 MFIs, as cited by Glenn Westley in *A Tale of Four Village Banking Programs. Best Practices in Latin America* (Washington, DC: IDB, 2004).

a comprehensive discussion of commercial funding for MFIs, but rather to focus on a select subset of issues that were addressed under the TAG to FINCA.

The TAG-targeted affiliates included FINCA affiliates in Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico and Nicaragua. For the purposes of this study, the affiliates in Guatemala and Haiti are treated as outliers and therefore are not included in the analysis. The Guatemala programme was very new during the TAG and it represents a special case in which commercial funding has been invested in the programme from its inception. It would make an interesting case study in its own right, but its trajectory is unique among TAG-supported programmes. FINCA's programme in Haiti, although considerably older than the one in Guatemala, has only recently been able to access sufficient resources to expand its outreach. In addition, this programme has had to contend with a broad range of external challenges, including social and political unrest and flooding. The decision to exclude these two programmes from the analysis allowed a tighter focus on the remaining programmes, which are much more comparable in terms of their trajectory and performance.

The experience of FINCA and IFAD under this TAG may serve as a useful reference point for similar interventions. Overall, the success of the TAG rested on a combination of at least two factors. First, the design of the programme, especially from IFAD's side, allowed an unusual degree of flexibility in the actual programming. This is reflected in the broadly-defined goals and objectives, as described in the chapter on goals and activities of the IFAD TAG to FINCA. By not excessively restricting the scope of the project, IFAD allowed FINCA to address practical needs in a local context. At the same time, however, FINCA brought a clear vision to the project and a specific methodology for the development of its affiliates. The proper balance between donor oversight and a practical approach to local issues by the recipient allowed the TAG implementers to design and execute those interventions that were the highest priorities for the targeted MFIs, ensuring the most significant impact in terms of the TAG's objectives.

Evolution of FINCA village banking programmes in Latin America

Brief history up to 1999

Donor funding enabled FINCA's village banking programmes to work out a successful credit methodology in their early years. With strict adherence to the principles of village banking, FINCA affiliates were able to achieve excellent repayment rates. Anecdotal evidence from clients attested to the programme's strong social impact, especially among the poorest. From the beginning, it was clear that village banking, as a lending methodology, was especially suited to the needs of the poorest entrepreneurs, whose economic activities are too small to be considered microenterprises. Using this approach, which features stepped credit, a link between savings and credit, and a group for mutual support and administration, FINCA distinguished itself as a provider with special emphasis on the poor, especially women. It has subsequently been established that village banking programmes, on average, also achieve higher outreach in rural areas than other lending methodologies.²

As its portfolio of village banking programmes grew, it became evident to FINCA that the group lending methodology, in general, presents certain challenges that need to be addressed for it to have maximum impact on its participants. For example, some group lending methodologies are excessively rigid in their treatment of group members, failing to account for differences in their ability to manage larger loans, or their need to access their savings. Within such constraints, successful clients can sometimes have strong incentives to leave the programme (for example, to make use of their savings). FINCA and other MFIs realized that improving services to clients would improve their financial performance by reducing client drop-out. But sustained efforts to address these challenges were put on hold while village banking programmes focused on securing the funds and building the systems to scale up their operations.

Until the early 1990s, FINCA's Latin American affiliates were severely constrained by a scarcity of grant funding to finance their operations, including the expansion of their loan portfolios. For most of the TAG-supported affiliates, this situation changed when they were able to tap into large government-funded grants, usually from USAID or subsidiary agencies.

2. Op. cit.

These large grants, generally US\$1 million or more, enabled FINCA programmes to build their delivery systems and achieve some measure of scale in their operations. By that time, the principles of sustainable microfinance (as described in the financial systems approach) had been well documented throughout the industry, and FINCA affiliates adopted practices that would enable them to achieve financial sustainability within a reasonable time frame. During this period, most FINCA affiliates were driven by three main imperatives to: (i) establish viable credit delivery systems with high repayment rates; (ii) achieve financial self-sufficiency; and (iii) maintain their focus on reaching the poor.

With a strong network-wide mandate to stay focused on the poorest borrowers, the FINCA programmes perhaps took a longer road to sustainability, though the eventual aim of financial viability was within sight and steady progress was achieved throughout the 1990s. By the start of the TAG in 1999, three of the five TAG affiliates had achieved (or very nearly so) financial self-sufficiency, covering the costs of their activities, including imputed costs, through interest income. As will be discussed later, 1999 in fact marked the first year that financial self-sufficiency was achieved by the five affiliates in the aggregate.³

Success in this drive placed certain Latin American affiliates in a position to consider their future possibilities from a new, broader perspective – in particular, the possibility of integrating themselves more fully into the commercial financial system.⁴ The various forms of commercial funding span a continuum from ‘soft’, unregulated investments (such as guaranteed or concessionary loans) to equity investments and savings mobilized within a regulated MFI. This continuum presents a natural progression for organizations such as the FINCA affiliates in Latin America, which started out as NGOs specialized in credit delivery and gradually matured into financially sustainable MFIs with prospects for delivering a wider range of services to their clientele.

Challenges to and constraints on commercialization

In one of the earliest surveys of the commercialization of microfinance, it was noted that “the institutional infrastructure and markets for microcredit services have remained small, institutionally fragile, and in most cases isolated from the mainstream financial-service industry and payments systems.”⁵ While this situation has certainly changed in the last ten years, vast numbers of potential MFI clients are still beyond the reach of existing service providers. There are approximately 193 million low-income families with no access to microfinance at present, according to the 2003 Microcredit Summit Campaign.⁶ It is widely accepted that commercial funding presents the best

3. See Chart 5 on page 25. This progress was gained despite a major setback in 1993, when it was discovered that a significant portion of the loan portfolio in El Salvador consisted of fictitious loans. The entire staff of one of the programme’s regional offices, in San Miguel, had conspired to defraud the organization through a pyramid loan scheme under which fictitious loans were paid off with the funds from new, larger loans. In response to the fraud, FINCA strengthened internal controls at all levels of the network, while vigorously pursuing legal action against the perpetrators (which was ultimately successful).

4. In this paper, ‘commercial’ and ‘formal’ are both used to describe the private financial sector overall. Commercialization generally refers to the adoption of a market-oriented approach to the supply of services, coupled with efforts to gain access to private sources of non-donor funding.

5. Jeffrey Poyo and Robin Young, *Commercialization of Microfinance: A Framework for Latin America*, USAID Microenterprise Best Practices Project (Bethesda, MD: Development Alternatives, Inc., 1999).

6. Microcredit Summit, *State of the Microcredit Summit Campaign Report 2003*, by Sam Daley-Harris (Bethesda, MD: 2003).

hope for meeting this need on a permanent basis, given the relative scarcity of donor and soft (or quasi-commercial) funding. However, as has been noted, the transition from donor funding to private capital has been “uneven, slower, and more difficult than most imagined.”⁷

There is a host of reasons why MFIs struggle for access to commercial funding. As the authors of the last-cited study point out, the failure to smoothly transition to commercial funding is partially due to characteristics that have been built into the sector over many years of donor funding. In part, donated funds may squeeze out potential commercial funding. At the same time, donor funding has resulted in institutions that are not fully aligned with commercial principles. The challenge for MFIs, including FINCA affiliates, is to address these shortcomings and embrace commercial norms, without abandoning their social purpose.

While much needs to be done to improve the access of MFIs to commercial funding, from both international and domestic sources, the fact remains that the capacity of MFIs to interact meaningfully with commercial lenders remains very limited. Below is a short overview of some of these constraints. The objective in this presentation is not to be comprehensive, but rather to identify some of the main factors that were addressed through IFAD’s assistance to FINCA.

Planning. A sound business plan, with clear strategies and defined outcomes, is the basis of a FINCA affiliate’s approach to potential commercial lenders and investors. To be credible, a business plan must consider the affiliate’s prior performance and embody specific policies (product and pricing, human resources, etc.) that will lead to the desired results. It must include cash-flow projections that, among other things, demonstrate the institution’s ability to repay commercial lenders without undermining its own financial situation. At the time of the TAG, the targeted affiliates lacked the capacity to produce business plans and cash-flow projections. Thus TAG resources were used to overcome this deficiency through the implementation of a specialized evaluation and planning methodology, developed especially for application to FINCA village banking affiliates.

Transparency and controls (MIS). Among FINCA affiliates, management information systems (MIS) are closely examined in the *due diligence* conducted by their potential lenders and investors. In this regard, these potential investors and lenders attempt to evaluate the quality of the information produced, its timeliness and reliability, and its use by management in decision-making. In addition, they examine the control measures that are in place through the MIS to prevent fraud and mismanagement. Some of these are integral to the design of the system itself, such as password controls, automatic reconciliations, and the integration of modules. Another key feature of a sound MIS is the

7. Marc de Sousa-Shields and Cheryl Frankiewicz, *Financing Microfinance Institutions: The Context for Transitions to Private Capital*, with Eileen Miamidian, Jos van der Steeren and Brad King (Washington, DC: USAID Accelerated Microenterprise Advancement Project, 2004).

generation of audit records, which identify the operator, time and date for every transaction and use control accounts for the clearance of special items. Other control features pertain to the way in which the system is administered and the associated controls that protect its integrity. FINCA's affiliates in Latin America were not uniformly prepared to meet such criteria. Hence a significant portion of the TAG activities focused on strengthening the MIS to improve the transparency and decision-making capacity of affiliates.

High operating costs. High operating cost ratios are problematic for FINCA affiliates, as for other MFIs. They diminish the prospects for commercial funding for the simple reason that a high administrative cost burden makes it difficult for an affiliate to cover all its costs from earned income and leaves less of a margin to cover financial expenses. At the same time, high operating cost ratios can result from low productivity of staff or reflect inefficiencies in the administration of the programme. As such, they raise questions about the implementation of the programme's activities and the quality of its management. This is one reason that operating cost ratios feature prominently in most MFI ratings exercises. These industry-wide standards and benchmarks are used by outside investors to assess the performance of MFIs and compare them with their peers.

Lack of familiarity with MFIs. One reason that MFIs are often isolated from the mainstream financial sector is that their assets are not understood or easily assessed by commercial lenders and investors. In this respect, FINCA itself faces some of the same constraints that its clients bear: the inability to post collateral for a loan, lack of a credit history, and high appraisal costs relative to the funding needed. These are significant constraints, especially in the developing world, where credit is in short supply and risk-averse creditors (and regulators) tend to impose high collateral requirements on all borrowers. The solution to this situation, as supported by the IFAD TAG, was for FINCA to establish direct working relationships with key individuals in the regional banking sector to familiarize them with FINCA's operations and increase their comfort level with FINCA affiliates and their commercial prospects.

Ownership and governance. From the perspective of a commercial investor, issues related to ownership and governance typically are particularly problematic with NGOs, which normally have no defined owners or stakeholders. NGO boards expose their trustees to very limited liability. This limited liability is obviously in the interest of trustees, especially since they are often serving on a volunteer basis. But it presents a problem to investors, who are putting their own (or their clients') money at risk and therefore want to know who can be held accountable if the organization fails its obligations.

Goals and activities of the IFAD TAG to FINCA

IFAD's goals and the TAG to FINCA

IFAD's technical assistance grant programme is a funding window that enables IFAD to directly support action research, innovation and information dissemination. These activities are implemented with technical partners across a range of interventions, including rural finance. Activities supported by the TAG are intended to provide technical input to IFAD's lending programme by unveiling successful approaches and providing concrete guidance to enhance IFAD's success in combating rural poverty. The TAG to FINCA was based on IFAD's recognition that the lack of access to financial services imposes severe constraints on the ability of the rural poor to generate income and accumulate wealth. Even as traditional banking institutions are expanding into this market niche (or 'downscaling'), large segments of the rural population remain beyond the reach of formal services. In this gap, NGO-type microfinance programmes – especially village banking programmes – continue to have a role in serving the rural poor. IFAD's strategy under the TAG was to improve the quality and volume of services reaching the poor by strengthening the institutions that serve them.

The stated objective of the TAG to FINCA was broadly defined: "to help strengthen the organizational capacity for delivering financial services to the poorer population of the Latin American region." This objective was to be pursued through the institutional development of FINCA affiliates. A second objective was "to disseminate best practices among practitioners, staff of the Fund and the staff of other donors and government agencies." TAG activities took place from April 1999 to March 2002.

In an effort to increase the outreach and sustainability of FINCA's affiliates in Latin America, a rigorous programme of institutional strengthening was devised, tailored to the particular needs of each affiliate in the region. Technical assistance was rendered through the FINCA Technical Assistance Hub located in Guatemala, with specific interventions carried out by specialists in banking and finance, MIS and internal controls. The desired outcome of these activities was that FINCA's village banking programmes would be able to generate enough operating income to cover all costs, including operating and financial expenses, an imputed cost of debt funding, and an adjustment to compensate for the erosion of the institution's reserves by inflation.

Institutional assessment and strategic planning

Performance assessment is the first step in devising an appropriate intervention strategy for any affiliate. With IFAD's support, FINCA launched the TAG by carrying out a specialized institutional assessment to identify the specific weaknesses that undermined its affiliates' ability to achieve planned levels of outreach and self-sufficiency. The evaluation methodology was developed in-house, taking into account the particular characteristics of FINCA affiliates, and it was linked to a planning tool that set strategic and operational targets. FINCA's approach to assessing the performance of its affiliates was based on analysis of the institution's market penetration, its servicing of clients, credit administration, financial management, human resources, funding and financial position, as well as on key ratios pertaining to financial performance (productivity, return on assets, etc.). Based on these findings, an institutional strengthening programme was devised for each affiliate, responding to those weaknesses that had the greatest impact on its possible expansion and sustainability. The institutional assessments also had a direct bearing on affiliates' access to formal funding in that they were used to assess their eligibility for credit-enhancement facilities (loan guarantees) offered by FINCA's Village Bank Capital Fund.

In one case, this IFAD-supported assessment proved critical in helping FINCA structure the extraordinary assistance that was provided to one of its affiliates which entered into a crisis during the period. The crisis was, in part, due to the after-effects of the devastating Hurricane Mitch, which inflicted serious damage in both El Salvador and Honduras. The storm struck in October 1998 and was the fourth-strongest hurricane ever recorded in the region, causing floods, landslides and 10,000 deaths, in addition to significant damage to homes, cropland, roads, buildings and bridges. The impact on FINCA Honduras was particularly severe, with many clients left without resources to repay their loans. The initial effects of the hurricane-related delinquency were magnified in the following year, as the institution suffered a general deterioration in almost all respects, including its financial performance.

FINCA used the institutional evaluation to identify specific weaknesses in FINCA Honduras. These included human resources (unqualified staff), market dispersal, weak implementation of controls and high cost structure. On the basis of this assessment, FINCA pursued a long-term strategy to rehabilitate the affiliate. The key objectives of this strategy were to restore the quality of the loan portfolio, reverse the erosion of equity, eliminate sources of fraud and reduce expenses. Twenty-one staff positions were eliminated, reducing wage and benefit costs by 25 per cent. These efforts had paid off by the end of IFAD support: the portfolio at risk (PAR), which had been at an all-time high of 12 per cent at the start of the TAG, was reduced to less than 4 per cent by its end.

The institutional assessments also constituted part of the business planning process and were closely related to the preparation and updating of five-year expansion plans and annual operating plans. These plans, in turn, served as the basis for FINCA's approach to commercial lenders.

The strategic planning supported by IFAD was an iterative process in which a set of external conditions was defined and multiple decision chains were established. Under the TAG, FINCA produced business plans based on simulations of differing economic and competitive scenarios for each country, reflecting factors such as changes in interest and exchange rates and inflation. Targets were set for productivity indicators – such as the number of clients or average loan balance per credit officer – and adjusted to achieve a set of desired financial results and thereby map a path to sustainability for each affiliate. A narrative text accompanying the projections described the strategies and policies that would achieve the intended targets. In order to devise a practical guide for the management of the affiliate, each strategic plan was used as the basis for a one-year operating plan. The operating plans set monthly targets and defined a schedule of institutional actions for implementation. These also set the internal benchmarks against which the performance of the affiliate could be judged.

Management information systems

The microfinance industry has seen much progress and a growing consensus concerning performance monitoring of MFIs. Many donors have begun to adopt rigorous, widely accepted standards of transparency and reporting and support various initiatives to improve the quality of data in the sector. For example, industry-wide rating agencies such as the Microfinance Information eXchange (MIX), with its *MicroBanking Bulletin*, promote improvements in the quality of data available on MFI performance while advocating a common set of benchmarks for their comparison. These activities have several objectives, including improving the performance and transparency of MFIs (and hence the comparability of performance data among them) and facilitating the entry of commercial funding into the sector.

MIS plays a key role in an MFI's ability to accurately portray and manage its performance, and it was the subject of rigorous examination by FINCA's potential lenders. Like most MFIs, FINCA initially found itself at a disadvantage when it came to obtaining proper MIS inputs such as software and support for its business. This disadvantage arises from the fact that, as individual consumers, MFIs must choose from among MIS packages that offer only limited prospects for customization according to the unique needs of each MFI. Since MIS has such a profound impact on virtually every

business process, MFIs often find they are working *around* their MIS, cramped by the constraints inherent in any generic system, and struggling against the limited availability of support needed to customize and maintain the underlying software.

To compound the problem, a range of highly specialized issues are at play in the design and configuration of MIS, such as the relative advantages or drawbacks of alternative database systems or the limits of certain programming interfaces. The managers of FINCA's village banking programmes do not normally possess the necessary expertise to engage their software providers on these issues, just as most software providers (even many that supposedly specialize in microfinance) do not possess a comprehensive understanding of the underlying business of microfinance. As a result, opportunities to gain efficiency in business processes are lost, and MFIs easily find themselves struggling against unforeseen limitations – which could be something as basic as the inability to void a loan.

FINCA's solution to this problem was to draw on its collective market power as a network. First, FINCA identified a security information and event management (SIEM) system that met a set of basic criteria for most of its affiliates. These criteria included basic functionality, system design (e.g. the integration of accounting and portfolio modules) and a broad range of user-defined parameters. In the first stage, FINCA contracted the company that owned and serviced the software to install SIEM throughout the network (in Latin America and beyond). By bargaining as a network, FINCA was able to gain leverage in its negotiations with the software provider and secure a high degree of customization and servicing. Once the basic suitability of the system was established, FINCA, once again drawing on its collective power as a network, purchased a controlling interest in the company that had produced the software and has since run it as a subsidiary of the FINCA International network.

In addition to FINCA's collective bargaining, IFAD's intervention enabled FINCA to address the thorny MIS issues by providing the technical support needed to enable its affiliates to communicate their needs effectively to the software provider and to evaluate the various solutions offered. Thus the TAG helped FINCA bridge the technical gap between its affiliates and the software provider through the intervention of staff fully-versed in both MIS and village banking. Hub personnel made repeated visits to the field to support the implementation and customization of MIS. In this way, mistakes made in one installation could be avoided in the next. At the same time, FINCA was able to ensure that all MIS upgrades were accompanied by the controls and procedures necessary to secure the integrity and soundness of the system and that the system's outputs and reports were usable by the management of the institution.

Product development

Impact of competition. As the microfinance sector has matured in Latin America, it increasingly reflects market forces in both the supply and the demand for services. One unmistakable sign of this process has been the emergence of an array of institutions, commercial and non-commercial, that are competing for the same clients. Competing MFIs have targeted clients with lower-priced services, or given them special incentives to switch providers, while also offering inducements such as higher loan amounts, ‘walk-in’ loans, lower interest rates and flexible repayment schedules. In the face of such competition, FINCA affiliates have expanded their product range by introducing more flexibility into existing products and by improving their service delivery and overall client orientation. In this process, the FINCA network has made the strategic decision to keep its focus on the poorest clients, as evidenced by the fact that, despite increasing average loan sizes, FINCA affiliates throughout the world continue to provide some of the smallest loans to the poorest clients, in markets as wide-ranging as Africa, central Asia, Latin America, and Russia and the Caucasus.

Rating clients as individuals and groups. Despite the competitive pressures, FINCA has always viewed product development within the context of its social mission to improve the livelihoods of its clients. FINCA’s original village banking loan product was most suitable to very poor women engaged in some form of income-generating activity, normally petty trade or services. The business activities of clients shared common characteristics, such as similar cash-flow patterns in which small amounts of loan capital could be quickly turned over with high rates of return. Small initial loan sizes, weekly repayment schedules, and the backing of a solidarity guarantee were ideally suited to this clientele. As its programmes matured, however, FINCA realized that its clients’ needs are neither uniform nor static. As some clients advance, the groups’ membership – and the total cohort of groups – becomes more diverse.

An effective methodology for poverty alleviation should take these differences into account so as to better meet the needs of an increasingly diverse clientele and to encourage clients to succeed. IFAD’s support enabled FINCA to undertake improvements in the village banking model in order to reward clients and groups that met higher performance standards. The primary focus of this effort was to create a system that *differentiates* between high- and low-performing groups and offers attractive incentives to those clients and groups with superior repayment histories. Such incentives typically include those items that top the list of client requests: larger loans, flexible repayment

schedules and grace periods. The Village Bank Rating System was pilot tested in Ecuador and El Salvador before being rolled out to the remaining affiliates.

Individual lending. Besides the introduction of these measures, which reward group lending clients based on their performance, FINCA also introduced completely new products, including individual loans. The rationale behind individual loans was that their availability would serve as a further incentive to group lending clients, who could aspire to individual loans if their performance as a group lending client was satisfactory.

Individual lending pilot tests were conducted in El Salvador, with strict measures to ensure that poor results would not ‘contaminate’ the rest of the portfolio. The pilot testing methodology included a schedule of ‘red-flag’ events that would trigger specific corrective action, including a moratorium on lending, in order to prevent the spread of flawed practices. Initial results from the pilot test were encouraging, but the programme required adjustments in order to make it more competitive. By the end of the TAG, the programme had not yet advanced from the pilot-testing phase, however its growth in subsequent years and its later application in Honduras have justified the efforts that were made under the TAG. At present, over 3,600 clients are benefiting from individual loans in these two affiliates.

Other efforts to introduce new products included pilot-testing of a marketplace lending methodology that combined elements of the group lending and individual lending methodologies. Marketplace clients were formed into smaller groups, while their individual businesses were subject to rapid appraisal, including a ‘back-of-the-envelope’ cash-flow projection based on total stock value and turnover. This product was meant to serve clients with higher loan requirements, up to US\$3,500 per client. After an initially successful pilot test, however, the product was shelved due to high delinquency.

Although there was not much progress in product diversification during the period of the TAG, the implementation of a rigorous pilot-testing methodology for new products has itself proved extremely valuable to FINCA in subsequent years. The application of a strict protocol has established means and parameters under which FINCA programmes can pursue innovative ideas without distracting management from its core priorities. Besides stemming the damage from unsuccessful innovations, this methodology has allowed refinement of the individual lending product, which can be confidently rolled out, having passed through a rigorous testing process.

The original justification for these activities under the TAG was to reduce client drop-out in the targeted programmes. It has not been possible, within the scope of this review, to draw any conclusions in this regard, due to

problems of both measurement and attribution. For example, each new cohort of incoming clients typically includes some returning clients who had previously dropped out. These are typically (but not always) classified as new clients, which masks their true status as returning drop-outs. To complicate matters, clients who are no longer borrowers, and therefore treated as drop-outs, often maintain some savings within the village bank with the intention to return as borrowers at a later stage. Besides these measurement problems, the attribution of changes in drop-out, however defined, to the offering of new products is problematic, given the myriad other factors – internal and external – that affect the rotation of clients in and out of the programme.

Impact of the technical assistance grant

Attribution of results

In its design, the TAG proceeded on the basis of certain assumptions that, while not proved, are both logical and widely accepted. One of these is that specific support to FINCA affiliates in the areas described (planning, MIS, etc.) will enhance their capacity to deliver services, and that increased capacity will be reflected in a growing portfolio of high-quality loans. Certainly, FINCA's experience shows that poor performance is often rooted in a MFI's inability to perform these key functions effectively. However, attributing improvements in FINCA's performance to the specific intervention of the TAG is complicated by the fact that there is a wide range of other issues at play, including both internal and external factors, which could explain the outcomes noted. This problem applies not only to the assessment of the TAG, but to all types of technical interventions and indeed to the impact of microfinance itself.

For example, growth in the targeted affiliates could reflect improvements in their capacity, or it could simply reflect that the same group of affiliates had gained access to more subsidies. One way to validate this assumption is to look at the cumulative value of donations to the targeted affiliates and to compare this with the number of clients those affiliates are serving at various points in time. This analysis corrects for the possibility that the growth in clients during the TAG period was simply due to the inflow of new donor money. In essence, this indicator shows the leverage of donor funding in terms of client outreach. Thus it can illustrate whether an increase in clients was due to the supply of additional donor money or to other factors, such as increased capacity or access to non-donor funding.

Chart 1 on page 23 approximates this analysis by presenting the ratio of clients to the cumulative total of capital donations (for equipment and loan capital), drawing on available data. As the chart shows, the leverage of donor funding improved in the first year of the IFAD intervention, from 10.5 in January 1999 to 13.5 in January 2000. Thereafter, this indicator suffered a decline to 12.5 (which was still higher than its pre-TAG level), and since then has improved regularly and dramatically, up to the final period, in which it suffered another drop from 18.0 to 15.0. The two points of decline in this indicator reflect

periods in which donor funding increased at a greater rate than the number of clients (rather than a decline in clients). Overall, however, the trend both during and after the TAG has been towards increasing leverage for donor funds in respect of the number of clients reached. This finding is consistent with improvements in other indicators, presented in the following sections, such as decreased administrative costs, improved financial self-sufficiency, and the general increase in commercial funding for the targeted affiliates.

Given these considerations, it seems both logical and fair to attribute at least some of the improvements in the performance of affiliates to the technical inputs financed by the TAG, especially since these were specifically targeted at those constraints deemed to be most detrimental to affiliates' performance and to their access to commercial funding.

Strengthened market position

The TAG intervention resulted in a significant increase in the value of loans outstanding in the Latin American affiliates, as illustrated in Chart 2 below. Starting at roughly US\$6 million in March 1999, the village banking portfolio of the five FINCA affiliates grew to roughly US\$15 million by March 2002, a 250 per cent increase during the TAG period. More importantly, the growth trend established under the TAG has proved to be sustainable, with total village banking loans currently at approximately US\$24 million two years later.

Similarly, the number of active clients grew from approximately 55,000 to roughly 80,000 during the TAG period (see Chart 3, page 24). As in the case of village bank loans outstanding, this growth has not only been sustainable, but has actually accelerated after the TAG, standing at 116,000 in May 2004. This shows that the measures undertaken during the TAG, particularly those improving FINCA's ability to reach its target market, achieved lasting results, even though some of the biggest gains were achieved afterwards.

Chart 1:
Clients per US\$ of donated capital

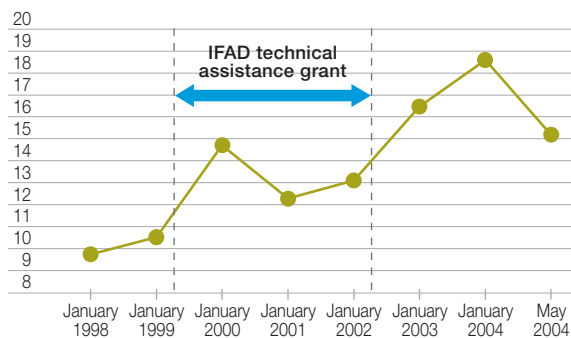
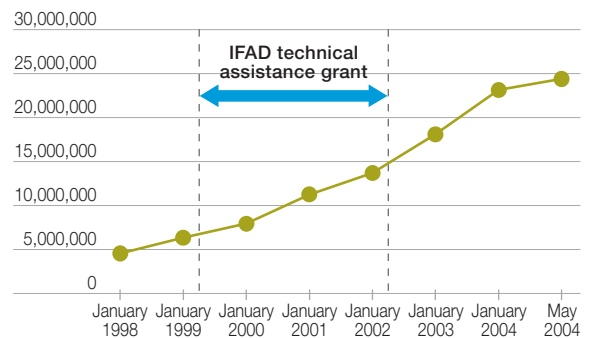


Chart 2:
Loans outstanding



A significant effort was made under the TAG to expand FINCA's product range beyond village banking to include loans to smaller groups and individuals. Because FINCA did not have experience in such forms of lending, the TAG was mainly directed towards the development of new products and their pilot testing. Despite these efforts, significant advances in other forms of lending (for this subgroup of affiliates) were not achieved. Indeed, the share of new products actually decreased during the TAG period relative to the value of village bank loans outstanding.

While this particular group of FINCA affiliates did not achieve significant gains in these new products under the TAG, the pilot testing itself was successful as a means of creating a controlled environment in which new ideas could be tested without hindering the ongoing work of affiliates. In many cases throughout the microfinance industry, organizations have allowed their attention to be diverted by new and ultimately unsuccessful products, to the detriment of their overall performance. Perhaps the best that can be said about the pilot testing done under the TAG is that new products were tested and, failing to meet established standards, were abandoned without causing any disruption to the overall performance of affiliates. In addition, the momentum that was given to this effort under the TAG has been sustained. Although it is still relatively small, the share of new products has increased since December 2002.

Improved operating cost ratio and earnings

Chart 4 below demonstrates a sustained decrease in the administrative cost ratios of the five FINCA affiliates that received the most assistance under the TAG. As a group, the overall administrative cost ratio stood at approximately 65 per cent in March 1999. During the three years of the TAG, this aggregate

Chart 3:
Active clients (consolidated)

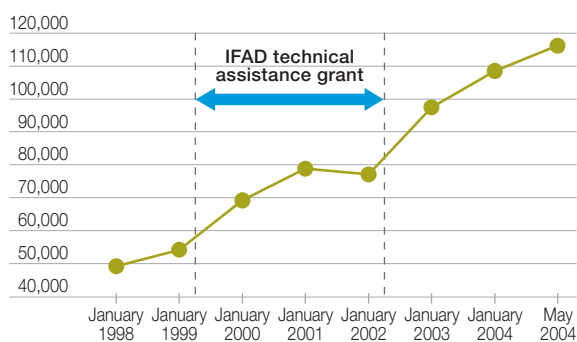


Chart 4:
Administrative costs as percentage of loans outstanding

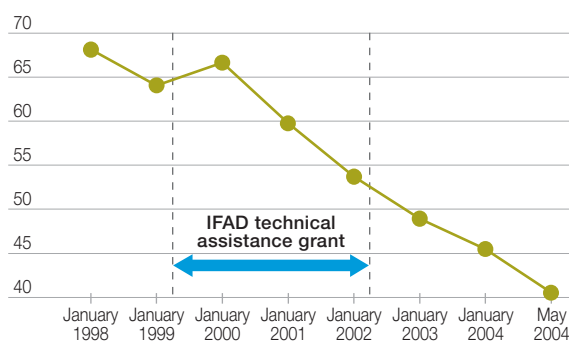


figure had dropped to nearly 50 per cent, and it currently stands at 40 per cent. With some year-to-year swings, the overall cost trend has been down for all affiliates, with notable particularly improvements in Ecuador and Mexico. Without any major adjustments in interest rates (except in Nicaragua, where interest rate caps were applied in 2003), the downward trend in operating costs is mirrored by upward growth in the self-sufficiency of the targeted affiliates and in their retained earnings.⁸

By reducing the administrative cost ratio, FINCA was able to consolidate its financial performance in the IFAD-supported affiliates, as illustrated in Chart 5 below by the upward trend in financial self-sufficiency (FSS). Aggregate FSS, which was approximately 100 per cent at the start of the TAG, had grown to 120 per cent by the TAG's end, and has continued to improve in subsequent years. As a group, the less-than-steady progress in a few affiliates (particularly Honduras, which never fully recovered from Hurricane Mitch, and El Salvador) has been more than offset by the strong financial performance of the affiliates in Ecuador, Mexico and Nicaragua.

The improved financial performance of the FINCA affiliates is reflected in their retained earnings, as shown in Chart 6 below. At the start of the TAG, the affiliates, as a group, were carrying forward net operating losses. By the end of the intervention, all of them had moved into a net positive position, except El Salvador, whose improvements were slower but steady. In particular, Ecuador, Mexico and Nicaragua achieved steady growth, while the position of Honduras was weakened (though it has since recovered somewhat). The improvements in earnings have strengthened affiliates' balance sheets by building their net assets. Institutions with strong balance sheets attract commercial funders, and the strengthened position of the IFAD-supported affiliates has built the base from which they have been able to leverage commercial debt.

8. FINCA Nicaragua experienced a short-term drop in self-sufficiency in 2003 as a result of the application of mandatory interest-rate caps. With other adjustments in its pricing, it was able to recover and make further progress towards self-sufficiency.

Chart 5:
Financial self-sufficiency

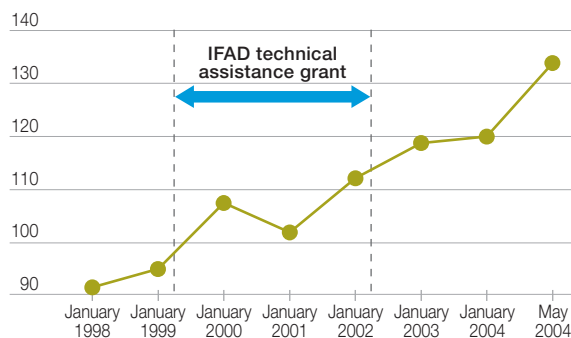
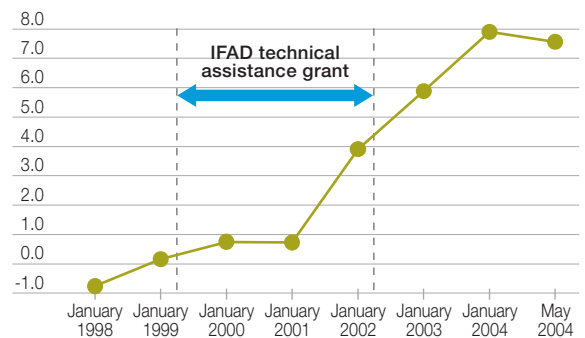


Chart 6:
Retained earnings



Cost per client and average loan size

While improvements in the administrative cost ratio are consistent with improvements in the overall financial performance of the targeted affiliates, they stand in contrast to an observed increase in the cost per client served during this period, as demonstrated in Table 1.

The increases in cost per client may have been caused by a number of factors, including inflation (the impact of which may be distorted by changing the currency into dollars), increases in administrative overhead as a result of growth in non-productive staff, and increases in cost due to improvements in customer service. In the absence of more detailed analysis, it can only be noted that the efficiency of the TAG-supported affiliates shows both negative and positive trends. On the negative side, the increasing cost per client reflects some decline in efficiency in the sheer number of clients being attended. This increase in per-client costs, however, has been outweighed by growth in the loan portfolio on both a total and per-client basis, which has driven improvements in overall financial performance.

Starting from a very low base of less than US\$100, the average loan gradually increased over six years to US\$212 in January 2004.⁹ Whether this represents an example of 'mission drift' is debatable. The targeted affiliates were starting from a low base at the outset and the current average loan size still places them firmly in the lowest niche of clients served by MFIs in their respective countries.

MIS, internal controls and branching

As a result of the IFAD intervention, each targeted village banking programme – including some that had been operating on manual systems – successfully upgraded their portfolio and accounting systems to the Microsoft Windows-based version of SIEM. In addition to hardware and software, policies and procedures were implemented to provide the necessary control environment for guaranteeing the integrity of the system and its outputs. Adherence to established policies and procedures was ensured through an enhanced

Table 1:
Cost per Client and Average Loan Size (US\$)

	Jan 98	Jan 99	Jan 00	Jan 01	Jan 02	Jan 03	Jan 04	May 04
Cost per active client	54.34	61.07	65.56	70.48	83.50	78.67	85.96	81.90
% increase		12%	7%	8%	18%	(6)%	9%	(5)%
Average loan per client	91.32	108.62	111.83	138.00	174.35	185.21	212.58	208.67
% increase		19%	3%	23%	26%	6%	15%	(2)%

9. It is beyond the scope of this paper to analyse the causes of the growth in average loan size, but these almost certainly include growth in the loan sizes for existing clients as well as higher loan values for entering clients.

internal audit function, which was strengthened through regional and international support, with particular attention to those functions related to the receipt and recording of loan transactions. In addition, by the end of the TAG, as mentioned, FINCA had entered into negotiations to acquire a controlling interest in the software company that had developed the system, which would ultimately form the cornerstone of FINCA's MIS strategy in subsequent years.

In FINCA, as in other MFIs, the MIS is typically a *back-office* concern, focused on capturing data related to loans, income, expenses, bank accounts and the production of timely reports. Under the TAG, FINCA pushed its MIS further out into the field, particularly in the case of Nicaragua. In Nicaragua, as in many other affiliates, FINCA had relied on commercial banks to cash of loan disbursement checks and collect payments. This practice resulted in crowded banking halls and the commercial banks in question informed FINCA that these critical services would be suspended. With support from the Central American Bank for Economic Integration (CABEI) and IFAD, FINCA was able to respond by implementing a teller system, which was integrated with its other MIS modules, to serve clients in FINCA's offices rather than through commercial banks.¹⁰ Along with the MIS, this posed new challenges in organizational development, which were met through intensive technical assistance to the programme in the areas of administration, physical infrastructure, human resources and management.

The creation of teller-equipped branches was a critical step in enabling FINCA to extend its services into more rural areas. As long as they are dependent on commercial banks to process loan transactions, the reach of FINCA's programmes is limited to those geographical areas in which the banks have established branches. By breaking this dependency, FINCA has been able to create its own infrastructure in areas that are beyond the reach of commercial banks and thereby broaden its outreach. This process has been accompanied by a significant *decentralization* of FINCA's administration, thereby creating an extended platform for faster growth in rural areas.

By strengthening FINCA's MIS, IFAD also played a crucial role in enabling affiliates to gain access to commercial funding. When they applied for commercial funding from CABEI, all affiliates were subjected to a rigorous examination as part of the bank's due diligence. Financial and portfolio reports were scrutinized to assess their accuracy. Examiners also assessed the degree to which affiliates were adhering to adequate procedures and controls associated with the MIS, and whether the reports were being used by management to take proactive measures to secure the quality of the institution's assets and meet its financial objectives. Failing to meet these stringent conditions would have made it impossible for FINCA's affiliates to gain access to the loan funding that was ultimately made available, and which played a crucial role in supporting their growth in subsequent years.

10. The teller system, itself, was donated by CABEI, while IFAD provided technical support through the FINCA Technical Assistance Hub for implementation of the new system and related areas such as those cited in the text.

Commercial borrowing

Chart 7 below shows the aggregate values of commercial borrowing and the net assets (the equivalent of equity for a non-profit organization) of the TAG-supported affiliates. At the start of the TAG, almost all of FINCA's loan portfolio was financed by the affiliates' net assets. This resulted in affiliates being seriously underleveraged, and it also placed a serious constraint on their prospects for growth, since the loan portfolio could only grow in tandem with growth in net assets. The first step in releasing this constraint was to establish the *preconditions* for commercial borrowing. As described throughout this paper, this effort aimed to improve the performance of FINCA's village banking programmes, particularly in terms of their MIS, market penetration, cost structure and, of course, financial results.

Though meeting the preconditions for commercial funding was necessary, it was not *sufficient* to overcome the factors that limited FINCA's access to commercial funding. Commercial lenders did not just appear on the doorstep looking for new clients. Rather, FINCA itself had to aggressively court commercial lenders, drawing on the professional relationships that existed between FINCA's senior staff and influential individuals in the banking industry. These informal contacts were critical given that FINCA's activities – which consist primarily of unsecured loans to individuals of low income – are perceived as extremely risky according to standard banking practice. FINCA's task was to change the perception of risk associated with microlending, using as primary evidence the superior performance of its loan portfolio. At the same time, FINCA had to demonstrate that its village banking programmes were commercially viable and that they would generate the necessary cash flow to service the payment of commercial loans and interest.

Chart 7:
Commercial funding and net assets

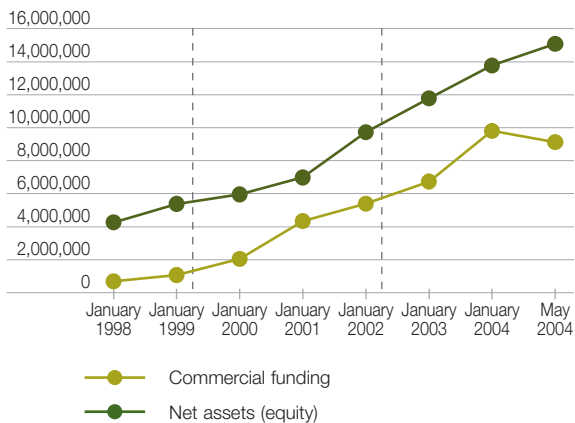
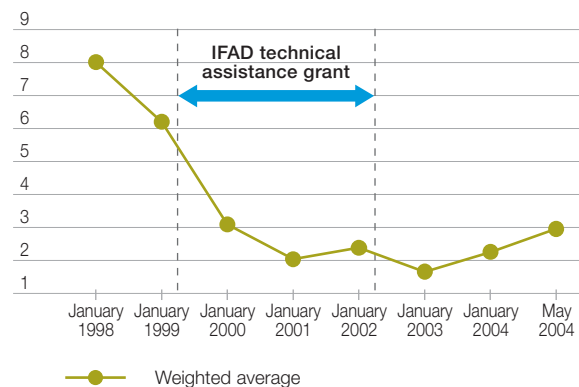


Chart 8:
Portfolio at risk



These informal discussions took place in venues such as regional banking seminars and chambers of commerce, among others. By participating in such discussions, FINCA aimed to raise its profile within this new constituency. Banking, like any industry, has its own language and what can broadly be referred to as an industry culture. The same is true of microfinance organizations such as FINCA. It was not reasonable to expect that commercial bankers would take it upon themselves to master the language of microfinance; thus FINCA drew upon the banking expertise of its senior staff in order to present itself to commercial lenders on *their own terms*.

The issue of loan guarantees is normally a feature of this discussion, and it is sometimes taken for granted that loan guarantees, or other forms of credit enhancement, will themselves bridge the gap between MFIs and commercial lenders. In FINCA's experience, such enhancements can facilitate access to commercial lenders, but they cannot ultimately replace those elements upon which a sound credit decision is based. For example, a loan guarantee might persuade an otherwise reluctant banker to consider making a loan to a FINCA programme, but it will not suffice if, in the course of his or her due diligence, the banker concludes that the FINCA programme is fundamentally unsound due to the inadequacy of its credit administration. Even a 1:1 guarantee will not suffice if a lending institution perceives that there is a high risk that it will have to draw down on the guarantee, given that this will incur costs and may itself be subject to some measure of uncertainty.

Ultimately, a sound commercial relationship between FINCA affiliates and their lenders is based not on credit enhancements or guarantees, but on the strength of FINCA's own financial performance and on the quality of its assets. For village banking programmes, this refers primarily to the quality of their loan portfolios, and it is one measure of the success of the TAG that the affiliates supported by IFAD were able to gain access to commercial credit secured by their own assets. Alternatively, when guarantees are present, these are leveraged so that the volume of credit available to FINCA significantly exceeds the value of the cash guarantee. In the case of Honduras, for example, a letter of credit backed by FINCA's Village Bank Capital Fund is leveraged at a ratio of 3 to 1.

As a result of the efforts supported by IFAD, external borrowing by FINCA affiliates, which was virtually non-existent at the beginning of the programme, had grown to US\$5 million by March 2002. It has since doubled to US\$10 million. At the beginning of the TAG, nearly 100 per cent of FINCA's loan book was financed by FINCA's own net assets (grants and retained earnings). By the end of the TAG, external borrowings were funding approximately 30 per cent of the total loan portfolio of the targeted affiliates. As shown in Chart 7, more than half the growth in loans outstanding during the TAG (roughly US\$7 million) was financed by an increase in borrowing (US\$4 million). This figure is distorted somewhat by the fact that, during this

period, FINCA Ecuador was the recipient of a large grant for its loan portfolio from the United States Department of Agriculture (USDA). If Ecuador is taken out of the analysis, roughly 70 per cent of the growth of TAG affiliates' loan portfolios was financed by growth in external borrowing.

True to expectations, access to commercial funding has been part of a virtuous cycle for FINCA affiliates. By removing one of the main constraints on growth, access to commercial funding has enabled FINCA affiliates to increase the scale of their operations, which, combined with a drop in the operating cost ratio, has resulted in an increase in their earnings and a strengthened financial position. This is seen in the growth in net assets (equity) of those affiliates that benefited from IFAD's intervention. The aggregate value of these assets doubled from US\$5 million to 10 million by the end of the TAG, and they currently stand at US\$15 million.

Of the TAG-supported affiliates, FINCA Ecuador has travelled furthest down the path of commercialization, and it is the first FINCA affiliate to secure a license to operate as a deposit-taking entity. On the way, it passed through two critical junctures. The first was recovery from the crisis of 1999-2000. In this stage, the IFAD intervention was instrumental in supporting a wholesale restructuring of the programme. The recovery programme included changes in the pricing structure made necessary by the imposition of official interest rate controls, as well as significant changes in the management of the programme. The second critical juncture was the infusion of over US\$2 million in loan capital from the USDA, which removed funding constraints. This enabled the programme to pursue an aggressive growth strategy, which saw significant improvements in its scale and its financial performance. With this funding, the management of FINCA Ecuador was able to focus on achieving considerable growth, while building its institutional capital. As a result of the success of these efforts, FINCA was able to purchase an existing, but defunct finance company. The newly reconstituted company has been authorized by CABEI to mobilize deposits from borrowing clients and institutional investors to finance further growth.

Conclusion: making commercialization a success

The new world of liability management

The first stage of commercialization for FINCA has been to strengthen the size and quality of its portfolio of village banking loans and to improve the financial performance of its affiliates. Not surprisingly, a village banking programme that has a low portfolio at risk and generates substantial returns is more attractive to commercial lenders. Thus the commercial strength of the programme's *assets* has made it possible for FINCA to commercialize and diversify its *funding sources*. But *access* to commercial funding represents only a first step, placing FINCA on the threshold of the financial sector, from which a whole range of new challenges can be discerned. While donor funding enabled FINCA, in its early years, to focus on the proper management of village banking assets, the recent shift to commercial funding has required that FINCA programmes pay closer attention to the management of their *liabilities*. Integration into the formal financial sector requires village banking programmes to navigate a new landscape – one that opens up new opportunities for growth while exposing them to new hazards.

Liquidity risk is a straightforward example of this issue. Unlike donors, commercial lenders expect their loans to be repaid on prenegotiated terms. If it fails to manage its liquidity properly, an MFI may find itself lacking sufficient cash to make the required payments, even though it is a solvent institution. As a result, the MFI may suffer penalty interest charges, damage to its reputation, and the threat of more aggressive collection measures by the lender. In order to avoid this situation, FINCA programmes have devised specific liquidity guidelines, including the use of specialized liquidity management tools, to ensure that MFIs are able to meet their obligations on time and at reasonable cost.

The risks associated with commercial funding arise from a wide range of sources. In addition, the impact of risk is determined by the nature and volume of commercial borrowing, which is different in each case. Each commercial loan carries its own conditions which affect the severity of risk. And the potential hazards multiply for those programmes that venture into savings intermediation.

Some of the more common risks associated with commercial funding include:

- *interest rate risk* – potential losses arising from mismatches in the pricing characteristics of interest-sensitive assets and liabilities;
- *exchange risk* – losses due to unfavourable movements in the rate of exchange between local and foreign currencies;
- *regulatory risk* – arising from adverse changes in the regulatory regime (such as unexpected increases in prudential liquidity requirements or in tax rates); and,
- *refinancing risk* – when a borrower is unable to find repayment sources for the principal amount of its outstanding loans.

The intent here is not to provide a complete inventory of risks, but rather to show the *range* of issues that apply when FINCA's programmes gain access to commercial funding. The severity and potential impact of each type of risk varies in each case and it is determined, in part, by local circumstances. For example, exchange risk does not apply in cases where commercial funding is denominated in local currency, but it does become an issue when there is a mismatch between the currency of the MFI's assets and its liabilities. Regulatory risk, in particular, varies significantly across programmes, in part reflecting the unique political climate of each country and the types of business engaged in by the MFI. Each village banking programme, therefore, has had to devise its own risk management strategy, responding to the type and severity of risks to which it is exposed.

Navigating new regulatory regimes

One basic regulatory issue that affects FINCA's prospects for commercial funding concerns its *legal constitution* either as an NGO or as a for-profit entity. As a matter of credit policy, some lenders will not finance the operations of non-profit organizations, which are deemed to be unsuitable as commercial borrowers.¹¹ In FINCA's case, registration as non-profit entities has not prevented the programmes from gaining access to commercial loans, though it has narrowed the field of potential investors. Certainly, the transformation from NGO to some form of for-profit entity will be imminent as affiliates strive to *diversify* their funding sources beyond short-term debt to include long-term investments and equity. This effort will require some FINCA programmes to abandon their status as NGOs in favour of for-profit companies that are able to accommodate the participation of new owners and to define their stake in the organizations. As a consequence of this change, some village banking programmes will forfeit their tax-exempt status. These programmes will need to devise a strategy to minimize their tax liability and ensure that they comply with tax and corporate codes.¹²

11. In addition, legal status is normally a factor in MFI ratings that are used throughout the industry.

12. For example, constitutional and audit requirements and reporting obligations to the registration authorities.

With reference to other laws that affect microfinance *specifically*, there is no standard approach to financial regulation in the countries in which FINCA works. In some cases, microfinance organizations are simply subject to the regulations that apply generally to financial institutions. In others, they constitute a special category of activity and specific regulations have been enacted to authorize and supervise their operations. While some of these regulations affect the prospects for commercialization – particularly the transformation into deposit-taking entities – others apply to all MFIs regardless of the source of funding. In Nicaragua, for example, an interest rate ceiling was applied in 1991 that affected all microfinance institutions. Each country is at a different stage in the evolution of MFI regulation and supervision, thus the regulatory environment facing village banking programmes is, in most cases, still uncertain.

Evolving MFI regulatory regimes present both risks and opportunities for village banking programmes. On the opportunity side, special MFI laws have been enacted in some countries that have made it possible for FINCA affiliates to intermediate client deposits in a way that is consistent with village banking methodology. On the risk side, regulatory agencies may have wide power to withdraw the rights of an MFI to undertake its business. Should an affiliate run afoul of local regulatory authorities, then the potential for damage is acute.

Regulatory risks, however, are both potent and wide-ranging. Even a partial list of regulatory issues would span the entire structure of the MFI and include its legal constitution, interactions with clients (e.g. interest rate caps, disclosure rules, collateral requirements), financial management strategies (e.g. liquidity, provisioning), taxation, registration requirements, reporting obligations, governance and ownership structure. The potential pitfalls are many and most of them are new to FINCA. To mitigate these risks, the next generation of FINCA's technical assistance to affiliates is emphasizing specialized legal expertise, including finance, banking, tax and commercial law.

A new challenge: from accounting to client-focused MISs

Lending, whether to the poor or non-poor, is an information-based activity. Good credit decisions are based on the sound assessment of a range of objective characteristics, such as the borrower's economic situation, the source of the repayment, and the borrower's propensity to default. The quality of a lender's portfolio reflects the amount and quality of the information used in its construction, along with the quality of the assessment and credit policies applied in loan decisions. However, information is a costly commodity – one of the fundamental reasons that credit is denied to poor entrepreneurs is that

formal lenders lack useful data on their prospective clients. Village banking itself is an innovative response to this information constraint, in that it draws on shared information among peers, who choose their own group and approve credit to its members, thereby relieving the MFI of the costly burden of collecting and analysing individual data.

As has been noted elsewhere in this paper, however, the commercialization of FINCA programmes, and of the sector at large, has resulted in increased competition among providers. This competition strengthens the imperative to improve the quality of services to clients – an imperative that is also fuelled by mission-driven efforts to improve not only the *quality* of services, but also to enhance their *impact* on clients. The success of these efforts will rely on the ability of FINCA programmes to collect and analyse client data and to tailor its programmes in light of the information that such data can provide.

This points to a new arena for research and development in village banking programmes, namely, the development of MIS that are not only effective in processing loan transactions, but can be used to collect and warehouse data to tailor FINCA's services to the unique characteristics of each individual client. Such data could be used not only for the design of individual lending products, but even to strengthen the village bank's ability to deliver customized services to its members. Relevant data might include, for example, the size and sector of the client's business, the number of family members, location and, of course, loan performance. Properly warehoused and analysed, a database of such client statistics would provide village banking programmes with a powerful tool to reduce credit risk, even while strengthening the quality and impact of their services to clients, as they strive to achieve commercial scale in an increasingly crowded market.

Changing role of technical assistance

As affiliates have diversified their funding sources, technical assistance continues to play a role in their success. Specialized technical assistance is, if anything, increasingly important, precisely because the stakes are higher for commercially funded MFIs. It is reasonable to assume that commercial investors will be less tolerant of non-performance than donors. If things go wrong, funding may be withheld or withdrawn, or the programme may find itself faced with escalating demands from a dissatisfied investor. The reputation of the programme can be at stake – if not its very survival. It is not enough that a village banking programme set its sights on the pursuit of commercial funding. That funding must be on favourable terms, and it must be structured so as to minimize risks to the institution.

Integration with formal financial markets requires village banking programmes to become integrated into a business culture in which the logic and priorities are different from those that prevail in the non-profit sector. FINCA programmes, which generally have more experience negotiating with donors than with private investors, may not fully anticipate the full range of issues that might impact them in a commercial deal and they may inadvertently agree to onerous terms that are not supported by their business plans. Unfavourable terms may involve issues such as prepayment provisions (or their lack thereof), reporting obligations, excessive collateral requirements, hair-trigger events of default, and a very wide set of conditions (such as *material adverse change* clauses) that may give investors excessive discretion on their end of the bargain. Any one of these conditions, if improperly structured, can ruin the whole deal, with potentially devastating consequences. Technical support by professionals from banking and related fields can be very effective in helping programmes avoid such circumstances from the earliest stages of identifying and negotiating with potential lenders.

The structure of a commercial deal, however, is really only a starting point. The ongoing management of liabilities presents a challenge to those managers that are more accustomed to worrying about the quality of their assets. Liquidity management, for example, means much more than having the money to pay for operating expenses, and holding cash in bank accounts can prove to be expensive when it is being funded by risk capital. Keeping the optimum level of liquidity can thus become a matter of survival, and specialized assistance to MFI managers can provide them with the tools and expertise necessary to manage this vital function. At the same time, the proper administration of the organization's liabilities, and the fulfilment of its legal and regulatory obligations, will prove to be key factors in the success of a commercialized village banking programme (which at this stage may more appropriately be referred to as a village banking *company*). Here, too, specialized technical assistance can help managers anticipate the full range of requirements – and implement the necessary policies and procedures to ensure that they are met – so as to avoid any disruption of their activities.

Conclusion

IFAD's support to FINCA through the TAG programme provided critical leverage that enabled FINCA programmes to improve their performance and diversify their funding sources. The link to non-donor sources was strengthened in two main ways. First, improvements in financial performance made FINCA affiliates viable clients of non-donor lenders. TAG-supported affiliates were able to expand their operations, lower their administrative cost ratios and generate net earnings. Technical assistance at this stage rightly

aimed to improve the capacity of village banking programmes to deliver services because a strong asset base and financial performance are preconditions for gaining access to commercial funding. At the heart of this effort, FINCA's MIS was upgraded, strengthening their ability to manage a growing number of transactions while improving transparency and internal controls.

Second, the TAG supported the managerial improvements needed to apply for non-donor funding in areas such as planning and reporting. During this period, FINCA successfully courted potential lenders, prepared and submitted business plans, and underwent the due diligence upon which commercial loans were conditioned. Finally, TAG support enabled FINCA affiliates to establish contacts through representation in the banking industry, laying the groundwork for the business relationships that followed. The success of the IFAD intervention is ultimately demonstrated by the progress affiliates have made in diversifying their funding sources. One affiliate, FINCA Ecuador, was so successful under the TAG that it has since transformed into a regulated, deposit-taking entity.

For all the potential pitfalls, the trend towards commercialization of village banking programmes is sure to grow, driven by a growing need for loan capital and diminishing donor support. IFAD's TAG to FINCA demonstrates one way in which donors can prepare MFIs to succeed in this process, first by strengthening their capacity to deliver services on a larger scale. Success in this endeavour then affords FINCA and its supporters a vantage point from which they can discern the range of issues that will determine the successful integration of village banking with the formal financial sector. Technical assistance continues to have a role in helping FINCA programmes thrive in a commercial environment and deal with its diverse challenges and opportunities so that village banking can realize its ambition of reducing poverty on a significant scale.

ANNEX I

Evolution of the FINCA international network**Mission**

FINCA International, Inc. (FINCA) provides financial services to the world's poorest families so they can create their own jobs, raise household incomes and improve their standard of living. FINCA delivers these services through a global network of locally managed, self-supporting institutions.

Legal personality and governance

FINCA International is a charitable institution, incorporated in the State of New York in September 1984, with nonprofit status as defined under Section 501(c)(3) of the Internal Revenue Service code of the United States. FINCA delivers microfinance services through a network of programmes throughout Africa, Latin America and the Newly Independent States and that are constituted as either *branches* or *subsidiaries*. Branches of FINCA operate under FINCA's incorporation in the United States as a nonprofit, while the subsidiaries are separate legal entities created under the law of the country in which each operates. Board members are appointed by FINCA International.

In addition to its network of microfinance programmes, FINCA International has partial ownership of two companies, Microfinance Solutions, Inc. (MFSI) and FINCA Microfinance Resource (FMR), which are limited liability companies. MFSI's purpose is to develop and implement management information systems (MISs) for microfinance institutions; it is 51 per cent owned by FINCA International. FMR's purpose is to expand the microfinance operations of FINCA Kyrgyzstan; it is 60 per cent owned by FINCA International.

FINCA International's board of directors approves the annual budgets, workplans and five-year strategic plans. The board includes grass-roots community activists, corporate executives, attorneys and leading global microfinance advocates such as Jordan's Queen Rania. In addition, any FINCA country programme with an active client base of 7,000 or more is eligible to have one of its board members sit on the FINCA International board.

Global loan portfolio

As of 31 July 2004, FINCA was providing microloans and other financial services to 316,030 active clients in 22 developing countries. Current statistics for the network and for each affiliate are attached as Annex III. Chart 9 portrays FINCA's trajectory in terms of the size of FINCA's loan portfolio relative to both loans outstanding and loans disbursed.

Since its founding, FINCA has grown at an average annual rate of 40 per cent, maintaining steady growth despite the shifting economic conditions of the countries in which it works. Equally important, FINCA has been able to achieve this growth while maintaining a portfolio at risk (PAR)

below 3.5 per cent, dropping to just over 2 per cent for 2004 year to date (YTD), as shown in Chart 10.

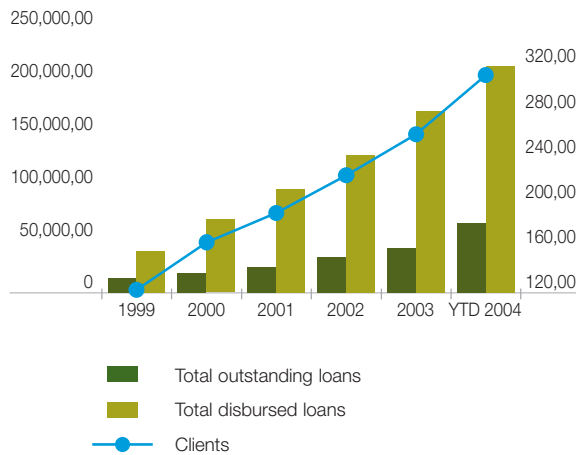
Market position in the microfinance industry

FINCA is one of the largest and most geographically diversified networks in the industry. Its methodology has proved transferable to different continents and many cultures. Its average loan size (\$289 as of 31 July 2004) is among the lowest among sustainable microfinance networks, demonstrating that FINCA is adhering to its mission to serve the severely poor while achieving sustainability and profitability. FINCA also targets more remote rural populations, which, while more difficult and costly to reach, might otherwise not receive services.

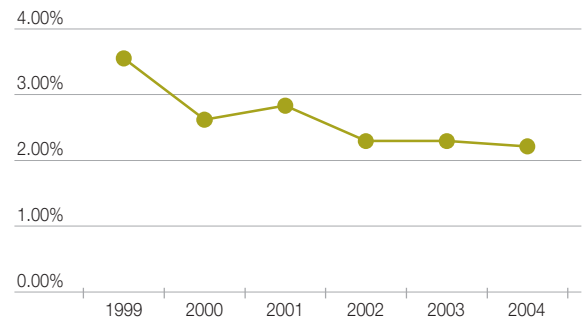
FINCA's beginnings

FINCA was founded in Bolivia in 1984 by John Hatch and Rupert Scofield. Hatch, who has taken a leading role in the microfinance industry, is a Fulbright scholar with a doctorate in economics who served in the Peace Corps and then a series of rural agricultural consulting projects in Latin America. Based on these experiences, he developed the village banking methodology (discussed in detail in Annex II) to promote participatory economic development at the individual, family and community levels. This original village bank model, which has been refined and modified over 20 years of practice, is still the flagship product in most of FINCA's programmes. Increasingly, however, these programmes are also offering new products, as discussed in Annex II.

**Chart 9:
FINCA loan portfolio**



**Chart 10:
FINCA International portfolio at risk**



With an initial grant of US\$1 million from the United States Agency for International Development (USAID), Hatch and Aquiles Lanao launched the first village banks in five separate geographical areas of Bolivia. Within four weeks, they had created funds in 280 villages serving 14,000 Bolivian families. Hatch taught the village banking methodology to more than 80 other organizations and FINCA's own village banks continued to expand throughout Latin America.

From early in its history, village banking proved to be both replicable and sustainable. Later, as FINCA continued to expand not only within Latin America but also to other regions, village banking has proved effective and sustainable across significantly diverse regions and cultures.¹³

By the early 1990s, FINCA had built a small network of affiliates, all in Latin America. Some of them, particularly the more mature programmes, had achieved sustainability; others remained donor-dependent. The year 1992 marked the beginning of FINCA's second stage, which was characterized by two major shifts: geographic expansion and increased focus on sustainability.

The drive towards diversification and sustainability

FINCA opened its first Africa programme in Uganda in 1992. At the time, Latin America was becoming a microfinance epicenter and Africa was an unknown territory. FINCA's management and board had to weigh the challenges of a less-familiar market and the logistical implications of having one new programme an ocean away from the rest of the operation. In the end, the decision to expand to Africa proved sound: FINCA now has six programmes there and they are among the fastest growing and have some of the deepest poverty outreach in the network.

The Newly Independent States (NIS) provided the next theatre for expansion. FINCA opened a programme in Kyrgyzstan in 1995; it quickly proved successful despite an operating environment very different from those in Latin America or Africa. In its NIS programmes, FINCA adapted its standard village banking methodology to local conditions. Unlike other regions, which have struggled against entrenched poverty since colonization, the NIS enjoyed reasonable standards of living until the abrupt collapse of communism. In this more industrialized and educated society, NIS borrowers need to operate businesses on a larger scale than those typically financed by traditional village banking loan products. Communism also took a toll on social cohesiveness and the tradition of mutual cooperation necessary to make village banking succeed. To respond to these market conditions, FINCA developed individualized loan products, including larger loans, although village banking remains the most widely used product in most of the NIS country programmes.

Expansion made it clear that FINCA needed to diversify its management structure as well as its product line. During its first phase, all technical

13. A complete listing of FINCA affiliates is located in Annex III.

assistance to programmes was delivered by staff from Washington, DC. As the network expanded, the limits of this structure became apparent. In order to ensure programme quality and reduce travel demands on Washington staff, FINCA developed a strategy that was unique in the microfinance industry at that time: the creation of decentralized technical assistance and management supervision offices, which came to be known as the regional hubs. The first hub, for the Latin American region, was established in Guatemala City in 1995. Hubs were added later in Kampala for the African programmes and in Moscow for the NIS. (See also the description of hub operations under “Management structure” in this annex.)

The rapid expansion of the FINCA network coincided with expansion and professionalization of the microfinance industry as a whole. There was a growing body of best practices and industry standards that provided clear benchmarks and strategies for growth. During its second phase, FINCA embraced the “financial systems” approach to microfinance, developing business and operating plans that would enable its affiliates to achieve the sustainability and profitability that would in turn ensure that they became permanent resources for their rural poor customers. All FINCA affiliates are expected to reach operational and financial self-sufficiency within three years, and sustained profitability within five. To the extent that donor funds are sought for a given affiliate after that time frame, the funds are used to expand geographically within the country, pilot new products or services or respond to unforeseen operational challenges or other emergencies.

Along with other early proponents of sustainability, FINCA was involved in the establishment of the Consultative Group to Assist the Poor (CGAP). It served for several years in CGAP’s Policy Advisory Group, helping articulate the following basic principles upon which the modern industry has been built.

- Poor people can pay back loans.
- They value access more than price, and can pay interest rates that fully cover costs.
- Microfinance institutions that do not charge sufficient interest to achieve sustainability and profitability will remain donor-dependent, if they remain in business at all, and cannot become permanent, reliable resources for their poor customers.

FINCA as a whole has reached more than 100 percent operational and financial self-sufficiency, while remaining a network almost entirely of NGOs. The major recent trend in FINCA’s institutional evolution, however, is a move away from the purely NGO model and towards commercialization and transformation.

Scaling up: commercialization and transformation

In addition to being one of the earliest advocates of sustainability among the major MFI networks, FINCA also helped develop and advocate the adoption of standardized terms, definitions and ratios. As these were implemented across the industry, and as FINCA made the necessary investments in management information systems in its own network, the resulting consolidated balance sheets revealed a global financial institution with the potential to leverage vast financial resources. The network can obviously scale up far more rapidly by attracting commercial investment than by continued exclusive reliance on donations and retained earnings. The more mature affiliates, at least those in countries with enabling legal and regulatory environments, can also achieve much greater scale if they can transform from NGOs into licensed, regulated institutions able to intermediate client savings.

In the last three years, FINCA has mobilized a growing pool of talent from international financial and legal circles to support the network's transition from donor funding to commercial sources of financing. Much of this talent has been contributed by volunteers on a pro bono basis. One leading New York law firm alone has contributed more than US\$840,000 worth of billable hours towards FINCA's commercialization and transformation efforts. In-house volunteers, ranging from graduate students to professionals on secondment from the banking and legal professions, have contributed 2,558 hours (worth approximately US\$ 103,000) during fiscal year 2004 alone.

Among the range of commercial sources of financing, local deposit-taking holds the most promise for fuelling growth and outreach and meeting FINCA customers' needs for a secure place for their savings. Accordingly, FINCA has dedicated significant resources to the launching of its first three transformations: Ecuador (which became a licensed, deposit-taking institution in the summer of 2004); Uganda (whose application to transform was submitted in early August 2004); and Kyrgyzstan (whose application to transform is expected to be submitted in the summer of 2005). FINCA provided support to the National Association of Microfinance Institutions in Uganda (AMFIU) for the drafting of a specialized law aimed at deposit-taking MFIs, and also assisted in drafting a similar specialized law in Kyrgyzstan.

FINCA recently consolidated its commercialization, transformation, and regulatory monitoring and advocacy activities under one umbrella department, the Capital Markets Group, that:

- Supports the increased commercialization of FINCA's funding base to include significant debt, equity and – in countries where enabling environments exist – deposit mobilization;
- Monitors global financial regulatory environments as they affect microfinance;

- Advocates for enabling legal and regulatory environments and, where possible, provides technical assistance to developing-country governments seeking to create such environments;
- Supports FINCA affiliates' investment readiness; and,
- Support the transformation process with affiliates for which transformation is advisable.

Management structure

FINCA programmes are managed by local and international staff. At the most basic level, FINCA village banking groups are self-governed by the borrowers. Members decide who is eligible to join their groups, elect their own officers, develop and enforce their own by-laws and policies – within standard frameworks – and keep their own books. However, each group is served by a FINCA credit officer, a staff member responsible for helping to form the group, teaching members how to operate it, visiting group meetings to collect repayment and general troubleshooting. The credit officers are themselves members of the communities they serve. Credit officers are supervised by a country director, who also oversees the accounting, operational, and administrative staff. In FINCA's more mature programmes, country directors tend to be natives of the country in which they serve. Start-ups are often headed by external staff until local talent can be identified and developed.

Until 1995, as mentioned, all technical assistance to FINCA programmes was delivered by staff based in Washington. Funding from CGAP, IFAD, IDB and USAID permitted FINCA to open three regional offices, or hubs, in order to deliver training and technical assistance more effectively. The Latin American hub is located in Guatemala City, the African hub in Kampala and the NIS hub in Moscow. Hub staff consist of a small technical team with expertise in planning, budgeting, auditing, financial services, staff training and MIS. Following an annual technical evaluation of each country programme's strengths and weaknesses, the hub develops a technical assistance work plan with each affiliate, with a specific focus on overcoming identified obstacles to achieving operating plan goals and reaching (or improving) profitability. Hub staff then make periodic visits (usually monthly or bimonthly) to each affiliate to monitor progress. Regional hub directors also serve on the senior management team of FINCA International, reporting directly to the executive director.

As the regional hubs have matured, they have grown beyond their initial mandate of technical assistance and oversight. The hubs are also becoming important central clearinghouses for recruitment and cross-programme technical exchanges. FINCA affiliates increasingly 'borrow' staff members from other programmes that have the needed expertise in given areas such as product development, MISs, staff development and customer service. Such

information-sharing – one obvious advantage of operating as a network – has become much more practical with the significantly increased on-the-ground presence provided by the hubs. In addition, FINCA staffers are increasingly able to transfer from one affiliate to another to further their career goals. Because the regional directors travel so extensively, they develop strong networks of local contacts and can also help recruit external staff, for both full-time positions and short-term consultancies, easing a significant burden of the country directors.

Standardized planning, financial management and MIS: FINCA's network model

The term 'network' is widely used in the microfinance industry to describe arrangements that have as many differences as similarities. Some networks are informal groupings of independent institutions that share common goals; others may focus on policy agendas; still others may be practitioner organizations that all receive funding or technical assistance from the same source. FINCA is a global network of institutions that are locally governed but that follow the same planning and management protocols, and which all report to FINCA International in Washington.

FINCA made this decision for two reasons. As a practical matter, the risk of fraud or other financial irregularities exists in any financial institution. To protect investor and donor money, and to ensure permanent access to financial services for its poor customers, any programme operating under the FINCA brand is held to the highest operational and financial reporting standards. The standardization and consolidation of financial statements also enable FINCA to attract major grants and investments for the network as a whole.

A key strategy in achieving this standardization was the development of a network-wide MIS known by its Spanish acronym, SIEM. In 1998, again with guidance from the hubs, SIEM was piloted in its Latin American affiliates. FINCA anticipates having it in place in every affiliate by August 2005. SIEM has received positive independent evaluations as "a reliable application for village banking ... even in areas with poor telecommunications infrastructure. SIEM has integrated loan portfolio management with comprehensive group tracking features, a good accounting module, and basic savings/deposit functionality."¹⁴

In addition to the practical considerations, FINCA's centralized approach ensures that its core values are upheld. As more of the microfinance industry shifts to small and medium enterprise development, FINCA has intensified its commitment to serving a severely poor clientele. Hands-on leadership from FINCA's top management – including its founder, who is still actively engaged – plays a key role in resisting the tendency to drift 'up market'. FINCA remains committed to the "double bottom line", and its own experience demonstrates that it is possible to serve the very poor while still achieving sustainability.

14. Information technology section, in the CGAP Technology Resource Center of the Microfinance Gateway (www.microfinancegateway.org).

Twenty years after its founding, FINCA has evolved into a global financial institution with operations in 23 countries, a diverse range of products and, now, a variety of institutional models that form part of a cohesive network. This evolution has brought FINCA the same challenges of change management that the industry as a whole has been experiencing as it moves beyond its development origins into the financial mainstream. FINCA embraces this trend as a means to serve substantially more of the millions of families still waiting for the financial services they need to work their way out of poverty.

ANNEX II

Evolution of FINCA's financial and non-financial service model

FINCA was founded on the village banking microcredit methodology. Under the original village banking model, neighbors in a poor community form a borrowing group. Each member of the group is required to save 20 per cent of all money borrowed. All members agree to repay any other member's default out of these savings, since the loans are otherwise uncollateralized. As a practical matter, however, since the groups are self-selecting (and often include family members as well as neighbors), default is rare, and the savings can thus form the beginnings of an asset base for the borrowers. Once the group has formed and been trained, FINCA staff will capitalize it and visit weekly group meetings to supervise repayment. Otherwise, the groups are self-governing; they elect their own officers, devise and enforce their own policies, and keep their own books.

FINCA has made various methodological refinements to the original village banking model, while retaining its emphasis on the group guarantee, self-governance and other essential features. For example, in several of the Latin American country programmes, village banking clients that have been in the system for several cycles and have a high credit rating can become members of a solidarity group. Solidarity groups consist of fewer members (five to seven) and are eligible for larger loans.

Speed groups are subgroups of five to seven members within a larger village bank. Speed groups meet 15 minutes before the village bank meeting and their own treasurer collects loan payments and savings. Once the speed group has collected its money and its treasurer has recorded the transactions, the speed group treasurer delivers the group's payment to the treasurer of the village bank. Both the clients and the credit officers benefit from the shorter, more efficient village bank meetings that the speed groups make possible. In addition, each speed group is guaranteed by another speed group, but two speed groups cannot guarantee each other. Only in the rare event that neither the first nor the second group can cover a delinquency does the whole village bank have to do so.

The reasons FINCA initially adopted the village banking model are readily understood. Uncollateralized lending to severely poor people is a risky business. Without at least the 'moral collateral' provided by the group guarantee system, FINCA would have had a far more difficult time containing defaults and building sustainable programmes. The self-governing nature of village banking groups also enabled FINCA to operate more efficiently and therefore to achieve rapid expansion. The social component of the group system remains a key value. Village banking group members provide one another with moral and practical support, building stronger communities as well as empowered individuals.

The village banking model, in its original form and with various refinements, remains a core FINCA product. But village bank loans are no longer FINCA's only product. Individual loans, for example, had increased to US\$38.3 million by the end of fiscal year 2004 (31 August 2004), a 92 per cent increase from the previous year.

FINCA's product diversifications have at times been driven by necessity. The insurance products in Africa were developed because the AIDS crisis and the threat to our African borrowers were simply too severe for FINCA not to design the programmes, and form the necessary partnerships, to respond. At other times, diversification was driven by competition or was simply smart business practice. Individual loans are popular in many circumstances and, at times, especially in the Newly Independent States, cultural conditions demand them. The compulsory savings feature has, in some cases, been waived.

Table 2 summarizes FINCA's product diversification and the countries in which these products are currently implemented.

Non-financial services

Health care. FINCA Uganda is also testing health care programmes with two separate providers, MicroCare and Health Partners. Under the Health Partners agreement, FINCA Uganda links its clients with Health Partners, which provides the insurance product, collects the premiums and monitors client satisfaction.

Under the MicroCare programme, FINCA Uganda clients are offered the option of subscribing to the MicroCare programme when they apply for a village bank loan. Upon approval, the loan is disbursed to the client, but the premium is paid directly to MicroCare, which then enrolls the client and arranges for delivery of services through its allied health service providers. The premium is included in the total loan amount and repaid by the village banking client as part of the traditional loan repayment process.

Potable water. Only about 25% of Haitians have ready access to potable water, the worst rate in the western hemisphere and one of the worst in the world. FINCA formed a partnership in the summer of 2003 with Moving Waters International (MWI) to launch a microutility service for FINCA Haiti's clients in order to expand their access to clean water. MWI engineers developed a potable water supply system known as the Solar Pedalflo (SPF), which uses solar or human pedal power to lift water from boreholes. The water is then filtered, purified and pressurized for delivery anywhere in a local community. MWI donated a Solar Pedalflo to FINCA Haiti as a test project. FINCA Haiti will maintain the equipment and manage the collection of water fees. The fees will be deposited in FINCA Haiti's loan capital portfolio once initial costs are recovered.

Table 2:
Financial Services Beyond Village Banking

Product	Location
Consumer loans	Armenia, Kosovo, Kyrgyzstan, Samara, Tomsk
Educational loans ¹	El Salvador
Equipment finance loans	Tomsk
Family loans	Samara
Health loans	Uganda
Holiday loans	Armenia
Home improvement loans	Kosovo
Individual loans	Armenia, El Salvador, Georgia, Honduras, Kyrgyzstan, Samara, South Africa, Tomsk, Uzbekistan
Life insurance ²	Azerbaijan, Mexico, Tomsk, United Republic of Tanzania, Zambia
Accidental death insurance	Malawi, Uganda, United Republic of Tanzania
Inventory loss insurance	Malawi, Uganda
Credit insurance	Zambia
MTN villagePhone Operators Partnership ³	Uganda
Parallel loans	Samara
Payroll loans	Uganda
Progressive loans	Zambia
Remittances (outgoing and incoming)	Uganda
Revolving lines of credit	Armenia, Samara
Seasonal loans ⁴	
Small enterprise loans (SELS)	Armenia, Azerbaijan, Kosovo, Kyrgyzstan, Tomsk
Working capital loans	Uganda

1. Educational loans may be taken out in December (for the winter school term) or February (for the spring term) and may be used to pay school fees and purchase books and uniforms. The minimum loan size is US\$100 and the maximum US\$250. Individual loan products are available to existing FINCA clients and non-clients alike. Terms are for from four to five months.

2. Several of FINCA's country programmes, the majority in Africa, have formed partnerships with insurance providers to deliver a range of insurance products. The FINCA affiliate acts as agent for the insurance provider, providing client names and collecting premium payments in some cases, but does not engage directly in service delivery of the insurance products.

3. FINCA Uganda is one of the microfinance institutions partnering with MTN Uganda, the country's largest telecommunications company, and the Grameen Technology Center to replicate the success of the South Asian village phone programmes in Africa. FINCA Uganda clients use the phones both to improve the communications and efficiency of their existing businesses and as a new business itself (selling minutes of phone-use time to customers).

4. In El Salvador, active AA-rated clients may take out additional seasonal loans of US\$100-600 during August, Holy Week or at Christmas time on the same terms as their village banking loan (any seasonal loan must be harmonized with the borrower's village bank loan cycle). Seasonal loan products vary from region to region, but are intended to help clients respond to business opportunities or to smooth consumption patterns in reaction to seasonal events.

FINCA has begun piloting other innovations, including completely new non-financial services. Throughout its history, FINCA has been approached by other NGOs and corporations that request it to leverage its extensive network to deliver unrelated services such as literacy training, health education, dentistry, and textbook distribution. FINCA remains committed to focusing on its own area of comparative advantage: delivery of quality financial services to severely poor clients. FINCA's approach is to form and effectively manage partnerships with other leading organizations that can deliver the services in which they enjoy comparative advantage. The results for FINCA clients will be partnerships that deliver value greater than the sum of their parts.

ANNEX III

FINCA International Network Statistics

(as of August 2004)

	Total clients	Outstanding balance	PAR	FSS
NIS and the Middle East				
Afghanistan	2 864	277 890	0.0%	21.9%
Armenia	6 466	3 137 182	0.9%	147.3%
Azerbaijan	13 774	2 710 150	0.2%	77.1%
Georgia	7 814	2 761 607	3.9%	133.0%
Kosovo	2 356	5 146 903	1.5%	95.8%
Kyrgyzstan	22 170	8 598 438	0.6%	128.1%
Russia (Samara)	3 518	5 373 755	0.4%	110.3%
Russia (Tomsk)	1 637	1 507 249	0.6%	62.6%
Tajikistan	312	40 514	0.0%	7.0%
Uzbekistan	1 322	214 003	0.6%	28.2%
Subtotal, NIS/Middle East	59 369	29 489 799	1.2%	104.9%
Africa				
Congo	13 296	1 433 700	5.5%	112.0%
Malawi	19 640	1 907 700	4.7%	82.1%
South Africa	643	69 955	10.0%	27.2%
Uganda	45 432	6 082 461	2.1%	96.5%
United Republic of Tanzania	35 732	3 796 152	2.0%	106.7%
Zambia	10 220	507 845	2.1%	69.7%
Subtotal, Africa	111 667	12 364 112	3.3%	91.1%
Latin America				
Ecuador	36 778	10 129 259	0.9%	139.6%
El Salvador	19 798	4 974 200	11.2%	100.1%
Guatemala	6 316	904 922	2.6%	83.9%
Haiti	7 781	712 550	1.2%	49.9%
Honduras	20 072	2 816 959	13.2%	104.3%
Mexico	15 760	3 954 812	0.8%	140.7%
Nicaragua	30 563	4 038 765	1.6%	133.1%
Subtotal, Latin America	137 068	27 531 467	3.1%	114.5%
FINCA network total	308 104	69 385 378	2.3%	104.6%

