EMPLOYMENT SECTOR
— SOCIAL FINANCE PROGRAM —

The impact of liberalisation policies on access to microfinance – the case of Peru

Alberto Didoni

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Since a few years there is a noticeable trend in the international development community to take a more systemic view of the provision of vital financial services to the poor. As a result the notion of microfinance is increasingly being superseded and replaced by inclusive finance or, more generally, access to finance. This change of perspective and emphasis was prompted by various reasons, but it is largely due to the dynamics of the microfinance industry itself. From obscure beginnings in the late 1970s with a few thousand clients and a few million US dollars involved, it has literally outgrown its micro dimensions. Practically every aspect is reaching scaled up significance, whether the number of clients, the amount of savings mobilized or the size of loan portfolios involved. Even the number of microfinance institutions has exploded and is now estimated to be close to ten thousand. The only aspect that would continue to justify the designation micro is the average transaction size which is still much below what commercial agents consider feasible.

It is generally assumed that the growth of individual microfinance institutions and the industry as a whole will improve access: the more MFIs operate in the market, the faster they grow. Indeed the steadily increasing penetration rates over the past decade would seem to corroborate this assumption (see for example ILO/BCEAO data bank on MFIs in Francophone West Africa, PASMEC).

Surprisingly, there has been little work done on whether and how policies geared at the microfinance sector actually improve the access of the poor to finance. This applies in particular to reform and liberalization policies that seek to make it easier for new market entrants to enter into competition with established microfinance institutions.

This is insofar surprising as there is a comparatively rich body of analysis on the distributional consequences of financial sector reform and liberalization in general (Besley, Calomiris, Gupta, Rajan/Zingales, Roe/Popiel, Stiglitz). Work by the Social Finance Program on financial sector liberalization in Africa suggests that there has

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1 see list of IFLIP working papers at end of this SFP Working Paper
been little, if any increase in competition, allocative efficiency, market deepening or broadening, as commercial banks on the whole failed to downscale.

Alberto Didoni’s study of the Peruvian microfinance market is a contribution to filling this gap as it examines specifically how liberalization measures affect the environment for new microfinance institutions entering the market, positively bringing about more supply and improving access for MFI clients.

Bernd Balkenhol
Chief
Social Finance Program
Executive Summary

It is vital to understand the effects of public policies on building a viable microfinance industry, especially where microfinance aims to assist low-income people and include the poor. This paper examines the role of policy in Peru in enabling the expansion of financial intermediaries targeting small and micro entrepreneurs. It analyses the extent to which the performance of Peruvian microfinance institutions over the five year period 1998-2002 was linked to policy initiatives by national authorities.

Financial and geographical liberalisation, in particular expanded the number and geographical coverage of financial intermediaries serving the poor. It created a competitive pressure which shifted financial services from a supply-driven to a demand-driven mode, which benefited the individual micro entrepreneur. Strengthening financial controls on local MFIs further enhanced the stability of the system, attracted more foreign investment.

Lessons can be drawn for other countries willing to undertake large scale expansion of microfinance services to benefit the poor.
Abbreviations and acronyms

CMACs  Cajas Municipales de Ahorro y Crédito
COFIDE  Corporación Financiera de Desarrollo
COPEME  Consorcio de organizaciones privadas de promoción al desarrollo de la pequeña y micro empresa
CRACs  Cajas Rurales de Ahorro y Crédito
EDPYMEs  Entidades de Desarrollo para la Pequeña y Microempresa
ENAH0  Encuesta Nacional de Hogares
FEPCMAC  Federación Peruana de Cajas Municipales de Ahorro y Crédito
FOGAPI  Fundación Fondo de Garantía para Prestamos a la Pequeña Industria
GTZ  German Technical Co-operation
INEI  Instituto Nacional de Estadística e Informática
MFIs  Microfinance Institutions
MSEs  Micro and Small Enterprises
MTPE  Ministerio de Trabajo y Promoción del Empleo
NGO  Non Governmental Organisation
SBS  Superintendencia de Banca y Seguros
SMEs  Small and Medium Enterprises
SUNAT  Superintendencia Nacional de Administración Tributaria
USAID  United States Agency for International Development
Introduction

The rapid expansion of microfinance across the world makes it worth trying to better understand the effects of policies on the microfinance industry, especially where microfinance is aimed at the very poor. Such an understanding could make a meaningful contribution to the ongoing debate on the role of the state in microfinance.

To undertake such an analysis is challenging, because of the difficulty of establishing causality between policies and their outcomes. To complicate things further, many other factors influence the expansion of financial services for the poor: the availability of investors, customer demand, the capacity of financial service providers, and above all the general economic conditions in the country.

Peru is a country where financial services for the poor have reached a significant level of density and stability. Over the five year period reviewed here (1998-2002) Peruvian microfinance institutions (MFIs) showed impressive growth rates, both in numbers of clients and amounts disbursed. MFIs also diversified their product offerings, introduced technical and financial innovations and modernised microlending methodologies.

In the 1990s the Peruvian authorities implemented policy measures which substantially affected the activities of financial intermediaries. They introduced bold reforms to liberalise the economy, created new conditions for a multiplicity of financial institutions serving different market niches and strengthened the regulatory and supervisory control of the financial sector. The combination of these measures had a powerful positive effect on the microfinance institutions and their clients.

The paper consists of seven parts:

- The first part presents an overview of the Peruvian economy in the 1990s, with a focus on reforms in the labour and financial markets.
- The second part describes the policies implemented by the authorities that directly and indirectly influenced the microfinance industry.
- Parts Three and Four describe the expansion of financial intermediaries for the poor and their social impact.
- In part Five some case studies are presented for illustration.
Parts Six and Seven draw conclusions about the effects of public policies on the expansion of microfinance institutions and related services.

1. Liberalisation policies: in Peru in the 1990s

To analyse the development of Peruvian microfinance over the last decade, it is useful to start by highlighting the main reforms that took place in Peru’s economy in the 1990s, because these reforms radically changed the structure of the economy.

1.1 Macroeconomic stability and financial liberalisation

The Peruvian economy used to be characterised by dysfunctional state interventions and protectionism. Towards the end of the 1980s it suffered from hyperinflation with a peak in 1989 at 2775%. In the same year GDP decreased by 12%. In 1990, the newly appointed government of President Fujimori implemented a rigid economic liberalisation programme to stabilise the economy and drastically reform its structure. The State reduced its presence in the market place and fostered foreign investment in mining and in public utilities such as telecommunications and power plants. From 1990 to 1992, these reforms were implemented; 1993 to 1995 showed accelerated growth; before a gradual decline in the performance of the economy from 1996 to 1999.

As shown in Figure 2, the reforms resulted in significant improvements in the exchange and inflation rates in the 1990s. The recovery plan led to a long run stabilization of the exchange rate, which dampened currency-related risks and stimulated investments in the currency. Eventually the inflation rate dropped drastically, inspiring investor and consumer confidence.

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3 Ibid.
Figure 1. Real GDP and GDP per capita (% change), 1990-2000

Source: Banco Central de Reserva

Figure 2. Inflation and Exchange rate (% change) 1994 - 2002

Source: Banco Central de Reserva
The improved economic conditions affected the financial system positively. Peru experienced a rapid increase in foreign direct investments (shown Figure 3) that contributed to the sustained growth of local financial intermediaries, and extensively leveraged their liabilities. As a consequence, the banking system expanded from 1994 until 1999 its exposure to the local economy as demonstrated by the amount of outstanding loans, shown in Figure 4.

**Figure 3. Stock of Foreign Investments, 1994-2000 (US$ millions)**

![Figure 3. Stock of Foreign Investments, 1994-2000 (US$ millions)](image)

Source: Proinversion

**Figure 4. Total Outstanding Portfolio of the Banking System, 1994-2002 (US$ millions)**

![Figure 4. Total Outstanding Portfolio of the Banking System, 1994-2002 (US$ millions)](image)

Source: Proinversion
Over the same period, the authorities reduced the role of the State in the economy. Policies were implemented to foster privatisation in most sectors. In the 1990s a series of state-owned banking institutions had failed. The government created a favourable environment for the expansion of foreign-owned financial intermediaries, and the number of financial institutions increased sharply in the middle of the decade.

To complement this liberalisation of financial markets, policymakers strengthened banking regulations in order to protect local depositors who had been deeply hit by banking failures. The strict criteria applied by the regulators led to some consolidation of the sector in the late 1990s (as shown in Figure 5).

Particularly relevant for the microfinance sector was the expansion of consumer credit, which can be considered as an alternative to microloans. Traditional banks did not succeed in expanding their consumer lending (Figure 6). Their recovery techniques were inadequate and repayment rates were while finance companies, on the other hand, greatly increased their share of this market segment, apart from the years 1997 to 1999, when the international financial crisis dampened their expansion.

**Figure 5. Number of Commercial Banks in the Banking System, 1998-2002**

![Bar chart showing number of commercial banks in the banking system from 1998 to 2002](source: Proinversion)
1.2 Labour reforms, under-employment and women

The liberalisation also showed its effect in the labour market, under-employment rate and the participation of women in the labour force which in turn radically affected the evolution of the microfinance industry. Between 1991 and 1995, the Fujimori government introduced reforms in the labour market that worsened conditions for both the individual and collective rights of employees. Individual rights were affected by greater flexibility in labour contracts, such as:

- reducing restrictions on the laying off of employees
- increasing temporary employment opportunities
- encouraging sub-contract agreements with labour intermediaries
- introducing ad hoc types of contracts for specific categories (such as students and recent graduates)
These policies made it easier for firms to hire and fire employees according to business needs. At the same time, trade union membership dramatically decreased because of the introduction of regulations that discouraged collective negotiations and worker cohesion.\(^4\) The first effect was that long-term contracts dramatically declined (table 1). Long-term employment was being replaced by fixed-term work and occasional employment (“on commission”). The second effect was that a new form of under-employment emerged, as shown by the increase in jobs “without contract”. Table 1 also shows a labour market shift from the public to the private sector. This was due in part to the fact that the policy reforms were making it easier for businesses to hire and fire, and in part due to the trend to privatisation. Finally, the new conditions of the labour market led to shorter durations of employment. Employment duration averaged 46 months in 1999, 23 months less than in 1991.

\begin{table}[h]
\centering
\caption{Employment Trends in Peru, 1991-1999 (%)}
\begin{tabular}{|l|c|c|c|c|c|}
\hline
\hline
Private sector & 42.3 & 44.3 & 44.7 & 43.6 & 52.5 \\
Public sector & 11.9 & 10.0 & 9.2 & 6.8 & 9.1 \\
Independent & 31.7 & 29.4 & 30.6 & 33.0 & 30.8 \\
Other & 14.1 & 16.2 & 15.5 & 16.7 & 7.6 \\
\hline
\textbf{Type of Contract} & & & & & \\
Long term/indefinite & 41.0 & 33.5 & 28.3 & 25.5 & 24.8 \\
Fixed term & 9.9 & 12.2 & 15.6 & 16.0 & 14.8 \\
On commission & 8.6 & 9.8 & 11.3 & 11.4 & 11.0 \\
Intermediaries & 7.1 & 2.7 & 5.4 & 3.8 & 3.0 \\
Without contract & 33.2 & 34.8 & 37.7 & 41.2 & 45.4 \\
Ad hoc categories & 0.2 & 7.0 & 1.7 & 2.1 & 1.0 \\
\hline
\textbf{Average Duration} & & & & & \\
(Number of Months) & 69.1 & 52.0 & 48.0 & 42.0 & 46.6 \\
\hline
\end{tabular}
\end{table}

Source: MTPE

Labour reforms were not the only factor contributing to the substantial change in employment patterns. The structure of the Peruvian labour supply was being significantly shaped by demographic growth and the increasing number of working women. The population growth rate, previously fluctuating around 1.6%, began to rise at the end of the 1970s, peaking in 1981 at 2.6%. By the 1990s there was a corresponding increase in the workers aged between 18 and 30. The other trend was the higher participation of women in the economy. In 1970, 38% of the total labour force was female. By 1998 this figure had risen to 58%. Much of this is explained by the youngest group of women aged up to 24, as can be seen in Table 2.

Table 2. Labour Market Changes and Gender, 1994-2000

<table>
<thead>
<tr>
<th></th>
<th>1994</th>
<th>1997</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Men</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Up to 24 years</td>
<td>54.1</td>
<td>62.8</td>
<td>60.3</td>
</tr>
<tr>
<td>From 25 to 54 years</td>
<td>91.1</td>
<td>95.8</td>
<td>95.5</td>
</tr>
<tr>
<td>More than 54 years</td>
<td>64.7</td>
<td>67.2</td>
<td>65.0</td>
</tr>
<tr>
<td><strong>Women</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Up to 24 years</td>
<td>32.0</td>
<td>48.3</td>
<td>42.9</td>
</tr>
<tr>
<td>From 25 to 54 years</td>
<td>60.0</td>
<td>67.0</td>
<td>66.0</td>
</tr>
<tr>
<td>More than 54 years</td>
<td>30.1</td>
<td>36.9</td>
<td>37.5</td>
</tr>
</tbody>
</table>

Source: MTPE

The inflow of workers into the Peruvian economy was not, however, matched by a corresponding increase in the demand for labour. GDP per capita had decreased over the years, leading to a lower demand for additional workers. The relative abundance of labour did not lead to a rise in unemployment, but caused a significant deterioration in working conditions.5

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5 The rise can be explained by the significant decrease in child mortality due to the improvement of public health services.
7 Ibid.
1.3 Consequences for the economy

The reforms and transformations throughout the 1990s had a significant impact on the working conditions of the local population and the structure of the economy as a whole. As a direct consequence of the reforms was the purchasing power of Peruvian workers weakened as shown by the trend of wages and salaries in the 1990s in Figure 7. Local workers were clearly worse off in 2000 compared to the real values of their wages and salaries before the reforms.

**Figure 7. Real Salaries and Wages Index in Metropolitan Lima, 1998-2000**
(Year base =1994)

![Graph showing real salaries and wages index in Metropolitan Lima, 1998-2000](image)

Source: MTPE

Another way of assessing the welfare of Peruvian workers is to measure their working conditions. Table 3 shows the situation at the end of the 1990s. As can be seen, the country is characterised by a relatively low and stable level of unemployment. By contrast, under-employment steadily increased over the decade, with nearly one out of every two employees in 2001 being under-employed. The trend of the “per earnings” and the “per hours” variables shows that Peruvian under-employment was defined by significantly low levels of salaries rather than by insufficient working hours per employee.
The rise of under-employment took place at the expense of the number of adequately remunerated jobs which by 2001 made up only 44.5% of the working population’s employment.

**Table 3. Trends in working conditions in Peru, 1997-2001**

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment</td>
<td>7.7</td>
<td>7.8</td>
<td>8.0</td>
<td>7.4</td>
<td>7.9</td>
</tr>
<tr>
<td>Under- employment</td>
<td>41.8</td>
<td>44.3</td>
<td>43.5</td>
<td>43.0</td>
<td>47.6</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per hours</td>
<td>17.0</td>
<td>14.6</td>
<td>13.6</td>
<td>13.3</td>
<td>14.5</td>
</tr>
<tr>
<td>Per earnings</td>
<td>24.8</td>
<td>29.7</td>
<td>29.9</td>
<td>29.7</td>
<td>33.1</td>
</tr>
<tr>
<td>Adequately employed</td>
<td>50.5</td>
<td>47.9</td>
<td>48.5</td>
<td>49.6</td>
<td>44.5</td>
</tr>
</tbody>
</table>

Source: MTPE

The labour reforms and privatisation measures also led to the gradual expansion of micro and small firms. According to a 1997 study,\(^8\) local small and medium enterprises (SMEs) absorbed 75.9% of the Peruvian workforce, of which 85.1% is located in urban areas and 37.2% in Lima. 95% of workers are concentrated in microfirms which are defined as any business with a workforce of up to four people. From 1995 to 1996, urban micro activities increased by 4.5% while from 1997 to 1998 they grew by 5.7%.\(^9\) Figure 8 describes the situation in Lima over the 1990s.

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\(^8\) ENAHO 1997.

The economic and labour reforms thus had a radical impact on the Peruvian economy, generating an environment highly favourable to the proliferation of (mostly informal) micro enterprises, which in turn lead to an increased demand for microfinance.

2. Policies affecting Peruvian microfinance

This section summarises how public authorities regulated microfinance institutions (MFIs), strengthened their status and fostered their expansion.

2.1 A gradual approach to microlending: the origins of Cajas Municipales

The first microfinance programmes in Peru were run by NGOs operating group lending schemes. Such schemes reduce the risks related to lack of collateral, formal guarantees and information on borrowers. Given the poverty focus of these NGOs, they were usually subsidised by international donors.
In 1980 in an effort to foster economic development, the State created financial institutions called Cajas Municipales de Ahorro y Crédito (CMACs).\textsuperscript{10} CMACs were decentralised bodies with a mandate to channel financial resources to micro and small enterprises within their respective provinces. Their expansion was limited to the province’s territory, so they did not compete among themselves. The main shareholder of each CMAC was the local administration of the province.\textsuperscript{11} For ten years from the beginning of their activities, CMACs were exempted from paying tax on financial earnings. During this time they were required to reinvest at least 50\% of their profits in their equities.\textsuperscript{12}

The public authorities took a gradual approach to regulating this new type of financial intermediary. Before starting normal financial lending operations, each CMAC had to go through a three-year modular growth process. During the first year, the CMACs were only allowed to set up pawn loan programmes which, because they were backed by gold, involved no risk of default. From the second year onward the CMACs could collect deposits to increase the amount of disbursements. Only in the third year were they allowed to collect public savings and use them to finance small enterprises. In reality, the process took even longer, because the initial capital of the CMACs was low and needed time to grow.

The first CMAC to effectively start microloans was the Caja Municipal of Piura in 1989. The cooperation with the German development agency GTZ, initiated by CMAC Piura in 1985, was extended to all CMACs one year later. It was of key importance for the development of the system. Between 1986 and 1990, CMACs assimilated the lending methodology designed by GTZ, using it to train their staff. The methodology provided an efficient technique to disburse and track microloans.

\section*{2.2 Strengthening governance}

\textit{Strengthening the CMACs system}

Before 1990, the governing body of each CMAC, known as the Directorial Committee, was made up of five members appointed by the Provincial Council. Three of

\begin{flushleft}
\textsuperscript{10} Law decree No. 23039.  \\
\textsuperscript{11} See Rock (1997) for a comprehensive summary.  \\
\textsuperscript{12} See Talledo P. (mimeo).
\end{flushleft}
these members were elected on a two year basis and the other two changed every year. In 1990 the Peruvian Congress issued a Supreme Decree to strengthen the governance of Cajas Municipales and decrease the likelihood of political interference with management.\textsuperscript{13} Each Directional Committee had to be made up of six directors. Three of these were to be nominated by political parties – two by the majority party and one by the opposition. The others were to be a delegate of the local church, and representatives of a second tier financial institution (or the Central Bank), and the Chamber of Commerce.

The Decree also introduced a tripartite management structure. Three managers were to be appointed by the Directorial Committee, \textsuperscript{14} responsible for credits, administrative issues, and financial issues respectively.

The same Decree directed the Federación Peruana de Cajas Municipales de Ahorro y Crédito (FEPCMAC) the apex institution of the CMAC system to follow up these organisational changes and assure the financial sustainability of each CMAC. The Federation was to provide the supervisory body (Superintendencia de Banca y Seguros, or SBS) with financial performance information. Through its internal audit department, FEPCMAC carried out a three-level audit to monitor each CMAC annually. The Federation was also responsible for assessing operations and training CMAC staff.

Delegating powers to the Federation of CMACs was an official recognition of the relative importance of Cajas Municipales in the financial system, both as credit institutions and as collectors of public deposits. Public authorities were fully aware of the necessity to preserve and strengthen these MFIs, because they represented an increasing proportion of the financial transactions in wide parts of the country.

The newly established role of FEPCMAC fostered cooperation between Cajas Municipales operating in different regions, which helped reduce and share their financial burden between themselves.\textsuperscript{15}

\textsuperscript{13} Supreme decree No. 157-90-EF.
\textsuperscript{14} At the time the cooperation between CMACs and GTZ, the German technical assistance agency, was still in place.
\textsuperscript{15} For instance, the FEPMAC financed the implementation of new technologies, personnel training and ad hoc expertise for all CMACs.
Cajas Rurales: political willingness and results

The collapse of state-owned banks at the beginning of the 1980s created the conditions for a new approach to rural lending by Cajas Rurales de Aborro y Crédito (CRACs). CRACs were privately owned institutions similar to credit unions. Their aim was to create financial intermediaries directly owned by small producers living in rural areas. The primary purpose of a Caja Rural was to leverage public resources and use them to expand rural activities. A CRAC could accept deposits, from the general public but it could only disburse credits to its members. CRACs were allowed to have offices in any rural area of the country with further possibilities to open branches in other locations.

In 1992, under strong political pressure, the authorities reorganised the system of Cajas Rurales by issuing the 25612 Law. The attempt was not particularly successful, and the law did not substantially improve things. Governance of CRACs remained cumbersome, as the law imposed an upper limit of 5% of shares that could be owned by a single shareholder. However, the new law did allow Cajas Rurales to disburse loans to non-members. This meant in effect that CRACs were being allowed to change from credit unions to classical MFIs.

Still, CRACs’ results were not particularly encouraging. At the time, the credit policies of state owned banks were lax that agricultural loans became synonymous with grants, and repayment rates were rather low. The impact of El Niño on Peruvian agriculture and the absence of economies of scale in the sector rendered lending extremely risky and discouraged further investments. Further disadvantages for CRACs were the absence of technical assistance and the absence of a strong apex institution to foster mutual cooperation in contrast to the CMACs. CRACs diversified their portfolios by disbursing credits in urban areas and becoming effective competitors of urban-focused MFIs.

2.3 Financial support of microfinance institutions

In 1992, as part of the liberalisation process, the Fujimori government transformed COFIDE, the state-owned development bank, into a second tier financial institution. COFIDE’s new mission was to refinance economic activities in rural areas and,

16 Law Decree No. 23028 (1980).
in particular, focus on micro entrepreneurs.\textsuperscript{17} COFIDE’s lending schemes were financed either directly through its own financial resources, or indirectly, by managing funds of international donors. MFIs attracted 15\% of the financial resources available from COFIDE (see Figure 9), while commercial banks were able to gather almost USD 300 million, 73\% of the total. Of the microfinance institutions, COFIDE mainly relied on CMACs, which received 65\% of the amount COFIDE disbursed (Figure 10). As for the other MFIs, the distribution of funds reflected COFIDE’s risk diversification policy, which assigned financial resources according to the relative size and financial situation of each MFI.

For donors, the creation of a second tier institution had two advantages: Firstly, the existence of COFIDE meant a substantial decrease in costs, as donors did not have to go through the selection of smaller institutions, disburse loans and control repayments. Secondly, the repayment rate improved, as COFIDE’s own loan policies were based on sound technical evaluations of financial performances and repayment capacities of each institution.

The use by international lenders of COFIDE as a channel for refinancing instead of financing MFIs individually, enhanced overall transparency as COFIDE propagated uniform financial practices and common criteria which had to be followed to obtain a loan.

\textsuperscript{17} Law No.25694.
Figure 9. COFIDE: Portfolio Composition as per Type of Institution (2002)

Source: COFIDE (2002)

Figure 10. COFIDE: Portfolio Composition as per MFI (2002)

Source: COFIDE (2002).
As a second tier organisation, COFIDE was only allowed to channel funds through regulated financial intermediaries. This became a obstacle because of the limited number of institutions registered to be regulated. A further problem was that funds available from international donors particularly interested in social outreach could not be distributed as none of the eligible institutions fulfilled the donors’ requirements relating to geographical focus and average loan size.

To facilitate the access to COFIDE’s financial resources new category of financial institution, Entidades de Desarrollo para la Pequeña y Microempresa (Edpymes) was created. By joining the regulated system, Peruvian NGOs could therefore gain access to credit lines offered by international donors through COFIDE. Adopted in 1998 by the banking supervisory authority Edpymes were designed to bring several benefits to local microfinance: greater financial transparency among the NGOs, a better distribution of financial resources, and a quantitative and qualitative increase in financial services for the poorer segments of the population. However, as it turned out the Edpymes initiative did not attract sufficient NGOs. At the end of 1998, only seven NGOs had registered. The main obstacle seems to have been the associated expenses, and the extra effort needed to recover these expenses from lending operations. The extra expenses include the cost of internal and external auditors, the bureaucracy for opening new agencies, and the supervision fees. In addition, as group lending schemes were not authorized the Edpymes had to radically change their lending techniques., Meeting these extra costs forced them to increase their average loan size and introduce individual lending.

One factor which did lead to more adherence to the Edpymes scheme was the decision in 1998 by the Superintendencia Nacional de Administración Tributaria (SUNAT – the Peruvian fiscal authority) to impose a value added tax on financial transactions. Financially regulated institutions were exempted. The tax was retroactive for five years so that NGOs which decided to stay out the regulated system had to pay tax for all financial operations since 1993.

One measure that proved to be efficient in supporting microfinance institutions was the creation of a guarantee fund. In 1996, the government created a small fund (USD 5 million) for securing portfolios of local financial intermediaries. The fund was initially transferred to COFIDE, which after a year delegated its management to Fundación Fondo
de Garantía para Prestamos a la Pequeña Industria (FOGAPI). Created in 1979 through a joint initiative of GTZ, COFIDE and other local organisations, FOGAPI was at that time offering two main products: guarantees for credits disbursed by financial institutions and letters of guarantee for SMEs.

After 1997, FOGAPI developed a product especially designed to secure the portfolios of microfinance intermediaries. In exchange for a commission, FOGAPI would secure up to 50% of MFIs’ overall portfolios. Reimbursement procedures were outstandingly rapid, as the MFI could claim a guarantee two months after a loan would be due. FOGAPI offered this product only to regulated and supervised institutions. A significant increase in the use of this facility occurred after 1998 when the financial guarantee specially designed for MFIs was launched (figure 11). In the same year, the fund was incorporated into the banking system and became a regulated institution. The downward trend of the average loan shows that FOGAPI shifted significantly to operations of smaller size over the years, partly due to the creation of Edpymes.

Figure 11. FOGAPI: Guarantee and Average Loan, 1994 -2002 (US$ Thousands)
Social outreach is expected to be further improved as FOGAPI signed in 2003 an agreement with the US Agency for International Development (USAID) to develop a portfolio guarantee for non-regulated NGOs. This agreement includes a partnership with the “Consorcio de organizaciones privadas de promoción al desarrollo de la pequeña y micro empresa (COPEME)”, an NGO consortium which promotes the long term financial sustainability of unsupervised financial intermediaries. According to COPEME, FOGAPI and USAID will share the risks with each NGO concerned by securing half of its portfolio.

2.4 Market regulation and supervision

Recognition of CMACs and CRACs as financial institutions

According to the banking law of 1992 Cajas Municipales and Cajas Rurales would be officially part of the national financial system, regulated and supervised. The formal inclusion of CMACs and CRACs into the banking system was an acknowledgment of the crucial role played by micro and small firms in the Peruvian economy and the importance of providing financial resources for their growth and development.

The new Banking Law of 1996 and the regulation of MFIs

In 1996, after the multiple failures of state-owned banks, the national parliament issued the General Law of the Financial and Insurance System and the Organic Law of the supervision of Banking and Insurance.\(^\text{18}\) These laws clearly stated that the state could not directly participate in the national financial system.\(^\text{19}\) To preserve overall stability, the laws established minimum capital requirements for each type of financial intermediary, (table 4).

\(^\text{18}\) Law No. 26702.
\(^\text{19}\) The only exception is investment through COFIDE.
Table 4. Minimum capital requirements per financial intermediary

<table>
<thead>
<tr>
<th>Type of intermediary</th>
<th>Amount (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Bank</td>
<td>5,200,000</td>
</tr>
<tr>
<td>Finance Company</td>
<td>2,600,000</td>
</tr>
<tr>
<td>Caja Municipal</td>
<td>236,000</td>
</tr>
<tr>
<td>Caja Rural</td>
<td>236,000</td>
</tr>
<tr>
<td>Edpyme</td>
<td>236,000</td>
</tr>
<tr>
<td>Credit Union</td>
<td>236,000</td>
</tr>
</tbody>
</table>

Source: SBS

To limit bankruptcies, the Banking Law obliged each institution to focus on its core business before widening the range of its activities. The amount of capital held by each institution would determine its core business category and the financial services it could offer.

To be promoted to a higher category, the institution was subject to three criteria:

- minimum capital requirement for that category;
- SBS evaluations of internal controls and adequate administration;
- qualification by external auditors.\(^{20}\)

Each type of institution was entitled to undertake only a range of operations. While CMACs, CRACs and Edpymes require the same minimum capital, Edpymes are not allowed to capture deposits, as they are mostly owned by NGOs that cannot necessarily provide grant strong financial support if there are calls for capital from the regulator.\(^{21}\)

\(^{20}\) The institution would have to be rated A or B grade for a whole year.

Table 5. Range of operations for type of financial intermediary

<table>
<thead>
<tr>
<th>Type of operation</th>
<th>CMACs</th>
<th>CRACs</th>
<th>Edpymes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits mobilisation</td>
<td>Savings and term deposits.</td>
<td>Savings and term deposits.</td>
<td>Not allowed.</td>
</tr>
<tr>
<td>Credit lines</td>
<td>Authorised from internal and external sources.</td>
<td>Authorised from internal and external sources.</td>
<td>Authorised from internal and external sources.</td>
</tr>
<tr>
<td>Lending products</td>
<td>Commercial, microcredit, consumption, pawn loans.</td>
<td>Commercial, microcredit, consumption, pawn loans.</td>
<td>Commercial, microcredit, consumption, pawn loans.</td>
</tr>
<tr>
<td>Other financial services</td>
<td>Expert appraisal of pawn objects, act as trustee when trust is involved.</td>
<td>Negotiate credit letters, act as credit guarantor, and as trustee when trust is involved.</td>
<td>Credit discount letters, act as credit guarantor, and trustee when trust is involved.</td>
</tr>
</tbody>
</table>

Source: Portocarrero (2001)

A new category of credits for micro entrepreneurs

In 1997 the Peruvian Superintendence issued a norm for credit classification. Among other things, it created a category of loans called “MES”, specifically designed for micro and small enterprises. A financial intermediary had to classify a loan as MES if it was made to individuals or firms with total assets or total debts worth not exceeding USD 20,000. This allowed for a gradual expansion of small intermediaries while preserving supervisory controls.

The geographical expansion of microfinance intermediaries

By the end of the 1990s, conflicting strategies among members had undermined the system of Cajas Municipales (CMACs). The differences in financial performance, size, needs and objectives of each CMAC had become significant. Looking for new markets to invest their excess liquidity, the biggest CMACs asked the SBS to allow geographical expansion outside their provinces. In 2002 the supervisory authority responded favourably. Authorisations were dispensed according to criteria such as the financial

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22 See SBS Resolution No. 572.
23 In 2003, the amount was adjusted to a new maximum of USD 30,000 (See SBS Resolution No. 808).
24 SBS resolution N. 1276 (2002).
strength of the institution, the potential of the new location and general market considerations. To maintain an overview, the SBS reserved for itself the right to distribute licences for opening new branches.

A Caja Municipal could not expand into provinces where another Caja already had its headquarters. This was intended designed to allow the expansion of microfinance while preserving the integrity of the overall CMAC system. The fact that the authorities took their requests seriously demonstrated how important they had become for the economy. However, the competition between the larger Cajas weakened the unity of the CMAC system and the role of its apex organisation, the Federation of Cajas Municipales (FEPCMAC).

### 2.5 Other measures

The regulation of microfinance intermediaries is not only way that public authorities can encourage the expansion of financial services for the poor. Other policies adopted by the Peruvian authorities had an indirect but significant impact on the activity of financial intermediaries.

**Consumer protection and microfinance**

According to MFI managers, consumer protection in Peru is excessive to the extent that it hinders their attempts to collect loan repayments. Law No 27598 states that loan recoveries cannot take place at the expense of the good reputation of consumers, and may not threaten their privacy or their economic activity. The law places restrictions on visiting clients to ask for the repayment, prohibiting such visits on weekends or at night.

This practice can be explained by the particular nature of microfinance. As many microloans are not backed by collateral, MFI loan officers have to rely on an ad hoc analysis to evaluate the repayment capacity of borrowers. Their evaluation techniques may include elements not directly related to the economic activity of the individual, such as the entrepreneur’s religious convictions, family situation and relationship with his or her community. Rigid criteria to preserve borrower’s privacy can undermine such analyses and discourage the institution from issuing loans.

The concepts of consumer privacy and good reputation take on a different meaning in micro and small enterprises. In these enterprises, business and household
activities are usually intermingled, as micro entrepreneurs often conduct their productive activity at home. Family members are usually directly involved in the business, so the whole family may feel responsible for the repayment of loans.

**Deposit insurance**

Regulations protecting depositors had an extremely positive impact on Peruvian microfinance.

In 1996, after a series of banking failures, Congress created a deposit insurance scheme that protected all public savings up to USD 3,500. Two years later, to stimulate public savings, this limit was raised to USD 17,300, covering most small deposits in commercial banks\(^{25}\) (table 6).

<table>
<thead>
<tr>
<th>Size (US$)</th>
<th>Number of Accounts</th>
<th>Share of Accounts (%)</th>
<th>Total Amount</th>
<th>Share of Total Amount (%)</th>
<th>Average Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1972</td>
<td>4,746,730</td>
<td>88,9</td>
<td>780</td>
<td>7,3</td>
<td>164</td>
</tr>
<tr>
<td>1,972 – 4,930</td>
<td>295,556</td>
<td>5,5</td>
<td>898</td>
<td>8,4</td>
<td>3,040</td>
</tr>
<tr>
<td>4,930 – 9,861</td>
<td>157,251</td>
<td>2,9</td>
<td>1,028</td>
<td>9,6</td>
<td>6,540</td>
</tr>
<tr>
<td>9,861 – 19,722</td>
<td>88,927</td>
<td>1,7</td>
<td>1,176</td>
<td>11,0</td>
<td>13,232</td>
</tr>
<tr>
<td>19,722 - More</td>
<td>53,906</td>
<td>1,0</td>
<td>6,815</td>
<td>63,7</td>
<td>126,439</td>
</tr>
<tr>
<td>TOTAL</td>
<td>5,342,370</td>
<td>100</td>
<td>10,699</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

Source: SBS

The impact of deposit insurance on local MFIs helped them to increase the percentage of deposits. The interest rate paid on deposits by CMACs and CRACs was significantly higher than commercial banks, so the guarantee was a strong incentive to shift public savings from banks to MFIs.

### 3. The evolution of MFIs in Peru 1998-2002

This section looks at Peruvian microfinance from 1998 to 2002, detailing numbers of operating institutions, geographical and financial strategies, and overall

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\(^{25}\) Law No.27008 (1998).

\(^{26}\) Exchange rate as per Dec 2003 (published by the Peruvian Central Bank).
performance. The impact of the legal framework and policies adopted for each type of MFI is examined.

3.1 Number of institutions serving poor people

A number of factors contributed to the reorganisation of the MFI sector, including the new regulatory schemes for MFIs, improvements in supervisory controls, and a greater emphasis on financial services for micro entrepreneurs. As a result of this process, the number and type of operating institutions increased significantly.

Traditional microfinance institutions

Over the six years 1998-2003 of the number of regulated financial institutions focusing on the poorer segments of the population increased from 37 to 41.

The number of Edpymes doubled in five years, by which time they had become the main type of regulated MFI in Peru. Five out of 14 were created by local Chambers of Commerce, while two were set up through private initiatives of local entrepreneurs. The number of Cajas Rurales, on the other hand, diminished over the 1998-2003 period. At the end of the decade, the financial situation of most CRACs was critical, and this led to a significant restructuring process. In 1999 three CRACs went bankrupt, bringing the number of CRACs forced to close down to seven.27 No upward or downward trend is found for the number of Cajas Municipales, suggesting that they had reached a level of stability in this period.

Mibanco, the first commercial bank whose primary goal was serving small and micro entrepreneurs28, and Financiera Solucion, the first company to offer financial services to lower segments of the population also entered the market. In the late 1990s, after severe consumer lending crisis, Financiera Solucion reoriented its lending from consumers to micro and small enterprises. The high repayment record of micro entrepreneurs convinced the company to radically shift its financial services toward this sector.

27 Nevertheless, the numerical trend remained stable after this, which means that the adjusting process within this category of MFIs may have been completed.
28 See Campion A. et al. (2001), The Transformation of Accion Communitaria del Perù (ACP) to Mibanco, DAI.
Other types of institutions

Traditional microfinance institutions were not the only regulated actors to target small and micro entrepreneurs. Peru’s hybrid regulatory scheme allowed multiple financial institutions to disburse micro enterprise loans. Commercial banks, credit unions and non governmental organisations all showed an interest in microcredit.

In recent years, commercial banks increasingly shifted their attention toward lower productive segment of the population. At the end of 2003, bank microloans accounted for 2.9% of the total portfolio, almost tripling from 1998, when MSE loans represented 1.2% (see Figure 13). The first wave of bank downscaling into microcredits happened in 1999 and culminated in the unsuccessful attempt of Banco Wiese, which withdrew from the market two years later. This experience demonstrated both the potential interest of formal financial institutions in the sector and the fact that microloans require different tools and managerial skills from commercial banks.

Over the years, commercial intermediaries developed efficient strategies to penetrate the market and refined their methodology to deal with micro enterpreneurs. The upward trend in microloans from commercial banks after 2000, the second attempt of

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commercial entities to downscale into microfinance were more successful\(^\text{30}\) (Figure 13). The creation of Mibanco, the first fully-fledged microfinance bank, in 1998 had no significant impact on the evolution of MSE loans of the banking sector, which gives an idea of the magnitude of downscaling by banks.

**Figure 13. MSE loans of Commercial Banks (% of Total Portfolio), 1998-2003**

![Graph showing MSE loans of Commercial Banks](image)

Source: SBS

The legislation allowed credit unions and non-governmental organisations to set up microcredit schemes. The most recent survey shows that credit unions and NGOs represented 18% and 2% of the MSE loan market respectively, (Figure 14). In 2003 there were 166 credit unions disbursing microloans, and 18 NGOs operating microcredit schemes. Credit unions are formally part of the regulated system, they have to abide by the regulatory framework and are supervised by their apex institution. On the other hand, NGOs operate as unregulated institutions and are not subject to SBS rules. The implementation of institutional reforms on the sector did not have a significant impact on the expansion of their operations.

\(^{30}\) The data shows that the evolution was not linear. In 1999, 60% of banks were disbursing microloans. This had reduced slightly to 57% by 2003. The peak was in 2000, when almost 67% of the institutions were offering financial products for microactivities.
3.2 Geographical expansion of MFIs

During the last decade, Peruvian MFIs expanded the number of their branches considerably, largely driven by the impressive performance of Cajas Municipales.

Cajas Municipales

The 2002 law had an enormous impact on the expansion of microfinance, and new CMAC branches were started all over the country. Between 2000 and 2003, the number of branches opened by Cajas Municipales doubled (Figure 15).
According to the norm set up by the supervisory authority, a Caja Municipal could not create a branch in a province where another CMAC had its headquarters. This affected CMAC expansion in three main ways:

- more competition for departments and cities still unexplored by Cajas Municipales; \(^{31}\)

- expansion of microfinance services in less populated areas where there were unmet credit needs; \(^{32}\)

- greater willingness to enter Lima, the capital, where the largest institutions were allowed to open branches.

This “institutionally-led” geographical expansion had two opposite effects. It increased the supply of financial services all over the country, including remote areas. At the same time, it increased financial services in densely populated areas like Lima, in order to reach significant economies of scale.

The growth of Edypmes branches was significant, increasing from 38 in 2001 to 56 in 2003. Almost half of them are located in the main cities (Lima, Trujillo and Arequipa) confirming that this type of MFI operates best in urban contexts. Due to their

\(^{31}\) Such as Cajamarca, Lambayeque and Ancash, in the north of the country.

\(^{32}\) As in departments like Loreto, Amazonas and Madre de Dios.
relatively small size and limited financial resources, Edpymes could not easily explore new areas in search for unmet demand for credit.  

In 1999, because of some bankruptcies, the number of CRAC branches diminished significantly. Cajas Rurales undertook a restructuring process which included a change in geographical strategy into urban areas. The SBS has been quite restrictive in granting licences to operate in Lima, but CRACs have strengthened in other major cities like Arequipa and Trujillo. At the same time, they have further explored rural areas poorly served by Cajas Municipales, their bigger competitors.

From 2000, Mibanco and Financiera Solucion enjoyed an oligopolistic position in Lima, holding a third of the potential demand for all the microfinance services in the country. This position changed when the supervisory authority allowed Cajas Municipales to set up branches in Lima. Both MiBanco and Solucion had a similar reaction to their competitors: as a counter-strategy, they set up agencies in other provinces, thus providing more services for the poor outside the capital.

The new geographical order brought about substantial advantages for the local population:

• increased proximity of institutions to potential borrowers;
• greater choices for poor people living in urban areas;
• downward pressure on interest rates.

3.3 Towards long run financial sustainability

The expansion of MFIs did not take place to the detriment of sustainability. The compliance with sound accounting practices, together with effective controls by the authorities, played a fundamental role in building a solid microfinance system. Over the five years 1998 to 2002, regulated MFIs showed extensive improvements in tracking their credits, as shown by the trend of loan losses (figure 16).

Performance varied: the strongest actors were those who could invest more resources in improving their recovery procedures and decrease the rate of losses. Bigger MFIs like Cajas Municipales outperformed other types of MFIs, demonstrating that it was possible to match a sustained growth while paying attention to portfolio quality. From 33 An exception is Edpyme Confianza, which operates mainly in rural areas.
1998, Cajas Rurales greatly improved their recovery techniques as they shifted their portfolio towards urban markets. From 1998, when they represented the benchmark for the sector, Edpymes slightly worsened their position. As for other MFIs, financial constraints made it difficult to combine expansion with high portfolio quality.

In compliance with SBS rules, MFIs increased their provisions for potential loan losses. By 2002, microfinance institutions had more than the necessary resources to secure their portfolios at risk (Figure 17), which had not been the case in 1998. An outstanding result was obtained by Cajas Rurales, whose provisions amounted to 62% of their portfolio at risk in 1998, rising to well above 100% four years later. In 2002 Edpymes were the only category of MFIs which had not secured all their doubtful credits.

The overall effects of tightening supervisory controls on financial intermediaries exerted different pressures on financial intermediaries:

- stronger MFIs tended to build up more provisions than required;
- weaker MFIs adopted conservative lending policies to immobilise fewer financial resources.

Figure 16. Loan Losses as per MFIs (% of Overall Portfolio) 1998-2002

![Figure 16. Loan Losses as per MFIs (% of Overall Portfolio) 1998-2002](source: SBS)
3.4 Financing Peruvian MFIs: national vs international resources

The growing number of microfinance institutions and the stronger controls exerted by the local authorities created optimal conditions for attracting potential investors. Important factors here were:

- a good variety of intermediaries through which to channel financial resources;
- the enforcement of clear and consistent accounting procedures;
- accessible and transparent financial information;
- a liberalised legal framework to attract an inflow of foreign direct investments (FDIs).

From 2001 to 2003, the trend of financial resources captured by microfinance institutions was positive, (Figure 18). This can be explained by the willingness of COFIDE to disburse financial resources to efficient and regulated MFIs. Regulating and supervising
former NGOs also proved to be a successful way of channelling public resources toward the expansion of small and micro entrepreneurs.

Figure 18 also shows that Peruvian intermediaries were attractive to foreign investors. It meant that Peru had closed the gap between international financial markets and financial institutions supporting the poorer segment of its population.

**Figure 18. Financial Investments in MFIs (US$ Thousands) 2001-2003**

![Bar chart showing financial investments in MFIs from 2001 to 2003.](chart.png)

Source: SBS
The increasing number of regulated MFIs improved COFIDE’s performance, since many more organisations had access to its funds. This was enhanced after 2000, when COFIDE became an institution supervised by the SBS. COFIDE began to pay more attention to investment returns and focused on supporting efficient institutions. The effect of this more commercial policy was a net decrease in the maturity of funds channelled to MFIs, (Figure 19). The outstanding growth of short term investments had a substantial effect on local microcredit.

### 3.5 In search of alternative funds: deposit collection

The international financial crisis of 1998-1999 had a negative impact on the funding strategies of Peruvian intermediaries. Attracting international capital proved cumbersome, as investors became more selective about where to invest, and the perceived risk to invest in developing countries increased. As a consequence local MFIs had to find
alternative ways to finance their growth. One solution was to collect public savings. After 1998 MFI deposits grew at a constant rate. The number of accounts grew at an annual rate of 26%, while the total savings grew at an average rate of 44% (figure 20).

The higher growth of the total amount compared to the number of accounts can be explained by a rise in 1998 in the upper limit of the deposit guarantee. The public responded immediately, and from 1998 to 1999 the total amount of savings collected grew by 60%.

The policy of protecting public deposits through a state guarantee fostered the reciprocal confidence between clients and institutions. The knowledge that they could eventually claim their losses from the state prompted Peruvian depositors to shift their resources from commercial banks to microfinance institutions, which were offering higher returns.

**Figure 20. MFIs’ deposits collection, 1998-2003**

In the area of deposits collection, significant differences emerged between types of intermediaries. As in many other aspects, Cajas Municipales outperformed their counterparts. Figure 21 shows that CMACs were more successful in accruing both the quantities of public savings and the amount of financial resources collected. This could be
attributed to the CMACs’ monopolistic position in the market and their geographical expansion. Both factors contributed to fostering an image of seriousness and solidity among Peruvians.

**Figure 21. CMACs’ deposits collection, 1998-2003**

![Graph showing CMACs’ deposits collection, 1998-2003](image)

* November 1998
Source: SBS

**Figure 22. CRACs’ deposits collection, 1998-2003**

![Graph showing CRACs’ deposits collection, 1998-2003](image)

** October 1999
Source: SBS.**
To a lesser extent, depositors also relied on Cajas Rurales to manage their financial resources. The number of CRAC depositors grew slightly over 1998-2002, but the positive trend was not matched by significant improvements in the amount collected, (Figure 22). This rather weak performance can be attributed to the restructuring process undertaken by CRACs, and from the perception among local depositors that Cajas Rurales were heavily investing in risky activities such as agriculture.

The success of MFI deposit collections played an important role in shaping geographical strategies. They had a strong incentive to search for new markets for depositors because of their newly established freedom to set up agencies all over the country.

The successful lobbying to open agencies in Lima was also the result of success in public savings collection. In 2003, 6% of the total amount of CMACs’ deposits were collected in the capital, compared to slightly over 2% in 2001 (see Figure 23).

**Figure 23. CMACs’ Deposits as per department (%), 2003**

![Figure 23. CMACs’ Deposits as per department (%), 2003](image)

Source: SBS
3.6 The new structure of liabilities

Decreasing the dependency on external funds was certainly a positive factor for MFIs as external debts tend to be more volatile than deposits gathered from the public. Table 7 shows the evolution of the composition of MFIs’ liabilities.

### Table 7. Percentage liabilities as per MFIs, 2001-2003

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Public deposits</td>
<td>68,1</td>
<td>68,7</td>
<td>54,3</td>
<td>67,8</td>
<td>-</td>
<td>-</td>
<td>43,6</td>
<td>81,5</td>
</tr>
<tr>
<td>Instit. Deposits</td>
<td>6,4</td>
<td>7,9</td>
<td>0,2</td>
<td>0,1</td>
<td>-</td>
<td>-</td>
<td>0,8</td>
<td>2,5</td>
</tr>
<tr>
<td>Debts</td>
<td>20,7</td>
<td>18,6</td>
<td>42,4</td>
<td>25,8</td>
<td>90,1</td>
<td>93,0</td>
<td>39,2</td>
<td>6,7</td>
</tr>
<tr>
<td>Inter-banking funds</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>6,0</td>
<td>0,3</td>
</tr>
<tr>
<td>Bonds</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Others</td>
<td>4,9</td>
<td>4,8</td>
<td>3,1</td>
<td>6,3</td>
<td>9,9</td>
<td>7,0</td>
<td>10,4</td>
<td>5,4</td>
</tr>
</tbody>
</table>

Source: SBS

Good examples are shown by Cajas Rurales and MiBanco, the commercial bank. After 2001, as soon as the CRACs’ restructuring process was complete, public depositors steadily increased their degree of confidence in the Cajas Rurales, and they were able to decrease their financial exposure in relation to their creditors.

Similarly, between 2001 and 2003, MiBanco concentrated its financial resources in the collection of deposits. Nowadays, its liabilities are highly concentrated in deposits – more than 80%. As an additional way to leverage capital and to diversify financial exposure, Mibanco issued its first commercial bond in 2001. This change in its fundraising strategy provoked a steady decline in borrowings. By 2003, Mibanco’s borrowings represented only 6.7% of its total liabilities of Mibanco.

Edpymes remained financially dependent on national and international lenders, as the regulatory framework did not allow them to collect public savings.
4. The impact of the MFI expansion

Peruvian microfinance institutions greatly benefited from the policies introduced by the authorities in the last decade; but the real test of success is whether borrowing conditions for poorer clients improved. Important indicators here would be: a substantial decrease in the interest rate charged to borrowers, a greater variety of financial products, and a deeper social outreach. Let us look at each of these indicators in turn.

4.1 Interest rates: did competition improve borrowing conditions?

Poor people are said to be more sensitive to the availability of credit than to its cost. Nevertheless, interest rates do play a crucial role in attracting borrowers. This is especially true for Peru where, much of the productive system is based on SMEs and microfirms whose borrowing capacity is extremely sensitive to interest rate variations.

Microfinance in Peru had always been characterised by particularly high interest rates. Intermediaries had total freedom to set their own interest rates and, until the end of the 1990s, they enjoyed a substantial oligopoly in the market. MiBanco and Financiera Solucion were the only regulated MFIs in Lima, and Cajas Municipales operated almost as monopolies in their respective provinces.

The creation of Edpymes, the geographical expansion of Cajas Municipales and the gradual shift of Cajas Rurales toward urban areas did not have a substantial impact on the level of interest rate charged on borrowers. Figures 24 and 25 show that Cajas Municipales and Cajas Rurales imposed a similar interest rate on their clientele. Even if there was a slight tendency toward a interest rate decline, CMACs and CRACs did not compete on rates aggressively. The greater number of MFIs did not seem to affect the financial strategies of MFIs already established in the market.
Figure 24. CMACs': Interest Rate on MSE Credits, Oct 2002- Jan 2004

Source: SBS

Figure 25. CRACs: Interest Rate on MSE Credits, Oct 2002-Jan 2004

Source: SBS
The widespread presence of micro enterprises is a good reason to believe that the potential clientele of MFIs is far from being exhausted and the expansion of financial intermediaries is still far below the demand. This explains the fact that, besides the increased number of financial intermediaries, a significant downward pressure on interest rates did not occur.

A similar conclusion emerges if we analyse the strategies of Edpymes, most of which operate in urban contexts in competition with other institutions. The interest rate charged by Edpymes at the beginning of 2004 for micro enterprise loans was eight points higher than their competitors, and the difference in the interest rate on consumer loans was even greater, more than 15 points. 34

This conclusion is further confirmed by looking at the interest rates applied by commercial banks to different client categories over the same timeframe. As shown in Figure 26, the interest rate for MSEs remained above 50% per year over the period. Clearly funding costs for micro entrepreneurs are significantly higher than for bigger firms and consumers.

**Figure 26. Commercial banks: Interest Rate as per Loan Type, Oct 2002-Jan 2004**

![](image)

Source: SBS

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34 See SBS database.
4.2 The variety of financial products offered

In 2003, loans for microactivities still represented more than a half of MFI portfolios (Figure 27). Peruvian microfinance intermediaries were facing increased competition in their core business: financing micro entrepreneurs.

However, the focus on microfirms did not occur at the expense of other sectors. In 2002, the percentage of MSE loans in the overall portfolio decreased by four points. As the expansion of other financial products such as consumer and commercial loans shows, microfinance institutions had started meeting clients’ other needs.

Consumer credits grew in 2003, accounting for 26% of MFI portfolios. This positive trend is mainly a result of ad hoc agreements signed between MFIs and public institutions (schools, provinces, municipalities) to finance the consumption needs of public employees. Under this financing mechanism, the MFI lends to the individual employee, but the monthly repayment is made by the institution, which deducts the repayment from the worker’s wage. The risks involved in this type of transaction are extremely low, and loan losses are significantly reduced (see Figure 28). The small risk explains the popularity of consumer lending among microlending institutions.

Interviews with MFI managers revealed that most public employees actually use these loans for income-generation. In the difficult economic context of Peru, they use them to set up activities such as taxi driving or small shops. In fact the expansion of consumer loans can be more plausibly related to the tightened conditions of the local labour market than to the greater variety of financial products.
Figure 27. Portfolio of Regulated MFIs as per Loans Type, 2003

Source: SBS

Figure 28. Loan Losses of Regulated MFIs as per Loans Type (% of Outstanding Loans), 2003

Source: SBS

Did financial intermediaries widen their financial services across sectors?

The distribution of loans across sectors reflects the geographical evolution described in Part Three. Peruvian intermediaries concentrated their financial resources in
supporting informal trade, which is mainly urban based with low fixed costs. The success of microloans in trade activities is explained by:

- their high concentration in certain urban areas;
- relative geographical isolation of local population;
- relevant cash flow in a short timeframe;
- low sensibility to economic downturn.

Credit for transport enterprises also showed a sustained expansion, which is partly explained by new products such as loans specially tailored for taxi drivers. Given the rate of under-employment, the Peruvian workforce has to look for complementary activities to generate extra earnings. Taxis represent one of the easiest solutions to this problem, as it is a market characterised by low entry barriers, high informality and negligible fixed costs for car owners. Another aspect of the expansion into urban areas is the increasing portion of the MFI portfolio invested in industrial activities. In 2003 industrial loans represented 7% of the portfolio as shown in Figure 30. A great percentage of these were due to Edpymes.\textsuperscript{35}

**Figure 29. MFIs loans as per sectors (% Variation), 1998-2003**

![Figure 29](image)

Source: SBS

\textsuperscript{35} In particular those created by the Chambers of Commerce or private investors.
The greater concentration of MFI loans in trade and urban activities had consequences for the agricultural sector (see Figure 29). Agriculture is characterised by particularly tight investment conditions: extreme uncertainty due to the risks related to natural phenomena, high investments in fixed assets, long-term cash flow and geographical dispersion. All these factors discourage financial intermediaries and particularly microfinance institutions from supporting agriculture. In addition, national and foreign investors prefer to finance MFIs on a short-term basis, which creates a further obstacle to the longer term agricultural loan schemes.

In conclusion, geographical expansion and greater number of financial intermediaries did not lead to a greater distribution of loans across different sectors. On the contrary, the tightened supervisory controls of the authorities and the short-term policies of national and foreign lenders had negative consequences for the expansion of microcredits for agriculture. The entrepreneurs served by Peruvian MFIs were primarily operating in urban contexts excluded from the formal financial systems because of the lack of collateral.

4.3 Outreach: did reforms have any significant result for the poor?

The third aspect which can be used to assess the overall improvement of borrowing conditions for the poor is social outreach. Social outreach can be measured
both by ‘breadth’ or ‘depth’. Breadth can be defined as the total number of borrowers reached by microloans. Depth can be defined as the number of poor people effectively benefiting from the loans.

**Measuring breadth of outreach**

The main indicator used to measure breadth of social outreach is the evolution of loans across time. In 2003, the total amount of loans was USD 68 million, more than four times the disbursement registered in 1998 (see Figure 31). This success can be attributed to the expansion of the Cajas Municipales. From 1998, when they accounted for 60% of the total amount of loans, CMACs strengthened their position in the marketplace. Five years later their share had climbed to over 72%. The expansion took place at the expense of CRACs, who lost half their market share. In 1998, they disbursed 33% of all microcredits, and five years later this was down to 15%. As for Edypmes, the amount of loans they disbursed was strongly dependent on the number of institutions operating in the market which, given their young constitution, greatly varied across the period.

**Figure 31. Amount of Loans per Regulated MFIs 1998-2003**

A higher quantity of financial resources invested in microfinance does not necessarily mean that the objective of social outreach has been accomplished. A better
measure of social outreach is the number of clients served by MFIs (assuming that the percentage of borrowers with more than one loan remains constant over time). As Figure 32 shows, from 1998 to 2003 the number of microborrowers more than doubled. The biggest expansion occurred in 2000 when Peruvian MFIs grew almost 24% over a year. With a market share around 80%, the performance of Cajas Municipales in client outreach is among the highest in Latin America. Allowing the CMACs to open branches outside their provinces clearly improved borrowing conditions for the local population. After 1998, CMACs’ market share decreased by seven points, which means that other types of MFIs were registering equally good performances. The contribution of Cajas Rurales to this social impact became clear in 2002 as they shifted their client base from agriculture to trade. This shift significantly multiplied the number of urban based borrowers with access to CRAC loan schemes. Edpymes, with a 12% market share in 2003, outperformed Cajas Rurales. Over the five years, Edpymes increased their portfolios by 80% – a notable success. Their numerical presence grew consistently from 1999.

**Figure 32. Outstanding Borrowers as per Regulated MFIs, 1998-2003**

Source: SBS

**Depth of outreach**

The most commonly used indicator to measure the depth of outreach is the average loan size as a percentage of per capita GDP. In 1998, as shown in Figure 33, CMACs, CRACs and Edpymes were targeting different types of clientele. Cajas
Municipales had a particularly low average loan per client (below USD 400) as they were operating in deprived environments using a prudential lending methodology based on progressive credits.

In the same year, the CRACs’ average loan was almost USD 1,800. They were operating in rural areas and setting up lending schemes mainly directed at agriculture. Edpymes were focused on micro enterprises and small firms, occupying a market niche between CMACs and CRACs (USD 1000).

**Figure 33. average Loan size as per Regulated MFIs, 1998-2003**

![Graph showing average loan size per Regulated MFIs, 1998-2003]

Source: SBS

The presence of local competitors induced a rapid increase in the average loan size of Cajas Municipales, which grew from USD 400 in 1998 to almost USD 900 in 2003. This upward path has to be attributed to an overall review of CMAC client evaluation methods, which were previously not adequate for a competitive setting. CMAC disbursements were often biased downwards so as to maintain a margin of security in case the loan went unpaid. This policy worked in an oligopolistic market, but competition soon prompted the Cajas Municipales to become more aggressive and to increase their average loan size.

Edpymes played a key role in this transformation. Taking advantage of the fact that bigger institutions tended to downgrade the repayment capacities of microfirms, these newly formalised institutions adopted simple and efficient criteria to build their portfolio:

- concentrate loans in specific geographical areas and within the same sector;
offer bigger loans to a smaller number of clients, as evidenced by the evolution of the average loan size;

• target the more affluent CMAC clientele by offering additional loans.

Edypmes did not possess the CMACs’ expertise to evaluate new borrowers. But by financing the CMACs’ clientele and offering further amounts of loans, Edpymes decreased their appraisal costs and mitigated the risk of disbursing loans to doubtful customers. This aggressive policy employed by Edpymes also affected the strategies of Cajas Rurales. The steady decrease in CRACs loan size is mainly due to their shift towards financing urban rather than rural activities, as described in Part Two.

In conclusion, the dynamics of the average loan size of the three regulated institutions describes a situation in which local MFIs became potential competitors for the same client niche. This is represented by the convergence of the three lines in Figure 33.

4.4 Cajas Municipales: pawn loans and credit range

From 1998, Cajas Municipales went upmarket and abandoned their traditional poverty orientation. Considering the importance of CMACs in financing small entrepreneurs, the increase in average CMAC loan size could lead us to the conclusion that financial and geographical liberalisation had a negative impact on depth of outreach. This may be so, but evaluating the depth of outreach purely by loan size may be simplistic. Evidence from case studies is necessary to shed some further light.

A typical pawn loan borrower belongs to the poorer segment of the population. He or she is usually someone for whom ownership of a quantity of gold is the only possibility for access to financial services. The evolution of pawn loans is thus a useful indicator with which to measure social outreach.

Information on the evolution of pawn loans is not available for all Cajas Municipales. Figure 34 illustrates the trend for three of the main institutions for which good information is available: the Cajas Municipales of Arequipa, Trujillo and Sullana.\(^{36}\) The growth rate of pawn loans is considerably smaller than the growth rate of the overall

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\(^{36}\) The particular sample has been chosen because of the greater transparency of the information provided. Due to their relative importance in the marketplace, these three institutions represent a good indicator of the whole CMAC system.
portfolios of the Cajas Municipales. In fact it even declined from 2001 to 2002. The fact that the proportion of pawn loans in the portfolios of Cajas Municipales shrunk implies that the outstanding performance registered by CMACs in the last five years was not accompanied by greater attention towards poorer segments of the population.

**Figure 34. Pawn Loans disbursed by CMAC sample 2000-2003**

![Bar chart showing pawn loans disbursed by CMAC sample 2000-2003](image)

Source: author’s reworking of MFI data

This conclusion is confirmed by an analysis of the strategy adopted by the CMAC Arequipa, the biggest in total assets after the CMAC Piura. The loans disbursed by this CMAC between 2001 and 2002 clearly show that there is a tendency to prefer upper size loans. The CMAC focused on issuing credits within the range of USD 2,000-10,000 and deliberately decreased the number of smaller credit loans (up to USD 500). Part of this shift can be explained by the greater number of consumer loans disbursed by Arequipa in 2002, most of which, because they were backed by public authorities, were larger. The trend is clear: Cajas Municipales were reacting to the tougher competitive conditions by moving up-market.
4.5 Gender outreach: the example of Edypme Edyficar

A different conclusion can be drawn from the strategy adopted by Edyficar, the biggest Edypme. Loans in the range USD 300 to 500 grew consistently during 2003 compared to the USD 3,000 to 6,000 range (Figure 36). Therefore this Edypme moved downscale towards lower income segments of micro entrepreneurs.
Information on the portfolio composition of Edyficar also allows us to examine the proportion of credits distributed to women. In one year, Edyficar modified its strategy by focusing on women, who became the predominant component of its portfolio (see Figure 37). This translated into more depth of outreach, as women represent the weaker part of society: their unemployment rate is higher and their credit needs are scarcely met.

The competitive pressure of bigger institutions prompted Edyficar to undertake a complete reassessment of its portfolio composition, so that it now includes a greater quantity of smaller loans which are mainly disbursed to women. Figure 38 shows how women are targeted through tiny loans, considerably lower in size than the average loans distributed to men.
Figure 37. Edypme Edyficar: Monthly Gender Trend as per No. of Loans 2003-2004

![Chart showing monthly gender trend as per no. of loans from 2003 to 2004.]

Source: Edyficar

Figure 38. Edypme Edyficar: Gender Trend as per Amount of Loans (USD) 2003-2004

![Chart showing monthly gender trend as per amount of loans in USD from 2003 to 2004.]

Source: Edyficar
The analysis of credit policies adopted by individual MFIs therefore indicate that some decided to concentrate on poorer segments of the population, while others preferred to upscale. This conclusion is complementary with the results analyzed in Part Four: competition between institutions led some institutions to diversify and target new unserved clients.

5. MFI strategies in the face of competition

The competitive pressure of diverse MFIs in the same geographical area led to the redesign of their strategies. The increased number of microfinance institutions in the marketplace did not bring about a downward pressure on interest rates, but MFIs competed in other areas such as personal guarantees, loan terms and repayment timings. Each of these aspects brought about more flexible delivery mechanisms and product designs.

5.1 Strategic flexibility of MFIs

MFIs showed impressive progress in adapting their credit supply to the needs of their clientele. In particular, their enhanced flexibility led to faster disbursements of loans and new forms of guarantees and incentive plans.

The number of days taken to process a loan is a key issue for a micro entrepreneur, as most micro entrepreneurial activities are characterised by rapid cash flows. Peruvian MFIs manage to drastically shorten the credit processing time by:

- a decentralisation of credit evaluations;
- more frequent meetings for credit approval;
- parallel loans.

MFIs decentralised loan approvals by strengthening the responsibilities of local managers giving them more decision-making power. This shortened the disbursement time and contributed greatly to reducing the funding gap of microactivities. This did not apply to larger loans had to be evaluated by a team of credit analysts and directly approved by a general manager. Dynamic MFIs also increased the frequency of evaluation meetings and
so that they now took place as often as twice a day. A further measure adopted to face urgent credit needs was establishing a parallel credit line to satisfy urgent requests from existing borrowers. As the evaluation of the micro entrepreneur is not necessary for additional loans, the disbursement is straightforward. This instrument was set up to meet the needs of borrowers with a good record of repayments, and proved to be useful for seasonal demand peaks.

**New guarantee policies**

Guarantee requirements were also revised. Previously each MFI set a maximum amount up to which a loan could be disbursed without a guarantee. Due to the increased presence of competitors, all MFIs shifted this limit upward (see Table 8). Aggressive competition also led to a relaxation of guarantee requirements. Generally speaking, MFIs realised that securing loans through borrowers’ fixed assets (houses, cars, shops) was not cost efficient. Recovering loan losses by selling physical assets is extremely cumbersome and time consuming, and the properties and businesses of most Peruvian micro entrepreneurs are usually located in the outskirts of cities and are extremely difficult to sell. The institutions also had to take into account the legal costs and the negative externalities involved in expropriations. As a result other types of guarantees were introduced. MFIs increasingly made use of documents that could attest the effective cash flow of the micro entrepreneur, like paid electricity bills and a certificate attesting the origin of the business. The business origin certificate stands as proof that the activity has been consolidated over time, which decreases lending risks. The competitive pressure also led MFIs to become more flexible in their risk evaluations: nowadays institutions require records of at least six months of business activity, whereas in 2002 the minimum timeframe requested was two years (see Table 8).

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37 Expropriating poor debtors invariably bad image of the institution in the minds of the local population. Cases in which the local community impeded the authorities from proceeding with the expropriation are not rare.
Table 8. MFIs’ guarantees and flexibility, 2001-2003

<table>
<thead>
<tr>
<th>Requirements</th>
<th>2001</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years of business activity</td>
<td>Two years</td>
<td>Six months</td>
</tr>
<tr>
<td>Maximum amount of loan without real guarantees</td>
<td>US$ 2000</td>
<td>US$ 5000</td>
</tr>
<tr>
<td>Type of guarantee requested</td>
<td>Fixed assets</td>
<td>Certificates of business activity, electricity bills</td>
</tr>
<tr>
<td>Maximum number of institutions per client</td>
<td>Not specified</td>
<td>Two</td>
</tr>
</tbody>
</table>

Source: author’s reworking of MFI data

As credit bureau did not provide real-time information on the effective position of borrowers, financial institutions set up their own systems to protect themselves against excessive loan losses. The most common was to fix an upper limit for the number of institutions lending to a single client. As a rule, an MFI does not offer credit lines to micro entrepreneurs who are already borrowing from two or more financial entities.

Incentives are an important tool to stimulate loans officials to look for possible lending opportunities. Throughout the period 1998-2003, Peruvian MFIs were particularly flexible and dynamic in setting annual targets for their staff. Incentives were assigned to specific targets such as: a consistent number of new clients, amount of loans disbursed, or number of small size credits. Monetary rewards were also introduced for tracking loan losses and for keeping them within predetermined boundaries.

5.2 Refinement of operational strategies

To face the challenge posed by the new competitive context, Peruvian MFIs introduced some key changes in their methodology and organisational structure so as to satisfy the needs of micro entrepreneurs and other clients. Significant results were obtained by:
- extending opening hours of branches;
- modifying the schedules of personnel;
- centralising information inquiry;
- creating new business areas.

Extending opening hours streamlined loan repayments, making it easier for microentrepreneurs to reach MFI offices outside their working hours. MFIs revised their staff schedules so as to reduce the amount of time spent at the office. As they spent much more time visiting clients, MFI analysts could share facilities such as computers and telephones, which reduced costs and enhanced productivity. To speed up evaluation procedures, the more dynamic MFIs appointed temporary employees to check the repayment capacity of potential clients on credit bureau websites, acting on telephoned instructions from financial analysts. MFIs also expanded the range of financial services. For instance, the outstanding performance of consumer credit has to be attributed to the fact that some MFIs appointed managers with the specific task of promoting these services.

5.3 Investments in technology

Updating lending techniques through the adoption of modern technology is an absolute priority for microfinance institutions, as they rapidly increase the scale of their operations. Relationships with clients were previously based on proximity and reciprocal knowledge. As the MFI grew in size and geographical coverage, improved technology proved to be a solution to overcome the asymmetry of information between lender and borrower.

The Peruvian Bank Supervisory Authority (SBS) played an important role in promoting advanced information technology to collect and store client data. In particular, SBS required MFIs to constantly update their system backup to better cope with the consequences of possible power blackouts. SBS also set stricter criteria for opening new branches. As a prerequisite for obtaining the licence for a new agency, MFIs had to show that they had the software to monitor the lending activity of all agencies and track the exposures of all their borrowers.
6. The influence of public policy on Peruvian microfinance

Isolating the effect of a single policy is particularly difficult in a context like Peru where other radical changes (such as labour reforms) occurred in the period under consideration. Nevertheless some links can be established which demonstrate the importance of the role of national authorities in the expansion of Peruvian MFIs.

6.1 The role of the authorities

Freedom to invest in microfinance

The regulation adopted by Peruvian authorities made investment in microfinance schemes extremely easy. This was true both for fully registered financial intermediaries (such as commercial banks and finance companies) and for other agents interested in channelling funds into fully licensed MFIs (such as private investors and Chambers of Commerce). Opting for market liberalisation increased the variety of lenders, which in turn multiplied the financial services opportunities for the public. The positive consequences of the regulatory regime were enhanced by the consistent presence of micro entrepreneurs, a typical feature of the Peruvian economic structure.

Liberalising geographical expansion of regionally focused institutions

The opened by the legal framework was followed by further measures to expand competition among financial intermediaries. Regional limitations for CMACs, the biggest type of MFI, were abolished in 2002 when they were authorised to expand outside their original departments. Allowing Cajas Municipales to open branches even all over the territory had a positive impact on what has been called “credit democratisation”. CMACs opened branches even in remote areas of the country, reaching people who did not previously have access to credit.

Strengthening financial controls

The liberalisation of the microfinance arena was accompanied by strict financial controls over intermediaries. This enhanced the financial solidity and transparency of the system. After a series of failures experienced by some MFIs, the market soon reached stability. MFIs authorised to gather deposits experienced an outstanding growth in savings
collection, demonstrating a renewed confidence of depositors among the public for microfinance institutions.

**Including non governmental organisations in the financially regulated system**

The creation of a new category of NGO-based MFIs known as “Edpymes” increased the number of regulated intermediaries in the marketplace. Former NGOs could benefit from their greater visibility to national and international investors, and thus facilitated their access to financial resources.

Specifically designed to provide loans to unbanked micro entrepreneurs, Edpymes targeted the same client group as other financial institutions, as demonstrated by the evolution of their average loan size. The fact that they grew within a short timeframe and under fiscal pressure greatly affected Edpymes’ financial solidity, making them particularly vulnerable to external shocks. For instance, an increase in the geographical proximity of competitors was sufficient to undermine their financial performance.

6.2 Consequences related to policy implementation

The public authorities laid the groundwork for effective competition among and between different types of financial institutions. Even though the majority of these policies were relatively recent, some of their effects already became tangible:

**Urban based development**

The new setting brought about a tendency toward the disbursement of microloans in urban districts and a corresponding decline of agricultural credit in the overall MFI portfolio. Geographical expansion was primarily focused on densely populated areas which were not fully saturated by already existing institutions. Expansion into villages did not occur for several reasons:

- Lack of proper evaluation techniques for village clients: Expanding credit activities to villages would require the development of specific financial tools to evaluate the assets and determine possible guarantees of the informal village micro entrepreneur.
High transaction costs: the fact that agricultural loans are so dispersed geographically is a serious cost obstacle for Peruvian MFIs, which have based their success on economies of scale through the promotion of credit in urban areas.

Relative scarcity of long term financing for MFIs: regulated MFIs did not possess the financial resources to invest in agricultural activities, which tend to require longer term financing. National and foreign investors were negatively inclined toward supporting MFIs, mainly the Cajas Rurales, which had a large exposure in agriculture. The same tendency existed among private depositors as shown by the difference in deposit collection between Cajas Municipales and Cajas Rurales. The financial structure of MFIs was characterised by short term liabilities that limited the possibilities to finance long term agricultural projects.

Differences among types of institutions

The impact of public policies differed according to the type of institution. Undoubtedly, the greatest success was registered by the Cajas Municipales which strengthened their position in the market and expanded all over the country. Three main factors explain this outcome:

- their gradual approach to microlending;
- the fact that CMACs could enjoy monopolistic rents for some years;
- the existence of a federation to represent their interests and to guide their overall expansion.

Once the liberalisation process designed by the authorities was complete, CMACs found themselves in a better position to take advantage of the new operating context.

The newly created Edpymes had to face a completely opposite situation. Their adherence to the regulated scheme was not gradual, since local authorities forced them to join it by increasing their fiscal burden. Because the market turned out to be highly competitive, the Edpymes had little time to refine their financial products and acquire a stable clientele. Originating in NGOs, the majority of them had to modify their techniques,
issuing only individual loans and pursuing a for-profit strategy. Moreover, they were not backed by an apex institution to coordinate a systemic development with a substantial decrease in costs and a widespread know-how.

The evolution of Cajas Rurales can less be considered as a direct result of policies implemented by the authorities, but more as a natural market outcome. Economically and technically unprepared to disburse agricultural loans, these institutions diversified their investments by greater participation in urban microfinance and became effective competitors to other types of MFI. As a direct result, the supply of urban microloans increased at the expense of agricultural microcredit. After the failure of the National Agricultural Bank, Peruvian agriculture remains highly undercapitalised and its credit needs are scarcely met.

**Differences within types of institutions**

After 2000, the gap between MFIs of the same type widened, both in financial performance and institutional arrangements. The new competitive setting led to a search for increased profitability among individual intermediaries, which hindered systemic alliances such as those established through apex institutions. This was particularly true for the Cajas Municipales whose Federation initially played an important role in coordinating the development of its members, but nowadays has been marginalised by the bigger CMACs.

The differences among institutions were determined by the following factors:

- the geographical expansion of MFIs;
- individual technological improvements;
- MFIs’ flexibility in relation to their clientele.

**Social outreach and the role of market practices**

The public policies had various consequences for social impact. The increased number of regulated institutions and their geographical expansion led to considerable breadth of outreach as expressed by the number of borrowers served during the five years under review.

The lending policies of the different MFIs brought about different consequences for depth of outreach. Table 9 shows the clear differences in depth of outreach between Cajas Municipales and Edpymes. Increased competitive pressure pushed CMACs to adopt
more aggressive strategies to consolidate their dominant position in the market, whereas the weaker structure of Edpymes forced them to redirect their financial products to newer and unexplored market niches.

**Table 9. Depth of Outreach for CMACs and Edpymes**

<table>
<thead>
<tr>
<th></th>
<th>CMACs</th>
<th>Edpymes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average loans trend</strong></td>
<td>Increase in the average loan size</td>
<td>Decrease in the average loan size</td>
</tr>
<tr>
<td><strong>Segmentation trend</strong></td>
<td>Tendency towards disbursement of larger sized loans</td>
<td>Tendency towards the disbursement of smaller sized loans</td>
</tr>
<tr>
<td><strong>Target clientele</strong></td>
<td>Smoothed growth of pawn loans</td>
<td>Expansion of credit addressed to women</td>
</tr>
</tbody>
</table>

One should bear in mind that the adjustment process for each type of MFI has just begun. The predominant issue in the near future will be competition in interest rates from commercial banks.

**7. Concluding remarks**

Financial and geographical liberalisation undertaken by Peruvian authorities had a positive impact on the expansion of financial intermediaries targeting poorer segments of the population. Facilitating the access of national investors and enabling them to set up microfinance programmes multiplied the number of institutions involved in financing local micro entrepreneurs and other clients. As a consequence, the number of loans increased, with beneficial effects for social outreach.

The competitive pressure engendered a dynamic process of redesigning lending schemes and improving disbursing techniques. The financial institutions designed innovative strategies for their clientele and improved their technological systems. The tendency overall was a shift from a supply-driven to a demand-driven approach, in which the single micro entrepreneur received increasing attention from financial intermediaries.

The microfinance expansion is not over. The presence of an extensive potential demand for microfinance products in the main urban areas of Peru has slowed down a more significant reduction of interest rates charged to local borrowers. As a consequence,
incentives for extending lending schemes towards other productive sectors of the economy have not yet emerged. Manufacturing and agriculture are still under-represented in the portfolios of Peruvian microfinance institutions.

MFIs are still highly focused on supporting unskilled micro entrepreneurs such as in small trade and transport, which represents the immediate response to short term under-employment. The large fraction of unmet demand in urban contexts, the risk aversion of some MFIs, and the lack of expertise to set up agricultural lending programmes are the main obstacles for further expansion towards more productive sectors and unexplored geographical areas.

Competition is likely to come from downscaling commercial banks. This could well lead to a sharp decline in interest rates and a further realignment of the financial system. The outcomes will most likely be a more complete coverage of the country geographically, and more extensive support for productive sectors.

The case of Peru demonstrates that liberalisation in itself is insufficient to promote an expansion of financial services for the poor. It must be accompanied by a transparent and clear regulatory framework and by effective supervision by local authorities. Peru stands as a clear example to show how strengthening financial control over local MFIs enhances the stability of the system, and consequently attracts an increasing amount of foreign investment.
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Finance companies: Financiera Solucion

National authorities: SBS, COFIDE, FOGAPI
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