Regulatory Frameworks, Weak Ties: Determining the Efficacy of Microfinance in Latin America

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Microfinance has recently emerged in many developing nations as an attractive anti-poverty, economic development tool. Microfinance describes a broad range of financial services, including credit, savings, insurance and more, enabling very poor families to participate in productive economic activity or develop existing micro-enterprises. Microfinance has become an increasingly important part of the financial sector due to its demonstrated capacity for helping poor and marginalized populations generate greater income. Given the significance of this role, I would like to focus on what factors make microfinance most effective for clients.

Because microfinance is generally funded by non-governmental organizations and private donors, the role the government can play in forming effective institutions is often overlooked. However, it seems problematic to discount the government’s ability to affect the functioning of financial markets. I would like to evaluate the importance of government support in the form of regulatory and supervisory frameworks for creating institutions that provide successful results for their clients. I will argue that regulatory and supervisory states which create a context in which “the strength of weak ties” can function will result in more effective provision of microfinance services by creating better relations between banks and clients.

A growing body of literature emphasizes the importance of interpersonal relations between banks and clients. Customer loyalty is one of the secrets of success in countries which have achieved impressive results for clients. A flexible and decentralized regulatory framework allows financial institutions to operate more effectively and better respond to client needs. Weak or poorly functioning regulatory frameworks produce ineffective institutions which are unable to serve client needs.
I seek to understand the role public policy related to regulation and supervision has played in development of microfinance through examination of two Latin American countries: Bolivia and Mexico. Bolivia represents one of the most well developed markets for microfinance in the world, while Mexico represents an underdeveloped market with much potential. I will examine the differences between the two regulatory states to determine the effect this has had on the microfinance sector. Both countries have experienced economic crises and policies of economic liberalization within the last thirty years, which have contributed to an interest in and need for microfinance.

To place interpersonal ties within a theoretical basis, I will utilize Mark Granovetter’s theory of social networking, “the strength of weak ties”. Granovetter says that information is most quickly and usefully translated among social groups that have weak ties to each other. He finds that information “to be diffused can reach a larger number of people, and traverse greater social distance […] when passed through weak ties rather than strong.”\(^2\) He explains that “those to whom we are weakly tied are more likely to move in circles different from our own and will thus have access to information different from that which we receive.”\(^3\) He uses the theory to explain the transmission of information about jobs among blue collar laborers in the United States. The same kind of dense communities joined by weak ties also exist in dense urban areas, such as La Paz and El Alto, Bolivia or Mexico, D.F., Mexico. This theory can be applied to explain how information about financial services is transmitted in such communities.

I hypothesize that countries with flexible regulatory institutions that allow for decentralization will see that clients in urban areas will transmit information about banks among themselves. I believe that in Bolivia the government has created a framework to
enhance the capacity of weak ties to function. The Bolivian regulatory structure allows for microfinance institutions to operate flexibly so they can better address their client needs. In so doing, they will build up a client base that is loyal to the institution and will transmit information about their experiences to other potential customers.

Jack Knight builds upon Granovetter’s theory. Knight observes that within social institutions actors can anticipate the actions of other actors. These institutional rules establish reliability of expectations. In the case of microfinance institutions clients know how banks will act and banks know how clients will act given past reputations or expectations. However, because there is still some uncertainty, contracts and guarantees take on a new importance.

The well being and healthy functioning of microfinance institutions is dependent on the ability of such institutions to build and maintain relationships with clients. Public policy that encourages weak-tie networks will enable the capacity of institutions to grow and to build trusting relationships with their clients. Due to the progress of microfinance, impoverished clients now can walk into banks and feel confident that they will be treated with basic human dignity. This was not so twenty years ago in Latin America.

I will argue that the decentralized and porous regulatory and supervisory framework established by the Bolivian government has led to successful outcomes for their microfinance institutions, particularly with regard to client interactions. Meanwhile, the weak regulatory framework coupled with a high level of government intervention in Mexico has created microfinance institutions that fail to meet market demand and have produced poor relations with clients.
I argue that effective regulatory frameworks which create an environment in which weak ties can prosper also dispel problems associated with information costs. The principal-agent theory describes the difficulties in situations with incomplete and asymmetric information. To offset the asymmetry of information between social actors requires a great deal of preemptive costs. Information costs include costs associated with acquiring, processing and using information. For microfinance information is necessary for institutions to know who will be a trustworthy lender. However, good regulation will reduce these information costs. In Bolivia, regulation that decentralizes to individual institutions allows institutions to create better relationships with each unique client. In an environment in which there are reliable expectations, financial institutions trust clients and clients trust financial institutions, the costs of acquiring information are not so great.

**The Study**

The dependent variable in this study is the successful performance of microfinance institutions. I use indicators of success of microfinance scholar Claudio Gonzalez-Vega. He argues, “A good microfinance program actually exhibits an attractive combination of: (a) quality of outreach, (b) cost of outreach, (c) depth of outreach, (d) breadth of outreach, (e) length of outreach, and (f) variety of outreach.” I hold that institutions are enabled to create successful institutions through regulatory and supervisory policies. The independent variable is regulatory and supervisory policies. 

**Microfinance in Theoretical Perspective**

Many scholars note that good governance is a necessary prerequisite for microfinance development. For example, Rhyne (2001) asserts that worldwide strong
macro-economic policy and low levels of inflation are necessary prerequisites for the development of microfinance institutions.\textsuperscript{6} Scholars are also united in their view that regulation and supervision are necessary and that to build “efficient financial institutions requires time, skill, appropriate institutional design, and a favorable macroeconomic and regulatory environment.”\textsuperscript{7} The advantages of regulation and supervision include: evaluation of ability to repay, decentralization of operations, risk diversification, and changes in policy to lend to people who cannot guarantee loans (which leads to changes in the prudential norms for risk management).\textsuperscript{8} One of the most important benefits of regulation is that it creates a more trustworthy environment in which malfeasance (either from the financial institution or the borrower) is not a likely possibility. In this environment, weak ties will function and clients will transmit information about microfinance institutions among others within their communities.

Before I address regulation, I must note that the historical and political context of each country ought to be taken into account when considering the necessary provisions for regulation. Scholars have observed that governments must properly administer regulatory policies to make them work most effectively. Gonzalez-Vega notes that the government role in developing access to credit in rural areas is particularly difficult because policy makers must determine, based on a specific economic and social context, when finance matters and will be most appropriate.\textsuperscript{9} He argues that government has an obligation to provide infrastructure to facilitate the development of microfinance services.

Recent literature is beginning to take notice of interpersonal relationships between banks and customers. Scholars observe that customer loyalty is one of the secrets of
success in countries with impressive results. This customer loyalty is the result of face
time and excellent service. The capacity to provide this service is partly the result of
regulatory practices that allow for outreach. When an unregulated institution makes the
decision to become regulated (also know as “upgrading”) it is usually “to better serve the
clientele”.\textsuperscript{10} Regulatory practices that allow for outreach to better serve clients can then
be served by the strength of weak ties. If clients are well served by a microfinance
institution, they will transmit that information to family members, friends, acquaintances,
neighbors, and any other contacts with which they may have ties. Such experiences will
also help to build reliable expectations of interactions between clients and financial
institutions.

In addition to the possibility that the institutions will function better, sound
regulation and supervision also protect clients. The benefits of regulation to clients of
microfinance include “access to permanent, stable and growing sources of financing and
provides them with information to make informed choices”.\textsuperscript{11} Because regulation creates
a more trustworthy environment, the lending process is much easier for both borrower
and lender. Regulation increases efficiency in institutions and allows them to lower
costs, which allows them to lower interest rates, an important advantage for customers of
microfinance.

Because effective regulation allows institutions to become sustainable they do not
have to worry about sources of funding. Funding remains a possible bottleneck that can
hold microfinance institutions back, particularly in terms of client outreach. Donor
subsidies are no comparison to financial sustainability and are often subject to whims and
can be strongly affected by exogenous shocks. When microfinance institutions become
part of the formal financial system they can then access capital markets with which to fund their lending portfolios, rapidly expanding the number of clients they can reach.\textsuperscript{12} In addition, the ability to borrow from depositors and commercial investors and then establish their own finance base means market permanence.

More importantly for clients, institutions that are subject to regulatory and supervisory structures can compete fairly. They can have access to information in credit bureaus, which allows them to better select clients and build relationships with trustworthy clients. With regulation financial institutions can insure deposits, which will increase the confidence of depositors. For borrowers a stable regulatory environment means they can have access to permanent, stable and growing source of financing.

Bank supervision is made possible with the appropriate legal and regulatory framework supporting the development of a low risk financial system, good accounting system, and respect for contracts. A supervisor establishes and enforces rules that promote secure operations and good performance of all segments of the banking sector. Supervisory structures also manage the credit bureau or central credit registry. Rule enforcement and sanctions for noncompliance can be instrumental in building reliable expectations for clients and institutions.

However, there are also times when microfinance benefits from the absence of regulation. When confronted with a weak state, a regulatory body that does not properly accomplish goals can be more detrimental than helpful. Governments and donors have been excited by the idea that “NGOs would be able to fill rural finance gaps and respond to the needs of the rural population”\textsuperscript{13} in situations in which the government is unwilling or unable. However, when regulatory frameworks are improperly implemented
(particularly by inexperienced politicians or regulators) they can harm the development of microfinance. Rosales (2006) says that regulation can only be properly developed with professional, independent and credible regulators, donors and politicians with a long term vision and managers of MFIs who would like to see long run returns on their investments.14 Pressure from donors or politicians can be as detrimental as a weak state that cannot provide the proper infrastructure for regulation.

Some institutions are unable or unwilling to undergo the transformation into a regulated institution. These institutions, primarily NGOs, lack the resources, skills or security to successfully transform. Many prefer their non-profit status in terms of targeting the most poor and avoiding the costs of upgrading. Some criticize institutions that have “upgraded” to become regulated because this process is not only associated with sustainability, but also profitability. In some Latin American countries pressure to integrate microfinance into the regulatory structure come “from purely commercial interests: traditional financial intermediaries interested in gaining entry into the microfinance market.”15 With the potential to make profits some worry that banks will become so focused on making money that they will experience “mission drift” and begin to ignore the original goals of microfinance. Given that regulation does increase potential for profits, this is a legitimate concern. However, close observers of Latin American microfinance assert that upgrading “is not necessarily upgrading the clientele; it is upgrading the institution to better serve the same type of clients.”16

Comparative Case Study: Bolivia and Mexico

I will use a paired comparison of Bolivia and Mexico to understand the differences in regulatory framework, context, and history in these two countries for the
different outcomes of microfinance. In my qualitative comparison of the two countries I will evaluate regulatory and supervisory policy and how this has led to different outcomes for microfinance in each country, particularly in terms of client relations. I will also include an evaluation of historical, political and social factors that have shaped each country in addition to economic policy. I will qualitatively evaluate causal relationships in each country, determine intervening factors and determine what caused differences and similarities in the outcomes.

I wish to examine how regulatory and supervisory policy impacts institutional governance structure which in turn impacts client relationships, client performance, and outreach to clients. A comparative analysis of Bolivia and Mexico will highlight successes, failures, policy implications and the role of history, socio-economic factors and natural endowments in the ability of microfinance to provide effective outreach.

**Bolivia: Economic Crisis and Regulatory Oversight**

Financial sector reforms in Latin America in the 1980s and 1990s created space and incentives for microfinance to develop through liberalization of interest rates and exchange transactions, reduction of legal reserves, elimination of credit controls, authorization for institutions to operate as full service banks, closing of public banks (ending policy of indiscriminate subsidies), strengthened prudential and supervisory framework of financial system to mitigate moral hazard, adverse selection of clients and other risks that exist in less well regulated financial systems. Bolivia was one of the strongest proponents of reform during this time.

In 1985 Bolivia initiated a series of economic reforms as part of its New Economic Policy under President Paz Estenssoro. This economic policy dismantled the
system of state capitalism since nationalization in 1952. Reforms were intended to stabilize the country after it had been struggling with hyperinflation, debt and economic distress. The entire financial system of Bolivia was liberalized as a result of these reforms. Specific reforms within Bolivia that created a viable market for microfinance include:

- liberalizing interest rates, eliminating directed credits, closing state banks and subsequently closing weak private banks, instituting a universal bank system, reducing the levels of reserves required on deposits, permitting financial institutions to accept deposits in foreign currency, strengthening the Superintendency of Banks and Financial Institutions (SBEF) both technically and in terms of increased autonomy from political pressure.  

These reforms created an environment in which microfinance could develop by promoting low levels of state involvement in the entire financial sector in Bolivia.

Liberalization in the 1980s enabled the rise of microfinance because liberalized financial systems are more effective, even in providing financial services to the poor.  

Closing public banks was an important step in moving towards microfinance development as these banks often operated inefficiently. These banks distorted credit markets and harmed credit culture by discouraging entry of private commercial institutions and by granting loans at subsidized rates to preferred clients.  

Bolivia was unique in the 1980s as one of the only countries to completely eliminate public banking. This left a space for providing financial services to many sectors of the economy, as well as a market niche for microfinance to fill. The first providers of microfinance developed about a year after reforms were enacted and public banks were closed. Private sector liberalization was crucial in the development of microfinance.  

Before financial reforms, regulators set ceilings on interest rates. Liberalization brought about full deregulation of interest rates in Bolivia. Interest rate deregulation is
important to microfinance because interest rates for microloans must be above prime commercial bank lending rates to cover the costs of making such loans. Of all the financial reforms, closing public banks and interest rate liberalization were most significant in facilitating an environment in which microfinance could develop. This is also one of the first steps towards meeting client needs. It has been observed that clients of microfinance are willing to borrow, no matter the interest rate.

The SBEF, however, played one of the most important roles in facilitating the growth of microfinance institutions. Reforms gave them greater power to operate as an autonomous institution, separate from political concerns. Although the first microfinance institutions in Bolivia were not in compliance with regulatory norms, the SBEF allowed them to operate. The first NGOs providing microfinance were very informal, with high operating costs. Many operated at around 20 percent or more, while mainstream commercial banks generally operate around five percent. Prodem’s original portfolio actually violated bank regulations as it was comprised solely of unsecured loans. However, the SBEF had enough confidence in the sector that they felt a few years might be necessary for institutions to develop. Reforms that strengthened the Superintendency, particularly the greater independence from political processes, were crucial for microfinance development. Many scholars have noted that a more politicized or less professional Superintendent’s Office could have stifled the successful development of microfinance.

The SBEF worked with NGOs to create fondos financieros privados (or private financial funds, hereafter referred to as FFPs), an institutional structure specifically
designed for the regulation of microfinance. The SBEF also worked with NGOs to create a specific regulatory framework in which could be established with regulatory principles. This involved actually creating a new regulatory category for microfinance institutions:

- to become licensed intermediaries without having to meet all of the requirements to become a commercial bank, particularly requirements relating to minimum capital and some of the more sophisticated banking operations.\textsuperscript{25}

For borrowers, the creation of FFPs meant that they had greater access to permanent institutions with greater financing options. It also meant that operations would become more decentralized. With fewer directives from a central power and more control on a local level, institutions were enabled to respond directly to the needs of their specific clientele, without the bureaucracy that defines some other regulatory states. In interviews with the management staff of BancoSol, each member highlighted that their institution specifically understood the needs not only of low income entrepreneurs in their city, but also in specific neighborhoods. They described the respect they have for their customers and emphasized customer loyalty as a key ingredient to their success.\textsuperscript{26}

The presence of a regulatory structure that allowed for the creation of such institutions helped to strengthen microfinance as a social institution. This created institutions specifically designed for the needs of their customers. The existence of these social institutions creates expectations for all actors in the system. Customers of microfinance can anticipate how they will be treated by banks, can know the rules of financial institutions and the reliability of such expectations guide social interactions. Such knowledge leads to better outcomes for both clients and institutions.

\textsuperscript{1} Supreme Decree 24000 of May 1995; passed into law in 2001 as Law 2297.
Before microfinance was the large and competitive industry that it is at present in Bolivia, would-be clients of microfinance had only one financing option: “short term credit at high interest rates from informal lenders.” Presently there are twenty microfinance institutions operating in Bolivia. They include non-profit (NGOs), banks, cooperatives/credit unions, non-bank financial institutions, and others. The institutions are generally characterized by successful outcomes in terms of client outreach and performance. This is, to a great extent, the result of a “unique combination of a non-interventionist financial sector policy with a strong (though non-interventionist) backing for microfinance.” Many scholars have determined that standards in conjunction with flexibility are the key to successful microfinance development, given the example of the Bolivian experience. The flexible regulatory structure allowed microfinance institutions to better serve clients and to build up a large client base.

Part of the success in building institutions comes from the way in which clients transmit information among themselves, as described by Granovetter’s strength of weak ties argument, which bolsters expectations of institutions. A client in the Garita de Lima branch of BancoSol said, “I never have had a problem paying back any of my loans. When we pay back our loans, we know we will be able to take out more in the future.” Clients are aware that the relationships they maintain with financial institutions are important and can expect that failure to pay back loans will result in poor relations in the future. An employee for the Alonzo de Mendoza branch of BancoSol said the employees of BancoSol,

develop relationships with their clients with the “plus” principal which makes them more than a bank. They talk with and get to know their clients. They also respect their clients schedules; many clients work 18 hours a day and they respect and value the time that they do have to give to the bank.
As Bolivian institutions have grown and upgraded into full commercial banks, there have been many concerns about the possibility of mission drift. However, rather than mission drift, we can observe the exact opposite. Institutions like BancoSol are able to serve more clients than ever, some with larger loans, but also continue “to focus a major share of their lending on small loans geared to people below the country’s poverty line.” Regulation increases institutional capacity and the ability of institutions to reach out to greater numbers than ever before. Further, interviews with BancoSol employees demonstrated that they are committed to building good relations with their clients.

Additionally, such institutions were also able to productively counteract the effects of the crash in micro-lending in 1999/2000. With increased commercial entry due to the relatively relaxed regulatory framework, Bolivia saw a rise in consumer lending in the late 1990s. Consumer credit is similar to microfinance in that lenders “offer loans about the same size as micro-enterprise loans, very quickly and flexibly, primarily on the basis of a worker’s salary.” Although the loans are primarily intended to target the middle-class, there is often a great deal of overlap between the two. Consequently, many clients of microfinance saw more loans that were easily available to them, and soon became over-indebted. This over-indebtedness coincided with an economic recession in South America in 1999 that hit the informal sector particularly hard. The SBEF tried to regulate consumer lending to control the problem of over-indebtedness. The most important provision of this regulation “limited the client’s total debt service to 25 percent of his salary. Thus a client who already had a substantial […] loan would likely not qualify for a consumer loan.” However, new regulation came too late and consumer lending crashed in 1999, leaving a severely weakened microfinance sector. Microfinance
lenders saw the highest delinquency ever in Bolivian microfinance as well as declining profits in the aftermath of the crash in consumer lending.

Clearly, the sector could have benefited from tighter regulations on consumer lending at the time. However, in the crisis of 1999/2000 the microfinance sector was able to use well-established mechanisms of the SBEF to attempt to control the situation before it hurt microfinance too much. They began by using the SBEF’s Central de Riesgo (Credit Bureau), to obtain reports on the indebtedness of clients. However, because the system was not properly updated, it was not enough. The Superintendent issued tighter regulations including “greater emphasis on repayment capacity relative to past group performance [and] greater emphasis on tangible collateral.” The SBEF also granted a one time amnesty for rescheduling loan repayments to deal with clients who wanted to repay their loans, but simply were not capable at the time.

The crisis however did serve to highlight the successful client outreach programs of Bolivian microfinance providers. FIE, a Bolivian microfinance institution, dealt with the crisis by focusing on clients as individuals. While clients were struggling with overindebtedness, the staff “paid direct visits to people with problems, examining their difficulties in depth, rescheduling their payments in depth, and sometimes even forgiving their debts.” FIE was able to offer such services to their clients because they had a system of credit assessment to fall back on, which was already in the infrastructure for microfinance providers in Bolivia. The regulatory structure in Bolivia provided the means for institutions to work with their clients to recover from the crisis. However, beyond the means provided by regulation, individual institutions worked to create better social outcomes for themselves and their clients.
The sector has since recovered. Although the crisis could have been avoided by more prudential regulation on the part of the SBEF, it was ultimately the regulatory structure of Bolivia that helped recovery. For institutions like FIE the already established and reliable credit bureau was helpful for determining which clients to reach out to in times of crisis. Clients that had been reliable or had extenuating circumstances benefited from the personal touch that FIE offered. These are the kinds of positive reviews of institutions that can be effectively communicated through weak ties.

Presently microfinance in Bolivia has achieved important markers of success. Loans are widely accessible to Bolivia’s urban poor. Loubiere, Devaney and Rhyne (2004) even go so far as to state that “the goal of providing access to microfinance services to the poor was largely accomplished in the urban areas by the end of the [1990s].”\textsuperscript{37} According to the Microfinance Gateway, in Bolivia, “urban poor have close to 100% access.”\textsuperscript{38} However, while penetration of the urban market is very high in Bolivia, the rural market is characterized by very low levels of penetration. In total, “only about 50% of economically active informal sector has access.”\textsuperscript{39} Many providers are reluctant to expand operations into rural areas because of the risk associated with agriculture. This will be the next great challenge for providers of microfinance in Bolivia. However, in urban areas, Bolivian microfinance has achieved the mark of a successful microfinance institution in both depth and breadth of outreach.

The competitive nature of the market has also pushed interest rates down. While interest rates were as high as 80 percent in the 1980s, they are now generally as low as 22 or 23 percent from most providers. Competition has also improved quality of service. In interviews with BancoSol employees they all prided themselves on the quality of their
service as compared to other banks.\textsuperscript{40} Awareness of the competition made them more committed to providing good quality with a personal touch.

Table 1 (Appendix) illustrates the extent to which microfinance has been able to penetrate the market for microfinance in Bolivia as of the year-end in 2006 as compared to year-end in 1998. The comparison is limited by which institutions have made data available, but it demonstrates the growth of microfinance institutions in Bolivia. Microfinance has become an important picture of Bolivia’s overall development picture as it has evolved from small NGOs in the 1980s into full scale financial institutions at present time. Some of the biggest and most important microfinance providers are regulated and perform well relative to the rest of the financial sector in Bolivia.

Granovetter and Knight both focus on social interactions and their theories can be applied to explain the functioning of microfinance institutions in Bolivia, and to understand their general success. Granovetter’s theory focuses on the transmission of information among social groups. I argued that regulatory structures which create strong microfinance institutions allow the strength of weak ties to function: satisfied clients will spread information about their experiences among their social groups. Knight describes how successful social institutions are created, with one of the most important elements being institutional rules and the reliability of expectations. Regulation of microfinance in Bolivia establishes institutional rules and expectations that both clients and banks can rely upon. Bolivia’s regulatory framework established a social environment in which institutions could grow, become financially sustainable, and continue to reach out to the poor who need financial services. Bolivia provides one of the most striking examples of how regulation can enable microfinance to accomplish social goals.
**Mexico: Finance and the Role of the State**

Microfinance in Mexico has developed very differently than in Bolivia for many reasons, but two drastic differences must be immediately addressed. With a population of almost 100 million, Mexico is more than ten times bigger than Bolivia. The greater population leads to “much greater stratification in the financial system [and] means that the banking authorities must cope with a much larger number of institutions.”

Even without taking into account all the additional factors that have created difficulties in Mexican microfinance development, a larger population and a high degree of stratification in the financial system create a situation that is inherently much more difficult than that of Bolivia.

The development of Mexican financial markets has been characterized by a high level of state intervention since the Mexican Revolution and continuing until present time, especially in rural financial markets. In Mexico, rural finance has long been a crucial feature of economic development and well-being. For many years, state development banks supported rural agricultural projects and this was one of the only forms of finance available to Mexico’s rural poor. Particularly, “until the end of the 80s rural politics were a clear priority for the state and played a fundamental role in finance for production, technical assistance and commercialization by means of substantial transfers.”

In the 1980s, the government decided that in order to improve their ability to provide good service to the rural sector they should segment the agricultural market. The government designed FIRA to finance big, medium, and small producers and BANRURAL to cover low-income people in rural areas.
Economic reform in the 1980s “meant drastic changes in the financial system, like privatization, international opening of the banking system, and the elimination of restrictions (such as direct credit, quotas, liberation of interest).” The environment of reform also included an effort to turn public sector development banks into second floor financial entities. BANRURAL significantly decreased in size. Credit cooperatives developed all over rural areas of Mexico. They were defined as informal credit operations and functioned outside of legal limitations and operated as the precursors to microfinance in Mexico. The 1990s were characterized by intermittent efforts to create government programs to regulate urban cooperatives and stimulate access to finance in rural areas. Such programs never achieved the desired outcome of regulation and instead saw a great deal of ineffective government oversight.

At present, there are a large variety of microfinance institutions in Mexico that provide microfinance services, including savings and credit cajas, cooperatives, 
*Sociedades Financieras de Objeto Limitado* (SOFOLSs) and governmental institutions. However, the presence of so many different types of institutions with different objectives and means of achieving them has created a fragmented system of microfinance, which has served to muddle microfinance. Scholars have observed that:

poor regulation and low standards can harm the financial system more than the absence of a suitable regulatory framework, as is demonstrated by the case of Mexico, where three different classes of institutions have been allowed to provide microcredit services, each with different levels of loan loss provisioning for the same category of debtor risk.

The lack of uniform regulation means that within government institutions there is a lack of cohesion in provision of services. There are second floor financial entities that grant funds for loans through entities such as PRONAFIM, FIRA, FINRURAL, and NAFIN.
There are also programs that provide technical assistance to financial entities such as PATMIR and BANSEFI. Finally, there are government economic development programs that provide services directly to the public, which also includes BANSEFI.\textsuperscript{47} There are several positions of government secretaries that are also committed to the development of microfinance services. These include the Secretary of Social Development, the Secretary of the Economy, and the Secretary of Agriculture, Livestock, Rural Development, Fisheries, and Food. By providing technical assistance, funds, or developing government run microfinance institutions the government has taken an interventionist role in providing finance since the 1980s. However, the government has simultaneously failed to provide regulation for non-governmental programs until 2001.

In some cases of rural development during the 1980s the government involvement only served to confuse the aims of microfinance. During this time, the state would sometimes grant “subsidies and transfers to rural families in large quantities.”\textsuperscript{48} Thus families became accustomed to accepting subsidies and were not accustomed to taking out lines of credit and do not already have a culture of repaying debts. This created a challenge for institutions attempting to bring microfinance services to such potential consumers in rural areas.

Poor regulatory and supervisory oversight by the government in Mexico has produced poor institutional results, which also means that clients are receiving poor service. Although high levels of interest rates rarely prevent clients from borrowing, they can be detrimental to a client’s success. Micro-banks sponsored by AMUCCS (Mexican Association of Credit Unions in the Social Sector) in the Mexican state of Puebla suggest a troublesome situation. In small rural areas, these banks are lending to clients for
interest rates as high as 50% annually. What’s more, the clients are generally engaged in rural economic activity, such as agriculture, and simply use the loans to buy food and avoid migration. When the time comes to pay back their loans, they are unable. This creates a situation of high arrears. Even more troubling, there is a low level of trust between the bank and clients.

Government programs can also muddle the aims of microfinance programs. Significant overlap across political administrations. The administration of President Fox hoped to instigate greater microfinance programs to combat poverty. But in so doing, they created many programs that overlapped with past microfinance programs. Although each program has similar goals, there is a lack of continuity that hinders their ability to create successful microfinance institutions. This, coupled with a lack of effective communication has led to a very complicated network of government programs that fail to effectively communicate with regard to how to accomplish goals together.

Government programs to provide funding to microfinance organizations through PRONAFIM or FIRA have made it difficult for institutions to provide the kind of service they would like to for their clients because they spend so much time dealing with government programs, especially those that distribute funds. Without the proper regulatory structures in place the government takes on an interventionist role which distorts financial markets. We can observe a crowding out of private institutions because the government monopoly has effectively removed incentives to enter into the market. In the instance of providing funding, many private institutions have found this to create a disincentive in the Mexican market. When government programs also offer financial services to low-income sectors of Mexican society this poses a challenge to private
institutions or NGOs. The participation of the government and the creation of microfinance programs from the state, “directly compete with non-governmental financial entities.”\footnote{53} As we have seen in the Bolivian case, competition can be a positive force for microfinance in that it can push down interest rates and increase quality of service offered to clients. However, in the Mexican case, competition from government run financial entities creates additional disincentives for private institutions.\footnote{54}

Government policies can also create feelings of insecurity for private institutions because they are aware that policies can change with each new government and disadvantage their operations. For example, the government “has the ability to impose ceilings on the interest rates charged on loans.”\footnote{55} When private institutions know policies like this can change at any time they feel ambivalent about participating in such an unstable market. Limiting competition in this way is detrimental for the clients. If clients only have one available institution they may be receiving much lower quality of service than they would in a situation of competition. The lack of consistent regulation across programs is clearly problematic and creates roadblocks in development of microfinance. Policies across institutions are inconsistent, clients do not know what to expect from financial institutions, and financial institutions do not know what to expect from policy makers.

A more reliable regulatory would help private institutions to feel more secure. In 2001 the Mexican government promulgated the \textit{Ley de Ahorro y Crédito Popular} (LACP, Popular Savings and Credit Law). This was the first attempt to create a system of regulation in Mexico that will be specific to microfinance. The law, passed by the Fox administration, includes the creation of a Division of Micro-enterprise within the
Ministry of the Economy. Finally, the law also gave the president’s chief public policy advisor the responsibility of “coordinating government microfinance initiatives.”

Although we might expect to see a higher level of government involvement in regulation given the top-down legacy within Mexico, the law gives more room for microfinance institutions to operate flexibly. This would be ideal as it would follow the Bolivian model of regulations with flexibility.

The law gives the Mexican banking authority, the Comisión Nacional Bancária y de Valores (CNBV) the power to organize the varied microfinance providers into regulated institutions, Entidades de Ahorro y Crédito Popular (EACPs). The law incorporated institutions that were not banking institutions into the financial system, regulates the functions of savings and credit, and reduces two of the previously existing judiciaries. The law creates regulation and supervision and establishes mechanisms that guarantee collection of public deposits. The benefits of regulation to both institutions and clients have been demonstrated. Regulation could drastically improve Mexican microfinance, in terms of institutions capacity to reach out to clients and provide clients with the best service possible. Clients and banks could operate within a clear context of institutional rules. The strength of weak ties would work to spread information about which banks are providing the best service. This transmission of information and competition would push interest rates down and push financial institutions to provide better services.

This was the first time the sector had ever experienced formal regulation. Regulation offers several crucial advantages to the development of microfinance. First, it provides an increase in coverage (in both the number of clients covered and the access to
financial resources). Second, it allows for a large decrease in interest rates. Third, it allows for greater geographic coverage, meaning deeper penetration into rural areas. Fourth, it allows for a notable increase in outreach and in diversity of services offered. Finally, it provides an increase in the number of low income people who can have the opportunity to begin saving. The creation of this law represents a positive step forward for microfinance markets in Mexico. For clients it would mean more options due to deeper market penetration. Regulation may also have the effect of decentralizing microfinance operations, to make them more independent from top down directives. This would allow each institution to more effectively address the needs of their specific clientele.

However, the design of the LACP may not allow it to make the kind of progress that would be hoped for from regulation. Mexican microfinance institutions will be supervised by federations authorized by the CNBV, which are comprised of representatives from member EACPs, who will be in charge of creating and enforcing regulation. However, the representatives will be individuals from the microfinance institutions they are also supposed to supervise, which has created concerns about potential conflicts of interest for the representatives.\(^57\)

This law was attractive to the authorities because it significantly reduced the costs of supervision.\(^58\) They were more willing to support a regulatory and supervisory framework that did not cost a lot of money. Although the best practice for microfinance would have been to create a regulatory framework that is independent from the microfinance institutions, the authorities preferred a cost-cutting method that may not be as effective for the sector. Further, the law only requires supervision for banks that offer
savings, so many institutions that only offer credit will choose to avoid the high costs of becoming regulated. Policy makers have demonstrated that they are unwilling to finance a regulatory framework that would provide better results for clients.

Although there have been attempts to foment greater activity in the sector, the total market penetration in Mexico is very low and the majority of micro-entrepreneurs lack access to microfinance services. Table 2 illustrates growth in microfinance in Mexico from year-end in 2006 to year-end in 1998. Although the growth seems extreme when compared to Bolivia, the differences in population must be taken into account. Also, it should be noted that Compartamos accounts for the majority of the growth and Compartamos has a very low level of market penetration. Out of 43 million active workers, there are 25 million who do not have access to financial services. It is estimated that microfinance has only achieved a market penetration of 7% per family. Further, PRONAFIM estimates that urban microfinance has the potential to expand their services by 300%. There is an even greater unmet demand in rural areas. Clearly there is a breakdown between the goals and capabilities of Mexican microfinance and it’s realization in reality.

Microfinance in Mexico has yet to meet the mark of successful institutions in that institutions lack quality of outreach and service. Microfinance institutions have been unable to achieve this potential due to weak and ineffective regulatory structures. This coupled with high levels of inconsistent government involvement across administrations has created disincentives and difficulties for institutions that which to achieve social objectives for Mexico’s poor. Policy choices in Mexico have created a context which undercuts the possibility for social institutions to flourish and for the strength of weak ties
to function. Given the unmet needs of Mexico’s urban and rural poor, such policy failure has serious implications.

**Conclusion**

I have argued that states with flexible, supportive, and appropriate regulatory and supervisory structures will provide better services and outcomes for their clients. Bolivian microfinance institutions have developed a regulatory framework specific to the operations of microfinance, achieved a high level of market penetration, and are seen as a model for other countries attempting to develop strong microfinance institutions. Mexican microfinance institutions are highly fragmented, include many levels of government oversight and involvement, and have not yet developed an appropriate regulatory framework, although the LACP is a good first step. Most significantly, in both urban and rural areas, there is still a great deal of unmet demand in Mexico.

Proper regulation should enable institutions to give a high quality of service to clients. This high quality service will reinforce positive social interactions between financial institutions and clients based on mutual trust and respect. Regulation also establishes reliable expectations for both clients and financial institutions and ensures that positive reviews of such institutions will be transmitted through weak ties.
Notes

3 Ibid, P 1371
11 Ibid, P 26
15 Ibid, P 119
17 Ibid, P 117
18 Ibid, P 11-2
19 Ibid, P 5
20 Ibid, P 6
21 Ibid, P 7
23 Ibid, P 12
25 Ibid, P 13
26 Interviews with BancoSol employees conducted by Kathryn Paul, La Paz, Bolivia, June-July 2007.


Interviews with BancoSol clients conducted by Kathryn Paul, BancoSol, Garita de Lima, La Paz, Bolivia, June-July 2007

Interviews with BancoSol employees conducted by Kathryn Paul, Alonzo de Mendoza, BancoSol, La Paz, Bolivia, June-July 2007


Ibid, P 147

Ibid, P 149


Ibid

Interviews with BancoSol employees conducted by Kathryn Paul, La Paz, Bolivia, June-July 2007.


Deugd, Michelle, Iris Villalobos, and Pedro Vuskovic. 2006. Políticas Públicas y Servicios Financieros Rurales en México. A report by Fondo Internacional de Desarrollo Agrícola (FIDA), Unidad Regional de Asistencia Técnica (RUTA), and Programa de Apoyo a los Servicios Financieros Rurales (SERFIRURAL). P 8

Ibid, P 9

Ibid, P 10-11


Ibid, P 72

Interviews with AMUCCS employees conducted by Kathryn Paul, Ahuacatlan, Puebla, Mexico, August 2007

Ibid, P 59

Ibid, P 63


Ibid, P 60

Ibid, P 60
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**Appendix**

**Table 1: Growth in Active Borrowers in Bolivia (1998/2006)**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Type of Institution</th>
<th>Number of Active Borrowers (1998)</th>
<th>Number of Active Borrowers (2006)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AgroCapital</td>
<td>Non-Profit (NGO)</td>
<td>4,319</td>
<td>6,768</td>
</tr>
<tr>
<td>Banco Los Andes</td>
<td>Bank</td>
<td>32,482</td>
<td>85,009</td>
</tr>
<tr>
<td>ProCredit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BancoSol</td>
<td>Bank</td>
<td>81,555</td>
<td>103,786</td>
</tr>
<tr>
<td>FADES</td>
<td>Non-Profit (NGO)</td>
<td>26,962</td>
<td>20,620</td>
</tr>
<tr>
<td>FIE</td>
<td>Non-Bank Financial Institution</td>
<td>20,848</td>
<td>71,334</td>
</tr>
<tr>
<td>PRODEM</td>
<td>Non-Bank Financial Institution</td>
<td>47,130</td>
<td>77,476</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td></td>
<td>213,296</td>
<td>364,993</td>
</tr>
<tr>
<td><strong>Growth rate:</strong></td>
<td></td>
<td></td>
<td>71.12%</td>
</tr>
</tbody>
</table>

Source: The MIX Market

**Table 2: Growth in Active Borrowers in Mexico (1998/2006)**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Type of Institution</th>
<th>Number of Active Borrowers (1998)</th>
<th>Number of Active Borrowers (2006)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADMIC</td>
<td>Non-Bank Financial Institution</td>
<td>360</td>
<td>14,045</td>
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<td>Compartamos</td>
<td>Bank</td>
<td>43,401</td>
<td>616,528</td>
</tr>
<tr>
<td>FINCA – MEX</td>
<td>Non-Profit (NGO)</td>
<td>3,650</td>
<td>63,614</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td></td>
<td>47,411</td>
<td>694,187</td>
</tr>
<tr>
<td><strong>Growth rate:</strong></td>
<td></td>
<td></td>
<td>1364%</td>
</tr>
</tbody>
</table>

Source: The MIX Market